

**UPPERWORLD**  
**and**  
**UNDERWORLD**  
**in**  
**CROSS-BORDER CRIME**



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**Editors**

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## **Upperworld and Underworld in Cross-border Crime.**

**Petrus C. van Duyne, Klaus von Lampe, Nikos Passas (Eds.).**

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# Introduction

## Upper- and underworld cross-border crime economy

*Petrus C. van Duyne*

If economy is bound to be in a state of constant change, unless sliding down into a state of stagnation, crime economy is an even more volatile phenomenon. Not in the first place because it concerns on-going changes in demand and supply, but also because its criminal characteristics are constantly changing. These changes are not only caused by shifts in the demand for illegal commodities or services, but also by valuations of the society itself. Human trafficking is a good example to clarify this point. Before 1989 helping persons to cross the Iron Curtain was not considered a criminal act (in the west), but a brave display of humanitarian solidarity with the suppressed and deprived citizens of the 'East Bloc'. At present helping people to escape their economic misery at home is criminal human smuggling, if not trafficking in human beings. Of some commodities, like cannabis, the consumption is tolerated in virtually all jurisdictions in the European Union, while the wholesale trafficking is punished draconically relative to that tolerance. Also the appreciation of the age-old interaction between the upperworld and the underworld criminal economy has changed. Whether the upperworld is at present more threatened by the crime-economy is difficult to determine, given the absence of any valid yardstick, but the *fear* of the penetration by crime -entrepreneurs has certainly been intensified. This anxiety seems to have been fanned by a number images, non of them new, but coated with new public fear arousing emotions. One of them is the *organized crime* scare, another the phenomenon of *cross-border* or *transnational crime*: (organized) crime in a *global* village to which at present is added terrorism.

What is true about this image? Is crime more 'global' than one or two decades ago? Is this 'global village' threatened by internationally operating organized crime groups? Let us first look at this alleged 'global village'. It is a strange metaphor. The connotation of 'village' is some rural, cosy and enclosed

community, where people know each other and also some protective shell of the benign (but also stiffening) social control exists. Looking at the global reality, such a village does not exist.

This so-called 'village' has many unattractive 'unvillage-like' features. Parts of that 'village' are aflame with civil war and bloodshed. Other parts enjoy an unprecedented wealth and prosperity, while the majority still find themselves in destitute circumstances. The wealthy parts of that 'village' have erected protective 'walls' against the destitute to keep them out of their neighbourhoods. The same applies to cheap goods which may compete with the expensive goods produced in the richer neighbourhoods. It must be admitted that mobility in that 'village' has increased, but mainly for the leisurely classes in the richer neighbourhoods, which spend cheap holidays in the poorer sunny areas, which they called 'unspoiled'. Communications have also intensified and accelerated up, though the reverse side of that medal is a decrease in transparency.

Given these differences in wealth and opportunities it is not surprising that the consequence of this state of affairs is a thriving trade in all those commodities and services, which the rich neighbourhoods are willing to buy. Many of these commodities are sold for inflated prices because of the 'criminal price wedge'. Though most prohibited commodities are actually cheap at the source, the chain of transactions from producer to the consumer is long and very price increasing, among other things due to the security requirements against the law enforcement agencies. Whether this cross-border crime trade has the terrifying capacity to threaten the rich neighbourhoods of our 'global village' remains to be seen.

In his contribution Nikos Passas elaborates the very thin or even absent foundations of this proclaimed threat. He first formulates a concise definition of cross-border crime, from which one can deduct that we are dealing with an age-old phenomenon of international crime-trade. In this he projects the interface between 'upper' and 'underworld'. This provides an intriguing interaction, which actually blurs the line between the two worlds. As a matter of fact, the legitimate upperworld knows too many criminal black holes of its own to maintain this comfortable dichotomy between the 'goodies' (us) and the 'baddies' (them). The typology which Passes designs provides some order in this complicated, or rather chaotic landscape. Nevertheless, it remains difficult to depart from the 'them-they' dichotomy, as illustrated by some of his categorizations, like 'legal actors' versus 'illegal actors' or the suggestion that 'there is no interface between legal and illegal actors.' It would clarify distinctions if we would call a so-called 'legal actor' committing crimes, a 'criminal actor',



even if his place in the market or the legal entity in which he functions is entirely a *legitimate* one. A legitimate corporation can turn into a crime-enterprise or a criminal organization (while still remaining a legal entity), all by the own extent of its own law breaking. It does not matter what commodities or services it sells: whether it handles prohibited substances (other than the usual toxic waste) or criminally jeopardizes individual or public safety (casualties are ‘collateral damage’, not killings) it is still a criminal legal entity (Mokhiber 1988). This more positive law oriented interpretation may prevent the creeping in of semantic ambiguities. By adopting the more simple neutral juridical meanings of the words ‘criminal’ and ‘legal’ we consider a corporation a legal actor if established according to the law, though as legal entity it can commit crimes, even ‘organized crime’. Lawbreaking is an activity, while the actor, either as ‘natural person’ or as ‘legal person’ is the bearer of the criminal liability for organizing crimes.<sup>1</sup>

Passas ends his elaboration with a number of fruitful research proposals to fill the void in our knowledge of this field. This call for a ‘knowledge policy’ should not be a parochial one. To foster and implement such a knowledge development the minimal requirements are a harmonisation of methodology, access to data in states which are involved and (of course) their financial support. Indeed, if the picture is so gloomy and threatening, the first task of the policy makers, who warned the public so intensely, is to collect knowledge and insight. Unfortunately, thus far, this appears to be the last thing that has entered their minds, let alone that anything has been initiated to improve our (or their) understanding.

A substantial part of the book and colloquium is devoted to the financial crimes, finances of crime and the policy against the handling of crime-money. This field is first described by Baloun and Scheinost in their study of economic crime in the Czech Republic. It reports the various forms of ‘upperworld crime’ or in Passas’ typology, the criminal symbiosis between ‘legal’ though highly criminal actors, whether it concerns the ‘tunneling’ of banks and privatized corporations by asset stripping or privileged loans which were never repaid. This appears to be a non-cross border crime, while its surrounding economic landscape is also determined by Czech internal relations and acceptance of a substantial black economy. However, local black and criminal economies

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<sup>1</sup> In the Dutch, Belgian, French and other EU systems of law (but not in Germany and Austria), a distinction is made between ‘legal persons’ and ‘natural persons’. Both can be held liable in civil and criminal cases.

are no islands either: the evasion of corporate tax and social security dues by the employers is to a large extent dependent on the availability of unregistered illegal foreign labour. The cross-border crime aspect of 'local' crime –local in the sense of the place where the goods are marketed– is evident in the case of the criminal trading of high taxed commodities like gas. Operating such scams is dependent on efficient cross-border co-operation between various crime-entrepreneurs. In the case of the Czech Republic, Poland, Russia, Slovakia and Ukraine.

Case descriptions of an economy in transit like the Czech Republic show a much more intricate and interwoven crime-market and criminal finances than the fear for the crime-money as has been fanned by the Financial Action Task Force. In the article of Van Duyne this phenomenon of the crime-money and money-laundering is analysed and compared with the tangible evidence which has been put forward thus far. Again it can be observed that there is an inverse relationship between the intensity of the expressed fear and the amount of generated knowledge. This does not only apply to the empirical side of the problem, but also to its conceptual aspects.

Though the concept of laundering is usually applied to *money*, and therefore referred to as money-laundering, the legal formulation of the circle of application is much wider. Rephrased loosely it concerns all consequential handling which are devoted to conceal the results of a predicate crime for profit. Analogous to hiding one's committing a burglary or a violent crime by wiping off traces, one may call it 'financial fingerprint wiping'. However, it does not only apply to the actually generated money, but to the manipulation, physical by or administratively, of all objects and rights, tangible and intangible. This blurs the distinction between money-laundering and predicate crimes like (tax) fraud, while it shifts the burden of proof almost over the edge of self-incrimination. At any rate, due to this formulation the problem has become so broad as to render it unmeasurable and very susceptible to political manipulation. This has resulted in the unreliable and inflated, but canonized (gu)estimates of the FATF and the United Nations.

A comparison with the claims of these political bodies and the few empirical fragments reveals much data pollution as well as a less sophisticated criminal financial management than has commonly been assumed. The examples of crime-money infiltrating legitimate firms are very rare and even then it mainly concerns the usual pubs, hotels and real estate. While research is still in progress and the picture may change, as far as Northwestern Europe is concerned, there

is still little evidence of the Mr. Bigs 'marching towards the bulwarks of economic power'.

Even if the fear and the reality of the actual threat may diverge, it does not mean that policy makers and law enforcement agencies should lean back. As a matter of fact, the crime-economy is volatile and its actors constantly, probing loopholes and potentials of circumventing regulations, even if less organized and sophisticated than assumed. Regional differences in regulations present *regulatory asymmetries*, stimulating crime-entrepreneurs to jurisdiction-shopping until they arrive at the jurisdiction which suits their financial secrecy requirements. There is little strange about this: there is no multinational corporation which does not operate in the same way and frequently with more unwanted outcomes, either for the homeland or for the jurisdiction of choice. At this point one may go back again to Passas' examples of corporations committing crimes where they go, but *not* in their own country. For the purpose of safe money-laundering the situation is not much different. Adamoli provides a thorough account of the regulatory asymmetries regarding the European Union and the surrounding off-shore financial centres.

In order to shed more light on this complicated area TRANSCRIME of the University of Trento carried out a research to compare types of jurisdictions with standards of integrity concerning: criminal and procedural law, administrative regulations, banking laws, company law and international co-operation. The results of the research project revealed an interesting variation of jurisdictions regarding the likelihood that proceeds from crime will transit their financial centres. On one side of the scale there are the countries which have a high interest in the integrity of their financial system and on the other side there are the countries which main commercial commodity is 'financial secrecy'. This creates an enduring asymmetry to the detriment of the (rich) jurisdictions who see many of their efforts to chase the crime-moneys nullified.

The suggested remedy is to impose on the 'laxist' financial jurisdictions the duty to improve their regulations to the standard of the other 'good' countries. Otherwise they face the penalty of being branded as 'non-cooperative countries and territories', a 'verdict' imposed by the FATF. This qualification can entail negative financial consequences for the local banking industry. At this point we return again to the metaphor of the 'global village' as set out at the beginning of this introduction. The FATF is an informal rich man's club, dominated by the US, responsible to no democratic institution. Against its qualification 'non-cooperative country or territory' there is no appeal. It is not surprising that

thus far this body has reserved this verdict only for relatively powerless jurisdictions, which have few other economic resources than taking advantage of the intensified demand for financial secrecy. And, as is the case with the drug market, the rich countries are the regions where this criminalized demand developed in the first place.

Irrespective of such moral considerations, every neighbourhood in that village has to put its own legal affairs in order. The efforts to do so in the European Union is presented in the paper of Gert Vermeulen. The European leaders, convened in Tampere (Finland) in 1999, pronounced their firm resolve to meet the threat of organized crime head-on and to design and implement a common approach. This resolution was made more concrete in the so-called EU Millennium Strategy on Organized Crime, adopted by the Justice and Home Affairs Council (JHA). It produced, among others, a number of recommendations to approximate the Member State's *procedural* law. This applies to compliance with formalities and procedures as well as means, techniques and methods of police investigations. For example: interception of (GSM and satellite) telecommunications, controlled deliveries and the sensitive topics of covert investigations (infiltration) and joint (multi-national) investigation teams. At Tampere also additional steps were taken towards a single European legal area: a new international body –Eurojust– should be set up. It is to be composed of national prosecutors, magistrates or police officers of equivalent competence from each Member State. This body is to function as the judicial counterpart of Europol.

This approach would remedy much of the legal asymmetries which are still present within the European Union. Criminals should have no more space for jurisdiction shopping. On the other hand, European prosecutors should also not be allowed their form of shopping, trying to prosecute a cross-border operating criminal or crime-organization in the jurisdiction which is likely to be the most lenient to intrusive investigation methods and is expected to impose the severest sentences.

All these well thought-out legal devises should not let us forget, that the crime-industry is still the result of the dynamics of the multitude of interfaces as set out in this volume. Klaus von Lampe gives a lively description of one of the most volatile crime-markets in Europe: the market of excise fraud with cigarettes. Though his research concerns the German illegal cigarette market, that market thrives due to the availability of a constant influx from abroad,

notably from Poland.<sup>2</sup> The development of this market reveals all the components of the dynamics of *organizing* crime, instead of the worn-out rhetoric of ‘organized crime’. As usual, cross-border (crime) trade begins with price differences between countries, whether the commodity is licit or prohibited. Like water pressing against a permeable dike, the illegal trade seeps through all small holes to be subsequently consumed by normal price sensitive citizens. Some of that seepage will be collected by organizers, who channel it into a somewhat more structured form. By chance Eastern Berlin has many Vietnamese residents, who cannot or do not want to return to their homeland. Facing unemployment after the unification of Eastern and Western Germany they grasped the opportunity of organizing the cigarette street market in Berlin. They succeeded in doing so, not because of some sinister mafia-like ‘transnational’ conspiracy or demoralising police corruption, but because they were already used to semi-legal marginal trade under the communist rule.

The Vietnamese cigarette-entrepreneurs were relatively insensitive to law enforcement intervention, also because of the relatively low sentences, until the violence stemming from ethnic protection rackets forced to police to clamp down on this industry. Though a reduction of street vending has been achieved, the mechanism of the fiscal price wedge still fans an on-going cross-border crime-trade, part of which concerns wholesale shipments of millions of cigarettes. It is interesting to observe that, on the basis of the available evidence as collected by Von Lampe, this wholesale traffic with its multi-million interests at stake also did not develop the features usually attributed to organized crime. Hardly gross violence and no monopoly building. One may wonder whether the ‘big bad wolf’ of ‘transnational organized crime’ may more appropriately be projected in the comic strips of Donald Duck than in the serious world of criminal policy.

The image of ‘organized crime’ (and certainly its international brand), rationally striving at monopoly building, is as widespread as ill conceived. True, certain forms of the crime industry, notably illegal protection, must by its very nature monopolize a certain area. As Gambetta (1994) has convincingly described, in one particular geographical territory there is place for only one – the strongest and most vicious – protector. But trade is difficult to monopolize,

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<sup>2</sup> At present the same applies to the illegal cigarette market in Great Britain, which is supplied from France and Belgium as well as by wholesalers operating professionally with Dutchmen, Baltic entrepreneurs and Chinese counterfeiters (Van Duyne, in preparation).

even if every trader, legal as well as illegal, has the tendency to strive for a closed market, either by himself or by a number of fellow-entrepreneurs. Though this image of monopolizing, 'rational, profit maximizing' oriented organized crime is echoed in all the mainstream literature, (Sieber and Bögel, 1993) very few manifestations of these traits are found in the real life crime-market. Even if it is important to approach the economy of the illegal commodity (drug) market from the angle of the economic theory, as is described by Matjaz Jager, in the end the shaping of the crime-market frequently follows different alleys. Apart from that it is interesting to follow Jager's account of the law enforcement advantage of organized crime when the objective is the reduction of some unwanted prohibited substance market. Monopolists do not strive for ever expanding markets but are rather interested in market control with more profits for less efforts. However, the comparison with the (limited) available evidence reiterates the dissenting opinions about the structure of the crime-market of prohibited substances. It is a relatively *open* market characterized by a high degree of cross-border mobility. What else can be expected? As Paoli (2000) in her study of the drug scene in the two cities Frankfurt and Milan describes, suppliers as well as customers are used to move around. They do that not only in their capacity as entrepreneurs or customers, but also because mobility as a part of the Western lifestyle has become cheap and therefore attractive.

The dynamics of the cross-border crime markets are fascinating as well as a matter of concern. Whether it is also a matter of fear, depends on a deeper valuation. A matter of concern remains our shallow knowledge of this part of contemporary history. This want of insight may fan the fear arousing rhetoric of the global village besieged or infiltrated by sinister interlopers. This second volume of the annual cross-border crime colloquia aims to contribute to the deepening of our understanding.

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# Cross-border crime and the interface between legal and illegal actors

*Nikos Passas*<sup>1</sup>

## Introduction

Processes of globalization have multiplied cross-border links and intensified interconnectedness in the economic, political and cultural spheres. Inevitably, criminal enterprises have also become global. At the same time, they have shown that they can exploit the weaknesses of the existing regulatory patchwork. Nationalisms, concerns about loss of sovereignty, and the lack of clear international rules and effective enforcement mechanisms have led to a situation in which cosmopolitan offenders easily escape the nets of 'parochial' controllers. Many governments have publicly voiced an anxiety over the risks posed by global 'organized crime', which many in the USA and the European Union consider a serious threat to national and international security (Godson and Olson, 1993; Paine and Cilluffo, 1994).

There are calls from different quarters to do something about this problem. Declaring a 'war' on transnational crime conveys the idea of militarization of law enforcement. In addition, calls are made for an active role of intelligence services in anti-crime and control efforts. These are drastic steps in a direction that may bring about risks of their own for democratic states (both established and, most importantly, those in transition). As these and other measures are being contemplated or implemented, one would have thought that the policy-making process is informed by accurate data and an adequate understanding of the problem.

Unfortunately, even a cursory review of media, other reports as well as public statements by officials indicates that the nature and causes of the problem have not been studied fully. There are many inaccuracies, simplifications, exaggerations and misconceptualizations, suggesting that either we do not have adequate information or we have not properly analyzed the available

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evidence (or both). The debate regarding the potential risks and need for draconian or exceptional measures is ongoing in the academic community (Andreas, 1997; Lupsha, 1996; Naylor, 1995; Shelley, 1995; van Duyne, 1996; Williams, 1994).

Official discourses focus on the ethnic and foreign elements of crime. However, portrayals of the phenomenon as a 'global conspiracy' or a *Pax Mafiosa* (Sterling, 1994) have been challenged as unfounded and misleading (Naylor, 1995). There is evidence to suggest that cross-border crime is not always as well organized as commonly assumed and that alliances among criminal groups are opportunistic and ad hoc rather than long-lasting (OGD, 1996; Williams, 1995; Williams and Woessner, 1996). Most importantly, there are complex and diverse relationships between criminals and respected actors (Arlacchi, 1992; Block, 1991; Chambliss, 1989; Naylor, 1984, 1995/96; Passas, 1995, in press; Passas and Nelken, 1993; Ruggiero, 1996; Van Duyne and Block, 1995; Van Duyne, 1997).

The roots of the problem often escape our attention, as many observers effectively individualize the problem and neglect systemic and structural causes of the demand for goods and services which are outlawed, in short supply or embarrassing. Underestimating the significance of such factors leads to false impressions on the risks posed by such crimes, to scapegoating, injustice, and to an illusionary comfort that some control systems do function satisfactorily (Passas, 1993, 1996, 1999a). So, before we get down to policy construction, a great deal of 'corrective' analysis needs to be done.

This paper aims at facilitating such analysis by focusing on the interface of legal and illegal actors (both individual and organizational). It first seeks to clarify the meaning of the terms 'international crime' and 'cross-border crime', in the literature frequently referred to as 'transnational crime'. Secondly, it separates for analytical purposes 'enterprise crime' from 'political crime', while recognizing that the two are often combined in practice. Thirdly, it attempts to construct a typology of legal-illegal links and associations, in order to better organize the existing knowledge and data on this subject. Fourthly, it addresses the question of whether the problem is growing and why. Finally, it outlines research and policy implications.

## **Distinctions between international and cross-border crime**

There are two general types of misconduct that transcend the interests of individual Nation States: international crimes and transnational crimes. International crimes are acts prohibited by international criminal law on the basis of the 1994 draft code, multilateral treaties or customary practice by all nations (Bassiouni, 1983; Malekian, 1991). Transnational or cross-border crimes, on the other hand, are sometimes defined as acts which violate the laws of more than one country (Bossard, 1990). I think it is preferable not to rely entirely on legal definitions of crime for social studies. In a global community made up of extremely diverse legal systems, it is particularly limiting to employ the rules of select countries, in order to delimit the scope of scientific research. It is possible to define cross-border crime in a more abstract and principled way while also taking into account legal norms:

cross border crime is conduct, which jeopardizes the legally protected interests in more than one national jurisdiction and which is criminalized in at least one of the states/jurisdictions concerned.

The process of globalization has contributed to the growth of this phenomenon through the use of new technologies, the more frequent and faster movement of people, capital and goods across national borders, and the integration of markets. Not all cross-border crimes are equally serious, sophisticated or 'organized'. The recent concern about global crimes has been fuelled primarily by illegal drug trafficking, terrorism, illegal arms or technology trade, smuggling of illegal aliens, frauds, corruption and money laundering. The list of serious transnational crime includes tax evasion, capital flight, theft of art and cultural property, smuggling of legal goods (minerals, agricultural produce, cigarettes, etc.) as well as endangered species, environmental crimes, and the use of child labour. Computer crimes are also frequently mentioned as 'the crime of the future', but they constitute for the most part a new *modus operandi*, rather than a different type of crime. The computer, in other words, is used as an *instrument* to commit an offense (Grabosky and Smith, 1998). Granted, most of the above mentioned criminal activities precede the awareness of a global, cross-border problem by decades (with the exception of the computer as an instrument for crime).

This paper focuses on all types of cross-border crimes and considers *international* ones only when the two overlap. I will also shun the term ‘organized crime’ and follow the concept of ‘enterprise crime’ (Smith, 1971, 1980; Haller, 1990). I will also use the term ‘political crime’ in order to underline that, while financial gain is the main goal in most cases, we also need to consider political, ideological, and religious motives for a more complete understanding of the phenomenon.

### **Interface analysis I: goals of transnational offenders**

It took many years and hard work to effectively challenge erroneous conventional wisdom about illegal enterprises within the US. Positivist and stereotypical conceptions drew clear lines dividing the law-abiding and conventional society from ‘the underworld’. Misconceptions about La Cosa Nostra as ‘the’ organized crime problem, alien conspiracies leading to nation-wide hierarchical organizations, monopoly control over illegal markets, and the clear separation between organized criminals and legitimate organizations have been dispelled (Anderson, 1979; Block, 1983; Brady, 1983; Chambliss, 1988; Reuter, 1983; Reuter and Rubinstein, 1978; Scott, 1996; Smith, 1990). It appears that similar research and analytical efforts are now necessary with respect to transnational crime.

While testifying at a Hearing on International Crime before the Senate Appropriations Committee Subcommittee on Foreign Operations, FBI’s Director referred to organized crime as ‘a continuing criminal conspiracy having a firm organizational structure, a conspiracy fed by fear and corruption’ (March 12, 1996). Such descriptions, frequently with a high degree of tautology, cloud the nature and causes of crime and do not advance the careful study of facts relative to the social organization of the best organised and most sophisticated misconduct that crosses national boundaries.

As corporate and other actors become transnational or engage increasingly in cross-border transactions, so do illegal enterprises, if alone for the simple commercial reason of price differences. As illegal enterprises commit offenses, so do legitimate actors. The line between the legal and the criminal is often fuzzy, especially in cases where actors from the opposite ends of the continuum come into contact and transact with each other. This empirical claim is much less controversial now than it was a few years ago, thanks to recent revelations with respect to the Iran-Contra affair (Walsh Report), BCCI (Kerry Report,

1992; Passas, 1995), BNL and the arming of Iraq (Mantius, 1995; Phythian, 1996), systemic corruption in Italy (Colombo, 1996; Tribunale di Milano, 1997) and throughout Europe (della Porta and Meny, 1995), links between the Yakuza and Japanese politicians (Economist, 1992; Kerbo and Inoue, 1990; Yayama, 1990). After all, it is plain that the goods and services offered by illegal actors are in demand by not merely other criminals but legal actors too. Moreover, many 'legal' actors act as crime-entrepreneurs by systematically offering legitimate goods and services made cheap because of fraud (Passas and Nelken, 1993; Van Duyn, 1991; 1993).

So, how do the underworld and the conventional society interact? Which parts of the conventional world have dealings or links with what sort of criminal actors? What are the main characteristics of the legal-illegal interface? As one explores this interface, there are different ways of going about it, depending on the criteria and variables one prioritizes. For instance, one may wish to concentrate on the relative power and autonomy of legal and illegal actors, in order to assess possibilities of intervention and the chance of criminal justice policies to succeed. Alternatively, one could focus on temporal issues by asking whether legal and illegal actors work together or their interactions take place primarily before and after crimes are committed. It would assist studies asking whether illegal actors work *with* legal actors or *for* them. The legal-illegal links are not always known, suspected or direct (there may be degrees of directness). Analyses in that direction could be useful in determining the benefits, risks or crime-facilitative role of legal actors. It would be also interesting to consider the strength of legal-illegal links (e.g., measured by at the frequency, duration and intensity of interactions). A typology catering for such concerns might be as follows, with each box highlighting different relationships.

	Strong Links	Loose Links
Sequential Links	1	2
Parallel Links	3	4

This typology, however, may not take sufficiently into account the question of reciprocity. Illegal actors can also work *against* legal ones. In addition, one may want to center on the causes of various types of interface, differentiating among both legal and illegal actors. For this paper, I thought it might be most productive to organize the discussion around two main criteria: motivation

and mutuality of interests. This will hopefully assist in the study of the social organization of cross-border crime, with emphasis on the questions of why, who and how. So, by looking into the primary objective of the actors involved, we can differentiate between 'enterprise crime', 'political crime' and 'hybrid crime'. At a second level of differentiation, we can distinguish between the two broad categories of 'antithetical' or 'symbiotic' relationships.

But first, a key issue as we explore the legal-illegal interface are the ultimate objectives of the actors in question. What are the underlying motivations of those prepared to break the law or to take the risk of transacting with law violators? True, most criminal actors are for-profit enterprises or use such enterprises for other goals. However, ideological, religious or political goals may be the driving force behind cross-border organized misconduct. The two objectives may also be equally important. In any event, the distinction on the basis of motive is important for both theoretical and policy reasons. Firstly, no complete account of the root causes of such crimes can be offered without an account of motives. Secondly, different types of policy interventions would be required for long-term and effective solutions. So, we can conceive of three types of misconduct. It can be hypothesized that each of these types fosters different kinds of associations between legal and illegal actors.

*a. enterprise crime [crime for profit]*

Enterprise crime refers to criminal acts carried out within an entrepreneurial structure, motivated primarily by financial gain. This is by far the most common type. The entrepreneurial structure may be outright criminal (a 'crime-enterprise' or legal, though permeated with crime (Van Duyne et al, 2001). Analysts almost automatically assume that what they call 'transnational organized crime' equals enterprise crime. A 'transnational criminal organization' has been regarded as 'an organisation with a single purpose or goal, which is the maximisation of profit' (Williams, 1994: 111). Illegal actors of this type take advantage of the demand for certain goods and services. They can act on their own or collaborate with other crime enterprises, which is historically the rule in cases of cross-border crime trafficking of prohibited substances. We have seen this in the illegal trade of drugs or arms, for example (Observatoire Géopolitique des Drogues, 1996).

At the other end of the legal-illegal continuum, the criminal activities of legitimate actors may reflect the organizational skills or level of their corporations. Since these actors are legal, their offenses are quite often of a

predatory nature. There are plenty of examples ranging from the looting of some savings and loan institutions (e.g., David Paul's CenTrust was seriously damaged by insider fraud and abuse with the assistance of foreign individuals and organizations), to insurance and other types of fraud, systematic tax and customs levies evasion (Magnusson, 1981; Passas, 1994; US House Committee on Energy and Commerce, 1982), the pharmaceutical and oil industries (Andvig, 1995; Braithwaite, 1984; Eaton, 1997), defense contractors (Seagull, 1994/95), and the list goes on (Clinard, 1990; Michalowski and Kramer, 1987). Given the scale and technique of these 'upperworld crimes', it is more likely than not that they are carried out with at least the connivance if not complicity of other parties, either in trade and industry or the administration (e.g., in commercial corruption cases where foreign public officials are bribed to ensure that a company obtains or maintains a lucrative contract).

In this light, there is little surprise when legitimate and illegal entrepreneurs act together. Indeed, this is the type of crime where most links to legitimate businesspeople and corporations can be expected. For instance, we have seen links in the disposal of toxic waste (Szasz, 1986; Van Duyne, 1993), insurance fraud and arson for profit (Brady, 1983), and in money laundering (Buffle, 1993; Levi, 1991; Passas and Groskin, 2001). The DEA has recently pointed to schemes bringing together drug traffickers, Colombian brokers and legitimate businessmen, who need US dollars in order to buy goods in the United States. The broker sells drug money at a 20% discount to the businessman, who deposits his payment in pesos at the trafficker's account in Colombia (Passas, 1999b).

Official corruption cases provide possibly the best illustrations of this sort of interface, as illegal marketeers seek regulatory or political protection ('blind eyes'), preferential treatment, inside information, and relative certainty in their environment (della Porta and Mény, 1995; Popescu-Birlan, 1994; Reed, 1994/1995).

*b. political crime*

There is more to crime causation and control weaknesses than strictly rational-economic motivation. Many criminal actors pursue chiefly political or religious goals. As clearly illustrated in the attacks in the USA, there is no material gain in suicide-bombing attacks. The main goal ranges from the overthrow of the government to political independence or land rights (e.g., sabotage on oil company facilities in order to protect indigenous people's rights; political violence

in the Middle East). There are sufficient ethnic, regional and religious conflicts around the globe involving transnational crime to make us transcend the assumption that all such crime is rational and based on the pursuit of maximization of profit. Of course, financial considerations are still important. Such crime requires financing, training, ammunition, information, protection, fighters and 'welfare systems' for their families (Adams, 1986; Naylor, 1993). However, profit is not the primary consideration here. Money is only the means to another end. Maximization of financial gains may not be a goal at all; rather, ideology, higher loyalties, cultural or political ties, and the desire for revenge can be much more important issues.

As political groups resort to violent and criminal methods, they seek allies, supporters, sympathizers and protectors (just like conventional political groups). In addition, foreign policy by most countries is not carried out exactly as it is officially announced. Covert operations (legal or illegal under even domestic laws) often bring government agents into contact with criminal actors, irrespective of their actual crime-trade (McCoy, 1991; 1998/99). When it comes to political cross-border crime, therefore, we should expect connections with political and government agents and agencies. Typical examples can be found in cases of states accused of supporting terrorism (e.g., at different times, East Germany, Syria, Libya, Iran, Iraq, etc.). US agencies have also been involved in such associations (Contras and the intelligence services; the Afghani rebels before the end of the Cold War, etc. McCoy, 1991). As with enterprise crime, legal actors may be involved in political cross-border crime on their own too (e.g., when French agents blew up the Rainbow Warrior, the Greenpeace ship, in Auckland; or when Israeli agents assassinated political actors outside Israel, including an innocent Norwegian citizen, for which they later apologized; on US-sponsored terror see Herman, 1987).

The causes, networks, associations, as well as conceivable policy and enforcement responses to political crimes are obviously very different from those of economic crimes.

*c. hybrid crime*

Hybrid crime amounts to a combination of the above two types. It may be that financial and political motives are of almost equal importance. In such cases, the networks of crime, corruption and other misconduct are likely to include both businesses and political or administrative actors. It has been claimed that



the communist government of Bulgaria set up Kintex, a state corporation, in order to sell arms in Europe and the Middle East and accept drugs as payment. With high-ranking security service officials on its board, Kintex was allegedly playing also a political role by furnishing weapons to Palestinians and Turkish terrorist groups (Sterling, 1994: 159). The evidence supporting this allegation has been seriously challenged. However, taken as a hypothetical scenario, it illustrates the hybrid type of crime.

The alleged communist conspiracy had its counterpart in the US. In the course of the Iran-Contra investigation, Richard Secord's [ret. General, US Air Force] testimony was instructive. He was asked before Congress why was the US selling the Contras arms bought from a communist nation at exorbitant profit rates. His surprisingly candid answer was to have two objectives: helping the Contras and managing a commercial enterprise. 'Cannot I have two purposes? I did.'

The par excellence illustration of this nexus, however, is provided by the BCCI affair, which revealed extensive networks of 'ordinary criminals', white-collar offenders, and respected professionals and organizations from a number of industries - banking, insurance, trade in commodities, telecommunications, etc. Holy and unholy alliances with mixed ideological, geo-political and financial motives operated with and through this bank (Truell and Gurwin, 1994; Passas, 1993, 1995, 1996).

Under this category, we can also consider those crimes, which are committed in the context of anti-American, anti-West and anti-capitalism sentiments. Faulty policies and Western government mistakes affecting mostly Third World countries have generated such sentiments, which may neutralize law-abiding values and principles held by people who feel justified to selectively target victims.

Nigerian people, for example, are worse off now than before the discovery of oil in their soil. Transnational corporations have exploited the environment and resources of the country and taken advantage of its corrupt regime (Eaton, 1997). Nigeria, subsequently became fertile ground for the recruitment of members in criminal organizations given the anti-Western feeling. We 'stick it to the Americans', is the kind of self-justifying argument that may make some ordinary people do extraordinary things. Similarly, many Latin Americans, having suffered through West-supported dictatorships and corporate exploitation, may afford little sympathy for US kids abusing drugs. These become loyal supporters of criminals and their enterprises. By analogy to the point that chemical weapons are poor countries' nuclear arms, cross-border crime

feeds off desires for independence, autonomy and self-determination. It must be emphasized that none of this implies that this is the only or most important cause of Nigerian or Latin American crime. My point is that this is a contributing factor, which we often neglect to take into account.

A different kind of hybrid crime can be seen in the context of international finance and assistance offered by regional banks. IMF and World Bank type of institutions offer assistance through loans and the financing of projects in developing countries. The terms of the loans frequently involve austerity measures that recipient governments must impose, if these governments wish to either refinance the loans or get new lines of credit. However, this process increases dependence on Western sources and creates discontent conducive to regional or civil conflicts (Bello, 1998/1999; Mander and Goldsmith, 1996; Passas, 2000). Projects funded by such institutions have sometimes assisted more Western corporations than the countries meant to benefit most. Companies often got contracts to deliver works that were not needed, for which there was no commitment on the part of the recipient country, and which were left incomplete (Plater, 1998). As Professor Falk (1993) has noted, the Permanent Peoples Tribunal in Rome has in the past condemned certain IMF conditions as illegal. In the past, some Third World governments have sought to circumvent IMF conditions and turned to BCCI for assistance (Passas, 1993). Resolving the controversy over the appropriate role and responsibilities of regional banks is well beyond the scope of this paper. The point is that not everyone in the recipient countries has a positive opinion of the lending institutions. In this context, it is not hard to imagine self-justifying arguments on the part of some government officials to the effect that 'we are defending the national interest, we are resisting unreasonable measures forced on us, we need to prevent crises of legitimacy and bloodshed in our country'. This may lead to 'extra legal' circumvention of the demands imposed.

## **Interface analysis II: the nature of the legal-illegal interface**

The legal-illegal interface can have either antithetical or symbiotic relationships. We will examine each in turn.

## **Antithetical relationships**

'*Antagonistic*' relationships obtain when there is competition between legal and illegal actors. Actors may be vying for market share acting independently, as for example in the case of state-run lotteries, casinos, and illegal gambling operations. Similarly independent is the antagonistic relationship between crooked financial institutions on the internet or offshore offering illegal services to clients who would otherwise do business with conventional banks (e.g., the European Union Bank in the Caribbean).

In the political, ideological or religious spheres, the competition may be for legitimacy. Actors may seek to gain popular support and following in the same geographic area by legal and criminal means. Illustrations of such antagonisms can be found in political conflicts, such as those in Northern Ireland, the Middle East, former Soviet Republics, Angola, Peru, or Sri Lanka.

'*Injurious*' relationships occur when actors undermine, attack or harm each other. This is typified by groups who may sabotage a foreign corporation, which they consider as exploitative or corrupt. Another example is when offenders commit robbery in order to finance a guerilla.

The above two analytically separate categories may overlap in practice: a combination of antagonistic and injurious relationship is when activists employ violent means against a state, its symbols or citizens.

The relationship is 'predatory' when the aim or effect is to destroy or bleed to death an organization – to control and fraudulently bankrupt a business.

The relationship is *parasitical*, when the aim is to preserve the viability of the target, such that illegal benefits can be extorted on a more or less regular basis. For example, triad members selling protection to Asian business owners; another example is offered by surplus line insurance companies selling a mixture of sound and bogus policies to foreign institutions keen to enter the US market (Brady, 1983).<sup>2</sup>

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<sup>2</sup> Lupsha (1996) has used the terms predatory and parasitical to define different stages in the evolution of criminal organizations. I am using these terms in a different way. I am not concerned with the evolution of single organizations here. Indeed, for many of the organizations I have in mind, there is no evolution from one type to another. The terms are employed here to denote different types of relationship between legal and illegal enterprises.

Counterfeiting goods may be a mixed antithetical/symbiotic (systemic) relationship: criminal entrepreneurs take advantage of and profit from a brand name, which however becomes more widespread and popular. So, the owner of the brand may not make all the possible sales, but expands and gains market share in additional regions (Shultz and Saporito, 1996).

## **Symbiotic relationships**

A widespread belief is that when legal and illegal actors come into contact, it is because criminals seek to infiltrate, extort, or bankrupt legal enterprises. Nevertheless, there is accumulating evidence of symbiotic relations between them. It is worth reiterating that illegal markets operate because there is a demand for what they offer. Very often their clients are conventional and respected actors (users of illegal narcotics, prostitution services, gambling, etc.) Such relationships can be of various types, depending on a number of factors, such as the mutuality or one-sidedness of benefits, awareness of the links, the intent of participants and degree of collaboration.

*'Outsourcing'*: this type refers to a division of labour between legal and illegal actors, where one party offers specialized services to the other. It can be a one-off or a continuous relationship between a client and a provider. For example, the dirty work may be delegated to actors outside an organization or agency for reasons of convenience, efficiency or for the sake of plausible deniability. The blame is thus externalized, if the misdeed and/or the direct offenders are ever discovered (e.g., Iran-Contra and other intelligence-related activities; use of agents or subsidiaries to bribe foreign officials in order to avoid scrutiny and sanctions under FCPA. Also, even a Turkish parliamentary Commission has looked into charges that successive governments have used death squads against Kurd nationalists (Bovenkerk and Yesilgoz, 1998).

In the above cases, legal actors are the clients. The reverse, however, is also possible. Legal actors may provide financial or other support to criminal groups. It is possible that only one of the parties is aware of the quasi-contractual relationship. The Abu Nidal organization, for example, has used a network of legitimate companies whose proceeds went to finance terrorist activities without the knowledge of the managers and workers of these companies.

*'Collaboration'*: in this case, the links become stronger and more direct as legal and illegal enterprises or actors work actually together for the commission

of the same offense. For instance, police officers may work with drug traffickers or an art gallery owner may fence stolen cultural property. Under this category, we can also examine various types of professionals - such as lawyers, politicians, accountants, bankers or casino managers - who knowingly offer their services to criminal operators or organizations.

*'Co-optation'*. In this category, there may be some arm-twisting or voluntary and friendly interactions. So, while co-optation involves mutual benefits, there are uneven power relations between the parties. For example, a deal may be struck for a company to operate unimpeded in X or Y country or at all, if a government agency is allowed to monitor its computers and collect information about its clients. For example, BCCI has been accused of being a bedfellow of intelligence services in several countries. Some BCCI managers have argued that this was the only way BCCI could hope to survive and do business internationally. They added that this sort of relationship is not atypical in the banking sector (personal interviews). Interviews I have conducted with retired cosmopolitan businessmen and reporters indicate (it is not easy to obtain hard evidence on such matters) that many business deals in 'high-risk' countries or regions receive an OK from certain government officials or agencies (e.g., building an oil pipeline through areas of conflict). Some of the business transactions may violate domestic or international laws. In return, businesspeople may have to share their knowledge about particular projects or simply allow themselves and their companies to become the eyes and ears of government agencies. For example, in the case of Matrix Churchill, the company charged in England with illegal exports to Iraq prior to the Gulf war, its top executive turned out to be an informant to British intelligence services (Phythian, 1996).

*'Reciprocity'* (or 'even exchanges'). This is the case when there are consciously mutual benefits between the legal and illegal actors (e.g., legal brothel manager working with smugglers of aliens). This type includes possibly the most common interface, whereby legitimate or conventional actors are the clients for goods and services offered by criminals (e.g., drugs, gambling, weapons, prostitutes, etc.). Other examples of reciprocity include dictators or government officials, who receive rich commissions and kickbacks in exchange for favours to transnational corporations. The latter are then allowed to exploit the land, people or entire country for short-term financial benefits (e.g., Somoza and Nicaragua or Marcos in the Philippines (Clinard, 1990); logging companies and the political elite in Papua New Guinea (Barnett Report, 1989)). Similar offers of safe haven

and protection are made to illegal entrepreneurs and criminal organizations too (examples may be found from Bolivia, Aruba, Italy, or Russia).

'[Systemic] *Synergy*'. We can speak of systemic synergy when legal and illegal actors benefit each other while they go about their business independently promoting their interests and objectives. The practical effects of synergy are similar with those of outsourcing. In this case, however, there is no conspiracy or no client-provider relationship. The synergy is a consequence of structural factors. There may be no knowledge, intent or even reasonable suspicion of such a link (in some cases, of course, suspicions may be 'cured' by efforts to avoid any knowledge). The legitimate actors merely reap benefits from others' criminal activities. For example, banks and other financial institutions in the West may be receiving from overseas substantial funds that are proceeds of crime. In such cases, the laundering has taken place elsewhere, and intermediary transactions have hidden the traces of illegality. In the chemical industry, companies benefit from the operations of networks illegally disposing toxic waste (if there is conspiracy to do so, we have a case of 'outsourcing'; if not (see for examples in Szasz, 1986) we have a case of synergy. Combinations are more likely than not, as in the toxic waste dumping scandal of South Holland, dumping toxic waste in Belgium (Van Duyne, 1993). Financial institutions are the main beneficiaries of certain arson for profit schemes without their awareness or liability (Brady, 1983). The smuggling of cigarettes across borders in order to avoid taxes and customs dues ultimately helps tobacco companies sell cheaper products to their clients and thereby increase their market share, which in the end creates an elaborate underground economy (Von Lampe, this volume). Japanese banks have in the past avoided consumer loan restrictions by lending to sarakin (akin to our loanshark), who in turn was lending to the wider public (Naylor, 1995/96).

The reverse is also possible. That is, criminal actors can benefit from the activities and practices of legal actors. For instance, secrecy jurisdictions and tax havens do not serve only the criminals. If that were the case, there would be little resistance to calls for action against such jurisdictions (or indeed, the very existence of such jurisdictions). The market for secrecy caters to a wide range of customers, including corporations, government agencies, and law-abiding individuals (Walter, 1985). Attempts to reform the system or to sanction anyone operating or doing business in these jurisdictions can expect strong lobbying and pressure from the conventional society to let things be.

*Funding* relationships are also possible, with legitimate organizations providing, knowingly or not, essential financial support for the operation of criminal groups. A recent example is provided after the September 11, 2001 attacks on the USA by agencies around the world, which are looking for charities and other legal entities (e.g., honey traders or farming businesses) that may have fuelled the Al-Qaeda network of extremists.

'*Legal Interactions*'. No criminal actor commits only and always crimes. Diversification is required not only for money laundering purposes, but also for the reduction of risk and maximization of benefits. Some may do so in order to leave the life of crime eventually, others seek protective shields, while still others strive for wider respectability. So, they all have legal aspects or faces (e.g., Cali drug traffickers). Inevitably, then, they interact with conventional actors. The latter's knowledge of their counterparts' 'diverse background' ranges from complete ignorance to benign neglect (perhaps anesthetizing their conscience by rationalizing that their transactions are only above board and legitimate) (e.g., the acceptance of campaign contributions from criminals; BCCI offered many examples of lawful interaction with the elites all over the world).

'*Legal actors committing organized crimes*'. In this instance, there is no interface between legal and illegal actors. Rather, legal actors engage in well-organized and sophisticated crimes on their own; legal actors behave in a typical illegal-actor fashion. An illustration of this type is provided by Eastern German state authorities, which used to run a well-organized stolen art illegal trade (Conklin, 1994); in another case, Citicorp systematically evaded taxes by booking European transactions in a tax haven (US House Committee on Energy and Commerce, 1982). Yet another example is offered by the BCCI affair, which has been branded as a criminal enterprise by New York City prosecutors. In such cases it would be more appropriate to differentiate between legal actors which commit criminal acts and legal actors, who are only 'legal' because of their formal corporate structures they (ab)use (Van Duyne et. al, 2001).<sup>3</sup>

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<sup>3</sup> Van Duyne et al. (2001) differentiate between criminal entrepreneurs and crime-entrepreneurs. The first category commits crimes, but is in essence devoted to their enterprise or other organizational or legal body. Such entities are to *crime*-entrepreneurs mere disposable instruments, as their core business is crime. Criminal entrepreneurs interact with or can slide down to crime-entrepreneurs.

## **Growth of cross-border crime?**

If cross-border crime is growing, how can we tell? What parameters need to be examined to reach a reasonable conclusion? Do we have sufficient and solid evidence on which to build policies?

I have argued elsewhere that the causes of transnational crime can be traced to 'criminogenic asymmetries' (Passas, 2000, 1999a, 1998). These are defined as structural disjunctions, mismatches and inequalities in the spheres of politics, culture, the economy and the law. Asymmetries are criminogenic in that they generate or strengthen the demand for illegal goods and services; they generate incentives for particular actors to participate in illegal transactions; and they reduce the ability of authorities to control illegal activities. For example, political and economic asymmetries between China and Western countries have fuelled smuggling of both commodities and humans. Asymmetries in environmental regulation facilitate the illegal trade of toxic and other hazardous waste. Asymmetries between art-rich and art-collecting countries underlie the trade in stolen art and national cultural property. In the global age, such asymmetries are multiplied and their criminogenic potential is now more easily activated. At the same time, official control capacities are seriously undermined. As the world 'shrinks' and becomes a 'global village', controllers remain constrained by their divergent domestic rules and limited within their jurisdiction.

Just as globalization serves well the needs of legal capital, so does it facilitate criminal enterprises. Both ordinary and illegal international business transactions can be concluded at the speed of light (though safety still requires many crime-business to be handled in a face-to-face fashion). Just as local destinies often cannot be explained without taking into account global factors, local crime victimization may not be fully understood without reference to global forces. As the autonomy of nation states is reduced, even domestic crimes can neither be prevented nor sanctioned without cross-national collaboration.

In the past we have seen how organizations became a 'weapon' for crime (Wheeler and Rothman, 1982). We have also seen how they served to distantiate the criminal hand from the criminal mind (Braithwaite, 1989). In the global age, this distance is stretched even further as the organizations are more compartmentalized and spread throughout the world. In addition, both criminal hands and criminal minds may be absent, far away from the locus of the crime. In many instances, crimes are so well camouflaged that only experts and specialists can detect them and realize the risks involved.



Globalization processes relate to all three types of criminogenic conditions. Illicit opportunities are produced by the fragmentation of enterprises and transactions over more than one country. For instance, lawyers, who form and represent a shell corporation in a secrecy jurisdiction on behalf of someone overseas, may not even (or preferably) know who is the owner of the company and for whom they are working. There are good incentives to form such shell corporations. They offer tax advantages and shelter against regulation and the detection of misconduct. They also help to hide criminals' assets that victims and prosecutors in distant places are looking for. Lawyers will see no problem with participating in such affairs. Not knowing the identity of their client, they do not have to know whether he is a drug trafficker, a corrupt dictator or a devious corporate executive. Even if required to testify, lawyers cannot offer any significant assistance to investigating authorities. So, controls get much weaker.

Secrecy and anonymity hinder investigators by covering the tracks of the global offender. Illegal financial transactions and losses that must be reported can be conducted and hidden through off shore entities of global enterprises. Secrecy jurisdictions serve as a 'black box' through which all manner of illegal activities can be shielded against prosecution and punishment (Blum and Block, 1993).

Globalization also facilitates 'jurisdiction shopping': finding the jurisdictions which allow conduct which has been criminalised in one's own state. Toxic waste may be dumped in countries with lax or no regulation of such waste. The bribery of foreign government officials (in order to ensure a contract is gained or renewed) has been treated by some countries as a tax-deductible business expense. Lawyers, accountants, former government or military officials often act as consultants or private businessmen after they leave public office and offer advice on how to engage in risky and harmful practices without breaking the laws of the countries where different operations take place. Transactions criminalized in many parts of the world may be concluded in countries that allow and welcome them. A wide gamut of activities, punishable in the own jurisdiction, may be 'exported', while their fruits can still be enjoyed. Particularly corporate entities are expert in this kind of criminal evasion (see how the pharmaceutical industry has taken advantage of such possibilities; Braithwaite, 1984).

Other examples of cross-border crimes without law violations (in the 'home state') include the use of child labour in poor countries that condone it by

companies that then export the manufactured goods to countries that criminalize the practice. Taxes may be evaded legally through the practice of transfer pricing, which allows the profits to be booked in countries with no income tax (Piccioto, 1992; see also illegal cases of transfer pricing by Asian logging companies in Barnett Report, 1989). Dirty money can be laundered in countries requiring no reporting of even substantial amounts of cash deposits (e.g., Panama) and then transferred to Western banks that may not know its criminal origin (and do not care to find out; Levi, 1991).

At first sight, this analysis suggests that cross-border crime may be on the increase. However, the process of globalization also offers new opportunities for better controls (Passas, forthcoming). As a result of new technologies in communications, more people can participate and make a difference in the fight against transnational (as well as domestic) crime. For example, there is a process of 'globalization from below' (Falk, 1993), which enables relatively weak actors to influence decisions at home and overseas (indigenous people and Occidental Petroleum in Colombia; see *The Economist*, 1998 June 7).

To the extent that criminal entrepreneurs rationally seek profit (whether as a goal or as a means to other ends important to them), the fear that they will destabilize nation states may be out of proportion. There is always such a risk, of course, especially for those countries, which are the target of politically motivated groups or organizations. However, the extensive legal-criminal interface and especially the symbiotic aspects of it suggest that the nullification or destabilization of governments is against the interest of criminal organizations. Given that these organizations operate in many ways according to market principles, they generally also need a comparatively stable and predictable environment. The government provides that for free.

The number of reports and debates on this phenomenon also suggest that the threat might be growing. However, it must be emphasized that not all information is accurate. In case after case and with respect to different types of crimes, careful investigations and analyses have shown alarmist reports and statements to be exaggerated. Recent Congressional hearings examined the risk posed by counterfeit dollars. Subsequent GAO reports and testimony from the Secret Service suggested that the danger was much lower than previously feared. The volume of drug proceeds in the US has also been exaggerated (Reuter, 1996), while in general the volume of the crime-money has been deliberately inflated for political purposes (Van Duyne, 1994). The extent of credit card fraud and computer-assisted crimes is unknown because of the victims'

unwillingness to report and thereby reveal vulnerabilities. Embarrassment prevents many victims of advance-fee frauds from coming forward, collaborating with investigators or even admitting that they have been fooled. The brutality of criminals and problems of Chinese illegal aliens in the US have also been exaggerated (Chin, unpublished manuscript). Finally, there has been more speculation than solid evidence on nuclear material smuggling (Williams and Woessner, 1996).

As with many other crime problems (or social facts), media and official reports serve to raise a broad awareness rather than provide any valid indication of the extent of the reported phenomenon: more reports and debate, frequently highly repetitive, about it do not necessarily indicate an increase of the problem.

## **Research Implications**

There are two main research implications of foregoing discussion. Firstly, we need to develop *solid empirical data*. Secondly, we need to engage in more *analytical work* towards a better understanding of the causes of the problem at hand. These two steps should provide the basis on which to build better theories and sound policies.

## **Developing a solid empirical ground**

Despite all the attention the problem of cross-border crimes has recently attracted, the information base remains remarkably weak. Many analyses are based on theoretical expectations, anecdotal evidence, unreliable data, and sheer speculation as well as ideological commitments and vested interests.

The noted lack of reliable data reflects years of neglect by the research and policy community. This is partly due to methodological hurdles one has to overcome and partly due to the lack of adequate funding for researching cross-border crime. This leaves the field open for journalistic, politically motivated or simply not very sophisticated accounts to shape conventional wisdom. This wisdom often equates cross-border crime with the stereotyped 'organized crime', when the latter becomes international. This, however, erroneously limits the

scope of the field. A number of concrete steps may be taken to remedy this situation.

First of all, we need to reach as wide an agreement as possible on what constitutes cross-border crime.

The definition I offered in this paper is unambiguous as well as succinct, while it encompasses criminal phenomena, which go *beyond* single national jurisdictions. It is not legalistic, while still law oriented.

A related problem, as mentioned above, is that the concept of cross-border crime tends to become associated with or even classified under the categories of 'organized crime', 'white-collar crime' or 'state crime'. This does not help very much, as these concepts are highly ambiguous due to more political or emotional attempts to define them than to clear analytical delineation. Frequently there is a confusion of actors with acts. Though this contribution has stressed the importance of the wide range of symbiotic relationships between legal and illegal actors, empirically and conceptually the general area of crime ought to be based on acts.

The second task is to establish what we know, what we think we know and what we need to know about these acts. Despite our common admission that we do not have adequate information on the nature of the problem, there is a plethora of articles, books, official reports, media accounts, databases and web sites with material relevant to our subject matter. It is quite possible that valuable and solid evidence can be found in this labyrinth of information. However, we currently have no way of assessing the validity and reliability of existing data. How can we evaluate the strength of the evidence used by other researchers and separate it from commercial and journalistic works or unsubstantiated 'conspiracy theories'? Because it is sometimes easy to identify inaccuracies, gross mistakes, contradictions, half-truths and exaggerations in these publications, the whole notion of interconnection and interdependence among various criminal and legitimate actors gets discarded or overlooked. We need, therefore, an instrument (e.g., a reliability scale) to evaluate the various sources and types of secondary data.

The third task is the collection of original reliable data. The methodological hurdles we face are legion. From the domestic experience, we are familiar with the unreliability of official and government records, with the distortions of information coming from journalistic sources, with the risks to researchers of serious crime, and with the high financial cost, when data collection must be undertaken in several jurisdictions. Scarcity of prosecutions related to

corporate and state crimes, lack of access to informants and privileged information, confidentiality of various types of records, classification of reports and other data compound the problem. Even if we wished to consider seriously official statistics, there are no such statistics kept on crimes which cross national borders or the available statistics are incomparable. Given the misgivings (expressed repeatedly in the literature and during our meeting) even about legitimate trade figures, quantitative studies on illegal transnational enterprises do not look particularly promising. Quantitative studies may yield some gross estimates on the volume of certain transactions, but they will have to be read with more than a grain of salt.

Qualitative studies are not without problems, but they appear more appropriate for this field. Case studies, for example, always run the risk of furnishing non-generalizable results. In such cases, however, we can gain invaluable insights for theoretical elaborations. Moreover, policy-making can benefit even from unique or atypical incidents, which occasionally reveal systemic problems and sound alarm bells before such cases become more common. Qualitative methods are also more adequate for the study of networks and of the interface between legal and illegal actors, the points at which criminals and conventional society meet. Methodological hurdles have turned the study of criminal enterprises into a business of accumulating (not always valid) information about either specific groups of people (e.g., La Cosa Nostra, the Yakuza, or the Russian 'mafiya') or particular offenses (drug trafficking, arms trafficking, smuggling of illegal aliens, etc.). Even the best works into 'organized crime' are group-, offense-, or institution-specific.

Although valuable insights are offered by such studies, there is a huge gap in the literature relative to the *social organization* of crime. We know very little about the *modi operandi* and methods used, about the ultimate beneficiaries and victims of these crimes, the degree of specialization, short or long-term alliances or division of labor. We have incomplete knowledge of the role of professionals and of the relationship between illegal markets on the one hand, and legitimate corporations and government agencies on the other. The links among criminal organizations are also under-studied. In short, we need more research into the multiple and complex links and associations among both legitimate and illegitimate actors. Findings of researchers, though usually rather fragmented, do indicate the plausibility of the hypothesis of the existence of networks of crime, but there is no systematic study of such interconnections. No one has attempted to put the various pieces of the global crime puzzle

together. Again, a major difficulty is methodological. Advancements in technology allow us to experiment with new software programs for a better organization and more systematic analysis of both primary and secondary data, especially in the area of networks and complex transactions.

Finally, as we collect and analyze our data, it is important to remember that the problem of cross-border crime is not uni-dimensional or monolithic. By its very nature it can only be studied from a *comparative perspective*.

## **Understanding the causes of transnational crime**

Analytical studies are also in short supply on the nature, causes, risks and growth of the problem. We need to focus more on the fundamental causes of the problem and spend more energy on the demand side rather than solely on the supply side. For instance, the above typology of the interface between legal and illegal actors can assist in understanding various sources of demand for prohibited goods and services, but requires some fine-tuning. It needs to be tested and elaborated on the basis of empirical data.

Any attempt to explain crime requires an examination of opportunities to commit the crime in question, of motives leading actors to take advantage of such opportunities, and of control options and weaknesses. While much of the literature on cross-border crime deals with the issue of opportunity, most observers neglect the question of motives. For instance, the profit motive is widely assumed to be the main or only reason behind cross-crime. Yet, political, religious or ideological motivations can be the most important causative element (especially when it comes to crimes connected with ethnic or political conflicts). Also, cultural differences are often overlooked. For example, the question of software piracy is approached differently in Asia, where the sharing of social knowledge is considered more important than proprietary rights (Swinyard et al., 1990).

Most analyses concentrate on the mounting problems in controlling certain types of cross-border misconduct (e.g., the drug trade, political violence or corrupt practices) rather than seeking to better understand the nature of the more general problem. Explanations of even spectacular disasters, such as the BCCI scandal or the Barings collapse, focus on corrupt, inept or greedy individuals out of control. Such explanations conceal the systemic causes of problems.

The above analysis suggests that structural problems - criminogenic asymmetries - may be a key to understanding, preventing and fighting serious crime. However, not all asymmetries produce the same crime problems. A number of issues remain unclear and need further elaboration. For example, when do asymmetries become criminogenic? Is it possible that all asymmetries are potentially crime inducing, but only some of them get 'activated'? If so, when is the criminogenic potential activated? Alternatively, one could ask whether there are asymmetries with no such potential. Are there any asymmetries with positive effects? In that case, how could one maximize such effects?

## **Policy Implications**

The foregoing discussion points to the need for restraint before the adoption of drastic measures against the perceived threat of transnational crime. Given that there are still too many open questions, careful and thoughtful cost-benefit analyses are of critical importance. Some of the policies currently debated or partially implemented are risky themselves (e.g., militarization of law enforcement, merging law enforcement with intelligence operations, international undercover investigations, extraterritorial application of domestic laws, etc.). Some measures may be costlier than the problem they are designed to remedy. A cost of the militarization of law enforcement, for example, is that the discourse of a 'war on crime' paves the ground for the acceptance of 'collateral damage'. This sort of collateral damage can take several forms, most importantly the harm to democratic processes and accountability. Excesses, abuses of power, limitations of freedom and collective or individual rights are a corollary of the war metaphor, even in domestic cases (Skolnick and Fyfe, 1993). In short: the maintenance of law is not a war, but a civil task for a civil society. If the authorities want to wage they should apply martial law.

It is important to differentiate according to the nature of the criminal activity, because the distinction between political and economic crimes has practical policy implications beyond the theoretical significance of motive. It draws attention to different root problems, which require different strategies and tactics, especially with respect to prevention. A demand-side approach to politically motivated crimes may be to seek peaceful resolution of a conflict, democratization, decolonialization, granting of independence or autonomy, etc. The intensity of beliefs held by political offenders will also require different

assessment of risks (e.g., suicide and more audacious attacks). In addition, the associations or alliances political criminals will form are likely to be different from profit-seekers.

This brings us to the policy implications of the legal-illegal interface. Overwhelmingly, the debate and policy-making energy centers on activities that resemble the stereotypical conception of 'organized crime'. As a result, better organized crimes, more harmful malpractices, and more dangerous networks of crime and corruption do not receive the attention that is due. We need to find out more about the relative frequency, cost and significance of various types of interface, as we seek to assess risks, estimate costs, sort out priorities, allocate scarce resources, and maximize the effect of our anti-crime efforts.

It is commonplace to call for more cooperation and collaboration among various control and other agencies at levels. Yet, certain crimes or associations may produce locally positive consequences. They may help with the balance of payments, by increasing wealth, by lowering unemployment rates, etc. Other crimes may have little or no effect on regional economies or other interests (on the European Union context, see Passas, 1994). Blind eyes, indifference or co-optation will inevitably affect the degree of cooperation with outsiders. In this light, there is a need to generate incentives for local action and mutual assistance.

The foregoing analysis of criminogenic asymmetries also suggests that many systemic sources fuelling the demand for illicit goods and services can be traced back to nation states. In some cases they are complicit; in other cases they are unable or unwilling to take remedial action. It is national policies and agencies, the exercise of asymmetric state powers, an obsession with sovereignty and nationalist resistance against international regulation that account for criminogenic asymmetries. It is their economic policies who bear responsibility for relative and objective deprivation. It is their protectionism and subsidization of domestic industries that impair the efforts of less developed countries to narrow the gaps. It is their monetary policies and control of international organizations that preserve asymmetric development and growth. It is authoritarian regimes that cause ethnic and political violence. It is their hegemonic policies and support for dictatorial regimes overseas that provoke international terrorism and fundamentalism. It is their selective control and promotion of domestic military industries that fuel armed conflicts (note that industries from the permanent members of the UN Security Council produce the overwhelming majority of



weapons). It is their unwillingness to share knowledge, information and technology that breeds unease and inequalities. It is their prohibitions of commodities and services in demand that create illegal opportunities. It is their inability or unwillingness to reduce the demand for prohibited goods and services that perpetuates the illegal markets. It is their imposition of quotas for new immigrants that gives rise to the inhumane smuggling of illegal aliens. It is their resort to criminal justice methods to deal with the consequences of their policies that provide incentives for more sophisticated organization of crime and raise the price of corruption. Even if these policies are understandable from a national perspective, their hidden costs may be cross-border crime.

There is little doubt that the process of globalization has fostered more and new types of transnational crime. However, globalization also furnishes new opportunities for more effective controls, some them rather informal in nature (e.g., the use of the internet to shame powerful actors into socially responsible policies). A detailed discussion of these control opportunities is beyond the scope of this paper. Yet, it is plain that we need to detect, create and maximize the use and effectiveness of such opportunities. We can make the public as well as controllers aware of them and fortify the process of 'globalization from below' and the 'democratization of control' (Passas, 1999a).

Finally, we urgently need an evaluation instrument, so that we know in advance what will constitute a success and what will be a failure of contemplated and existing policies. This is important both for line agents, who should know whether they are doing a good and efficient job, and for policy makers, who must have the ability to measure the progress, success or failure of particular strategies and methods.

In conclusion, serious as the threat of cross-crime is, it is perhaps too early to panic about it. We are not helpless and powerless against it. Clearly, more systematic (and well-funded) studies are necessary to ensure that our analyses and policies are based on sound evidence rather than conjecture and speculation. There are plenty of things, however, that we can undertake in the meantime.

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# **Economy and crime in the society in transition:**

## **The Czech Republic Case**

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### **Introduction**

Before 1989 the economic system in the former Czechoslovakia as well as in the other countries of the previous Eastern block was based on state-planning, which as time passed by changed into a permanent ‘in-short-supply economy’ as it was described by the well-known Hungarian economist János Kornai (1995).<sup>2</sup> In Czechoslovakia this system acquired some specific features that were absent from other neighbouring socialist countries, except the Soviet Union. Because of the total nationalisation of private property, the private economic sector did not exist at all. Consequently, the imbalance on the market of goods and services was even larger than in Poland or Hungary, where the private sector was at least partly maintained. This imbalance had to be redressed and, as this was not possible within the framework of the economic regulations in force, it was done ‘non-legally’, in the area of the shadow economy.

The total nationalization of the economy had reduced virtually all people into state employees. The incomes were generally levelled out and certain private property (which of course could be neither manifested nor invested again) belonged to a relatively small group of people, who could afford the scarce goods and had the opportunity to provide some of the lacking services. Under the Czech conditions, the established network of the shadow economy

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<sup>2</sup> See J. Kornai: *Way to the free economy; Theory of in-short-supply economy*, study materials of the Economic Institute of the Czech Academy of Science, Prague (internal translations) and Kornai J., *Highway and Byways: Studies on Reform and Post-Communist Transition*, MIT Press, Cambridge Mass., 1995.

obtained much more the shape of many minor undertakings than large-scale illegal entrepreneurial ventures, like in the former Soviet Union. Nevertheless, the shadow economy networks were quite extensive and above all socially accepted. It was not considered illegal, but 'non-legal'. However, in the 1980s the *illegal* or criminal economy (organized prostitution, illegal exchange of foreign currency etc.) also began to develop along the pattern of this shadow non-legal economy.

In November 1989, a political transformation entered this social and economic landscape. A section of the population considered this change as an opportunity to continue the development that had started in 1968, i.e. the modernisation of the socialist model to an acceptable shape. Another part of society wanted to put a complete end to the socialist model and to establish a modern economy according to the model of the majority of European countries: socially oriented market economy. A third section –let us say the liberal one– wanted to create a 'pure' market economy without any other attributes. The first group looking for the continuation of the year 1969 failed and was relatively quickly put aside. The key dispute between the other groups arose when the proponents of socially oriented market economy tried to limit the starting process of economic transformation by more strict legal rules, while the proponents of pure market economy (mostly the theoretical economists from research institutes and banks) preferred above all the acceleration of this process. They argued that the economy must get 'ahead of the law' (it was later said that the economists were on the run from lawyers). This second group was more successful (also thanks to the social support expressed in elections). The warning that the lack of adequate regulation opens the door for shady or criminal operations and for the infiltration of organised crime activities was not heeded (Webster, 1998). Except for restitution and standard methods of privatization, an extensive process of denationalisation of the state property started through the so-called 'coupon privatization'.

It is obvious that economic reforms in the countries in transition –no matter how necessary and well meant they were– opened the door to very lucrative opportunities to invest. The underestimation of the strict legal framework for the privatisation process together with the high demand for scarce capital, further strengthened this opportunity and established the favourable conditions

for the profitable influx of illegal capital—foreign capital on a much larger scale than domestic capital.<sup>3</sup>

As mentioned above, before 1989 citizens had no opportunity to accumulate capital in a legitimate way. The illegally hoarded capital was formed by members of the former regime establishment on the one hand and by members of non-legal and illegal economic networks on the other hand. At the very first beginning of the transformation process, opportunities were created to change this hoarded capital into working capital and to legalise it in this way. This process was not of the same nature and extent as in Russia, where Zabryansky speaks of the change of the property monopoly not towards the market economy, but toward the re-distribution of property to the benefit of the bureaucracy.<sup>4</sup> Aromaa (1996) adds that an established illegal private economy has existed for decades in the countries in the area of the former Soviet Union and patterns of activities that have developed within this economy prevail even today. As a result, the privatisation process did not lead to a free market economy or a democracy; it was hijacked from its inception by the political-criminal nexus (Shelley, 1999). Given these assessments it may be concluded that one of the roots of the contemporary form of criminal economy stems from this early period of transformation.

### **The manifestations of economic crime: 1989-1999**

In the period of transformation, especially during its first phase, a so-called small privatisation took place within an underdeveloped legal frame. This meant that the hoarded financial means acquired by non-legal or straightforward illegal activities during the previous regime could be legalised without anyone checking their origin. Many controversial decisions of the privatisation commissions, which were definite and could not be reviewed by court (by the positive law), were a by-product of this process. The same can be said about the sometimes Mafia-like ways of influencing the decision making process

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<sup>3</sup> See: Douglas, I., Economic Reform and Criminal Finance, *Transnational Organized Crime*, Vol.2, No.1, 1996.

<sup>4</sup> Zabryansky, G., Power, Property and crime in the CIS: Past and Present/How they interrelate, paper presented on the Baltic Criminological Seminar, St. Petersburg 1999.

in the commissions: threats, corruption and manipulation were not uncommon. Nevertheless, it is fair to observe that, at that time, these methods were not very much condemned by the major part of the population, partly because of the continuation of habits developed during the previous regime and partly because of personal advantages (many got out) of these methods of privatisation. Moreover, during this time span, hardly anyone felt threatened by the process of transformation. Actually, the people had very positive expectations about future developments. The transformation of the economy was presented with radical and fierce liberal rhetoric, but in fact it was being carried out so 'softly' that it was even considered the 'Czech way of transformation', as a pattern with a very low level of unemployment, acceptable inflation, growth of real income, etc. However, the necessary pressure on the effectiveness and restructuring of economy actually was not exerted and the real entrepreneurial milieu was not created, or it developed in the context of a weak legal framework and in the absence of ethical unwritten norms.

After 1993 and after the splitting up of the Czechoslovakian state, the situation changed for the worse. This was caused by the incomplete restructuring of big plants that were economically supported by big banks, in which the state still was a major shareholder. The newly created ownership relations were sometimes not transparent: the banks founded the privatisation funds, which were the shareholders of the privatised plants that received credits from the same banks. A process of privatisation based on credits requested from banks in order to buy shares in a plant produced many difficulties. Subsequently there was a shortage of capital for investment to develop and modernise the production and to be able to pay off the credit. The resulting debts increased steadily. The phenomenon of 'tunnelling' (as it is called in the CR), emerged.

Tunnelling is the term for the following type of fraudulent operations. Essentially this operation consists in the transfer of the assets of a prosperous firm or company by its owners to another company, often established for this purpose only. Most of the companies privatised either by direct sale or through the coupon method were unprepared to face such schemes. The tunnelling could be managed by the majority shareholder (who often paid off neither the purchase price nor the credit from the bank), by the minority shareholder (which could be the privatisation investment fund) or even by the management of the company in question. There were various ways of property transfer: for example the plant could pay very unusually high prices for goods and

services to selected firms, the machinery and raw material could be carried away and sold, the customer database could be misused, etc. The financial institutions, such as banks, could also be 'tunnelled' through the abuse of credits and loans. The holder of any share in the bank –minor or major one– received a credit from his bank, which was much higher than his collateral and subsequently did not pay this credit back. Another frequently occurring variation of this type of credit fraud was offering overvalued collateral (most frequently, overvalued real estate or precious stones) for the bank credit.

This robbing of private property by its very owners or shareholders seems to contradict the original theory about the automatically positive effect of privatisation on the behaviour of new private owners, making them act responsibly. Moreover, the properties acquired through tunnelling were probably not used for subsequent investment in the economy, but for financial sharp practices and for private consumption. Apparently in the Czech entrepreneurial circles, the traditional ideas about the responsibility of private owners for their own property, as elaborated in Max Weber's classic works, no longer apply. Nevertheless, neither the private property nor the stratum of these new owners –"tunnellers"– have been brought about by working hard, step by step, but have been established very quickly and sometimes very easily. It is therefore understandable that their primary intention was not to take proper care of the property, to husband and improve it in the sense of Weberian 'capitalist ethos', but to take advantage of it as soon as possible for their immediate personal needs. In simple words: the immediate satisfaction of greed prevailed over the expectation of responsible ownership.

## **Some cases of economic crime during the transformation period**

### **The CS Funds**

The most successful case of tunnelling in the history of the Czech transformation was the case of CS Funds. Since 1995 this investment company was headed by the controversial financial group *Motoinvest* and in February 1997 was sold to the unknown firm *Austel Enterprises*. However, before the sale, the shares in the accounts of CS funds were exchanged for cash. Following this feat in

the following weeks, the ownership of CS Funds was changed twice again and subsequently in March 1997 1,24 billion of Czech crowns disappeared from CS Funds to the accounts of several foreign companies. The assets in accounting records were replaced by worthless shares (for example, shares of some poultry farm, which were never transferred into the accounts of CS Funds). In this case, various safety measures, which should have prevented this fraud, failed. The bank, a stakeholder of the CS Funds, failed to stop the transfer to the Ministry of Finances, which in turn allowed the transfer of more than 1 billion crowns, despite having received warnings that this transaction was suspicious. The lawyers of the cheated shareholders succeeded, after an intensive search, to return only about 180 million crowns.

There is unconfirmed intelligence that the whole scam has been managed from abroad and that various entrepreneurial persons in the CR were involved. However, there was insufficient evidence to corroborate this story. The investigation is still continuing.

### **The case of light fuel oils**

This case seemed to have started as a typical ‘white-collar’ crime, namely tax evasion, but as a matter of fact it may rather be qualified as a characteristic example of a combination of organised and economic crime.

The essence of the fraud scheme is similar to the regularly occurring mineral oil fraud in Western Europe (Van Duyne and Block, 1995; Van Duyne, 1996). Since 1993, a different consumer tax has been imposed on chemically identical and visually similar products, i.e. light fuel oil (low tax rate) and diesel oil (high tax rate). This made the product highly attractive to fraudsters. We present two variations of this scheme.

#### *a. The carousel fraud scheme*

A cargo of light oil (usually a train load) is bought. Subsequently the merchandise is sold to an intermediate firm, which may be a front firm or even fictitious. This firm changes on the documents the name of goods and sells it to a collaborating firm as diesel oil, for which the tax due has ostensibly been paid. Of course the consumer tax is not paid. The buyer acquires the false tax payment receipt and the cargo of ‘diesel oil’ is exported again. The exporter

applies for the reimbursement of the (unpaid) consumer tax. The firm to which the merchandise has been exported is part of the scheme, which consists of a chain of connected fraud firms. The foreign link of the chain may change the documents again and return the cargo back to the CR as light oil. This cycle may be repeated with the same shipment for several times, creating a carousel. The profit from such a scam can amount to over 15 million crowns.

*b. Label swindle*

A delivery of light oil is imported. In the documents, the nature of the substance is changed into diesel oil and the shipment is sold on the domestic market. The profit comes from the price difference: price of light oil was 6 crowns per litre, whereas the price of diesel oil was 16 crowns. The wholesale oil traders buy the diesel oil from the importer below the market price, but still leaving the importer with a handsome profit. The wholesale dealers subsequently sell the cheap product to the small distributors and consumers. One shipment might yield a profit of about 18 million crowns.

The extent of this organised fraud can only roughly be estimated: in 1993 the import of light fuel oil increased from former 2,000 tons per year to half a million tons. The import of diesel oil in the same period decreased from 2,5 millions tons per year to 800,000 tons. Taking these figures into account, the damage to the treasury ranges from 5 to 15 billion crowns. Based on other information, from the police reports and from the press, the amount of the financial costs was estimated by the Czech Ministry of Trade and Industry at about 3,7 billion crowns.

The reaction of the authorities to stem and prevent this financial bloodletting may be considered amazing, to say the least. To start with, no provisions preventing these activities have been worked out for some time. Until mid-1993, the interpretation of the existing legislation did not even allow the prosecution of the wrongdoer. Only in 1994 the Ministry of Finance issued an order to colour the light oils in order to prevent this abuse. However, despite full knowledge of the opportunities for fraud, it was still possible to obtain an exception to this regulation.

The press mentioned that, in connection with light fuel oils, 176 firms have been investigated in 1993 and 1994, though approximately 900 firms were involved in the fraudulent activities. The press also vented the suspicion of corruption of civil servants, because of the production of many amendments

on tax and custom bills, which, nevertheless, still left some space for certain kinds of abuse. The press mentioned the suspicion that there were 13 murders and 17 missing persons in connection with the light fuel oil fraud cases in 1993 and 1994.

The attempts to prosecute these frauds had only meagre results. Only in two cases did the court pronounce a guilty verdict against the prosecuted firms or rather their owners' tax evasion of 140 and 25 million crowns.

The light oil fraud may have started as traditional and technically simple tax evasion, however at a large scale. Even according to conservative estimates, it resulted in a staggering loss to the treasury, while the offenders profited enormously. This 'criminal profit expectancy' probably attracted new players in the field, which grew soon more complicated, similar to the excise fraud schemes in the Netherlands and Belgium (Van Duyne and Block, 1995). There is evidence that these frauds have been committed by structured groups of offenders with a division of labour. We may find a so-called declared foreign buyer (that is sometimes fictitious), the investor (who sponsors the operation and collects the profit), the carriers who transport the cargo, the real customers and external collaborators who provide the forged documents, stamps etc. including taking care of the bribing of civil servants (customers etc.).<sup>5</sup>

A comparison of the available information with the distinguishing features of organised crime as formulated in the definition of the Bundeskriminalamt (Küstler, 1991), (organised and well-planned continued activity, division of labour through a network of suppliers, middlemen and buyers, corruptive behaviour, conflicts and their resolution through violence), allows us to qualify these criminal schemes as organised crime with extensive cross-border connections.

These criminal activities may seem to be only of domestic origin, because only the Czech offenders were prosecuted. However, it is not only a Czech concern. The problem of the abuse of differential taxation of diesel oil and light fuel oil existed in several post-socialist countries and some partial information indicates that there exists a substantially broader international criminal activity (Van Duyne and Block, 1995). Such schemes are massively and typically done in all subsidy fraud regimes, including EU subsidised markets.

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<sup>5</sup> Chmelík, J., Konrád, Z., Porada, V., *Organizovaný zločin?*, Kriminálnístika 1/1998.



It is believed that the light oil transactions began at the Romanian-Hungarian border, then continued across Slovakia to Poland and Czech Republic. Another branch led from Russia across the Ukraine to Poland. Such transports were not possible without the collaboration of the local police and custom service. According to some sources, the main investors of these transactions were Russian criminal groups. The name of the infamous Semion Mogilevitch was mentioned in this respect.

### **The Case of Bank Moravia**

This case is in a certain sense typical for the Czech form of economic crime - it is a tunnelling of the bank by the owner himself. As such, it may illustrate the fact that financial crime could manifest itself as an 'assault' of the owner against his very own property, as is the case with other forms of economic crime. In addition it confirms the observation of Van Duyne (1993, 1996), that economic crime may be qualified as organised crime in its own capacity, without having necessarily the other features of more traditional forms of 'underworld' organised crime.

The case concerns the Bank Moravia, which was established as a regional bank during the banking boom in 1992. The institution was making losses since 1996, for which reason it was submitted under the stabilizing programme of the Central Bank in the following year. In 1999, it was disqualified from this program, because it had not accomplished the mandatory criteria. Subsequently the bank declared its insolvency. It was a relatively small bank: the ordinary stock was 1,07 billion crowns and the bank kept about 118 thousand accounts. It also provided loans to the big plants in northern Moravia, i.e. plants of interest of every Czech government during that time. This was also the reason why it was placed under the stabilization program and why its losses were refunded by the Central Bank to the amount of 0,75 billion crowns in 1997.

Of course the Bank Moravia did not only provide loans to the big plants owned fully or partially by the state. In 1993 it loaned of 15 million to the leasing company owned by two entrepreneurs. One of them was a silent partner of another firm that was involved in the bankruptcy of three other banks. This entrepreneur finally gained the control over the Bank Moravia; he became the president of the supervisory board and it is believed that his share in Bank Moravia exceeded 60%. The firms owned by this entrepreneur were provided

with more and more loans. The consequence was that the Bank Moravia had in its credit portfolio hundreds of millions of credits given to the companies directly owned by this entrepreneur or personally connected or acting in concert with him. The total amount of these loans given by the Bank Moravia probably exceeded one billion crowns, including the guarantees. As a majority owner, he 'robbed' his bank to the benefit of his other companies. This fraudulent scheme should not be considered a Czech speciality, it may be met everywhere, like the Loan and Savings scandal in the US or the Maxwell case in Britain. However, the Czech bank milieu seemed to be extremely unprepared for this kind of 'robbery'.

This case illustrates the financial situation in many banks: one third of loans supplied by the average Czech bank is considered to be risky, because of the small likelihood that they will be paid back. This compares unfavourably with the surrounding countries in transition: the proportion of risky credits in the Czech Republic is four times higher than in Poland and Hungary. This means that the banking sector is significantly weakened. At the same time, the banks represent the main financial source for the economy due to the shortcomings of the capital market. The main cause of the weak capital market is the bad experience of foreign investors with the local mismanagement (see the case of CS Funds) and also the coupon privatisation. It is not only an economic problem that could be solved by the privatisation of the banking sector, which would require the massive financial help from the state budget; it is also very much a social and political problem.

There are indications that part of the risky loans that are uncollectible, have not been the result of wrong economic assessments by the bank management or have been forced upon by state pressure to support inefficient companies and plants, but are the outcome of the kind of well organised criminal schemes illustrated above. Nevertheless, the situation is improving, albeit slowly. This is not only due to the very complicated nature of the economic crimes, slowing down their judicial/criminal investigations, but probably also to the extent of influence of people in or around the circles of economic crime, who have more than enough means at their disposal to become almost 'untouchable'. The corruption, which was at the beginning of transformation related to its specific areas (for example to influence the decision-making of the privatisation commissions, to receive credits etc.), has now been recognized to have reached a higher *strategic* level and to influence the regulatory and decision making

functions of the organs of state and to influence the law enforcement authorities.

## **Corruption and organised (business) crime**

Corruption is a traditional common feature in which economic and organised crime merge to such an extent that differentiating them is almost an academic issue. We have observed that the investigated cases of organised economic crime have virtually all the characteristics which are attributed to 'traditional' organised crime: continuity, division of labour, corruptive influences, international connections, violent dispute settlements. The concept of organised crime, with its usual 'underworld' connotations, entails the idea that as a kind of 'outside' force it tries to infiltrate or penetrate the political and social structures. However, if we broaden our angle to include organised economic crime in the concept, the feature of upperworld influence obtains a different meaning: organised economic crime does not penetrate the legitimate economy and social structures, it is part of it from the very beginning, albeit a parasitic part. In other words, the effort of 'traditional' (i.e. underworld) organised crime to infiltrate the official structures usually takes place *ex post*, for the economic crime the infiltration *ex ante* is characteristic (Van Duyne, 1997).

We may consider the activity of Czech organised groups in the field of economic crime as characteristic for the emerging Czech organised crime. It reflects very adequately the specific context of the Czech society and economy in the process of transformation, and the offenders are capable to take advantage of the many opportunities created by the shortcomings and gaps in management, control and legislation. This phenomenon demonstrates the thin line between what is considered 'classic' organised crime and business crime (Passas and Nelken, 1993). If we do not confuse criminal acts and actors, as Fijnaut (1997) has done, but take the nature of the criminal conduct as focus, we may consider many forms of economic crime as a modern form of organised crime.<sup>6</sup> The circumstance that the organised criminal conduct takes place in economic areas, which in the history of criminology have been named 'white-

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<sup>6</sup> See Ruggiero, V., *Organized and Corporate Crime in Europe*, Dartmouth 1996.

collar' crime, should not confuse us to apply the wrong qualification. Individual manifestations of 'white-collar' crime may develop into the specific forms of organised crime in accordance with its usual concept. Our examples concerning the characteristics, structure and activities of groups involved in the light fuel oil frauds and the criminal skimming of the banks are to be qualified as organised business crime in their own right.

### **Shadow economy and organised crime**

The phenomenon of organised business crime should be projected against the background of an extra-legal economy. The fall of the socialist planned economy did not cause the disappearance of the deeply ingrained shadow economy. There is still a broad area of economic non-legal activity that does not concern the provision of illegal goods and services, but consists of income undeclared to the Inland Revenue Service, the Customs and social securities agencies. In brief: tax and social security fraud.

It is estimated that in the Czech Republic the shadow economy produces between ten to fifteen percent of the Gross Domestic Product (Czech Statistical Office).<sup>7</sup> According to the estimates of analysts of the Czech Statistical Office, the Czech shadow economy has been producing goods and paying out wages with an annual value of about 110 billion crowns. The illegal employment of workers concerns mainly foreigners, a usual phenomenon in the shadow economy: according to the figures of the police about 120 thousand foreigners have been employed illegally. This phenomenon is the breeding ground for the development of a symbiosis of shadow economy and organised crime-entrepreneurs. The supply of illegal workers has to be organised and maintained, which is a criminal business.

If one is quick to brand this 'organised crime', one should not forget that on the same dimension of labour/income tax fraud, one finds also the very popular practice of Czech firms, which officially pay their employees very low wages in order to pay lower taxes and social insurance payments, while the

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<sup>7</sup> In comparison with the previous Soviet Union: the share of the unofficial economy in overall GDP *prior* to the transition was estimated to be 10-15 percent; in Ukraine the unofficial segment of the economy had grown to more than 40 percent of overall GDP by 1994 and later it was estimated to be about one-half of overall GDP.

difference is paid 'under the counter' to the satisfaction of both employer and employee. Other examples of tax evasion relate to the illegal letting of flats, which is another very common practice, and the smuggling of textile goods sold on the street market, in which mostly the Vietnamese community is engaged. It is estimated that the monetary value of this tax and custom evasion could be about 10 billion of crowns. Nevertheless this 'underground trade' is doing extremely well thanks to the broad response of the public, or rather thanks to the permanent demand for cheaper textile goods, which is fulfilled by a host of individually operating small-time smugglers as well as crime-entrepreneurs. For the law-abiding public it makes no difference, as long as the price is low.

## **Response of State and Society to the Economic Crime**

There is little doubt about the extent and seriousness of economic crime, which increased rapidly in the last years. It is not possible to compare the figures found in 1989 or even earlier to the current situation, because of the fundamental change of economic relationships and statistics. Still, some rough trends concerning the quantitative relation between economic and other crime can be discerned: while until 1994 the proportion of economic crime in the total of all registered crimes did not exceed 5%, after that year it began to rise to 7,5% in 1997 and 8,5% in 1998. More significant is the amount of damage caused by economic crime. Since 1995 economic crime accounted for 60% and more of the total loss caused by criminality. Given the presumed large 'dark figure' in this field, which is certainly the case if there is no direct victim or only satisfied customers and traders, the problem must be much larger.

Again, the phenomenon of economic crime is not a characteristic of the Czech Republic. To quote J. Blum (1998): 'International financial fraud, commercial fraud, money laundering and tax evasion will be the most important enterprise crimes in the future... the number of these types of crime is growing because key elements that deter crime are missing from the international commercial environment. However, in our conditions, the widely prevailing economic crime put many achievements in the Czech Republic at risk. The victimisation of the Czech society is huge and widespread, material and non-financial. Promising firms became victims of organised business crime and went bankrupt, causing unemployment; banks collapsed because of 'tunnelling',

robbery of investors and frightening off new capital, while leaving numerous depositors deprived of their savings. The damage does not only victimise the private firms and households, but also the state, which in times of capital scarcity has to support defrauded banks, while it faces already a reduced budget due to tax evasion.<sup>8</sup>

If the material damage is staggering, the non-financial costs to the public consciousness and attitude to the state and entrepreneurial community is equally, if not more, serious. The publicised economic crimes have had a devastating impact on what may be called 'the public trust', which – given the communist heritage – was not very strong in the first place. Added to the personal and business losses was the weak performance of the law enforcement agencies, showing difficulties to detect and prosecute the wrongdoers, particularly the wealthy and highly-placed ones. Indeed, among the economic offenders, we find a new type of offender: qualified professionals, managers, very often first-time offenders, who occupy (and abuse) the responsible posts in the managing structures of companies and institutions. The low prosecution rate (and perhaps also the bungling of the police and prosecution) left the impression that these offenders are actually 'untouchable'. Only during the last two years the prosecution of some prominent people from the top managerial sphere has been started (the most apparent example is the prosecution of Viktor Kozeny, former „symbol“ of the Czech coupon privatisation). 'It is obvious that it is extremely difficult to gather evidence against this sort of people' Blum (1998). He remarks that despite highly publicised task forces, extraordinary rhetoric, and special budgets, only a handful of the bank officials were ever prosecuted, and the conviction rate was depressingly low.

The frail belief in the state of law and the trust in its institutions and guarantees, hesitatingly developing after 1989, can be weakened. Not only can the belief in the state as the guardian of law and democracy be harmed, economic crime has resulted in an increase of the public's low esteem of the business community. Of course, not every entrepreneur is an intentional lawbreaker, but according to political scientists, the possibilities to run a business in a fair and legitimate way are slim. In public opinion, being a successful entrepreneur is almost tantamount to illegality: how else could one have amassed wealth? The image of the successful entrepreneur with his sharp

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<sup>8</sup> See: *Economic Crime*, Council of Europe, 1991, p. 19.

financial transactions, being the owner of dubiously acquired property, has a negative impact on the social forces which are required to establish a healthy entrepreneurial middle class. It also radiates negatively on the prestige, social attractiveness, acceptability and authority of those circles in the entrepreneurial community which comply with the law. Consequently, the impact of this image on the creation of a desperately needed 'entrepreneurial ethos' is absolutely pernicious.<sup>9</sup>

The efforts of state authorities to control and suppress economic crime are from time to time hampered by the resistance of supporters of a completely free market without any regulations. For example, the initiative of the Ministry of Industry and Business to order the mandatory registration of tills in order to reduce (at least partly) the tax and custom evasions was not authorised by Parliament.

There is also the apparent lack of professionals and specialists in the banking sector and commercial law, who should be available to the police and the public prosecution. This lack of expertise is one of reasons why so few cases are successfully brought to justice, contributing to the image of the 'untouchables' and in high places.

To address these problems, changes of the Penal Code are being prepared, including the introduction of corporate criminal liability. This amendment has been broadly discussed, but a significant number of lawyers consider it too great a departure from the traditional liability concept of the penal law.

The government intends to re-establish the system of financial controls at all levels of public administration and to strengthen the protection of public and state assets. The number of prosecuted economic crime cases submitted to courts has been growing during the two last years. However, more efforts and time are required to overcome the long lasting negative image of state and business in the social consciousness.

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<sup>9</sup> See Shelley, Louise, I., *Organized Crime and Corruption: Security Threats, Trends in Organized Crime*, Vol.3, No.1, 1997, pp.35-38.

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# Crime-entrepreneurs and financial management

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## The problem

When the Berlin wall came down, many sighed with relief thinking that after the fall of the Soviet empire they would live in a safer world. They did not enjoy this peace of mind for long as professional troubleshooters detected new sinister threats. While the erstwhile subversive forces were clearly identifiable, namely coming from the Communistic Bloc, the new threat was emerging from all sides, frequently unnoticed, sometimes even from within: Organised Crime (Naylor, 1997). That is, the New Threat is considered the more menacing as it knows how to veil its anti-social character. It is supposed to penetrate society using the best leverage there is: *money*. To conceal the criminal origins of the crime-money, it uses all sorts of subterfuges to pretend a decent, legitimate source.

The prospect of the penetration of the crime-money, real or imaginary, created great alarm, or rather, the US thought it time to raise the alarm and the rest of the world duly followed suit. At the summit of the heads of states of the seven most industrialized countries at Paris in 1989, the US turned the problem of money-laundering – as a derivative of the pernicious drug trade – into a major ‘global problem’. The safety of the world was (again) at stake. As usual in the ‘war against drugs’, the other heads of states obediently followed the American lead and together they decided to establish the well-known Financial Action Task Force on Money-laundering, brief: the FATF.<sup>2</sup> Since

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<sup>1</sup> The author is professor of empirical penal law at the Tilburg University.

<sup>2</sup> The importance of the FATF should not be underestimated, as a matter of fact in terms of what it is *not*: it is not an organism accountable to some other responsible democratic organisation. It has been created by the heads of states of the G-7 and can be abolished or manipulated by them. In this capacity it can do as it pleases, issue reports without needing to listen to criticism (except

its beginning this task force has dominated the debate on money-laundering and what may be called the financial outlook on (organized) crime.

Putting the phenomenon of money-laundering on the political agenda was not a major innovation by the US. As a matter of fact, it had already been problemised into an international political issue by the Council of Europe in 1980. After the Vienna Convention of 1988 and the Basel Committee of 1988, the US jumped on the bandwagon on which it put its FATF flag.<sup>3</sup> The FATF report of 1990 aimed to quantify the enormous threat to the industrialised world by estimating the proceeds from drug trafficking at \$300 billion *per year*, the lion's share 'available' for laundering. Later estimates raised the number to \$500 billion or even higher (UNDCP, 1997). Whatever the validity of these claims, if we take these figures at face value, something must happen in the real world of finances and in the field of trade and industry. This staggering volume of crime-money, being pumped in and out of the financial upperworld year after year, must remain somewhere: if it keeps merely floating around it is not in a position to threaten anything. Despite the questionable assumptions (elaborated in the next section), policy makers nor scholars questioned the figures produced by the FATF and later by the UN. Few people tried to imagine what it entails for the criminal community to perform such a huge financial feat.<sup>4</sup> What kind of financial management is required to accomplish this? And suppose this management is successful (which is implied by the ever increasing estimates of the volume of crime-money, followed by more severe countermeasures), how does this work out tangibly in terms of sold and acquired assets and production factors? After all, in the real world

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from the heads of state), inspecting countries, evaluating their policy making, giving evaluative 'marks', put 'lax' countries on a black list and perform other tasks as if it were the global financial super-inspector.

<sup>3</sup> One may wonder why it took the US so long to declare this financial war. It is an interesting subject for historians to find out whether there is a connection with the end of the Cold War: the diminished need of secret services like the CIA to finance covert operations on the one hand and the intensified attention for money-laundering on the other hand.

<sup>4</sup> See Van Duyne (1994) for a recalculation of the FATF's estimates set out in the statistical addendum of its report. The highly questionable nature of its assumptions on which the calculations are based are as stunning as the gullibility with which these 'findings' have been endorsed. See also Naylor (1999).

anything of value has an owner, and shifts in economic relationships find their expression in corresponding shifts in ownership.

This article will address these questions by reviewing what has been established empirically in the last decade: what are the statistics on money-laundering; what has been established as the precipitation of crime-money in the upperworld (the dreaded penetration by organised crime) and what do we know about criminal financial management? The question of what is known will be addressed first.

## **What is known**

It is always interesting to observe the higher cerebral, cognitive energy people spend on the problems they face. However, that cognitive energy is not always commensurate with the valued magnitude of the problem. For example, the difference between the interest in the monster of Loch Ness and money-laundering is that, while those who take the Loch Ness monster seriously have never abated their zeal to find out something factual about it, while the believers in the monster of money-laundering hardly ever made a serious attempt to obtain a realistic insight into the nature and extent of that phenomenon. This is a peculiar state of affair. Having carried out some survey of facts and figures, I obtained such depressing yields, that one may reasonably wonder, whether the statements of responsible 'high level' policy makers, repeatedly expressing their grave concern, should actually be taken seriously.

As remarked above, the first attempt to make some quantitative assessment of the money-laundering problem has been carried out by the FATF in 1989/90. Though it might be considered a brave attempt to shed light on this difficult issue, as set out previously (Van Duyne, 1994) it looks very much like a politically manipulated investigation based on questionable assumptions, unreliable statistics and an incoherent application of arithmetic. Its basic assumptions were:

- the '*golden ten percent rule*': of the contraband only 10 % is intercepted. This is a dogma going back to the 1930s when it was mentioned the first time;
- the '*street level price calculation*': at this level of the drug trade there is virtually no laundering given the fact that most street dealers are also users;

- the *price level of expensive places*, like London, despite the fact that in most other reports Amsterdam is considered the 'Mecca' of the drug trade because of its much lower prices;
- the '*high-end multiplication*': this means that of any range of figures the multiplications are carried out by the *highest* ends of the scale resulting in deliberately systematic overestimations.

Having thus arrived at a global figure of the gross-proceeds of \$ 300 billion and \$ 122 billion for the US and Europe together, the FATF report states that for the last two regions 50 -70 % 'or as much as \$ 85 billion per year could be available for laundering and investment'. The reader may notice that not the 50 % but the 70 % has been taken as multiplier. The reader may also pay attention to the subjunctive phrase '*could be available*', containing a double contingency, which implies simply the *possibility* that there is a certain amount of money which *might* be laundered sometime. Anyone who has any experience with public relations can predict that such vague and cautious formulations use to be transformed into affirmative phrases: so much money *is being* laundered. Actually, this is the way in which the public menacing image has been created, which served policy makers well to attain their objectives. Later on, the initial subjunctive in this formulation has indeed been turned into a simple affirmative 'is', which has become canonized.

In view of this evaluation, the FATF-report should be considered a deliberate source of disinformation and deceit rather than of knowledge. This leads to the question whether there are other sources of information. And if that is the case, is this information validated?

We will first make a small tour around some of the Financial Intelligence Units to see what kind of quantitative data they have and subsequently we will try to answer the question about the validity of the information.

First I made a request to the main driving force behind the whole money-laundering issue, the USA. After repeatedly requesting the responsible agency, FinCen, for quantitative information for more than a year, the following reply left no doubt about the state of the statistical art or the level of knowledge in that agency: 'To my knowledge, no one at FinCen maintains statistics on money-laundering in the USA'. The author was referred to the Treasury instead. Though there are statistics on assets forfeiture, these cannot serve as indicators of money-laundering or of the volume of crime-money, certainly not in the US. For example, forfeited assets do not need to have been derived from crime:

smoking hash in my car or on my bike make these objects as liable for confiscation as the joint itself. The broom of the US-assets recovery regulation sweeps very broad indeed: according to some authors, the assets forfeiture policy has at some places degenerated into some kind of legalized police robbery (Naylor, 1999).<sup>5</sup>

If the lack of money-laundering statistics in the US is amazing, I placed my hope in the FATF. This turned out to be equally in vain. After the ill-designed, but politically very effective report of 1990, that august body has made no further public attempt to obtain insight into the extent of the problem they proclaimed in such piercing tones.<sup>6</sup> Though it continues to warn the world in its annual reports with unflagging zeal about new dangerous forms of money-laundering and has even assumed the power to put non-complying nations on the 'black list' (a procedure without appeal), no other zeal but a few weak complaints about the lack of figures could be detected. This can hardly be considered a realistic promotion of a proper statistical 'bookkeeping' of this high priority policy against a global phenomenon.

This state of knowledge was reaffirmed by a survey of the European FIUs by Europol. It proved to be impossible to obtain reliable statistics, let alone comparative ones, despite various proposals to remedy this state of affairs.<sup>7</sup> This was not due to hardware equipment. Though all European FIUs are equipped with computers, no use was made of modern statistical data analysis.<sup>8</sup> With the wisdom of hindsight this outcome is not surprising, given the absence of any basic knowledge of statistical analysis or skills for transforming raw

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<sup>5</sup> See the website of Forfeiture Endangers American Rights: [www.fear.org](http://www.fear.org) for on-going information on the application of the *In Rem* principle.

<sup>6</sup> The FATF appeared to have made one more attempt to quantify the problem. However, the professor assigned to this task produced too low figures, which were unacceptable to the FATF and the whole enterprise ended in dismal disagreement. (Personal communication).

<sup>7</sup> Various recommendations have been proposed to improve this state of affairs, such as proposed by the informal Money-Laundering Experts Group of 6 November 1998 to 'identify a uniform statistical model with minimum basic statistics formulated in a compatible manner' (Crimorg 173, 1998).

<sup>8</sup> Europol concludes in its 1998 report that 'the lack of statistical data makes it impossible to assess the effectiveness of the money laundering measures of the Member States (in Europe) in any depth. At present, there are only rough estimates based on fragmented numbers available which do not form an appropriate basis for policy making of Governments and Parliaments.'

data into strategic information and insight. Statistics are little valued by law enforcement agencies and considered the lowest clerk's job. This level of education and skill allows little more than just adding numbers, basically a manual job, though it is carried out on too big computers.

The Netherlands was to a certain extent an exception to this state of affairs. The police unit, handling the processed suspicious transaction reports, has established and maintained a statistical 'SPSS'<sup>9</sup> database, which could be used for strategic, statistical analysis. However, analysing the years 1994-1996 revealed to what extent an unprofessional database maintenance may lead to very misleading figures (Van Duyne and De Miranda, 1999). The database used for our analysis proved to be ridden with elementary flaws: double-counting because of wrong spelling of names; the same persons reported in various years being counted as separate persons; with VAT-fraud the whole turnover was considered suspicious money, instead of the evaded 17.5 % VAT; multiple transactions with the same money have been added as separate sums instead of counting them as the same sum. The cleaning of this 'suspicious' database of suspected transactions resulted in a reduction of the volume of suspicious transactions by 48 %: from ± €1.45 billion to ± €750 million. Of equal importance is the finding that many suspicious transactions did not concern crime-money in the sense that it was derived from a predicate crime, but those transactions were intended to *make* crime-money, for example by tax evasion or embezzlement. Concerning 37 % of the transactions, we had serious doubt about the criminal origin of the money or the laundering character of the transactions.

When we go back to the question raised in the title of this sections 'What do we know?', we can conclude that we do know very little indeed. Nor did we find many indications that leading policy making bodies or 'high level' officials felt really handicapped by this absence of knowledge. It is a not too daring conclusion that after a decade of the anti-money laundering crusade, the responsible authorities appear to ask as few questions about the real nature of the money-laundering phenomenon as the pre-FATF banker did about the origin of the money.

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<sup>9</sup> Statistical Package Solution Service.



## **What can be known?**

There is an old adage that knowing is measuring. Measuring itself requires a yardstick to determine what there is and what size the measured phenomenon or object has. It may be that our lack of knowledge is only partly due to the lack of interest or education. The way the problem has been formulated may also make it methodologically 'unmeasurable'. Put in other words: do we have a proper yardstick or definition, which lays down the criterion, which delineates laundering transactions and draws a line around the problematic area such that we can really measure?

Criminal law intends to delineate as precisely as possible certain behaviour as punishable so that citizens know what they are responsible for. In our field it must specify which behaviour is to be included in the 'circle' of laundering and what is to be left out. When we take as our basis the definition of money-laundering as formulated in the Convention on Laundering etc. of the Council of Europe, December 1990, of which the essential elements have subsequently been adopted by the European Commission, we observe a very large circle indeed.<sup>10</sup> In Chapter II article 6 we find the following description:

- the conversion or transfer of property, knowing that such property is proceeds, for the purpose of concealing or disguising the illicit origin of the property or of assisting any person who is involved in the commission of the predicate offence to evade the legal consequences of his actions;
- the concealment or disguise of the true nature, source, location, disposition, movement, rights with respect to, or ownership of, property, knowing that such property is proceeds;
- the acquisition, possession or use of property, knowing, at the time of receipt, that such property was proceeds;
- participation in, association or conspiracy to commit, attempts to commit and aiding, abetting, facilitating and counselling the commission of any of the offences established in accordance with this article.

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<sup>10</sup> The elements of this definition are in its turn derived from the UN convention against illicit trafficking in narcotic drugs and psychotropic substances 1988. Because of its restriction to drug offences some of my comments do not apply to this convention.

In Chapter I article 1, the concept of ‘proceeds’ is described as ‘any economic advantage from criminal offences’, while ‘property’ includes anything, ‘whether corporeal or incorporeal, movable or immovable and legal documents or instruments evidencing title to, or interest in such property’.

The question is not whether this definition has internal consistency or linguistic coherence, but whether it unambiguously indicates the boundary between laundering and other offences. For example does it differentiate between committing a predicate offence and subsequent attempts *not* to get caught by tampering with its outward appearance of the ill-gotten proceeds? A precise linguistic interpretation of this formulation will show that this boundary tends to become blurred. The reader will also have noticed that, while all authors and annotators discuss the concept of *money*-laundering, the prefix ‘money’ does not occur in the convention, which mentions only ‘*laundering* offences’. The word *money*-laundering does occur in the guideline of the European Council, but by subsequently adopting the definition of the concept of ‘proceeds’ as an equivalent for ‘objects’ from the Convention text, it embraces *all* criminally obtained goods, rights and advantages and not just *money*. This implies that according to this convention and EU-guideline laundering is more than money-laundering. So, what is meant by it?

The text of the applicable articles shows us the way. Going through the sections (a)-(c) of the Convention or article 1 of the EU-guideline, the kernel can best be summarized by: ‘Any conduct which is instrumental in keeping any accrued illegal advantage hidden from the authorities is punishable as laundering’. This is a deviation from the monetary meaning of money-laundering, resulting in the coverage by the laundering clauses of a wide range of conduct inherent in or directly connected to crimes for profit. The simplest example is changing the identity of a stolen object, either for own use or for selling it. When I steal a bicycle and want to use it without it being recognized by the rightful owner, I paint it red (my favourite colour). This is covered by the anti-laundering code, even if I ‘launder’ my ‘own’ stolen object. This is because the laundering articles can be applied *reflectively*: the offender is punishable if he himself ‘conceals, disguises’ etc. the proceeds of his own crime.

The reader may not in the first place think of the student (instead of the author) who repaints his pinched bike (not an out-of-the-world example), but of (organized) professional car or art theft. The chassis number must be replaced by another, papers have to be forged, stolen objects of art must get faked origins or must be changed such that its identity is not recognizable

during export or auctions, etc. (Conklin, 1994). As long as the stolen object has not got a new identity, it must be hidden. Is that laundering? That is not certain as it depends on how one hides, but *not telling where it is hidden* if asked for (concealment of the location) is certainly laundering, having the amusing result that you can hide your stolen object, but if asked for by the competent officer you must tell where it is, otherwise you are committing a laundering offence! It is a fair conclusion that only the remorseful thief, who in tears immediately after his crime goes to the police station to hand in his stolen property or tell the location where it is hidden, may escape a laundering charge. Meanwhile the legislation has silently moved over the edge of forced self-incrimination.

In larceny cases the act of stealing and laundering are physically and temporarily separated: first stealing than hiding or 'identity change'. When we subsequently look at fraud, we observe a more intriguing legal overlap of the predicate offence (tampering with invoices, annual accounts, tax returns or any other false paper work), and laundering. If I forge invoices of mineral oil (from diesel into domestic fuel oil; see the paper of Scheinost and Baloun) I pay less excise and obtain an illegal advantage. As soon as my tax return hiding that advantage has been accorded by the tax inspector, these 'proceeds', crime-money, is laundered. Similarly, in cases of subsidy fraud the act of defrauding (submitting the false paper work) and the act of laundering overlap: as soon as the subsidy agency (for example for a pretended meat export) assigns the subsidy the money is 'cleaned'. The act of defrauding and laundering interact so intricately that they virtually coincide. Depending on the nature of the fraud the overlap can be wholly or partially. However, because of the complexity of the administrative rules, the overlap may only be temporally. For example, the fraudulently accrued company assets may have to be justified to another agency (for example the income tax inspector) at a later moment by again including the previously forged documents in the paper work. In the area of fraud, the coverage of the money-laundering clause is in this way very pervasive: the hiding of the dirty money has oftentimes to be repeated. Suppose I falsely mention a regular 5 % loss of the transported fuel, due to alleged carelessness of the workers at the port of transshipment, which is accepted by the tax inspector because it is difficult to disprove. The saved 5 % is sold on the black market, from which I get undeclared revenues, while the 'reduced' profits create an illegal saving for the company tax. The undeclared money itself is kept in the till. Subsequently the entrepreneur spends it on enlarging the plant, which

requires no or lower, i.e. forged, invoices for materials, because part is paid 'black', under the counter. This creates new proceeds. The subsequent tampering with the books may again be qualified as laundering. This time the company which accepts black payments, while issuing too low invoices, can also be charged with laundering as it assists in hiding the crime-money of the firm as well as accepting part of that crime-money. In addition, one may raise the question whether an offender should be prosecuted on both counts, if the act of defrauding and laundering do not completely overlap, but constitute a logically connected sequence of events. For example, when the fraudster has to commit subsequent frauds in order to keep the book balanced, his subsequent fraudulent acts can technically be subsumed under 'laundering'. The same applies to his bookkeeper and probably also to the tax consultant in case his advice proved valuable to a 'creative' balancing of the books.

Where does the application of the laundering act end? To realize the broad and uncertain reach of the laundering clauses we may think of all the ill-faith users of stolen intellectual property rights: anyone downloading software or music, illegally put on the internet and knowing it is derived from violating these rights, may be punishable for laundering.

If these annotations are correct, we face the problem of undeterminability. In that case the phenomenon of laundering is simply unmeasurable. Even if we restrict the laundering to monetary acts, we still have a problem of measurement due to the overlap of predicate offences in the field of economic crime and what has been designated as laundering.

One may argue that this is all legal theory and that the law does not concern the repainting of stolen bikes or similar petty crimes, but *big* crime and *big* money. Apart from the finding that this does not hold true –the laws on confiscation are more often applied to 'small fry' than to 'Mr. Big'<sup>11</sup>– we add another confusion in the form of the concept of 'big'. The real flaw in the law is the attempt to cover all and everything and thereby undermining the principle of *lex certis*. The simple solution to this problem may be to reconsider the legal construction by starting from the essential meaning of laundering or (the literal Dutch translation) 'white-washing': namely the *false justification* of someone's criminally derived increase of wealth. 'Self-laundering' is considered a *derivative* act in order not to get caught, which should therefore not be criminalized, as

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<sup>11</sup> This was the finding of Vrugink (2001), who investigated the impact of the recovery of the crime-money on the perpetrators.

long as the perpetrator does not induce someone else to perform any 'laundering act'.<sup>12</sup> That could simply be prosecuted as incitement to commit the criminal act of laundering or 'fencing', adding transparency to simplicity.

As far as our 'knowledge question' is concerned, the lack of clarity is compounded by the law enforcement authorities, adding their own obstacles in the form of an inadequate registration and poor information management. As observed earlier, there are databases on suspects, on suspicious transactions, in some jurisdictions even on prosecutions and convictions, but it remains difficult. However, few if any can be connected with or translated into an analysable total database for answering specific questions like: the extent and the statistical parameters of money-laundering differentiated per category of currency, nationality of offender and other relevant descriptive features.

Given this state of affairs, we have to face the conclusion of a 'policy of ignorance', forcing policy makers as well as researchers to grope in the dark, an outcome not unfamiliar in criminal financial policy areas (Van Duyne, 1999). However, contrary to policy makers, researchers cannot rely on politically acceptable 'make-beliefs'. They have to find facts and figures.

## **What there is and what they do**

The previous sections elaborated some of the politically endorsed 'make-beliefs', like those presented by the FATF or the UN. When we look at more serious studies, we find some attempts to summarize the official statistics as maintained in England and Wales (Levi, 1997), the US Bureau of Justice Statistics (Tonry, 1997) or the Central Directorate of the Criminal Police in Italy (Paoli, 1997). From these publications one can deduce, that the researchers had to resort to rather rough descriptive statistics with few distinguishing capabilities. From these simple 'frequencies' we can glean some of the results of confiscation orders: like the vast amounts of moneys seized by the US Customs Service and the DEA (\$ 520 million by the Customs and \$ 650 million by the DEA) or the more moderate sums in England and Wales (£ 12 million

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<sup>12</sup> As far as the offender and the consequences of his criminal act are concerned: cleaning the money-trail is just as normal as sweeping fingerprints after the crime. This is not punishable either, unless we accept the principle that it is a criminal offence to not assist in one's own conviction.

in 1993). Though these figures look impressive (England excepted), they do not tell us much about the volume of the potential *crime-money/assets*, let alone the extent of *money-laundering* or the criminal financial management. These gross totals are composed of more than crime-money. They may also contain seized objects related to crime: for example, a forfeited car may be bought with clean money or belong to the neighbour who should have known that it was instrumental in the commission of the crime.

In order to obtain more insight into the economic role of the crime-money and the criminal financial management, the Tilburg University, together with the Central Intelligence Service of the Dutch police, has initiated some research projects. The first project, the analysis of the database of suspicious transactions of 1994-1996, has already been mentioned. Apart from the necessary corrections of the inflated database and the official figures, it provided a number of insights while raising new questions.

An interesting finding concerned the *cash* versus *electronic* banking transactions. Contrary to the general emphasis on the cash based underground (drug) economy, the database showed the importance of non-cash, banking transactions: though 24 % of the suspect transactions concerned electronic interbank transfers, these accounted for more than 53 % of the money-volume. It goes without saying that because of its physical nature large cash transactions are more visible and labourious as well as risky and arousing suspicion. Do the suspicious transaction reports provide an indication how this part of the financial management is carried out? The data themselves proved to be too poor for deeper analysis, but a comparison of the persons in the disclosures with the income-tax files of the Inland Revenue Service provided the following cross-table of income versus the reported amount of suspected money.

Table 1 shows that most subjects handling cash transactions are situated in the lower income levels, either based on their stated income or because of their social security allowance. This income compares badly with the amount of money they handled. Even if they may not be charged for money-laundering, they will certainly have to answer many penetrating questions, if they will not be charged with tax or social security fraud. This is not a hypothetical proposition, given the finding of a large proportion of the cash-depositors, who receive a social security benefit: 47-49 %. This social security group has to a large extent been involved in *foreign* currency cash transactions: in 45 % of the suspicious transaction reports of this group (total value €10 million), 35% of these subjects carried out *Dutch* currency cash transactions (total value

€7.3). Persons registered as entrepreneurs were mainly involved in Dutch currency cash transactions: 51% of their transactions, yielding €13.6 million. Contrary to the expectations of ‘global money flows’ the foreign cash transactions of the entrepreneurs were less important: 34 % of the transactions for a value of €9.1 million.

**Table 1**  
**Income versus money-moving**

*The median and the volume of the money, differentiated by income*

Income	%	md.€	T ml €	%	md.€	T ml €	%	md.€	%
<€11,400	50	15	73	51	45	5	35	91	23
€11,400-23,000	17	127	32	21	182	36	24	205	55
€23,000-23,000	23	218	41	9	227	18	16	214	23
€34,100-45,500	4	264	123	2	617	18	12	45	82
> €45,500	6	223	14	17	241	32	13	227	10
Total N+ 100%	654			574			368		

It would be interesting to carry out a deeper analysis of these two groups (entrepreneurs and lower income/social welfare receivers). It is a plausible hypothesis that an important recruitment process of lower income/welfare persons had been going on to make deposits of foreign cash, while (part of) the entrepreneurs’ reported transactions are related to economic crime or tax evasion. Unfortunately, the database does not allow such an analysis.

In general the importance of persons, either as couriers or as ‘own launderers’ proved to be less significant than that of corporations. Persons reported for suspicious transactions accounted for 57 % of the transactions, but represented only 31 % of the money volume. The legal entities proved to be more important in monetary terms. As a matter of fact, the frequency distribution was even more skewed than these figures suggest. Analysing the 87 ‘big money’ cases of more than €500,000, we found that the 178 persons and related companies involved (8 %) accounted for 89 % of the money-volume. This leads to the conclusion that ‘many move few and few move much’. The

division of criminal income appears to be as unevenly distributed as in the upperworld.

An intriguing question concerns the hypothesis of the supposed ‘waves’ of foreign transactions. This was only partly underpinned by the findings of the database as indicated already in one of the sections above: *Dutch* legal entities accounted for 55 % of the money volume. Foreign enterprises accounted for only 8 % of the money volume. This figure is somewhat biased because of one large Indonesian transaction of €98 million, which could also be attributed to the recipient British corporation (€28 million remained in the transferring Dutch firm). Despite this and similar uncertainties, it casts some doubt on the general belief that there is a continuous global trekking of huge amounts of crime-moneys around the globe. I do not deny that much money is roaming through many jurisdictions, but if it is such a dominant universal phenomenon, while the volume is supposed to be of a staggering magnitude, why do not we find stronger evidence?<sup>13</sup>

This brings us to the next question of the criminal financial management: what is the economic destiny of all these hundreds of billions of crime-moneys (in US dollars) generated year after year? Where do these moneys precipitate to become an economic factor in real life, instead of merely being pumped around the world? After all, money is like cattle: if it does not rest, it does not grow, while the legitimate financial institutions (and their shareholders) grow ‘fatter’ by charging fees for their job of pumping around.<sup>14</sup> To address this question it is necessary to do some basic research on a micro-level. This means analysing per criminal entrepreneur or crime-enterprise what has been done with the crime-money. In order to answer this question the *Tilburg University* started the ‘*precipitation of crime-money project*’ (Van Eekelen, 2000).

In the first reconnaissance phase carried out by the *Tilburg University*, the forfeiture verdicts, which had been finalised by the (appeal) courts, were taken as the ‘factual’ basis. Even if one can disagree with the wisdom of judges, what

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<sup>13</sup> The analytical and methodological problems in the field of international money-flows are almost unsurmountable. One may even question the ‘international’ nature of transactions in the monetary union of the EU, certainly after the introduction of the Euro.

<sup>14</sup> It has always been taken for granted that this ‘money-pumping’ might corrupt the financial system. How this could be accomplished if the electronic money-transfers do not differ in any way from any other transaction remains to be explained.



has been determined in court is at any rate a legally established state of affairs. That is what the courts are for. The next question was, whether we should analyse all the settled forfeiture cases. Based on our previous research on organized crime, we determined a financial base line: under f 100,000 or € 45,378 (rounded up to €50,000) the economic conduct of criminals is in most cases very predictable. Crime-money to that amount precipitates or flows directly into the economy by spending on daily needs, even if these are extravagant in middle-class terms. This baseline limited the number of cases, but it did not distract us toward describing the obvious 'spilling and spending'. The next selection criterion consisted of those cases, which had been transferred to the Justice Collection Office. This contains also a limitation, because cases in which the convicted criminals made huge fortunes, which have been dissipated on a conspicuous life style and bad luck leaving no assets for recovery, may not be offered to this Collection Office.<sup>15</sup> The same applies to organised tax fraud cases and brand piracy, in which the recovery is executed by the Inland Revenue and the Agency for Intellectual Property. The last selection constraint was given by the database of the Justice Collection Office, which at the time of investigation (1999) was complete till September 1998. This resulted in 21 cases (23 convicted persons) with a recoverable illegal profit of more than €50,000.

Of the 21 cases 2 had a recoverable illegal profit of more than €500,000. The majority, 15 were in the range of €50,000 - 100,000 and four between € 100,000 - 250,000. This is in agreement with previous research on a larger database, in which 1 % of the recovery cases concerned illegal profits of more than €500,000 (Nelen and Sabee, 1998). Most defendants had been convicted for drug trafficking (13) or fraud (5).

What did the criminals do with their crime-money? This is represented in table 2.

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<sup>15</sup> This is a possibility, though a rare one. Particularly criminals with a conspicuous life style have generally also concrete assets to be seized during searches: cars, jewellery and frequently cash. After conviction and forfeiture sentencing, such cases end with the Collection Office, even if the seized objects represent only a minor fraction of the determined criminal income.

Table 2

## Pattern of spending crime money in €

€ Kind of spending	50,000- 125,000 (N=16)	125,000- 250,000 (N = 5)	250,000- 500,000 (N = 0)	>500,000 (N = 2)	Total (N = 23)
Luxury items	13	4	-	2	19
Capital export	3	2	-	2	7
Cash money	6	2	-	2	7
Bank account	3	-	-	2	5
Crim. Reinvestment	2	1	-	-	2
Real estate	3	2	-	1	6
Investment in firms	4	3	-	1	8

Not surprisingly spending money on luxury items was the most frequent. In 16 cases expensive cars were the most favourite, but not always. In 7 cases the criminals preferred to save the money, either hoarding it cash at home or putting it on a bank account. Other luxury items which were confiscated consisted of jewellery. These were not considered hidden investments like savings for a rainy day. This jewellery, together with other visible spending on dinners and holidays are actually functional in showing off one's success and credibility: 'I am a successful businessman'. In only two cases did the crime-entrepreneurs spend a fair amount of money on assets as a form of long-term investment: paintings (€125,000) and valuable old-timers, of which a number still had to be restored.

The cash 'capital export', consisting of the traced money in foreign bank accounts as well as the purchase of real estate abroad can overlap. Part of these money-movements are carried out by ethnic minorities, investing it in their home-lands and safeguarding their future retirement or just supporting their extended families at home, as is also observed in other studies (Suendorf, 2001).

In six cases the crime-money had been invested in real estate. In two cases this investment consisted of the acquisition of a holiday cottage in Belgium

and Aruba. In three cases parcels of land had been bought of which the intended usage was not always clear. Of a Turkish crime-entrepreneur (XTC-traffic) it was known that the parcels of land were bought for building villas, a common investment pattern as has also been described by Suendorf (2001). Another trafficker, a hash-wholesaler, used his crime-money to buy premises in the Netherlands, in which bars and restaurants were located.

Economically more interesting are the investments in either legitimate enterprises or the own crime-enterprise. In only three cases an investment in the own crime-enterprise could be observed. Two hash-dealers owned a coffee-shop, which are in the Netherlands retail outlets for this commodity, and a trader in stolen cars had a garage and a transport company. These investment are not surprising as they are directly instrumental to the continuation of the crime-trade. Some hash-wholesalers have an understandable interest in coffee-shops to secure an outlet. The reverse is also observed: coffee-shop owners invest in hash trafficking to secure their supply. The stolen car trader with a garage of his own needs similarly the facilities for hiding and providing the stolen property with a new identity.

In three other cases more substantial investments in the legitimate upperworld could be observed. These investments were not instrumental to the continuation of the crime-enterprises and were made to become a shareholder in a company. The nature of the business of the enterprises was quite traditional for the criminal milieu: catering, disco and a brothel. The exception was a firm for interior decoration. As far as could be assessed from the profit sharing accounts, the criminal investors never acquired a larger share of interest than 50 %.

In the cases with the highest amount of crime-money (over €500,000), the criminals established companies of their own or took over small loss-making firms. The previously mentioned Turkish XTC-trader established in Turkey a company for foreign currency and gold (apart from buying parcels of land). This firm was registered in the name of his brothers, which was his only 'laundering act'. Only the Dutch hash-wholesaler displayed a more sophisticated form of money-management and upperworld investment: a firm in gambling machines, a chain of Italian food stores and a small loss-making advertisement firm. To accomplish this and to manage his criminal income of €4 million, the crime-entrepreneur had to organise a real money-laundering system, the only one observed in this small data-base. His laundering scheme consisted of the trusted loan-back method: depositing money in a tax-haven, establishing

off-shore companies and loaning the money to Dutch enterprises which were owned by other off-shore companies, which he himself controlled through trustees.

What conclusions can be drawn from this reconnaissance? Granted it is a bit hazardous to extrapolate the findings from such a small database to the whole criminal entrepreneurial population. Nevertheless, if we compare these outcomes with the research on organized crime-entrepreneurs carried out earlier (Van Duyne, 1996; 1997), we still have very little economic 'feats' which underpin the threatening image of 'organized crime-on-the-march toward the upperworld'. Of course, we do have the traditional references to the Mafia (Italian and American), the Yakusa and the Triads to which the questionable 'cartels' of Colombia are added. In addition self nominated or interviewed 'experts' use to express their concern about the financial 'sophistication' of the crime-entrepreneurs (Dini, 1997; Suehndorf, 2001). Experts always do so. Nevertheless, every time when one goes into a detailed case-by-case analysis, one finds only a few examples of crime-entrepreneurs who have established or have taken over legitimate companies and who reveal some financial sophistication. These investments outlets appeared to be small or middle size, often loss-making firms in branches which are traditionally attractive for criminals: real estate, catering, gambling and sometimes a business which has some connection to their previous enterprises, like a transport company or a garage.

This reconnaissance is followed by a more extensive research project carried out by the Central Intelligence Service of the Dutch police. In this project we have access to a larger database, consisting of the finalized confiscation cases (as before), the cases already dealt with in the lower courts, but which are taken to a higher court and cases handled by the Inland Revenue Service and dealt with administratively (out of court with a 'administrative fine' of 100 % of the evaded taxes). Learning from the reconnaissance project and looking for evidence of some more sophisticated 'precipitation of the crime-money in the upperworld', we have raised the threshold from €50,000 to €500,000. Below the sum of €500,000 the 'economic life' of the crime-entrepreneurs shows again too few indications of real 'upperworld penetration'. Otherwise the methodology of this extended project is similar to the preceding research project. Of the approximately 160 cases with an estimated amount of criminal proceeds of more than €500,000 we selected 52 cases for further analysis.

At the time of writing the project is still in progress; releasing temporary results would therefore be premature. Suffice it to remark that there is still little evidence which falsifies the hypothesis of Van Duyne that ‘underground’ entrepreneurs, the crime-entrepreneurs from the unregulated prohibited commodities markets, reveal little skill or inclination to venture with their crime-money much further than the traditional outlets outlined above (Van Duyne, 1997). Granted, there are a few remarkable exceptions of upperworld business investments or attempts to do so. Some of these were ethnic minority crime-entrepreneurs who transported their crime-moneys to their home countries to invest it in the local trade and industry, like hotels, a fishing processing factory.

This contrasts with the organized *business* crime-entrepreneurs and criminal ‘legitimate’ entrepreneurs, who have the available outlets and business acumen. They do not *penetrate* the upperworld: they are already right there. Even then only a few used their crime-money to obtain a criminal competitive advantage for their firm. Among the many organised VAT and excise fraudsters I studied thus far, I found no crime-entrepreneur who made strategic investments, for example by establishing a new firm, which was backed up with crime-money.

I do not claim that these Dutch findings may be representative of other Western European or North American jurisdictions. As a matter of fact it is difficult to find comparative data, apart from the German investigation of Suendorf (2001).<sup>16</sup> However, the crude categories of seizures, presented by the DEA certainly do not contradict the picture of our simple ‘homo economicus criminalis’: much cash, real estate, foreign currency and fast cars to drive in. Maybe some more sophisticated economic conduct is hidden in their category ‘other financial currency’, but that may have been too sophisticated for the DEA to recognize and mention.

Even if law enforcement officers and policy makers use to be convinced of what constitutes (their) truth, based on the ‘threat images’ presented by the threat assessment industry, researchers have to resort to hypotheses, which have to be tested. One of our hypotheses is that most crime-entrepreneurs from the *underground cash based economy* lack the education and sophistication, but also the cultural backgrounds and interest to become involved in

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<sup>16</sup> The Dutch findings do not deviate from the opinions expressed by many German experts interviewed by Suendorf (2001) or –more important– the actual cases she presents in part 3 of her dissertation.

upperworld economic life. Crime-entrepreneurs from the legitimate industry, organized fraudsters for example, stand a better chance to integrate their crime-moneys in an economically efficient way in their legitimate surroundings of which they are a part. And even then many fail dismally because of greed and overconfidence.

## Discussion

Thus far we have made only a few small steps towards more insight into the criminal financial management. Is this due to the sophistication of the crime-entrepreneurs. As could be observed, only a small criminal elite displays the cunning and craft in the art of higher money-laundering. The argument that the problem is much bigger, but that we only get the 'obvious suspects', who are not clever enough to launder their crime-moneys properly, still sounds somewhat like the 'Terrible Snowman' or the 'monster of Loch Ness' reasoning. If the laundering problem has the extent the FATF and the UN (UNDCP) wants us to believe, we have an *economy of scale* problem, which should entail unaccountable shifts of currencies and huge acquisitions of property in economic regions which yield the highest profits: the industrialised, politically stable, and fiscally well controlled regions of Western Europe, Northern America and Australia. What is the tangible, unambiguously documented evidence for this assumption? Thus far we have come across a few examples of enormous illegal wealth, professionally laundered and invested in the upperworld (mainly real estate). However there is no supporting evidence to consider these criminals as the vanguard of the 'host' of other criminals ready to penetrate our 'clean' economy. As a matter of fact, many prefer to remain on the fringe of our 'clean' economy. As Kelly et al. (1994) conclude: 'So far, organized crime's infiltration of legitimate business seems to be limited to small companies'. This may suit their purposes better as 'big business' entails high visibility. Also the management of the crime-money is better served by remaining in the shadow (a shady business indeed) than developing power positions by corruption, either for handling their crime-money (for example

through ‘underground banking’)<sup>17</sup> or by investing for a rainy day after retirement.

The anecdotal observations of the small elite of Mr. Bigs do not answer the question of the whereabouts of the crime-moneys and how these are managed. As a matter of fact, I think this is too broad a question, which needs to be broken down into sub-questions. Criminal money management reflects the surrounding economy, the legal system and the organization of law enforcement, as well as the culture and expectations of life of the crime-entrepreneurs. The latter must have saved sufficiently from their *net* profits in the first place. How much net crime-money remains for saving and investment after criminal business and lifestyle expenses? To our knowledge crime-enterprises have high business costs. A large part of the business costs is spent on staff and conspicuous display of one’s success. One may interpret this as the ‘evaporation’ of the crime-money. This interpretation does no justice to some criminal economic aspects. In the first place the money does not evaporate in the sense that it disappears in thin blue air. It simply returns directly to the legitimate upperworld being spent on taxed objects and services. In the second place, when it is spent on ‘staff expenses’, the recipients do not get so much money that they have a laundering problem: they also spend it in the upperworld. To the crime-entrepreneur rolling observably in wealth, this conspicuous conduct does not always constitute a whimsical spilling of money: it may have a function in boosting his reputation as a reliable and creditworthy businessman. As a matter of fact it is not unlike the squandering of money of some big legitimate companies, showing off their economic weight. After all, crime-entrepreneurs and legitimate entrepreneurs are both human.

To understand the phenomenon of money-laundering, we have to leave the ‘threat image’ and generalized assumptions behind us and concentrate on the tangible social-economic and human aspects of crime-entrepreneurship. This can only be accomplished by creating a proper information management which allows us to make a more detailed description of ‘what there is and what they do’.

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<sup>17</sup> See: Passas (1999), who argues that also the phenomenon of underground banking is rather demonized. As a matter of fact, it is no banking at all, but an old trusted form of informal value transfer, usually resorted to for legitimate reasons, though criminals may abuse its facilities alongside the official banks.

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# **The protection of the EU financial system from the exploitation of financial centres and offshore jurisdictions by organised crime**

*Sabrina Adamoli<sup>1</sup>*

## **Introduction**

The scope of this contribution is to analyse the risk that facilities in financial centres and offshore jurisdictions are abused in money laundering operations by organised crime, to the detriment of the EU financial system.

Money laundering is a world-wide problem. Through legislative measures the international community and single countries have attempted to construct a ‘protective net’, aimed at preventing illicit proceeds from infiltrating financial systems. Nevertheless this protective net still has some weak connections and big holes that could be exploited by organised crime groups. Weak connections are those financial centres where standards of transparency are not fully implemented. Big holes are those fiscal and ‘criminal’ havens which offer two main facilities: tight bank secrecy, refusing investigation by foreign authorities, and avoidance of legal responsibility regarding the activities which are carried out using off-shore companies (Bernasconi, 1997: 251). The demand for these facilities – also, if not primarily, for the purpose of assisting criminals – may be growing due to the combination of the increasing needs driven by tax evasion, corruption and fraud and the tighter controls imposed on the non off-shore financial centres. The increasing divergences in regulation between different financial centres in the world might create the risk of control systems becoming weaker.

In order to analyse the risk that facilities in financial centres and offshore jurisdictions may be (ab)used in money laundering operations, this contribution is structured as follows. Section 2 deals with the problem of the ‘exploitation’ of these jurisdictions for money laundering purposes as it is perceived and

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studied by the international community, which considers the existence of 'under-regulated' and 'non-cooperative' financial and offshore centres a serious issue. Section 3 describes respectively the demand by organised crime of money laundering services and the supply of facilities by financial centres and offshore jurisdictions. Section 4 analyses the point at which the demand for laundering the proceeds from crime could meet the supply of financial services furnished by financial centres and offshore jurisdictions. This is the point at which *regulatory asymmetries* existing in these jurisdictions may be exploited by criminals in order to reduce the 'law enforcement risk'. Regulatory asymmetries may be defined as the differences between a certain type of regulation in one jurisdiction and the standards established by the international community to protect financial systems. Section 5 describes the research conducted on this issue by Transcrime – University of Trento, which was aimed at determining and explaining in which jurisdictions and sectors of regulation these asymmetries are to be found, and the results achieved. Section 5 delineates the general conclusions of the study, followed in section 6 by some considerations regarding policy implications.

### **Financial centres and offshore jurisdictions on the international community's political agenda**

The phenomenon of financial centres and offshore jurisdictions is nowadays on the agenda of numerous national and international organisations. Their main concern is the existence of jurisdictions whose legislative system guarantees anonymity in financial matters. Moreover, preoccupation comes from the fact that the recourse to these jurisdictions is not, as in the past, a privilege of few people who used it essentially for legitimate fiscal purposes, but involves today a high number of subjects who may not always have legal motivations.

Thus, financial centres and offshore jurisdictions are in first place on the political agenda of numerous international organisations which deal with money laundering and which supervise and regulate international financial markets. Not all of these organisations face the problems of financial centres and offshore jurisdictions from a money laundering point of view. According to their specific competence, they focus on one or more of the following aspects.

The OECD, for instance, concentrates on the ‘offshore problem’ from a purely fiscal point of view, while the United Nations and the FATF deal with aspects related to company, criminal and administrative law, which are relevant in the fight against money laundering and, therefore, in terms of the protection of the transparency of financial systems and international co-operation.<sup>2</sup>

The United Nations have been actively engaged in the analysis of money laundering in general and of financial centres and offshore jurisdictions in particular. The report issued by the United Nations Office for Drug Control and Crime Prevention stresses the potential role of financial centres and offshore jurisdictions in money laundering, stating that “*criminal organisations are making wide use of the opportunities offered by financial havens and offshore centres to launder criminal assets, thereby creating roadblocks to criminal investigations. Financial havens offer an extensive array of facilities to foreign investors who are unwilling to disclose the origin of their assets. [...] The difficulties for law enforcement agencies are amplified by the fact that, in many cases, financial havens enforce very strict financial secrecy, effectively shielding foreign investors from investigations and prosecutions from their home countries.*” (Blum, Levi, Naylor, Williams, 1998: 1).

In 1998, the OECD produced the report *Harmful Tax Competition* (OECD, 1998) which examines harmful tax practices in the form of tax havens and harmful preferential tax regimes in OECD member countries and their dependencies. The report focuses on geographically mobile activities, such as financial and other services and is relevant for two reasons. In the first place, it defines the factors to be used in the identification of harmful tax practices. In addition, it sets out nineteen wide-ranging Recommendations to counteract such practices, divided into three categories (OECD, 1998: 37-55):

- recommendations concerning domestic legislation, aimed at increasing the effectiveness of the existing national measures;
- recommendations concerning tax treaties, aimed at ensuring that the benefits deriving from these treaties do not involuntarily cause opportunities

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<sup>2</sup> Given the different point of view adopted, these organisations also use different terms to identify financial centres and offshore jurisdictions. The OECD calls these jurisdictions ‘tax havens’, because tax is its main concern. The United Nations call them ‘financial havens’, to give prominence to banking and company law. The FATF instead calls them ‘non-cooperative countries and territories’ because the main concern is the scarce international co-operation and the insufficient adherence to international standards.

to introduce more favourable tax practices, and at utilising more effectively the rules regarding the exchange of information;

- recommendations for intensification of international co-operation.

The Report concludes that “*there is a strong case for intensifying international co-operation when formulating a response to the problem of harmful tax competition, although the counteracting measures themselves will continue to be primarily taken at the national, rather than at the multilateral level. The need for co-ordinated action at the international level is also apparent from the fact that the activities [...] are highly mobile. In this context, and in the absence of international co-operation, there is little incentive for a country which provides a harmful preferential tax regime to eliminate it since this could merely lead the activity to move to another country which continues to offer a preferential treatment*” (OECD, 1998: 38). On the basis of the factors identifying jurisdictions as tax havens a list of 35 jurisdictions to be considered ‘tax havens’ has been elaborated<sup>3</sup>, which is contained in the report *Towards Global Tax Co-operation. Progress in Identifying and Eliminating Harmful Tax Practices* (OECD, 2000).

The Financial Action Task Force on Money Laundering (FATF), the leading international body on anti-money laundering, has also been concerned with the issue. On 14 February 2000 a first report was published (FATF, 2000a), highlighting twenty-five criteria, which covered such aspects as loopholes in financial regulation (e.g., inadequacy of rules on customer identification and on financial intermediaries), the obstacles raised by regulatory requirements (e.g., inadequate or no requirement for the registration of business and legal entities and the identification of their beneficial owners), the obstacles to

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<sup>3</sup> The jurisdictions are, in alphabetical order: American Virgin Islands, Andorra, Anguilla, Antigua and Barbuda, Aruba, Bahamas, Bahrain, Barbados, Belize, British Virgin Islands, Dominica, Gibraltar, Grenada, Guernsey/Sark/Alderney, Isle of Man, Cook Islands, Marshall Islands, Jersey, Liberia, Liechtenstein, Maldives, Montserrat, Nauru, Netherland Antilles, Niue, Panama, Principality of Monaco, Samoa, Seychelles, St. Lucia, St. Kitts and Nevis, St. Vincent and the Grenadines, Tonga, Turks and Caicos Islands and Vanuatu. Other six jurisdictions, although possessing all the requisites to be included in the list, have been excluded thanks to an ‘*advance commitment*’, that is a public engagement undertaken on 19 June 2000, which will oblige them to eliminate harmful tax practices and to conform to the standards established by the OECD by 31 December 2005. These jurisdictions are Bermuda, Cayman Islands, Cyprus, Malta, Mauritius and San Marino.

international co-operation at both the administrative and the judicial levels (e.g., existence of laws or practices prohibiting the international exchange of information), and inadequate resources for the prevention and detection of money laundering. Particular attention was paid to the obstacles posed by administrative and judicial institutions, which prevent the exchange of information and slow down money laundering investigations.

On the 22 June 2000 this report (FATF, 2000b) was published in its final version, as an Annex to the Annual Report 1999-2000. The report identified fifteen jurisdictions, which are strongly encouraged to improve their anti-money laundering systems.<sup>4</sup> Until these jurisdictions have improved their tools to fight money laundering, the FATF recommends that “*financial institutions should give special attention to business relations and transactions with persons, including companies and financial institutions, from the ‘non-cooperative countries and territories’*” (FATF, 2000b: 13).

The European Union has been a leading institution in the fight against money laundering since 1991 when the Directive 91/308 was enacted. Action against money laundering through financial centres and offshore jurisdictions was taken with its Action Plan to Combat Organised Crime of 1997 (Council of the European Union, 1997). Recommendation no. 30 of this Action Plan focuses on the jurisdictions which are linked to the EU Member States as dependencies, in order to encourage them to improve their regulatory systems harmonising them to the standards established by the international community.

On 15 and 16 October 1999 in Tampere (Finland), the European Council held an extraordinary meeting on the creation of a space of liberty, safety and justice in the European Union. In the meeting’s conclusive document (European Council, 1999) a section was devoted to the ‘fight at the Union level against crime’, specifically mentioning the fight against money laundering. The necessity of improving the transparency of financial transactions and of companies management and to accelerate the exchange of information among financial intelligence units are highlighted.

The Financial Stability Forum (FSF) was created in 1999. On April of the same year, during the inaugural meeting, the FSF created a *Working Group on Offshore Financial Centres*, with the task to analyse the role of offshore

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<sup>4</sup> They are: Bahamas, Cayman Islands, Cook Islands, Dominica, Israel, Lebanon, Liechtenstein, Marshall Islands, Nauru, Niue, Panama, Philippines, Russia, St. Kitts and Nevis and St. Vincent and the Grenadines.

financial centres in the stability of financial markets and to elaborate recommendations for the problems identified. The report of this Working Group was published on 5 April 2000 (FSF, 2000). According to the report, offshore financial centres do not jeopardise global financial stability, provided that there is sufficient supervision and that national authorities co-operate among each other. The implementation of international standards, however, differs significantly in the various financial centres considered (FSF, 2000: 58-68). It is evident that some offshore financial centres are subjected to an effective supervision and co-operate with other countries. At the same time, however, there are other jurisdictions which make very little effort to harmonise their legislation to international standards, and for this reason represent 'weak links' in the chain created for the protection of the international financial system.

All these international initiatives are important, for they confirm that the problem of financial centres and offshore jurisdictions is one of international public concern.

### **Organised crime goes offshore**

The laundering of the proceeds of crime is almost automatic where organised crime groups are concerned. This is the organised crime-money laundering cycle which links criminal activities and their proceeds with the need to launder the latter in order to disguise their criminal origin and enable their reinvestment in legitimate enterprises (Savona, 1998:2). The development of the demand for money laundering services is therefore closely connected with the development of organised crime groups and their activities.

A variety of criminal offences appear to be associated with the offshore sector. The investigation and prosecution of complex cases involving financial crimes such as fraud, tax offences, corruption and money laundering frequently reveals that organised crime groups exploit financial centres and offshore jurisdictions in a variety of locations.<sup>5</sup> Criminals prefer financial centres and

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<sup>5</sup> Financial crimes such as fraud, tax offences, corruption and money laundering are present in numerous international operations involving financial centres and offshore jurisdictions. See for instance U.S. Department of Justice, Drug Enforcement Administration, *Operation Dinero*, Internet address <http://www.usdoj>.



offshore jurisdictions, because the anonymity guaranteed by the opacity of their banking, tax and company regulation provides an effective shield against requests for information by law enforcement agencies.

The hypothesis made in this paper is that, although in European countries anti-money laundering measures are being harmonised to the standards set by the international community, their effectiveness could be hampered by the existence in financial centres and offshore jurisdictions of regulatory asymmetries. These asymmetries has been defined in the previous section as differences between a certain type of regulation in one jurisdiction and the standards established by the international community to protect financial systems, present in sectors such as company and banking law, which could be relevant for the enhancement of transparency in financial systems and, consequently, for a more effective tracking of the 'paper trail' of illicit proceeds and assets.

Acting on the regulation of the markets infiltrated and exploited by organised crime requires understanding and explanation of why and how the demand for money laundering could be matched by opportunities which facilitate it. It is on the mechanisms and markets in which such opportunities arise that a re-regulation process should take place, in order to make them more resistant to infiltration by criminals.

## **The demand for laundering the proceeds from crime**

The globalisation of the economy (which at the European level means the abolition of border controls between Schengen states, the free movement of goods, capital, services and persons within the European Union) and the integration between Western and Eastern Europe, bring citizens and corporations from foreign countries increasingly in contact. The world's

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gov/dea/pubs/briefing/4\_5.htm; M. Allen, "Usa: Murky World of Offshore Banking Emerges in U.S. Tax-Fraud Probe", in *Wall Street Journal*, 19 August 1999; United States General Accounting Office (GAO), *Private Banking. Raul Salinas, Citybank and Alleged Money Laundering*, GAO, GAO/OSI/99-1, 30 October 1998; Money Laundering Alert, "Conviction of Drug Lord Aids Salinas Inquiry", November 1996; A. Zarembo, "A verdict at Last – But the Case is Not Closed", in *Newsweek*, Internet address [http://newsweek-interactive.org/nw...4\\_99a/printed/int/wa/ovo6o4\\_1.htm](http://newsweek-interactive.org/nw...4_99a/printed/int/wa/ovo6o4_1.htm).

economies have been strongly influenced by the increased cross-border economic activity as well as by the developments in computer and financial technology, which permit instantaneous communication.

In response to the globalisation of financial markets, legal businesses tend to expand internationally. Multinational enterprises are re-organising their structures and directing their business where an opportunity for increased profit and lower costs exist. This often implies adopting more flexible and fluid structures with a more dynamic management, capable of exploiting local conditions more effectively (Williams, 1998: 73).

Globalisation, however, means also increased opportunities for illicit cross-border transactions. Just as legitimate businesses are doing, criminal enterprises are seeking to diversify their illicit activities often at the international level. As Williams points out (Williams, 1998: 69-74), some groups decide to go transnational in order to exploit the opportunities provided by globalisation. The most attractive markets are those in which the demand for the products and services they supply is large and the profit levels are high, but also those in which regulation are relatively lax or insufficiently implemented and in which the risk of being detected and prosecuted is low. In order to achieve their goals, they need to undertake a process of reorganisation of their structures to a different form, from a large and often hierarchical structure to that of a network, which is characterised by greater flexibility and capability to go beyond borders with a lower risk of detection.

It is possible to infer that, for the laundering of their dirty money, criminal groups tend to choose those jurisdictions where anti-money laundering defences are low and regulation less effective, thus minimising the law enforcement risk (Bell, 1999: 104). Part of this risk is represented by the wide range of anti-money laundering measures taken by many countries in the past decade, which have made the laundering of proceeds of crime more difficult.

This reasoning can be applied to the European context. At the European level the Directive 91/308 has allowed for the harmonisation of anti-money laundering policies in Member States in order to prevent the European financial system from being infiltrated by illicit proceeds. This has created a sort of protective net of national legislation, aimed at preventing dirty money from infiltrating the EU financial system.

In order to bypass national legislation enacted as a consequence of the directive, organised crime groups could have turned their attention to other EU and non-EU financial centres and off-shore facilities which have penal,

tax, company, banking and currency laws not in line with the European Union standards. In these jurisdictions the law enforcement risk is lower, since anonymity and scarce transparency guaranteed by the regulation of financial matters often hamper the effectiveness of requests for information by domestic and foreign law enforcement agencies.

It is possible to argue that the lesser this risk in some jurisdictions (due to the opacity of the legislation governing the financial services), the greater the probability that the demand for money laundering services by organised crime groups turns to them. In other words, a displacement effect might develop, shifting economic activities from better regulated centres to less regulated and less co-operative jurisdictions, which will remain 'havens' for illicit activity (Wiener, 1997: 57).

## **The supply of financial services at risk of exploitation**

There are several jurisdictions which offer a wide variety of financial services which facilitate 'tax planning' and the exercise of offshore financial operations (Douvier, 1995). These centres are geographically located in every part of the world, principally at the crossroads of international commercial traffics and therefore near the big actors in the global economy. They are mainly small jurisdictions, often islands, with advanced legislative systems and good connections with the rest of the world, but lacking significant production resources, apart from the tourist industry, and which chose to develop activities in the commercial sector trying to attract capitals from abroad. The supply of tax advantages and, later, of other financial services enabled them to overcome a difficult financial situation and contributed to the development of a global financial market and to the de-regulation in financial matters (Hampton, Abbot: 1-17).

The choice of a financial haven, both by legal investors and, as in many money laundering cases, by a criminal, depends on some 'environmental' conditions and on other factors, more relevant, related to the jurisdiction's legislative system (Johns, 1983: 53). In the first place, political and economic stability is an essential condition for investment. From the point of view of the non-resident willing to invest abroad some jurisdictions, for instance those characterised by a form of government 'without parties', are more stable.

Related to this is also the stability of the currency and the ease of using foreign currency.

A second element is the availability of professional financial advisors. To be successful on the international market, a jurisdiction needs to have banks, trust companies, accountants and solicitors able to process extremely sophisticated financial operations. The potential investor needs to be followed in every operation and has to find all the services, both financial and non-financial, which they need for their economic activity.

Thirdly, essential for the success of an offshore centre are good connections and communication links. These connections are relevant in several cases: when it is necessary to make operations on the territory of the jurisdiction or when confidentiality is preferable, through a 'face to face' contact with the financial operator. Moreover, telephone and electronic communication links are fundamental since they cancel geographic and time distances between the offshore centre, where the operations take place, and the place of residence of the investor who makes them.

Besides these environmental elements, other factors contribute in greater ways to the attractiveness of an offshore financial centre. These are geo-politic 'proximity' to onshore countries, competition with other offshore centres and the existence of strict bank secrecy.

The geographic location of financial centres and offshore jurisdictions is a crucial factor in the development of the business relations of the jurisdictions located in the same time zone of major international finance centres such as New York, London or Tokyo (Roberts, 1994: 101; Cobb, 1998: 131). Moreover, offshore financial centres can benefit from a second kind of link, that is the 'political' proximity with onshore centres, which guarantees political stability and the existence of an advanced legislative system based on that of the mother-country. The power that the latter can exercise depends on the degree of political dependence of the offshore centre: in some cases the very existence of an offshore jurisdiction depends on the political consensus of the mother-country, in others it can be less incisive.

A second factor of attractiveness of an offshore financial centre derives from the competition with other offshore jurisdictions. This competition determines the level of regulation and the financial services offered on the international financial market. Every offshore centre competes with 'rival jurisdictions' (Roberts, 1994: 99) in order to attract single investors and multinational enterprises. In order to advertise their financial services, these

jurisdictions develop a real 'market strategy'. However, the supply of financial services is necessarily limited. Consequently, jurisdictions will try to specialise in the supply of a specific facility (as the Channel Islands with offshore companies and the Cayman Islands with offshore banks) and to reach a level of excellency which allows to win competition. If this is not possible, their success as an offshore centre will be based on the level of regulation of these services: the less regulated (and consequently the more flexible) the better.

A third factor which determines the level of attractiveness of an offshore financial centre is given by bank secrecy. Offshore jurisdictions see confidentiality in financial matters as an essential 'ingredient' of the offshore industry, which needs to be protected from the drastic measures that onshore countries would want to introduce to limit it. Relevant information on tax, banking or financial matters is often not available, even if necessary in civil or criminal proceedings (Antoine, 1999: 9). The supply of bank secrecy is basically made of two components. The first is represented by the laws on bank secrecy, which prevents access to banking documents both to national and foreign authorities. The second is represented by the so-called 'blocking legislation', which impedes the supply, analysis and exchange of financial information following a request by a third country. This kind of legislation has been enacted by some offshore centres which actively offer bank secrecy services.

All these factors combined the guarantee that the services offered by an offshore financial centre are extremely flexible. The entire life of an offshore financial centre is based on the supply of competitive financial services, at competitive conditions and at competitive prices.

One of the most popular financial services is the *International Business Corporation* (IBC) i.e. the offshore company. Although minor features may vary from one jurisdiction to the other, the main characteristics of these companies are common to all offshore centres. What they all have in common is the very aspect that leads criminals to use them: scarce transparency (see Walter, 1986).

IBCs are totally tax-free: no withholding, capital gains, return, donation, succession taxes are imposed on IBCs in case they do not do business in the jurisdiction of incorporation. Anyway, from the point of view of a criminal, exemption from taxation is not the most appealing characteristic of an offshore company. He is certainly more attracted to the opportunities offered by the regulation concerning incorporation procedures.

Firstly, incorporation can be achieved at remarkable speed. Different from onshore countries, offshore jurisdictions allow incorporation of an IBC in a few days (in Cyprus five days are sufficient) and even the existence of shelf companies, i.e. already incorporated 'ready-to-use companies' (this is allowed, for instance, in Anguilla, Bahamas and Cayman Islands). Secondly, characteristics that may be appealing for criminals are the possibility of issuing various types of shares, included bearer shares, and the privacy surrounding the documents of the company. Although in many financial centres and offshore jurisdictions corporate regulation requires the keeping of a company shareholders' register, often the information contained therein is only accessible to shareholders themselves and not to the public (this happens for instance in Anguilla, Bahamas, British Virgin Islands, Cayman Islands and Turks and Caicos Islands). Equally important, scarce transparency characterises the documents that contain information about the company's economic activities. Administrators are only required to keep those documents which they consider 'necessary in order to show the financial situation of the company'. There is often no requirement for annual returns to be compiled and made available to independent auditors.

Besides IBCs, a popular financial mechanism is the trust (Kenney, 1998; Kleinfeld, 1998; Sydenham, 1997), principally offered by common law offshore jurisdictions, but recently introduced by other civil law countries such as Monaco and Liechtenstein. This mechanism allows the so-called 'asset protection' and tax planning, since many jurisdictions allow tax exemption for every relationship which is related to the trust. Moreover, the legislative systems of many jurisdictions keep the identity of the settlor and the beneficiary secret.

There are many kinds of trust, in some of which (such as the 'discretionary trust') no mention of the beneficiaries needs to be made. Their identities is kept completely anonymous, is very useful for criminals to manage their assets without being identified. Moreover, this guarantee of anonymity is not only an advantage for the beneficiary, but in some jurisdictions also for the settler. In this way not only is it impossible to link the assets to their owner, but he/she can also be the beneficiary at the same time. To the basic structure of the trust it is possible to add some clauses. For instance, it can be useful (and for criminals it surely is) to include the so-called 'flight clause', which allows the trust to be transferred to a safer jurisdiction in case the assets are in danger of nationalisation, expropriation, political or social instability (Lorenzetti, 1997: 148).

## **Demand for money laundering meets the supply: regulatory asymmetries and the risk of ‘exploitation’ of financial centres**

Criminals give preference to financial centres and offshore jurisdictions because the anonymity guaranteed by their banking, tax and company regulation provides an effective shield against requests for information by law enforcement agencies. Both individuals and financial institutions have been increasingly using the services offered by these jurisdictions because of the characteristics of scarce transparency described in the previous paragraph. The same financial services are also utilised by criminals with the aim of committing illicit activities. This use does not take place because offshore services are criminal *per se*, but because their regulation creates opportunities to criminals, so that they can commit crimes with a minimum risk of detection.

There appear to be three main advantages that attract capital (both clean and dirty) to financial centres and offshore jurisdictions: anonymity, freedom of financial movement and fiscal advantages. All three (but mostly the first two) perfectly meet the demand by organised crime of sophisticated financial services, of anonymity in financial transactions and of acting in jurisdictions whose criminal and criminal procedure laws are weakly enforced.

Freedom of financial movement derives from the opacity of company law, which guarantees complete anonymity to the people actually controlling a company. Company law in financial centres and offshore jurisdictions is very flexible, permits to incorporate a company in a very short time with privacy and discretion, so that no information regarding the company and its beneficial owner is accessible. This is why offshore companies are not only used by ‘clean’ operators, but also by those who want to evade taxes and launderers as well. The same anonymity is granted by banking law (Bernasconi, 1999: 52). Scarce transparency in banking activities, due to the lack of effective controls on the identity of the beneficiary of an account/transaction, allows individuals to undertake transactions which in more thoroughly regulated jurisdictions would arise suspicion. Moreover, ‘know your customers’ procedures can be side-stepped in case the beneficial owner of an account is introduced by a notary or by a lawyer. In fact, in many offshore centres the declaration of the

professional that he knows the identity and the 'integrity' of his client is enough for a bank to proceed with the opening of the account.<sup>6</sup>

It is therefore possible to assert that the demand of money laundering services by organised crime meets the supply of opaque financial services in offshore jurisdictions, because the latter reduce the law enforcement risk. In other words, exactly as it happens in every market, the demand and supply of anonymity interact in the 'secrecy market' (Walter, 1985: 8).

Moreover, information about offshore financial services is nowadays easily available. Precious information is traceable on the media and, above all, on the Internet (Savona et al., 2000). Technological developments and the increased use of Internet are factors which facilitate the meeting between the criminals' demand for money laundering services and the supply of financial services at risk of being utilised to this aim. Internet is an ideal tool to operate in offshore markets efficiently, since it guarantees lower transaction costs than the 'traditional' financial market while at the same time a high level of confidentiality. In particular, the use of Internet reduces the transparency of company law, already scarcely regulated in the 'real' financial world. Criminals can select the offshore jurisdiction which best suits their need for anonymity, choosing it among those which offer anonymous bank accounts, shelf companies established with bearer shares or managed through nominees, or a second citizenship. Moreover, when a risk of being individuated arises, Internet allows a quick 'migration' of the company and of the money invested to more favourable jurisdictions, thus making it very difficult for law enforcement to follow the paper trail effectively.

This means that criminals have cheap and fast access to a myriad of information regarding offshore financial services. As a consequence, criminals will balance the various services offered in offshore jurisdictions and will choose those which guarantee higher probability of success.

As it has become apparent, criminal organisations may exploit the opportunities provided by what can be defined as 'regulatory asymmetries',

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<sup>6</sup> The opening of an account by the notary/lawyer on behalf of their clients was allowed by Liechtenstein regulation up to October, 1, 2000. The disposition was then modified in response to the strong pressure that many European Union Member States put on the Liechtenstein Banking Association. Therefore, at present, lawyers and notaries are not allowed to hide the name of their clients to banks and financial institutions, when acting on their behalf.



that are discrepancies in certain sectors of regulation between offshore jurisdictions and onshore countries. These discrepancies, that Passas subsumes under the wider category of 'criminogenic asymmetries' (Passas, 1999), provide criminals with possibilities of money laundering and reduce the law enforcement risk.

The aspects so far discussed can be translated into two main assumptions. The first assumption is that asymmetries in regulating the transparency of financial transactions between EU countries and other financial centres and offshore jurisdictions could increase the risk that the latter will be abused by organised crime groups. An example can clarify this assumption: the stricter bank secrecy is and the higher anonymity is guaranteed to the ultimate beneficiary of a transaction, the easier it is for criminals to launder their illicit proceeds successfully and the lower the law enforcement risk.

The second assumption is that the greater the risk of exploitation of financial centres and offshore jurisdictions, the more vulnerable the EU financial system and other financial systems would become to pollution by proceeds of crime. After transiting through financial centres and offshore jurisdictions, dirty money is often invested in legitimate activities thus hampering fair competition among companies.

All this leads to the inference that the risk that the degree in which the EU financial system may become exploited by organised criminals in order to launder money could depend on the width of regulatory asymmetries existing in the jurisdiction and present in the criminal and criminal procedural law, in the anti-money laundering administrative regulation, in banking and company law and, finally, in the international co-operation field. A second deduction that can be drawn is that the greater the risk that financial centres and offshore jurisdictions may be abused by organised crime, the more vulnerable the other financial systems (including the European one) will be to the infiltration of illicit money.

## **The research conducted by TRANSCRIME – University of Trento and the report ‘Euroshore’**

### **The research project**

On the offshore financial centres and on the regulatory asymmetries which characterise their legislative system Transcrime conducted a research as part of the project “EUROSHORE. *Protecting the EU financial system from the exploitation of financial centres and offshore facilities by organised crime*”.<sup>7</sup> The aim of the research was to foster the development of the promising path of ‘organised crime prevention’ that the European Union has undertaken with its Action Plan and the Forum ‘Towards a European Strategy to Prevent Organised Crime’ held in the Hague on 4-5 November 1999. Its rationale was that there is a broad area of regulatory measures that could be used to hamper the growth of organised crime. This action, if properly pursued, would be less costly and more effective in terms of reducing the amount of organised crime than crime control action alone, with which, however, it should be combined.

Three groups of ‘financial centres and offshore jurisdictions’ were selected according to their level of (geographical, political, economic) ‘proximity’ to the European Union member states, which were treated as another homogeneous group. The groups selected were:

- Group 0: *EU member states*
- Group 1: *European financial centres and offshore jurisdictions* – those that are not member states of the Union but have special geographical, political or economic links with the European Union;
- Group 2: *Economies in transition* – those jurisdictions belonging to the ex-Soviet Bloc and those located in the Balkan region. Some of these countries are connected with the European Union by Association Agreements and have commenced the process of gaining entry to the European Union;

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<sup>7</sup> This research was awarded by the European Commission under Programme Falcone 1998 and carried out by TRANSCRIME, Research Centre of the University of Trento (Italy) in co-operation with CERTI – University Bocconi (Italy) and the Faculty of Law, Erasmus University of Rotterdam (The Netherlands). The full text of the report and if its Annexes is available on Transcrime’s web site at <http://193.205.199.126/transcrime/index.htm>.

- Group 3: *Non-European offshore jurisdictions* – those jurisdictions entirely unconnected with the European Union.

The research aimed at answering the following questions:

- Which group of jurisdictions deviates most markedly from the general integrity standards and in which sector's?
- How substantial are the asymmetries in each of these sectors and in which group of jurisdictions?
- What remedies can be suggested to reduce the risk of exploitation and ensure the best protection of the EU financial system?

The analysis was conducted for each jurisdiction with facilities vulnerable to organised crime activities, followed by a detailed description of the regulation in the sectors of criminal law and criminal procedural law, as well as of administrative, commercial and banking regulation and international co-operation. To gather information, a number of primary and secondary sources were used. The primary sources consisted of the replies to two questionnaires sent to all jurisdictions and by their reactions to the country profiles thus elaborated, which were sent to each jurisdiction considered in the project. Among the secondary sources were research reports, scientific and professional journals, police and press reports.

### **The model for the assessment of regulatory asymmetries**

The data collected were analysed by using a model, which made it possible to quantify the overall levels of the asymmetries for each group for the purpose of comparative analysis. In other words, the research conducted allowed to individuate the legislative sectors in which the regulatory asymmetries are more evident and to quantify them.

The first step in the research project was to define five 'integrity standards' which, if respected, should ensure the optimal integrity of a country's financial system and protect it against infiltration by organised crime (henceforth 'integrity standards'): the criminal and criminal procedure law standard, the administrative regulation standard, the banking law standard, the company law standard and the international co-operation standard. 'Standard' was defined as the 'optimal level of regulation' *in each of the different sectors of law*. The 'optimal level of regulation' is the one that ensures the optimal integrity

of a country's financial system. Each standard is assessed by a number of indicators, properly weighted, which corresponded to the questions used in the questionnaires sent to the jurisdictions.

The second step consisted of quantifying the level of deviation from the integrity standards by offshore jurisdictions and EU member states. In order to accomplish this, the values 0 and 1 were assigned to each answer by every jurisdiction. 0 indicated non-adherence to the indicator of the standard considered, while 1 indicated total adherence. Since the various indicators contributed differently to the definition of each standard, they received different weights. Under this criterion, for every group of jurisdictions, for each sector of law considered, it was thus possible to achieve a total score –made up of the weighted average of the scores assigned to each indicator– representing the level of adherence to a certain standard, or, in other words, deviation from that standard.

Two comparisons were made:

- a. among asymmetries representing the distance of the regulatory systems of the four groups from the optimal levels of integrity established by operationalising the concept of standards as adopted by the international community;
- b. among asymmetries representing the distance of the regulatory systems of the three groups of jurisdictions considered from the levels of integrity set by the European Union members states.

## **The research findings**

Using this methodology, for every sector of regulation scores (from 0 to 1) were assigned to each of the four Groups considered in the research. These scores expressed the extent to which the regulatory systems of the Groups deviates from the integrity standards. It was thus possible to determine analytically the difference (from 0 to 1) in deviation from the integrity standards among Groups 0, 1, 2 and 3 and between Groups 1, 2 and 3 and Group 0 (EU member states). The differential in scores between Groups expressed the level of asymmetry in regulatory systems between them. Table 1 shows the level of each Group's deviation: the closer the value to 0, the less the regulation deviates from integrity standards.

Table 1

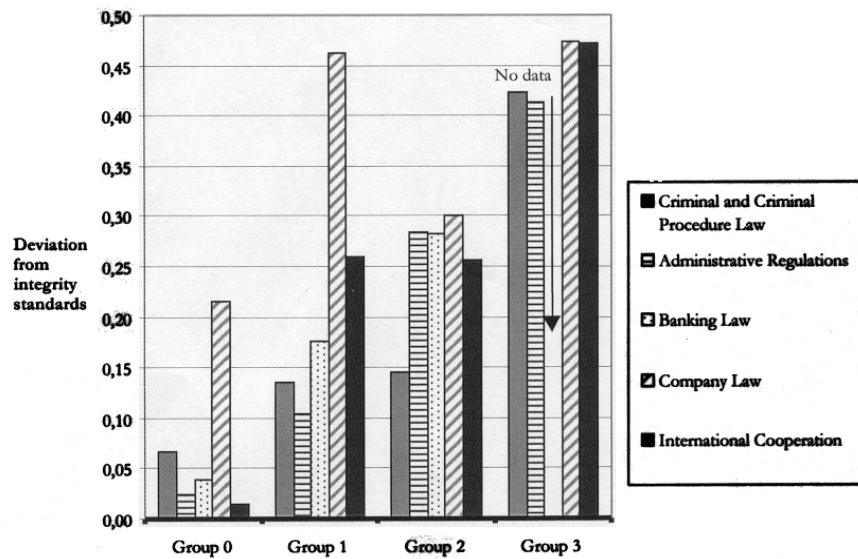
Level of deviation of Groups from the integrity standards

	Criminal and Criminal Procedure Law Standard	Administrative Regulation Standard	Banking Law Standard	Company Law Standard	International Co-operation Standard
Group 0	0.07	0.02	0.04	0.22	0.02
Group 1	0.14	0.10	0.18	0.46	0.26
Group 2	0.15	0.28	0.28	0.30	0.26
Group 3	0.42	0.41	n.a.	0.47	0.47

Figure 1 is a graphical representation of the results set out in Table 1.

Figure 1

Deviation of each Group from the integrity standards in each sector of regulation



These data furnish an idea of the distance between the level of regulation of the jurisdictions considered and the integrity standards which, if respected, should ensure the integrity of their financial system.

On the basis of these data it is possible to draw some conclusions. The EU Member States (Group 0), apart from company law, seem to be almost in line with all the integrity standards. The jurisdictions grouped under the name of 'European financial centres and offshore jurisdictions' (Group 1) do not display relevant deviation from criminal and criminal procedural law and administrative regulation standards, but they do so as far as banking law, company law and international co-operation standards are concerned. The 'financial centres in transition' (Group 2) show a medium deviation from all the standards. Administrative regulation, banking law and company law appear to be the most problematic sectors. Finally, the 'non-European offshore jurisdictions' (Group 3) are the most distant from the integrity standards in each of the sectors of regulation considered, particularly as far as the international co-operation standard is concerned. It is to be noted that the company law standard is the one from which all the four Groups (including the European Union) deviate most markedly.

## **Policy implications**

The results of this research give the input for a discussion about its policy implications. In order to progressively reduce and eventually eliminate regulatory asymmetries, some measures could be suggested, which involve the legislative sectors in which regulatory asymmetries are mostly evident. As the research results show, these are criminal law, anti-money laundering administrative regulation, banking law and company law.

## **Criminal law**

Undoubtedly, since the end of the Eighties, the trend has been towards the criminalisation of money laundering as an autonomous criminal conduct, and therefore independent from the predicate offence. Two reasons are behind this phenomenon (Blum, Levi, Naylor, Williams, 1998, p. 4). On the one hand,

if one accepts the theory according to which criminal organisations' main goal is profit, 'taking profits out of criminals' pockets' means destroying one of the most relevant motivations for the commission of crimes. On the other hand, the sanctions for money laundering often overlap those for predicate offences, thus increasing the costs related to the commission of a crime, which could induce criminals to co-operate more actively with the law enforcement.

With regard to criminal law, however, big discrepancies appear among offshore jurisdictions in the provisions regarding the number of predicate offences. The international community has introduced provisions aiming at harmonisation. The FATF in its Recommendation no. 4<sup>8</sup> and the 'Joint Action adopted by the Council on the basis of art. K.3 of the Treaty on European Union on the Laundering, Search, Seizure and Confiscation of the Proceeds of Crime' (98/699/JHA) have pressed for the introduction of 'serious crimes' anti-money laundering legislation, while Council of Europe Convention 1990/141 defines predicate offences as "*any criminal offence as a result of which proceeds were generated*". Even though the above Joint Action defines 'serious offences', differences in national criminal codes mean that the coverage of criminal activity will not be the same. Any two countries will tend to have a different conception of what constitutes 'serious crime'. This will lead them to envisage different crimes as money laundering predicate offences, thus making international police and judicial co-operation more difficult, insofar as the application of the principle of dual criminality may give rise to practical difficulties. It would therefore be preferable to adopt the option of an 'all crimes' legislation (as it has already happened in most EU jurisdictions). This would make international police and judicial co-operation easier, reducing problems related to dual criminality, often claimed by financial centres and offshore jurisdictions as the reason for their denial of co-operation.

Moreover, as regards criminal law a second element is worth considering. At the international level a consensus has been reached on the introduction of corporate liability as an effective means to fight organised crime, money laundering and other economic crimes. Many differences, however, persist

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<sup>8</sup> Each country should take such measures as may be necessary, including legislative ones, to enable it to criminalise money laundering as set forth in the Vienna Convention. Each country should extend the offence of drug money laundering to one based on serious offences. Each country would determine which serious offences would be designated as money laundering predicate offences.

among countries as regards this provision. The international community has requested through various international instruments that such liability be introduced. The UN Convention against Transnational Organized Crime provides for the establishment of corporate liability (though limited in its scope, insofar as it has been addressed to separate and specific crimes, such as organised crime, money laundering, fraud and active corruption). Moreover, numerous acts of the European Union, among which art. 3 of the Joint Action of 21 December 1998 (98/733/JHA) adopted by the Council on the basis of Article K.3 of the Treaty on European Union, on making it a criminal offence to participate in a criminal organisation in the Member States of the European Union, envisage the introduction of forms of (criminal or administrative) liability of corporations. Moreover, art. 14 of the *Corpus Juris* calls for the introduction of criminal liability for the entities (also if not legal entities) in case of violation, through fraud, corruption, money laundering and other crimes, of the financial interests of the European Union.

Though these instruments leave the decision of whether or not to implement administrative or criminal corporate liability to the individual country concerned, the issue of introducing corporate criminal liability in each jurisdiction has not yet been subject to single and comprehensive action, and therefore warrants particular attention. The most effective solution would certainly be that of introducing the liability of corporations, either administrative (short term) or criminal (long term), as a generic sanction applied in cases of crimes committed by corporations. The objection often made to the introduction of such form of liability regards, however, obstacles related to provisions contained in national Constitutions in many 'civil law' countries, according to which criminal liability is *personal*: this is the position of countries such as Italy (which, however, is now in the process of introducing administrative liability of corporations), Germany and Austria.

### **Anti-money laundering administrative regulation**

Besides criminal law, other legislative sectors show wide asymmetries. Among them, anti-money laundering administrative regulation, particularly as regards the subjects covered by anti-money laundering legislation (such as identification requirements and suspicious transactions reporting). Moreover, this asymmetry will increase even further when the amendments to the EU Money Laundering



Directive 91/308, come into force. As highlighted by the FATF in its 2001 Report on Money Laundering Typologies, “*lawyers, notaries, accountants and other professionals offering financial advice have become the common elements to complex money laundering schemes*” (FATF, 2001: 12). Action should be taken to reverse this trend by monitoring the activities of these professionals and institutions. The effectiveness of the new obligations introduced by the amendments to the Directive, however, depends on the sanctions imposed in cases of misconduct (sanctions which, for professionals, are suspension, disqualification, confiscation).

It would therefore be advisable that as many jurisdictions as possible extend identification and reporting obligations to non-financial businesses and professionals, so as to be able to create a system of sanctions which are deterrent, effective and proportionate for those who do not comply. This would increase the transparency of financial transactions, making it easier to prevent the misuse of office/trust accounts (by professionals), and to deter the use of non-financial businesses for money laundering purposes.

## **Banking law**

Wide asymmetries among financial centres and offshore jurisdictions are also evident in banking law, particularly as regards the effectiveness of the customer identification requirement in case financial operations are made through bank accounts owned by legal entities.

If doubt arises as to whether a customer is opening an account or carrying out a transaction on his/her own behalf, identification requirements will make it possible to ascertain the identity of the person on whose behalf the account is opened or the transaction conducted. In financial and offshore centres, this requirement is often circumvented by the existence of corporate confidentiality. Although the data provided by these countries confirm that, in the vast majority of cases, the law provides for the identification of the person or the entity on whose behalf an account is opened or a transaction conducted, this requirement does not always ensure a sufficient level of transparency. This comes about when transactions are conducted on behalf of certain kinds of corporations or trusts established according to a company or trust law, which in many jurisdictions allow a high degree of anonymity for the persons who control them. In this case, it is not possible to disclose the identity of the person on

whose behalf an account is opened or a transaction conducted. Consequently, the opacity of company or trust laws may restrict the possibility for disclosure of the real identity of the person on whose behalf an operation is conducted and who effectively controls the corporation or trust.

To address this problem, concerted action in the area of banking, company and trust law is required. As regards banking law in particular, identification of the real identity of the person on whose behalf a transaction is conducted is essential, and in the case of a corporation or a trust, also the name(s) of the director(s) and trustee(s). Only in this way can the 'know your customer' clause be properly applied to financial transactions.

### **Company law and its relevance for the transparency of a financial system**

One of the most relevant legislative sectors, which more than others contributes to the level of a financial system's transparency/opacity, is company law. It sets share capital and regulates the issue of bearer shares by limited liability companies, the possibility that legal entities may act as directors, the requirement of establishing a registered office, and also the compulsory auditing of financial statements in the case of limited liability companies and the keeping of shareholders' registers. According to the type of regulation, company law produces the greater transparency or the greatest opacity of a financial system, thereby influencing the other sectors of regulation and determining the effectiveness of police and international judicial co-operation.

That is why, referring to company law, it is correct to use the term 'domino effect'. In order to clarify the scope of this effect and of the chain impact that company law exerts on the other regulatory sectors, it is useful to proceed through an example. Certain offshore centres (such as Anguilla, Netherlands Antilles, Cayman Islands, Lithuania, Bulgaria and many other jurisdictions in the Pacific area) allow a company to be incorporated through the issuing of bearer shares and to be administered by other legal entities. Consequently, when a bank account is opened on behalf of one of these companies the beneficial owner remains anonymous, thus making any inquiry by banking supervision authorities useless. Moreover, the above-mentioned anonymity prevents law enforcement agencies from discovering the identity of the

beneficiary of any transaction carried out through that bank account. As a consequence, international co-operation is also impaired, because any offshore law enforcement authority, although willing to co-operate, can not provide other parties with information that is not at its disposal.

The 'domino effect' of company law thus influences the transparency of other legislative sectors, producing a general opacity in a financial system. Therefore, in case the widest asymmetries are found in this sector, every measure aimed at protecting financial systems (among which the European one) should have company law as starting point.

However, though in criminal law much effort has been devoted to proposing modifications in order to harmonise the legislation in the various countries, in the field of company law this has not happened yet. This observation particularly concerns two aspects which are fundamental for the transparency of a financial system: the regulation of incorporation procedures and the control of the activities undertaken by legal entities. Only increasing transparency in this sector of regulation the search for the 'paper trail' left behind by criminals laundering dirty money may end with the detection of those proofs that can be legally used in judicial proceedings aimed at convicting and punishing organised crime members. Therefore, steps should be taken to harmonise and give the greatest transparency possible to EU company law standards and then to export these standards outside the EU. It is important that minimum standards of company transparency are set up, in order to prevent the abuse of companies as vehicles for money laundering (in that they shield the identities of real beneficial owners), facilitate the investigation of money laundering cases, and lay a better basis for co-operation among law enforcement/judicial authorities across countries.

## Conclusion

The analysis made so far seems to lead to an inevitable conclusion. The conduct of various countries and territories with regard to the risk that illicit proceeds transit in their financial systems is very diverse. On the one hand there are countries with a marked interest for the integrity of their financial system while, on the other hand, this integrity does not bring substantial economic advantages to other jurisdictions but, on the contrary, mainly disadvantages. These jurisdictions see no reason to bear any cost for the fight against organised crime and money laundering. Since their major source of income derives from economic transactions, they could even have an incentive to favour the influx of funds, no matter their origin (Masciandaro and Castelli, 1998: 18).

Criminal organisations benefit from the existence of these two opposite approaches, and are ready to exploit the asymmetries of the 'laxist' financial centres and offshore jurisdictions in the regulation of the relevant legislative sectors. Consequently, the action of the international community and of single countries has to be directed at imposing, to 'non-cooperative countries and territories', the improvement of those regulations towards greater transparency and the reduction of asymmetries. These improvements need to be global, otherwise a 'displacement effect' would be created, shifting economic activities, both legal and criminal, to jurisdictions which do not harmonise to the standards set by the international community.

Although with some difficulties, financial centres and offshore jurisdictions are moving in the direction of a more comprehensive regulation of these legislative sectors and thus to the reduction of regulatory asymmetries. The pressure coming from the international community, which does not tolerate '*cowboy jurisdictions*', is getting them to improve their legislative systems (Ridley, 1999: 241).

The real challenge will be, for financial centres and offshore jurisdictions, to improve their anti-money laundering standards, making financial centres more transparent, at the same time keeping the efficiency and flexibility of financial services unchanged.

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# New Developments in EU Criminal Policy regarding Cross-Border Crime

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## Introduction

In the course of the last decade, society and law enforcement authorities have increasingly been confronted with a growing globalisation of crime and an increasing involvement of organised criminal groups, operating frequently on an international level or having many connections abroad. This state of affairs induced policy makers, at national as well as international level, to concentrate their efforts increasingly on combating (organised) cross-border crime. At global policy making level, reference should especially be made to both G8<sup>2</sup> and - recent - UN<sup>3</sup> efforts to combat transnational organised crime. At regional level, in the last years the EU has been particularly active in designing strategies to combat cross-border organised crime. These intensified efforts are related to the abolition of border controls between the so-called Schengen countries, which created the concern that cross-border crime in the EU would become very easy.

A first action plan to combat organised crime was formally adopted by the EU Justice and Home Affairs (JHA) Council in April 1997 and endorsed by the Amsterdam European Council of June 1997. In March 2000, the JHA

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<sup>2</sup> See in particular the conclusions of the so-called G8 Lyon Group (P8 - Senior Experts Group on Transnational Organized Crime, *P8 - Senior Experts Group Recommendations*, Paris, 2 April 1996, 6 p.).

<sup>3</sup> In December 2000, a UN Convention against Transnational Organized Crime, supplemented by two Protocols, was adopted and opened for signature in Palermo. See: United Nations Press Release, L/T/4359, 15 December 2000. See also: United Nations General Assembly, Resolution regarding the High-level Political Signing Conference for the United Nations Convention against Transnational Organized Crime, 28 January 2000, A/RES/54/129.

Council adopted a follow-up strategy to the 1997 action plan, hereinafter referred to as the *EU Millennium Strategy on Organized Crime*.<sup>4</sup> In addition, numerous international legal instruments have been adopted in recent years by the JHA Council with the explicit aim of improving and facilitating the fight against international, cross-border crime.

The present analysis of *new* developments in EU Criminal Policy regarding cross-border crime focuses on the development towards the approximation of criminal law on the one hand, and the enhancement of traditional mechanisms for judicial cooperation in criminal and customs matters, particularly the mutual assistance in criminal matters, on the other hand. Both aspects will be elaborated in the next sections.

## Approximation of criminal law

With the coming into force of the Amsterdam Treaty, the EU JHA Council has been given the competence to approximate the Member States *substantive* criminal law in a number of areas. According to Article 31, under 2 TEU (on judicial co-operation), the JHA Council can progressively adopt measures establishing minimum rules relating to constituent elements of criminal acts and penalties in the fields of organized crime, terrorism and illicit drug trafficking.

At the special meeting of the European Council, held in Tampere (Finland) in October 1999 (Vermeulen 2000a and b), the European heads of State and Government have specified that, with regard to criminal law, in the first place the efforts should be focused to reach an agreement on common definitions, penalisations and sanctions on a limited number of sectors, such as financial crime, drugs trafficking, trafficking in human beings, particularly exploitation of women, sexual exploitation of children, high-tech crime and environmental crime.

The EU Millennium Strategy on Organized Crime, referred to above, provided more details. The Strategy envisages, as an important element of the EU's criminal policy for controlling organized crime, the adoption of Third

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<sup>4</sup> Strategy of 27 March 2000 for the beginning of the new millennium, on the prevention and control of organised crime, in Vermeulen (2000).

Pillar legal instruments with a view to approximate the legislation of Member States, at least for the following offences: financial crime (money laundering, corruption, Euro counterfeiting, tax fraud), drug trafficking related offences, trafficking in human beings (particularly exploitation of women), sexual exploitation of children, terrorism related offences, high-tech crime (computer fraud and offences committed by means of the Internet) and environmental crime. It also sets an ambitious time schedule for the adoption of such instruments, pointing out that these should be adopted at the rate of at least one (offence) per Presidency. In the meantime, several framework decisions, being the specific instruments introduced by the Amsterdam Treaty to approximate the Member States' legislation, were already adopted,<sup>5</sup> and several proposals for framework decisions have been tabled.<sup>6</sup>

The EU Millennium Strategy on Organized Crime also introduced a number of recommendations aiming at the approximation of the Member States' *procedural* criminal law. *Inter alia*, the strategy announces the examination of the possible need for an instrument introducing the possibility of mitigating

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<sup>5</sup> See e.g. Framework Decision on increasing protection by penal and other sanctions against counterfeiting in connection with the introduction of the euro, adopted by the JHA Council of 29 May 2000, Council of the European Union, 8726/00 DROIPEN 19, Brussels, 25 May 2000.

<sup>6</sup> See *inter alia*: Proposal for a Council Framework Decision on combating trafficking in human beings - Proposal for a Council Framework Decision on combating the sexual exploitation of children and child pornography, Council of the European Union, 5624/01 DROIPEN 6, Brussels, 26 January 2001; Draft Council Framework Decision on the strengthening of the penal framework to prevent the facilitation of unauthorised entry and residence, Council of the European Union, 6254/01 DROIPEN 16 MIGR 9 COMIX 125, Brussels, 15 February 2001; Council Framework Decision on money laundering, the identification, tracing, freezing, seizing and confiscation of instrumentalities and the proceeds of crime, Council of the European Union, 5531/01 DROIPEN 4, Brussels, 8 February 2001; Draft Framework Decision on the protection of the environment through criminal law, Council of the European Union, 5674/01 DROIPEN 10 ENV 42, Brussels, 31 January 2001; Initiative of the Commission with a view to adopting Council Framework Decision combating fraud and counterfeiting of non-cash means of payment, Council of the European Union, 14353/00 DROIPEN 59 CRIMORG 165 ECO 372, Brussels, 12 January 2001; Council Framework Decision on criminal law protection against fraudulent or other unfair anti-competitive conduct in relation to the award of public contracts in the Common Market, Council of the European Union, 9230/00 DROIPEN 21, Brussels, 28 June 2000.

the onus of proof regarding the origin of assets held by a person convicted of an offence related to organized crime, as well as of an instrument allowing confiscation regardless of the presence of an offender. Intending to make investigations of cross-border organized crime more efficient, the Strategy recommends the EU to work towards the approximation of national legislation on criminal procedure governing investigative techniques, in order to make their application mutually more compatible. In addition the Strategy aims to further the adoption of a common instrument concerning the protection of witnesses and persons willing to co-operate with the prosecution, which should contain the possibility of mitigating punishment of such a defendant. In the same context, an EU model agreement allowing *inter alia* for relocation of protected persons in other Member States should be developed and used on a bilateral basis.<sup>7</sup>

## Judicial cooperation in criminal matters

In the context of EU criminal policy making concerning cross-border crime, judicial cooperation in criminal matters takes a very important place. Among the most significant elements of the EU policy in this area in the recent years are the EU's continuous efforts to enhance the traditional mechanisms of mutual assistance in criminal matters (a) and the special meeting of the European Council, held in Tampere (b). At that meeting the Council decided to make mutual recognition of various types of judicial decisions in criminal matters the cornerstone of future judicial cooperation within the EU, as well as to create a judicial counterpart for Europol by setting up Eurojust.

### *a. Mutual assistance in criminal matters*

Mutual (legal) assistance in criminal matters is not just one of the traditional forms of judicial cooperation in criminal matters. In daily practice, its importance for international criminal law enforcement, and in particular for combating international organized crime, is much more significant than any

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<sup>7</sup> See in this respect the proposal for an EU Model Agreement on the protection of persons in the context of combating serious or organized crime in: Siron et al. (2000)

other form of judicial cooperation, be it extradition, transfer of proceedings, or transfer of the execution of sentences.

Traditionally, the levels of cooperation relevant to mutual assistance in criminal matters between European states have been the Council of Europe (CoE), the Benelux Economic Union, the Nordic Union and the level of bilateral agreements. Concerning the Council of Europe, we refer to the 1959 European Convention on mutual assistance in criminal matters<sup>8</sup> –ratified by all EU Member States– and the 1978 Additional Protocol to this Convention<sup>9</sup>, ratified by all Member States but Belgium and Luxemburg. In the relations between the Benelux countries, the 1959 European Convention does not apply, and mutual assistance is governed by chapter II of the 1962 Benelux Treaty on extradition and mutual assistance in criminal matters.<sup>10</sup> In addition a number of European states decided to supplement the provisions of the 1959 CoE Convention or to facilitate its application by concluding additional bilateral<sup>11</sup>

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<sup>8</sup> Strasbourg, 20 April 1959, *European Treaty Series*, No 30.

<sup>9</sup> Strasbourg, 17 March 1978, *European Treaty Series*, No 99.

<sup>10</sup> Traité d'extradition et d'entraide judiciaire en matière pénale entre le Royaume de Belgique, le Grand-Duché de Luxembourg et le Royaume des Pays-Bas, Brussels, 27 June 1962, *Union Economique Bénélux, Textes de Base*.

<sup>11</sup> See, as regards the mutual relations between the EU Member States: Vertrag vom 31 Januari 1972 zwischen der Republik Österreich und der Bundesrepublik Deutschland über die Ergänzung des Europäischen Übereinkommens über die Rechtshilfe in Strafsachen vom 20. April 1959 und die Erleichterung seiner Anwendung, Bonn, *Bundesgesetzblatt für die Republik Österreich*, 31 January 1977, No 36; Vertrag vom 20. Februar 1973 zwischen der Republik Österreich und der Italienischen Republik über die Ergänzung des Europäischen Übereinkommens über die Rechtshilfe in Strafsachen vom 20. April 1959 und die Erleichterung seiner Anwendung, Vienna, *Bundesgesetzblatt für die Republik Österreich*, 29 November 1977, No 558; Convention du 24 octobre 1974 entre la République Française et la République d'Allemagne additionnelle à la Convention européenne d'entraide judiciaire en matière pénale du 20 avril 1959, *Journal officiel de la République française*, 13 January 1981; Aanvullend Akkoord van 6 maart en 18 juli 1975 gesloten bij wisseling van brieven, tussen de Regering van het Koninkrijk België en de Regering van de Bondsrepubliek Duitsland, bij het Europees Verdrag voor onderlinge

or –in the case of the Nordic countries– multilateral<sup>12</sup> treaties and conventions.<sup>13</sup>

In the mid-1980s, new levels of cooperation –Schengen and the EC/EU level– were established. In addition to this, the Council of Europe continued drawing up new legal instruments relating to, or having relevance for, mutual legal assistance. Special attention must be given here to the 1990 European Convention on laundering, search, seizure and confiscation of the proceeds of crime.<sup>14</sup> Moreover, since 1995, the Council of Europe’s Committee of Experts on the Operation of European Conventions in the Penal Field (PC-OC) has worked on a Preliminary Draft Second Additional Protocol to the 1959 CoE Convention,<sup>15</sup> which is intended to adapt the 1959 mutual assistance mechanisms to the needs of (organized) crime fighting in the 21st century. The new Protocol is expected to be signed in 2001.

In 1985, Germany, France and the Benelux countries concluded the so called Schengen Agreement. It was followed by the Schengen Implementing Convention (SIC)<sup>16</sup> in 1990, containing provisions on mutual assistance in criminal matters (Articles 48-53) and intended to supplement and to facilitate the implementation of the 1959 CoE Convention and of chapter II of the 1962 Benelux Treaty. The SIC entered into force on 26 March 1995 for the 5 initial Schengen countries plus Spain and Portugal. Since, it has entered into force

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gerechtelijke hulp in strafbare zaken, ondertekend te Straatsburg op 20 april 1959, Brussels, *Belgisch Staatsblad*, 20 August 1978; Overeenkomst van 30 augustus 1979 tussen het Koninkrijk der Nederlanden en de Bondsrepubliek Duitsland betreffende de aanvulling en het vergemakkelijken van de toepassing van het Europees Verdrag aangaande de wederzijdse rechtshulp in strafzaken van 20 april 1959, Wittem, *Tractatenblad van het Koninkrijk der Nederlanden*, 1979, No 143; Vertrag vom 18. November 1983 zwischen der Republik Österreich und der Französischen Republik zu dem Europäischen Übereinkommen über die Rechtshilfe in Strafsachen vom 20. April 1959, Paris, *Bundesgesetzblatt für die Republik Österreich*, 9 August 1985, No 331.

<sup>12</sup> See the 1974 Nordic Convention on mutual assistance in criminal matters (Nordisk overenskomst av 26. april 1974 om gjensidig rettshjelp), Copenhagen, justisdepartementets rundskriv G-140/75 (Norway).

<sup>13</sup> In accordance with Article 26.3 of the 1959 CoE Convention.

<sup>14</sup> Strasbourg, 8 November 1990, *European Treaty Series*, No 141.

<sup>15</sup> See e.g. Council of Europe, PC-OC (2000) 19, Strasbourg, 14 June 2000.

<sup>16</sup> Convention d’application de l’Accord de Schengen du 14 juin 1985 entre les Gouvernements des Etats Membres.

in 10 Member States<sup>17</sup> and was on 1 May 1999<sup>18</sup> even integrated in the European Union structure. In the meantime, the United Kingdom and Ireland have also officially applied for participation in the Schengen *acquis*, with the exception of border controls. The coming into effect for the Nordic countries has been scheduled for 25 March 2001.

For almost six years now, the provisions of the SIC on mutual assistance have been applied satisfactorily by many practitioners throughout Europe. For the sake of completeness, the changes prompted by the SIC, are briefly recalled hereafter. In Article 49, the scope of the traditional multilateral European mutual legal assistance treaties (the 1959 CoE Convention and the 1962 Benelux Treaty) has been widened substantially.<sup>19</sup> Article 50 contains an undertaking for the Schengen countries –in accordance with the 1959 CoE Convention and the 1962 Benelux Treaty– to provide mutual assistance regarding infringements of their rules of law with respect to excise duty, VAT and customs duties. Article 51 SIC facilitates the conditions for the admissibility of letters rogatory for search or seizure. The execution of such letters rogatory may not (any more) be made dependent on the condition that the offences giving rise to the letters rogatory are extraditable offences. Article 52 has introduced the possibility to transmit procedural documents directly by post to persons, who are in the territory of another Schengen country, simultaneously providing guarantees for the translation of the documents concerned into a language the addressee understands. Article 53, finally, allows for the direct transmission and return of requests for assistance between the judicial authorities being locally competent for their sending and answering (Article 53).

From the mid-1980s onwards the then 12 Member States of the European Communities (EC) have also concluded, in the framework of the so-called

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<sup>17</sup> Not yet for the Nordic Member States (Denmark, Finland, Sweden), Ireland and the United Kingdom.

<sup>18</sup> Date of the entry into force of the Amsterdam Treaty.

<sup>19</sup> Now mutual assistance is allowed in proceedings brought by the administrative authorities, in proceedings for compensation in respect of unjustified prosecution or conviction, in proceedings in non-contentious matters, to communicate legal statements relating to the execution of a sentence or measure, the imposition of a fine or the payment of costs of proceedings, and in respect of measures relating to the suspension of delivery of a sentence or measure, conditional release or the postponement or suspension of execution of a sentence or measure.

European Political Cooperation (EPC), a series of five agreements/conventions with relevance for judicial cooperation in criminal matters.<sup>20</sup> None of these however, pertained to mutual legal assistance. Only with the coming into force of the Maastricht Treaty on European Union (TEU) on 1 November 1993 has judicial cooperation in criminal matters formally become a matter of common interest for the EU Member States (See Article K.1.7 TEU). Within the framework of the 'Third Pillar' of the EU, negotiations were started subsequently with a view to drawing up a EU Convention on mutual assistance in criminal matters,<sup>21</sup> additional to the 1959 Council of Europe Convention, its 1978 Protocol, chapter II of the 1962 Benelux Convention and Articles 48-53 of the SIC. After almost five years of tough negotiations, agreement on this new convention was finally reached on 29 May 2000,<sup>22</sup> under the Portuguese Presidency of the EU Council.

Discussion on the provisions to be inserted in the convention with regard to the interception of satellite telecommunications, have been a continuous stumbling-block in the negotiations of the last two years and forms the main reason why it has been impossible to reach a final agreement on the draft convention. The Third Pillar negotiations on mutual legal assistance, however, have not only focused on the drafting of a new EU convention. They have

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<sup>20</sup> Agreement on the application among the Member States of the European Communities of the Council of Europe Convention on the transfer of sentenced persons, Brussels, 25 May 1987; Convention between the Member States of the European Communities on double jeopardy, Brussels, 25 May 1987; Agreement between the Member States of the European Communities on the simplification and modernization of methods of transmitting extradition requests, San Sebastian, 26 May 1989; Agreement between the Member States of the European Communities on the transfer of proceedings in criminal matters, Rome, 6 November 1990; Convention between the Member States of the European Communities on the enforcement of foreign criminal sentences, Brussels, 13 November 1991. For the full text in English, see the website of the European Judicial Network (<http://ue.eu.int/ejn/index.htm>), 4, sub a).

<sup>21</sup> For a profound analysis and critical evaluation of the negotiations on the new convention, since the entry into force of the Maastricht Treaty, see: G. Vermeulen (1999). Concerning the recent developments in the field of mutual assistance in criminal matters at the EU level, see also Vermeulen (1998a) and Vermeulen (1998c).

<sup>22</sup> For the text of the new convention, see: *Official Journal*, C 197/1, 12 July 2000; Vermeulen (2000c). For the explanatory report on the Convention, see: Council of the European Union, 13008/00 COPEN 75 COMIX 788, Brussels, 20 November 2000.



resulted in the adoption by the JHA Council, on the basis of Article K.3.2, under b) TEU, of a number of joint actions, which are only binding upon the governments of the Member States but have no direct effect for the citizens. Nonetheless, they do and will continue to have an impact on the organization and logistics of the judicial cooperation between the Member States, in particular in the field of mutual assistance in criminal matters. The joint actions relevant for mutual legal assistance are:

- the 1996 Joint Action concerning a framework for the exchange of liaison magistrates to improve judicial cooperation between the Member States of the EU;
- the 1998 Joint Actions on the creation of a European Judicial Network and on good practice in mutual legal assistance in criminal matters;
- the 1998 Joint Action on the laundering of money, the identification, tracing, freezing, seizing and confiscation of instrumentalities and the proceeds from crime.<sup>23</sup>

Also of particular importance to mutual legal assistance and combating cross-border crime is the 1997 Convention on mutual assistance and cooperation between customs administrations (the so called Naples II Convention (*Official Journal*, January 1998), a legal instrument with the potential strength (depending on its ratification by a sufficient number of Member States) of a convention adopted on the basis of Article K.3.2, under c) TEU.

Meanwhile, another step has been taken to enhance the EU legal framework with regard to mutual assistance. Almost immediately after the signing of the new EU Convention on 29 May 2000, the French Presidency of the Council of the EU (2<sup>nd</sup> half of 2000) took the initiative for another convention on the matter, aiming at further improving mutual assistance between the Member States. The JHA Council of 15 March 2001 is expected to reach political agreement on the latter.<sup>24</sup>

Given its importance we will pay attention to the new EU Convention on mutual assistance in criminal matters of May 2000 and its relationship to the so called Naples II Convention. Subsequently, a brief overview is given of the major new trends and cooperation mechanisms contained in the new

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<sup>23</sup> To be found in the *Official Journal* 1998, Brussels.

<sup>24</sup> See *inter alia* Council of the European Union, 5268/01 COPEN 2 COMIX 30, Brussels, 24 January 2001.

convention that have specific relevance for controlling cross-border crime. Further, attention is also given to the new EU Convention on *improving* mutual assistance in criminal matters (2).

### **1. The EU Convention on mutual assistance in criminal matters**

It must be recalled that, according to the Naples II Convention, the judicial authorities in charge of the criminal investigation of customs offences may either make use of the Naples II Convention or revert to the regular channels of mutual legal assistance (such as the 1959 CoE Convention, the 1962 Benelux Treaty, the SIC or even the new EU convention on mutual assistance in criminal matters) as a basis for requesting assistance or cooperation. Following from the fact that on some issues (controlled deliveries, infiltration, joint investigation teams, ...), the options selected in the Naples II and the new EU convention differ, the judicial authorities are in a number of cases invited to perform 'convention shopping': they may choose in favor of the rules/the convention that best suit(s) them. The better solution would have been to avoid adopting different solutions or options for the same problems/questions in two Third Pillar conventions.

Below, a brief overview is given of the main new trends and cooperation mechanisms contained in the new EU mutual legal assistance convention with specific relevance in the context of cross-border mobility of the crime-economy and the use of human resources. The following aspects will be elaborated:

- the compliance with formalities and procedures and deadlines set by the requesting Member State;
- interception of (GSM and satellite) telecommunications;
- controlled deliveries;
- covert investigations (infiltration);
- joint (multi-national) investigation teams;
- hearing by video or telephone conference;
- and direct transmission of requests for mutual assistance.

*a. Compliance with formal conditions set by the requesting Member State*

Compliance with *formalities and procedures* stipulated by the requesting Member State is a new concept. It is the reverse of the traditional *locus regit actum* rule<sup>25</sup>, as contained in Article 3 of the 1959 CoE Convention and Article 24 of the 1962 Benelux Treaty. Until now, the *locus regit actum* principle has never really been challenged, not even in more recent conventions such as the 1988 UN Convention against illicit traffic in narcotic drugs and psychotropic substances or the 1990 European Convention on laundering, search, seizure and confiscation of the proceeds of crime. Both conventions stick to the traditional *locus regit actum* concept. Only to the extent that it does not conflict with their domestic law, there is an obligation on the requested state to execute requests in accordance with the procedures specified in the request, by the requesting state.<sup>26</sup>

The new EU mutual assistance convention introduces the *forum regit actum* concept, thus causing a revolution in the European practice of the past 40 years. According to the new rule, the requested Member State will have to comply with formalities and procedures expressly indicated by the requesting Member State, provided that these are not contrary to the *fundamental principles of law* of the requested Member State. In other words, compatibility with the own legal system will in the future only be marginally tested. In addition, the requested Member State is bound to inform the requesting Member State, when the request cannot (fully) be executed in accordance with the procedural requirements set by the requesting Member State.

The rationale of the new concept is clear. International compatibility of evidence-gathering is of growing importance, particularly in view of the control of organised crime. Therefore the requested procedural and investigative actions should be regarded as an extra-territorial extension of the criminal investigations or procedures conducted within the *forum* state.

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<sup>25</sup> Rule according to which the formalities and procedures of the requested state have to be complied with in carrying out mutual legal assistance requests, the requesting state being the state where the request is carried out, i.e. the state being the *locus* of the action requested for.

<sup>26</sup> See Articles 5.4, under d) and 7.12 of the 1988 UN Convention and Articles 9 and 12 of the 1990 European Convention.

The new rule is especially important to the extent that the presence of the defense counsel at the execution of letters rogatory is requested. However, the scope of the rule is broader, not just limited to the execution of letters rogatory. The only forms of cooperation to which the *forum regit actum* principle will not apply, are controlled deliveries, covert investigations and cooperation in so-called joint investigation teams.

Compliance by the requested Member State with *deadlines* indicated by the requesting Member State may truly be considered revolutionary. The new EU convention does not only introduce an obligation to execute requests for assistance as soon as possible, it also urges the requested Member State to take maximal account of deadlines set by the requesting Member State. The possibility for the requesting Member State to set deadlines, is counterbalanced by an obligation for the latter to explain the reason for setting such a deadline. In addition, the requesting Member State has the duty to inform the requesting Member State if it is foreseeable that the deadline set for execution cannot be complied with.

The 1998 Joint Action on good practice in mutual legal assistance in criminal matters, mentioned above, is also relevant in this context. It contains an obligation for the Member States to deposit with the General Secretariat of the Council of the EU a statement of good practice in executing requests for legal assistance. This statement must, among other things, include an undertaking to acknowledge, if requested to do so by the requesting Member State (i.e. in case of urgency or if necessary in the light of the circumstances of the case), all requests and written enquiries concerning the execution of requests, unless a substantive reply is sent quickly. Acknowledgements must provide the requesting authority with the name and details of the authority or contact person responsible for executing the request. Such a mechanism may be of great practical value. In the meantime, most of the Member States have made the required statement.<sup>27</sup>

*b. Interception of (GSM and satellite) telecommunications*

Neither the 1959 CoE Convention, nor the 1962 Benelux Treaty, nor the SIC provides for an explicit, adequate legal basis for cooperation in the interception

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<sup>27</sup> The text of the statements is on the website of the European Judicial Network (URL: [ue.eu.int/ejn/index.htm](http://ue.eu.int/ejn/index.htm)).

of telecommunications. The only –non-binding– international legal instrument dealing with the matter is Recommendation No R (85) 10 of the Committee of Ministers of the CoE concerning the practical application of the 1959 CoE Convention in respect of letters rogatory for the interception of telecommunications.

Since then, the telecommunication systems have been revolutionized with the inventions of the GSM and other modes of mobile satellite communication.<sup>28</sup> Future international cooperation will have to keep pace with these developments, for example it needs to take account of the concept of real-time interception, where the intercepted signal is directly transmitted to a law enforcement monitoring facility (in another Member State). This concept has been introduced for the first time in the EU context by the Council resolution of 17 January 1995 on the lawful interception of telecommunications.

As already mentioned above, discussions on the provisions to be inserted in the new EU convention on the interception of satellite telecommunications have been the main stumbling-block in the negotiations for about two years. For the sake of clarity, it should be noted that networks for personal satellite communications make use of new types of satellites, i.e. satellites in a low or medium earth orbit<sup>29</sup> (so-called LEO or MEO satellites), which can be reached directly with a portable handset. Next to satellites, the systems concerned consist of a network of ground stations, acting as a gateway between the satellite constellation and the regular earth infrastructure for (mobile or fixed) telecommunication. Ground stations are the places where the signal transferred via the satellite (network) re-enters the earth infrastructure. *Iridium* e.g. –the satellite–based systems, the first of which became operational on 1 November 1998, had *one* ground station in Italy for an area covering 40 countries (among which all EU Member States). As signals routed via satellite systems cannot be intercepted while being transferred from the portable handset to the satellite and the best place therefore to intercept them is the local ground station, the

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<sup>28</sup> Both GSM and satellite systems are characterized by the fact that the sole identification datum is the SIM card (Subscriber Identity Module).

<sup>29</sup> This is contrary to geostationary satellites (so-called GEO satellites), which are in a high earth orbit and thus require high capacity transmitting equipment. GEO's are traditionally being used for military, meteo or broadcasting activities and for certain telecommunication applications, such as telecommunication from boats or plains or global positioning systems.

relevant ground station will be an important intermediary in all interception scenarios.

During the initial EU negotiations on the new convention's provisions on interception of telecommunication, the leading principle has been that the Member State hosting the relevant ground station must be requested to supply technical assistance in the interception of the telecommunication of any target person on the EU territory (and that the Member State where the target can be found, must be asked for its permission or is given the right to impose conditions to the interception, or to prohibit the use of data gathered via interception while the target was on its territory). In July 1998 however, Iridium proposed an alternative approach, allowing for the judicial authorities in the Member States to ask the *local* service provider for help in the interception of a target's telecommunication, the service providers having remote control over the (in the case of Iridium: Italian) ground station and thus capable of carrying out interception themselves.

Ultimately, the general agreement was reached that the remote approach is a convenient option. However, as the remote or service provider approach will chiefly apply in the scenario, where the target, whose communication is to be intercepted, can be found in the territory of the investigating Member State, it does not offer a complete solution for the interception needs in a European context. Other scenarios, which apparently could not (in all cases) be covered by the remote approach, include those where the target is located in another Member State and the relevant ground station is also in that or still in another Member State, or in the investigating Member State itself. Also the scenario where the target is in another Member State and the relevant ground station is hosted by a non-Member State would not be covered by the remote approach. A complete solution would moreover need to take account of even more complex scenarios, where the target moves/has moved from the intercepting (Member) state to a(nother) Member State, which is neither the requesting, nor the intercepting Member State.

The main obstacle in reaching a final agreement on provisions concerning the interception of telecommunications in the new EU convention on mutual assistance, has been the UK's unwillingness to accept that the Member State on whose territory a target is intercepted should be informed thereof, in the case where the interceptions concerned has been *authorized by secret services*. Ultimately, however, it was agreed that the new rules on interception will only apply to interception orders authorized in the course of criminal investigations,

which present the following characteristics: ‘an investigation *following* the commission of a specific criminal offence, including attempts in so far as they are criminalized under national law, in order to identify and arrest, charge, prosecute or deliver judgement on those responsible’. Thus, proactive or administrative interceptions authorized by secret services would indeed not be subject to the obligation to inform the Member State on whose territory the target is or has been intercepted about the interception concerned.

*c. Controlled deliveries*

The new EU Convention contains an undertaking for the Member States to ensure that, at the request of another Member State, controlled deliveries may be permitted on their territory.

Unlike in the 1988 UN Convention (Article 11) and the SIC (Article 73), the technique may also be applied in combating forms of crime other than illicit traffic in narcotic drugs and psychotropic substances. It may be applied in the framework of criminal investigations into any extraditable offences.<sup>30</sup>

The decision to carry out controlled deliveries is taken by the competent authorities of the requested Member State. Also the competence to act and to direct the operations lies with these authorities. By way of exception to the new *forum regit actum* rule (*supra*), the law and procedures of the requested Member State are applicable.

*d. Covert investigations (infiltration)*

Until now, international cooperation in the field of covert investigations has usually been performed at police level, in a juridical vacuum, facilitated for example by the International Working Group on Undercover Policing (IWG). The IWG, in which police or secret services of 13 European states take part (Vermeulen, 1997; 1998), facilitates the continuation of covert investigations

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<sup>30</sup> Note that it is unclear which is the point of reference for deciding whether an offence is extraditable (the 1996 EU convention relating to extradition, the multilateral treaty applying in the bilateral relation between the Member States concerned, the national law of the requested Member State).

on the territory of other states, as well as the placing of undercover agents at each other's disposal.<sup>31</sup>

The new EU convention creates an international legal basis in the context of judicial cooperation in criminal matters for the operation of investigations into crime by officers acting under covert or false identity. Implicitly, the convention allows for three different cooperation scenarios: (1) the continuation of an infiltration operation on the territory of another Member State, (2) the 'lending' of a foreign undercover agent for the purpose of an infiltration operation on its own territory, and (3) the operation of an infiltration operation in the requested Member State by (an) undercover agent(s) of that Member State, on the request of the requesting Member State.

A decision on the request is taken by the competent authorities of the requested Member State with due regard to its national law and procedures. As in the case of controlled deliveries, the new *forum regit actum* rule (supra) does not apply: the relevant law and procedures of the Member State where the action takes place must be observed. The duration, the detailed conditions, the preparation, the supervision and the security of the infiltration operations are agreed between both Member States concerned.

*e. Joint (multi-national) investigation teams*

The new EU Convention also allows for the setting up of joint, multi-national investigation teams, composed of judicial, police and/or customs officers or even of officials of international organisations/bodies (e.g. Europol). Such teams may be established for a specific purpose and for a limited period, where difficult and demanding investigations, having links with other Member States, are required or where coordinated, concerted action between the Member States concerned is necessary. The teams will be headed and led by an official from the Member State where the team is operating and seconded team members operating in another Member State will be bound by the law of that Member State. In other words: the traditional *locus regit actum* rule would still apply. Apart from being allowed to be present when investigative measures are taken, seconded team members may in addition be entrusted with the task of certain investigative measures, and team members may request their own

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<sup>31</sup> The IWG maintains a directory listing the special skills of the undercover agents of its member agencies.



authorities to take the necessary investigative measures in their own Member States as if they would be taken in a domestic investigation. Also, information lawfully obtained by seconded team members may be used in their own Member State.

*f. Hearing by video or telephone conference*

The 1962 Benelux Treaty is the only multilateral legal assistance treaty in Europe containing an obligation for persons to appear in the requesting state, with a view to being heard there as a witness or expert. This may be a cumbersome procedure. In many cases therefore, hearing by video or telephone conference could be an alternative solution. As the technique of video conferencing allows for hearing persons at a distance, hearing by video conference is also important with a view to protecting crown witnesses or persons collaborating with the criminal justice system.

The new EU convention contains a consistent set of rules on hearing by means of video or telephone conference. According to the convention, hearing by video or telephone conference is a combination of a regular request for assistance (by the requested Member State) and a direct exercise of jurisdiction (by the requesting Member State). On the one hand, the *requested* Member State is responsible for summoning the person to be heard, for realizing the real time link technically, for making sure that its fundamental procedural guarantees are observed, and for exercising a number of controls at the place of the hearing. On the other hand, the hearing is conducted by or under the direction of a judicial authority of the *requesting* Member State.

The convention primarily allows for the hearing of witnesses and experts, either in the investigation or the trial stage. As for hearing by video conference, the technique could also apply to accused persons, for example in the trial stage. On this point, however, the Member States have been given an opting out possibility. In any case, the consent of the accused is necessary. It is also worth mentioning that the necessary technical means for video conferencing may be made available by the requesting Member State.

In the course of either types of hearing, the person to be heard may claim the right not to testify which would accrue to him/her under the law of either the requested or the requesting Member State, so that a loss of rights can be avoided. Measures extending to the protection of the person heard (e.g. voice or image deformation) may be agreed upon. Finally, the requested Member

State must make sure that perjury and unlawful refusal to testify can be punished according to its national law.

*g. Direct transmission of requests for mutual assistance*

Finally, the new EU convention reinforces the *acquis* of Article 53 SIC. Instead of a mere *possibility*, it introduces an *obligation* to make requests for mutual assistance as well as spontaneous communications directly between the judicial authorities with territorial competence for their service and execution, and to return them through the same channels. It also extends the possibility contained in Article 53.5 SIC to directly transmit information with a view to proceedings in respect of infringements of the legislation on driving and rest time, to *any* offences.

The convention also allows for the direct transmission, where the competent authority is a judicial or central authority in one Member State and (in respect of requests concerning controlled deliveries or covert investigations) a *police or customs* authority, or (in respect of administrative offences) an *administrative* authority in the other Member State. Clearly, the goal has been to maximize flexibility in the transmission of requests.

There is one important potential restriction though. Member States may declare that their judicial authorities do not (in general) have the authority to execute requests received directly. In the absence of such a declaration, however, the local judicial authorities will have the autonomy to *execute* requests received directly, and not only to *receive* them. As a matter of fact a number of Schengen countries interpret Article 53.1 SIC in this way. Moreover, the obligation of direct transmission is also without prejudice to the possibility of requests being sent or returned *in specific cases* between central authorities or between a central authority in one Member State and a judicial authority in another Member State. In a limited number of cases, finally, documents will have to be sent *via* the central authorities (a.o. requests for temporary transfer of persons held in custody).

## **2. EU convention on improving mutual assistance in criminal matters**

This new(est) convention aims at further improving mutual assistance within the EU *inter alia* by further restricting the effect between Member States of reservations and restrictive declarations (allowed under Article 5 of the 1959

CoE Convention) concerning the execution of letters rogatory aimed at carrying out search/seizure orders. Moreover, refusal of mutual assistance on the basis of either banking secrecy or commercial confidentiality rules is explicitly denied. In addition, specific provisions are being introduced in order to facilitate the transfer of information on bank accounts and banking operations. The fiscal exception is being completely banned, and in as far as serious forms of organized crime or money laundering are concerned, assistance can no longer be refused except in case where granting assistance is likely to negatively impact on the fundamental interests of the requested state (*ordre public*).

## **Tampere European Council**

The meeting of the European Council, held in Tampere on 15-16 October 1999,<sup>32</sup> has been an important event in the field of criminal justice. At least two decisions taken by the heads of state and government of the EU at the special will have an important impact on future mutual assistance and cooperation in criminal matters between the Member States of the EU.

### **1. Mutual recognition**

Among other things, the European leaders recognized the need for enhanced *mutual recognition*, not only of judgements in the trial stage, but also of *judicial decisions taken in the investigation stage* (Tampere conclusions, no 36 and 37). It can be assumed that this principle will quite radically change traditional cooperation in the field of mutual assistance, as this would mean that judicial decisions or orders (e.g. to hear witnesses abroad, to carry out a house search or to seize evidence abroad, to intercept the telecommunication of a target in the territory of another Member State) would have direct effect in the Member State where they need to be carried out, the latter not being allowed to invoke traditional grounds for refusal or to check whether the actions concerned would be allowed according to its own law, in a domestic case.

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<sup>32</sup> Presidency conclusions, Tampere European Council of 15-16 October 1999, in Vermeulen (2000).

According to the decision of the Tampere European Council, an action plan for implementation of the mutual recognition principle was to be adopted in December 2000 at the latest. In line with this decision, the JHA Council adopted a so-called 'Programme of measures for the implementation of the principle of mutual recognition in criminal matters' in its meeting of 30 November 2000.<sup>33</sup>

The aforementioned Program distinguishes mainly between the recognition of earlier, final judicial decisions (a), procedural judicial decisions (b), convicting judicial decisions (c) and decisions taken in the context of the follow-up of criminal judgements (d).

*a. Earlier, final judicial decisions*

In this context, the Program *inter alia* calls for a reconsideration of the scope for making reservations allowed under the 1990 SIC on *ne bis in idem* provisions (e.g. by applying the principle also<sup>34</sup> to final decisions that prevent prosecution, following penal mediation or granting of immunity from prosecution to persons co-operating with the judicial system). It also calls for individualized sanctions in court decisions in a prosecution for another crime, by assessing the defendant's 'EU' criminal record & persistence in offending, thus introducing a legal notion of EU recidivism. In order to facilitate this, the program envisages the adoption of a standard form for criminal records applications and announces a feasibility study on the establishment of a genuine 'European criminal record', either as an intra-net of national criminal records databases or as a centralized database.

*b. Procedural judicial decisions*

According to the implementation program, the principle of mutual recognition should also apply to pre-trial orders relating to property as well as to interim measures with a view to confiscation. In this context, a proposal for a framework decision on mutual recognition of orders to freeze assets and

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<sup>33</sup> See: Council of the European Union, 13750/1/00 CATS 68 COPEN 78 CRIMORG 158 REV 1, Brussels, 24 November 2000.

<sup>34</sup> See in this respect the proposal for an EU Convention aiming at improved application of the *ne bis in idem* principle contained in Siron et al. (2000).

evidence is likely to be tabled soon on the initiative of the incoming Belgian EU Presidency.

In addition, pre-trial orders relating to persons should be mutually recognized as well. Therefore, the Program envisages the development of a EU standard form of arrest warrant, having equivalence to a request for provisional arrest (modeled on the standard form one used in the Schengen Information System, i.e. on the basis of Article 95 SIC). Also non-custodial supervision measures (e.g. bail, temporary withdrawal of a driving licence, ban on possession of/carrying arms, prohibition on frequenting certain places...) should be mutually recognized in the future. Very important, finally, is the envisaged application of the mutual recognition principle of decisions to prosecute taken in another Member State. In this way, conflicting claims of jurisdiction could be settled and multiple prosecutions for the same facts in various Member States could be avoided. Moreover, the Programme of 30 November recognizes the role to be played in this matter by Eurojust (*infra*).

*c. Convicting judicial decisions*

With regard to sanctions involving deprivation of liberty, the Program envisages the introduction of an obligation for the Member States to either extradite their own nationals or to enforce the sentence imposed on them by foreign court decision themselves. In addition, persons having fled justice after being sentenced, should simply be transferred to the Member State they fled from or be subjected to enforcement of the sentence imposed in the Member State where they have been discovered. According to the Program, the system of transfer of prisoners in the interests of social rehabilitation should be extended as to apply to residents also, instead of to nationals only. Fines should be automatically levied below a specified amount. Confiscation orders should be mutually recognized in other Member States, and asset sharing possibilities should be further explored. Finally, also disqualifications and similar sanctions should be given international effect within the EU, so as to allow *inter alia* for a Union-wide exclusion of applicants having committed organized crime-connected offences from public tender procedures. To that end, a 'European disqualifications register' (listing driving disqualifications, occupational disqualifications, deprivation of civic rights, ...) should be established.

*d. Decisions taken in the context of the follow-up of criminal judgements*

Finally, mutual recognition of decisions taken in the context of the follow-up of criminal judgements is to be introduced. Clearly, this would be critically important in cases where persons, who in one Member State are subject to obligations or are undergoing supervision and assistance (probation, parole) move to another Member State. In this context, a review of the 1964 CoE Convention on the supervision of conditionally sentenced or released offenders is envisaged.<sup>35</sup>

## 2. Eurojust

At the Tampere European Council, it was also decided that a new international body – Eurojust – should be set up, composed of national prosecutors, magistrates or police officers of equivalent competence, detached from each Member State according to its legal system (Tampere conclusion, nr. 46).<sup>36</sup> According to the Tampere conclusions, a legal instrument on Eurojust must be adopted by the end of 2001, at the end of the Belgian Presidency of the EU Council.

Current negotiations on a legal instrument setting up the actual Eurojust are chiefly based on a joint proposal of four consecutive Presidencies of the EU (Portuguese, French, Swedish and Belgian).<sup>37</sup> Awaiting the adoption of this instrument by the end of 2001, the JHA Council has already decided to set up a so called ‘Provisional Judicial Cooperation Unit’ within the premises of the General Secretariat of the Council of the EU, i.e. the Justus Lipsius Building in Brussels.<sup>38</sup>

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<sup>35</sup> It is anticipated that the dual criminality rule as embedded in this Convention should be abolished, and that the grounds for refusal the Convention allows for should be revised.

<sup>36</sup> The decision on the nature and extent of the powers granted to them will be left to the discretion of each individual Member State.

<sup>37</sup> Draft Council Decision setting up Eurojust. See *inter alia*: Council of the European Union, 14052/00 EUROJUST 19, Brussels, 4 December 2000.

<sup>38</sup> See: Council of the European Union, 13634/2/00 EUROJUST 11 REV 2, Brussels, 12 December 2000.

Eurojust will have to work closely together with the European Judicial Network<sup>39</sup> (the secretariat of which is also located within the premises of the General Council Secretariat) on the basis of crime analysis carried out at Europol level. Apart from the Eurojust members to be detached to Eurojust as a centralized unit, Member States would have the possibility to appoint one or several national correspondent(s), which may be (a) contact point(s) of the European Judicial Network.

The formal recognition of the Heads of State and Government that there is a need to establish a judicial counterpart for Europol is to be seen as once another step<sup>40</sup> in the establishment of a 'genuine European legal area' in which the judicial authorities – in most Member States traditionally in charge of criminal investigations – will be enabled to control and guide European police cooperation with a view to combating (organized) crime. The rationale for setting up Eurojust is the need for further improving judicial co-operation, in particular in combating forms of serious crime often perpetrated by transnational organizations.

Its principal task would be to help in ensuring proper coordination between the competent national investigating/prosecuting authorities with regard to investigations and proceedings involving two or more Member States and requiring coordinated action. The forms of crime within its competence will most probably cover the offences within Europol's (extended) mandate (i.e. including: child pornography, terrorism, counterfeiting of money/means of payment), computer crime, protection of the EC's financial interests, laundering of the proceeds of crime and other or connected forms of serious crime.

The unit is expected to be vested with the power to ask Member States to undertake investigations, to prosecute or to allow that another Member State may be in a better position to do so. Eurojust should also ensure that the Member States' competent authorities are informed reciprocally on interrelated investigations and prosecutions under way, and would need to be informed

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<sup>39</sup> On the complementarity between the European Judicial Network and the Provisional Judicial Cooperation Unit (predecessor unit of Eurojust), see: Council of the European Union, 11209/00 EUROJUST 11, Brussels, 8 September 2000.

<sup>40</sup> Also for cooperation with regard to controlled deliveries and covert investigations the traditional –national– prerogatives of the judicial authorities were formally recognized (*supra*).

of requests to set up a joint investigation team as meant in the new EU mutual assistance Convention of May 2000 (*supra*).

One of the principal items for discussion during further negotiations should take regard to the criteria to be used by Eurojust in coordinating prosecutions at EU level. The risk of forum shopping is evident: for example one could opt for prosecuting a case in the Member State where the best evidence can be found, in the Member State where the regime for the use of intrusive investigation techniques is the most supple, or in the member State where the heaviest sanctions apply (*lex severior*), ...

In trying to resolve this question, Member States should perhaps, as also envisaged in the Programme of measures to implement the mutual recognition principle (*supra*),<sup>41</sup> rely on existing criteria as contained in Article 8 of the 1972 CoE Convention on the transfer of proceedings (Vermeulen, 1997). Essential thereby, in my opinion, would be to strictly respect the *ne bis in idem* principle, to forbid intentional and clearly targetted *lex severior* scenarios and, if two or more options offer equal chances for effective international law enforcement, to make a choice in favor of the forum that best meets the interests of the suspects and/or the victim.

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<sup>41</sup> See measure No 11 in: Council of the European Union, 13750/1/00 CATS 68 COPEN 78 CRIMORG 158 REV 1, Brussels, 24 November 2000, 12.



## **Conclusion**

The EU has chosen to further and substantially enhance the horizontal, interstate cooperation between its Members. This is revealed in the shift towards the approximation of (substantive) criminal law, the adoption of a new convention to drastically improve and modernize traditional mutual legal assistance mechanisms and the introduction of the principle of mutual recognition of judicial decisions as the new cornerstone of judicial cooperation in criminal matters and the establishment of Eurojust.

It would only be correct for Member States and—in the future—candidate Member States to dutifully implement and thus give a fair chance to the legal instruments and initiatives described above, instead of promoting alternative scenarios of a more vertical, federal nature<sup>42</sup> in a premature stage.

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<sup>42</sup> Such as the establishment of a genuine European Public Prosecutor, which in particular the European Commission and the European Parliament have called for.

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# The Trafficking in Untaxed Cigarettes in Germany

## A Case Study of the Social Embeddedness of Illegal Markets

*Klaus von Lampe*<sup>1</sup>

### Introduction

In April 1991 the Berlin based daily newspaper '*die tageszeitung*' felt it needed to do something about its readers' foreign-language skills. In order to buy a carton of cigarettes on Kantstrasse, a major street in the Western part of Berlin, the proper thing to say, the newspaper advised, was the Polish phrase '*Ile kosztuje karton Marlboro?*', how much is a carton of Marlboros.<sup>2</sup> Since the visa obligation had been lifted for Polish citizens travelling to the then capitalist enclave of West Berlin in January of 1989, smokers could choose between the highly taxed cigarettes sold in tobacco stores and supermarkets, and cheap contraband cigarettes from Poland sold by illicit street dealers. In the turbulent times after the German re-unification, however, a crash-course in Polish was soon outdated. In West Berlin, under pressure from a law-and-order-seeking public, the authorities cracked down on the Polish dominated street sale of untaxed cigarettes. Meanwhile in East Berlin and other cities in the former German Democratic Republic (GDR), an illegal market for cigarettes of even greater proportions had emerged. It was not just the continuation of the previous Polish street trade as tourists from Poland and other Eastern European countries were increasingly replaced by vendors of a completely different nationality: Vietnamese. Male and female Vietnamese offering near metro stations and supermarkets contraband cigarettes became common a common

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<sup>2</sup> Slaska, E., and A. Böhm, Guten Tag - Dzień Dobry - Dschijn dobri, in: *die Tageszeitung*, 8 April 1991.

sight. For a while they even managed to establish themselves as quasi-legitimate business people. For example, at *Frankfurter Allee*, one of East Berlin's main traffic junctions, peddlers from Vietnam could be found selling untaxed cigarettes from long rows of make-shift stalls.

Today, although fewer vendors sell fewer cigarettes at fewer locations than during the early 1990s, the street sale of untaxed cigarettes has proven to be not just a temporary phenomenon in East Germany. At the same time, it seems that an increasing number of contraband cigarettes are being distributed to consumers through more clandestine channels in both the Eastern and Western parts of the country. In the end, the illegal cigarette market appears to have gone through significant changes in volume, geographical expansion and structure.

This paper will describe this development by outlining its basic characteristics and will explore the conditions that have contributed to its emergence and continued existence. Data were obtained from various sources, including media reports, government documents, interviews conducted with law enforcement officials, informants, and a representative of the German association of cigarette manufacturers.

## **Basic Parameters of the Illegal Cigarette Market**

Regardless of the specific conditions prevailing in Germany, the illegal cigarette market has a greater chance of being tolerated than other illegal markets, namely the drug market. Unlike illicit drugs, such as heroin or cocaine, the cigarettes that are sold on the black market are legal products. Though there have been confiscations of counterfeited cigarettes presumably stemming from Chinese product pirates, these cigarettes were not destined for Germany but for other, more profitable retail markets such as Great Britain, which imposes a much higher excise rate than most other EU Member States. In the Berlin area, the largest regional market for untaxed cigarettes in Germany, only a handful of cartons of counterfeit merchandise has been seized so far.

Just like the contraband cigarettes sold in Germany come from legal manufacturers, the consumption of these cigarettes in itself is neither illegal nor even deviant. Importing, distributing and acquiring cigarettes in violation of tax laws does constitute a criminal offence or at least a summary offence. But unlike injecting heroin or sniffing cocaine, smoking cigarettes is more or

less socially accepted, though, of course, there is some controversy over the extent to which smoking should be tolerated with regard to the inherent health risks. In sum, only part of the process that leads from the production to the eventual consumption of cigarettes is potentially subjected to definitions of illegality.

While the black market for cigarettes provides a link between two sets of legal activities (producing and consuming cigarettes) and for this reason alone seems to be less prone to stigmatisation and intense prosecution than other crimes, involvement in the black market for cigarettes appears to be regarded as a lesser crime also because it is in essence a variety of tax evasion, i.e. an offence which is widely seen as trivial.

The basis for the smuggling and illegal distribution of cigarettes is, quite obviously, the tax burden imposed on cigarettes. In Germany, some 70 percent of the retail price consists of excise and value added tax. This is less than, for example, in Great Britain or Denmark, but significantly more than in countries like Poland and the Czech Republic (Körner, 1996). The state imposed 'price wedge' (Van Duyne, 1996) as well as the tax rate differences between various countries provide wide profit margins, which are a stimulus for those who are capable of circumventing tax regulations. In Germany, the cigarette 'bootleggers' use three major channels through which they supply the black market:

- Cigarettes from a legitimate plant in a low-tax country such as Poland are legally purchased and then smuggled into Germany. With this method, differences in retail prices between high-tax and low-tax countries are exploited. It has been characteristic of the early phases of the black market and is still being used today by amateur smugglers.
- Cigarettes legally produced in Germany for export to non-EU countries are diverted to the black market before they cross the border. This method takes advantage of the fact that in the EU export goods are exempt from taxation. Since 1993 a series of restrictions on the shipping of cigarettes has apparently made this method more costly and therefore less frequent, including an increase in guarantees demanded from manufacturers or

dispatching agent to cover potential losses in tax revenue, and a more cautious sales policy adopted by the tobacco industry.<sup>3</sup>

- In recent years, it seems that the supply for the black market in Germany has increasingly come from cigarettes which are legally exported to non-EU countries only to be smuggled back. This category also encompasses untaxed cigarettes delivered to Russian army facilities before their closure in 1994. Allegedly, members of the Russian forces in Germany systematically sold cigarettes to black marketeers.<sup>4</sup> The advantage of actually exporting the cigarettes is avoiding the risks of having to bribe customs officials or to use false documents pretending that the goods have actually left the country.

Once the cigarettes are funnelled into the black market, they are supplied to consumers through a longer or shorter chain of distributors, depending on the size of the original shipment. For example, the Polish tourists travelling to West Berlin in 1989 functioned as both smugglers and vendors of the small amounts of cigarettes they brought with them. Later on, a division of labour emerged between smugglers from Eastern Europe and Vietnamese vendors. The longest distribution chain can be observed in the case of container-size contraband shipments. They are divided up and passed down a pyramid of wholesale and intermediate distributors until they reach the broad base of retail dealers.

The retail market in Germany is split into the visible street market and a hidden market. While the street market consists of vendors who offer their merchandise to the general public, the clandestine market largely relies on pre-existing social networks for transactions to take place, for example, at the workplace or among friends and family (Gosztonyi, 1994).

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<sup>3</sup> Restrictive measures include the introduction of a special carnet "TOBACCO-ALCOHOL" within the TIR system in 1993, the complete exclusion of cigarettes from the TIR system in 1994, and the exclusion of cigarettes from the comprehensive guarantee procedure within the Community Transit System in 1996 (see Committee of Inquiry, 1997).

<sup>4</sup> Reinhard, M., Berlin ist der Stützpunkt der Russen-Mafia in Deutschland, in: *Der Tagesspiegel*, 21 January 1993.

## **Historic Trends**

West Germany had known a small-scale clandestine market for contraband cigarettes that were procured from low-tax countries like Luxemburg and from Eastern European valuta stores. But it was only in the course of the political changes taking place in the late 1980s and early 1990s that a black market of any significance came into being. It was during these years that the street sale of untaxed cigarettes first emerged and it seems fair to say that it was only then that a broad demand for untaxed cigarettes developed.

The black market for cigarettes as we know it today originated in the late 1980s, when the Iron Curtain began to corrode and travel from Soviet Bloc countries to the West became more and more common. Travellers could take advantage of the lower prices charged in valuta stores and regular stores for products such as cigarettes, which are easy to carry and could be sold for high profits. These opportunities were first exploited on a large scale by Polish citizens travelling to West-Berlin after the visa-obligation was lifted in January of 1989. Within weeks, thousands of Polish tourists gathered in shopping malls and at improvised market places to offer a whole variety of merchandise, including Polish and Western made cigarettes (Irek, 1998). Soon, especially after the economic and currency union between East and West Germany in June of 1990, four months prior to re-unification, the open sale of untaxed cigarettes spread to other places in the Eastern parts of Germany. Within a year the selling of contraband cigarettes had developed into a well established business.

The statistics on the seizure of contraband cigarettes indicate how quickly the black market expanded during this period, particularly in 1991 and 1992 (Tab. 1). While the number of cigarettes confiscated by the West-German customs service had not exceeded 20 million per year until 1987, it was well over 20 million in 1988 and 1989. For 1990 no accurate figures are available, but apparently some 50 million cigarettes were seized in West and East Germany combined. Then, in 1991, the first year after German unification, a fivefold increase occurred with a total of 260 million contraband cigarettes being confiscated by the customs service, followed by 350 million seized in 1992 and 624 million seized in 1993.<sup>5</sup>

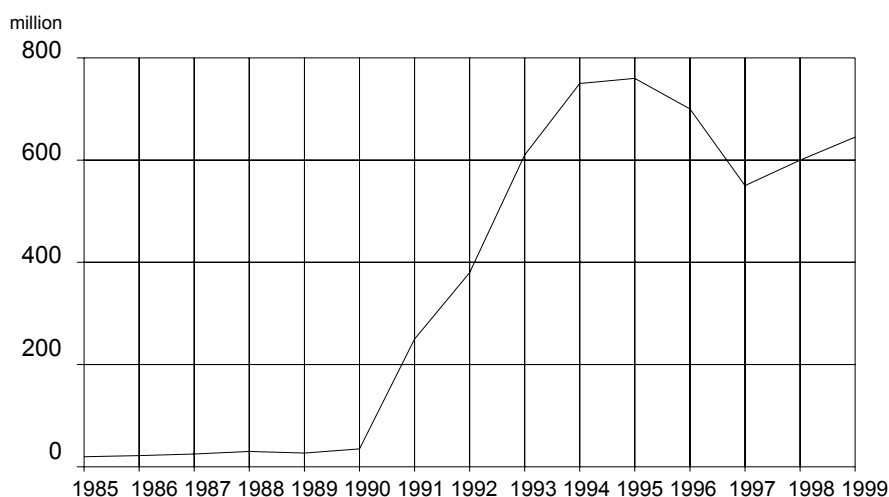
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<sup>5</sup> Figures were obtained from various publications of the Bundesfinanzministerium and the Zollkriminalamt.

**Table 1**

**Seizures of Contraband Cigarettes in Germany, 1985-1999\***

(source: Zollkriminalamt)



\* 1986-1989: West Germany, 1990: East and West Germany combined (incomplete statistics), 1991-1998: Germany

Of course, these figures are no accurate representation of the overall volume of the black market. To a considerable extent they simply reflect different levels of intensity of law enforcement. Still, a trend becomes discernable that also appears in other statistics, such as those on the legal consumption of cigarettes (Tab. 2). These figures not only indicate a shift from the legal to the illegal cigarette market in the early 1990s. They may also provide the basis for a rough estimate of the volume of the illicit cigarette market.

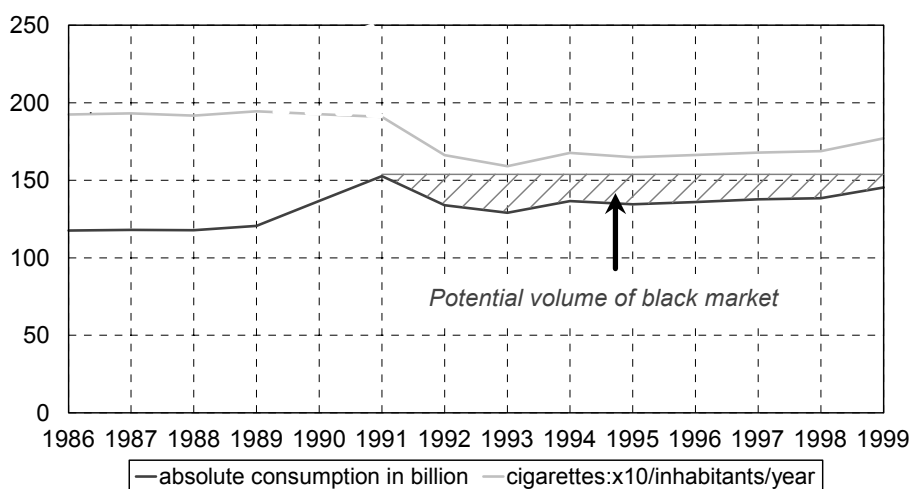
In the 1980s, the per-capita consumption of cigarettes had reached a level of about 1,900 per year in both West and East Germany. Accordingly, when the 16 Million East Germans joined the 61 million inhabitants of the Federal Republic of Germany the number of tax paid cigarettes rose by some 30 billion from 120 billion in 1989 to 152 billion in 1991. However, in 1992, the second year after the unification, the per-capita consumption of taxed cigarettes



dropped sharply to about 1,600 and the overall volume of taxed cigarettes decreased to about 134 billion.<sup>6</sup>

**Table 2**

**Legal Consumption of Cigarettes 1986-1999\* in Germany**  
(source: Statistisches Bundesamt)



\* No numbers available for 1990

This drop in the legal sales of cigarettes coincided with a seven percent increase in the average price of taxed cigarettes due to an increase in the tobacco tax which took effect in March of 1992. Therefore, some of the reduction in tax paid cigarette sales will have to be attributed to normal consumer reactions to price increases, like abstaining and switching to lesser taxed tobacco products (Körner, 1996). Yet, it seems fair to say that the sharp decline in legal sales between 1991 and 1992 reflects to a large part not a shift away from cigarette smoking, but a shift away from the legal cigarette market. This assumption is supported by household surveys conducted by the German Bureau of Statistics, which indicate that the actual consumption of cigarettes decreased only slightly, if at all, in 1992 (Fiebiger, 1992, 1993).

<sup>6</sup> See statistical yearbooks of the GDR and the FRG.

## The Volume of the Illegal Cigarette Market

Assuming that the actual consumption has not significantly dropped below the 1991 level of some 1,900 cigarettes per capita or some 150 billion cigarettes overall, it is possible to give a rough estimate of the volume of illicit consumption by comparing these figures with the respective figures for the following years. Between 1992 and 1998, legal sales fell short of the 1991 level by amounts of between 14 and 22 billion cigarettes annually. Percentage wise this implies that untaxed cigarettes have accounted for between 9 and 15 percent of the overall consumption. However, according to estimates by the German association of cigarette manufacturers, VdC, over half of the untaxed cigarettes smoked in Germany each year stem from across-the-border purchases within or slightly exceeding the permitted limits, while less than half are brought into the country by outright smugglers. Taking these estimates into account, contraband cigarettes sold on the black market would have held a share of only between about 4 and 7 percent of the overall cigarette market in Germany, which would still represent a share of a remarkable size. But the true dimension of the problem does not become apparent unless the unequal geographical expansion of the black market is taken into consideration.

## The geographical concentration in East Germany

One of the most striking characteristics of the illegal cigarette market in Germany is its concentration in the territory of the former GDR. The most obvious aspect in this regard is the fact that the street selling of contraband cigarettes is an almost exclusively East German phenomenon. Another indicator are the statistics on the seizure of contraband cigarettes, which consistently show higher amounts for East Germany than for West Germany, although since 1997 a trend towards greater approximation can be observed. For example, in 1995 the most successful year for the customs service, 583 million cigarettes were seized in East Germany, more than three times the amount of 175 million confiscated in West Germany.<sup>7</sup> This leads to the conclusion that more than just a few percent of the cigarettes consumed in East Germany come from illicit sources.

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<sup>7</sup> The amounts confiscated in East and West Germany from 1991 until 1998 are as follows, 1991: 180/80 million, 1992: 285/62, 1993: 522/102, 1994: 600/125, 1995: 583/175, 1996: 498/176, 1997: 293/247, 1998: 343/252; 1999: 339/314 (source: Zollkriminalamt).

The fact that the illegal cigarette market is unequally distributed across Germany provides a quasi-experimental set-up for exploring the factors most conducive to its emergence and continued existence. Actually, there are a number of aspects that may explain why the black market for cigarettes is more prevalent in the East than in the West.

On the *supply side*, one obvious aspect is the proximity to Poland and other Eastern European countries from where most of the smuggled shipments originate. On the *demand side*, differences in the social and economic conditions between East and West Germany have to be taken into account. The average household income is significantly lower and the unemployment rate significantly higher in East Germany than in West Germany. Therefore, East Germans have stronger incentives to purchase cheap contraband cigarettes. This assumption is supported by surveys that show a clear correlation between income levels and the willingness to procure cigarettes from illicit sources (MSI Market Services, 1997). Another reason could be that West Germans are less willing to engage openly in illegal activities, like the purchase of untaxed cigarettes, whereas East Germans may be more defiant of prohibitive laws. This may either be an after-effect of the shadow economy prevalent under communist rule, or a sign of opposition against a legal system that has been rigorously transferred from West Germany.

Also conducive to the emergence and proliferation of the illegal cigarette market is the relative weakness of the police and customs service in East Germany as a consequence of the general restructuring of government agencies following the collapse of the communist regime and the re-unification of Germany. Even in Berlin, where authorities could rely on the well established public-service apparatus of former West-Berlin, the customs service never had more than about 60 officers at its disposal to combat the trafficking of untaxed cigarettes taking place on a regular basis at up to 1,200 different locations.

Finally, one exceptional quality of the conditions in East Germany is the existence of a marginalised Vietnamese community. Of course, this is not to argue that there is some ethnic trait making Vietnamese particularly suitable to the illicit cigarette market. Nevertheless, the street vending of contraband cigarettes, initially the domain of tourists from Poland and other Eastern European countries, was largely taken over by members of East Germany's Vietnamese community in 1991 and 1992. Since this take-over coincided with the rapid expansion of the black market, it is plausible to assume that there is a causal relation between these two phenomena. Therefore, one of the reasons why a visible black market has not emerged in West Germany, may be because it has no similar Vietnamese community. Though there are also Vietnamese

living in West Germany, they are mostly well-integrated former boat-people with no particular incentives to engage in illegal activities. In contrast, the former migrant workers who make up the Vietnamese community in East Germany suffer from social deprivation and from seclusion from their host society.

## The Vietnamese involvement

The dominant role of the Vietnamese in the contraband cigarette street market is likely to conjure up images of an ethnic mafia taking over an illicit market by force, violence and corruption. Such stereotypical notions are without foundation. There is no indication whatsoever that Vietnamese street sellers used violence in the process of asserting themselves against non-Vietnamese competitors. On the contrary, it is likely that the Vietnamese were welcome to take over the most exposed and riskiest positions in the market hierarchy and that the Eastern European market participants gladly confined themselves to the less conspicuous roles of smuggler and wholesale distributor (see Gosztanyi, 1994; Irek, 1998). Likewise, there is no evidence that Vietnamese obtained a competitive advantage by corrupting officials. Only isolated incidents of rudimentary forms of police corruption have been reported. In one case, frustrated police officers gave up chasing fleeing street peddlers if they dropped their merchandise. The officers then kept the cigarettes for their private use or to sell them on their own account.<sup>8</sup>

A more convincing explanation for the success of Vietnamese street vendors than mafia imagery seems to be that they were simply better prepared for this business than any other social group. The Vietnamese who entered the street market for cigarettes in the early 1990s had come to the GDR from the Northern and central regions of Vietnam as temporary workers some five years before. By the time the communist regime collapsed in 1989, some 60,000 Vietnamese lived in East Germany. They were among the first ones to become unemployed as factories had to rationalise or close down completely, causing many to return to Vietnam. However, about 20,000 stayed behind in search of new sources of income. Since Vietnamese had been wheeling and dealing in textiles and other rare products on the fringe of legality under communist rule, it seems like an obvious choice that many of them began to follow the example of Eastern European tourists selling untaxed cigarettes.

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<sup>8</sup> Polizisten korrupt, Richter schockiert, in: *Der Tagesspiegel*, 14 May 1994.

As it turned out, the Vietnamese street vendors not only had the necessary skills to succeed in the cigarette business. For various reasons, they also proved particularly resistant to law enforcement.

Similar to other marginalised ethnic minorities, the Vietnamese in East Germany have –voluntarily or involuntarily– conserved their culture and language and remained mainly isolated. Consequently, the allegiance to the norms and values of the host country tends to be weaker than the internal solidarity within their own community. These conditions hamper investigations in many ways, as the willingness to co-operate with the authorities is limited and qualified interpreters are required to overcome the language barrier. Another specific problem arises from the absence of standardised rules for the registration of Vietnamese names, which do not follow the pattern of first name and last name. This has reportedly led to instances where peddlers were arrested several times without being identified as one and the same person. Finally, even if criminal charges are pressed, street vendors stand a good chance of receiving a sentence that allows them to return to their business right after each arrest. Though sentencing has reportedly become more severe since the mid 1990s, illegal vendors in Berlin still only face a suspended sentence of three months with probation after the third arrest and a suspended sentence of six months with probation after one prior conviction.

While every vendor –regardless of his or her ethnic background– could benefit from such leniency, Vietnamese have an additional advantage over other foreigners insofar as they run a lower risk of deportation. This is due to the requirement that Vietnam, like apparently no other country in the world, requires an entry-visa, even for its own citizens. Among several criteria, the visa is denied unless the applicant states that he or she wishes to return to Vietnam voluntarily. Few Vietnamese do.

The problem is aggravated by the fact that in the street sale of contraband cigarettes former guest workers, who received the status of legal residents in 1993, have increasingly been replaced by newly arriving illegal immigrants from Vietnam. These illegal immigrants are likely to use false documents and they seem even less inclined to co-operate with the authorities.

In 1995, a treaty between Germany and Vietnam went into effect which aimed at facilitating the extradition of Vietnamese involved in the illegal cigarette business. The Vietnamese government agreed to grant re-entry to 40,000 of its citizens from Germany until the year 2000. During the first three years, however, the execution of the treaty passed off slowly. Instead of 20,000

only about 5,000 Vietnamese returned to Vietnam under the provisions of the treaty.<sup>9</sup>

Even if an illegal cigarette vendor has successfully been extradited, law-enforcement officials claim that this has no lasting effect insofar as he or she is immediately replaced by a new immigrant from Vietnam. Vendors who in recent years have been apprehended for the first time usually had just arrived in Germany a few days earlier. Reportedly, alien smugglers have made a profitable business from recruiting prospective vendors, who are charged several thousand dollars they either have to pay in advance or work off by selling cigarettes.<sup>10</sup>

### The Special Case of West Berlin

The relative immunity from law enforcement displayed by the Vietnamese street peddlers and the list of other conditions favourable to the black market in East Germany explain a great deal. However, they cannot explain why the street selling of cigarettes has not extended into West Berlin. In fact, in West Berlin the same conditions exist, for example, the proximity to Poland and a high rate of unemployment. Still, ever since the authorities in West Berlin successfully curbed the wheeling and dealing by Polish tourists in the early 1990s, the Western part of the city has remained largely unaffected by illegal street traders.

It is interesting to observe that Vietnamese vendors of untaxed cigarettes did briefly appear in various places in West Berlin, but failed to achieve continuity. At the same time in East Berlin they succeeded in establishing the central position in the open cigarette market. This points to conditions unique to East Germany as a society in transition, i.e. conditions which are rooted in the process of transformation from a communist system to a free-market economy and which exist neither in West Berlin, nor in the Western parts of Germany.

In the early 1990s, street sellers of cigarettes, particularly if they were Vietnamese, were perceived as an alien element in West Berlin. Whenever Vietnamese peddlers made inroads into West Berlin they were immediately

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<sup>9</sup> Mai, M., Statt Vietnam Ausreise nach Tschechien, in: *die Tageszeitung*, 22 September 1998.

<sup>10</sup> For a more comprehensive description of Vietnamese street vendors and the associated phenomenon of Vietnamese extortion gangs, see Habenicht (1995), Laudan (1999), Lehmann (1998) and Niggel (1994).

reported to the police or customs service. The agencies were pressed, especially by legal cigarette dealers, to take immediate action. In contrast, despite the fact that illegal cigarette sellers had previously been just as unknown in the East, it was only one of many new worrying phenomena characterising the period of transition. Compared to the rise of widespread unemployment and social deprivation and the occurrence of more serious forms of crime, the emergence of an illicit market for cigarettes appeared as one of the minor problems.

### **Impulses for action**

A certain degree of indifference towards the illegal cigarette market in East Germany has not only been shared by East Germans, but also by the federal government and the Berlin administration, both of which have been dominated by Westerners. The common indifference is reflected in the history of countermeasures adopted to curb the street sale of cigarettes in East Germany.

The first major step was taken by the federal government in late September of 1991 with the creation of a special unit of some 50 customs officers charged with intensifying the control of smuggling routes and trading locations. Until then it had been rather restrained in its comments about the estimated several hundred million Deutsche Marks in lost tax revenues. Reportedly, the special unit was established only after a tobacco company had brought complaints before the minister of Finance, asserting unfair competition against the background of a black market in which none of its products held a significant share.<sup>11</sup>

On the state level, most notably in Berlin, the impulse to take decisive action against the black market was even less directly connected with the harm associated with the trafficking in untaxed cigarettes. Rather, it was an outbreak of violence within the Vietnamese community that led to a concerted effort of customs service and police. Until then—with the exception of West Berlin—the police had only reluctantly become involved in the fight against the illicit cigarette market. It considered violations of tax regulations the exclusive competence of the customs service. This attitude changed with the escalation of violent conflicts between Vietnamese extortion gangs, which had emerged shortly after Vietnamese vendors took over the street sale of contraband cigarettes.

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<sup>11</sup> Sommerfeld, F., Zigarettenhandel - die polnische Mafia sahnt ab, in: Berliner Zeitung, 16 June 1992.

The trafficking in untaxed cigarettes is a profitable business down to the street level. Profit margins for street vendors, according to various sources, range between 2 and 20 Deutsche Marks per carton of 200 cigarettes. One peddler interviewed by a journalist in 1995 reported that at lucrative spots up to 600 cartons could be sold in a single day for a profit of 2 to 4 Marks each, while less attractive locations were allegedly still good for selling 10 to 20, sometimes 100 cartons a day.<sup>12</sup> In some cases this would amount to monthly earnings well above the average legal income in Germany. The profitability of the business combined with its visibility and illegality make street sellers of untaxed cigarettes a likely target of predatory criminals. In fact, early on Vietnamese peddlers have been victimised in two distinct ways. On the one hand, they were harassed and assaulted by right-wing extremist juveniles, on the other hand they increasingly became victims of Vietnamese extortionists, who organised along lines of regional affiliation.

The activities of these extortion gangs are purely predatory in nature. They exact protection payments from vendors without interfering with the sale of cigarettes as such. This finding corresponds with general assumptions about the respective functional autonomy of violence oriented criminal groups and illegal enterprises (Block, 1980; Schelling, 1971; Skaperdas & Syropoulos, 1995). Likewise, it is not surprising that these extortion gangs soon engaged in a bloody conflict over spheres of influence, as continuous extortion, by necessity, requires the establishment of a monopoly of power in a specific territory (Schelling, 1971).

In Berlin, this conflict culminated in a virtual gangland war in late 1995 and early 1996 with shoot-outs taking place on busy streets during business hours, such that passers-by were at risk of being hit by stray bullets. It was only at this point that a massive and concerted attack against the illegal cigarette business was launched. For the first time, police gave full support to the customs service in cracking down on the open market. As a consequence the number of vending locations and dealers and the volume of the street sale dropped significantly. According to one series of surveys, the volume of the open market decreased by about 40 percent between September of 1995 and September of 1996 (MSI Market Services, 1998). The remaining street dealers were forced to change their modus operandi to adjust to increased law-enforcement pressure.

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<sup>12</sup> Smoltczyk, A., Der neue Ho-Chi-Minh-Pfad, in: *Wochenpost*, 6 May 1995.



## **The structure of the cigarette street sale**

The structure of the visible retail market for untaxed cigarettes had long been characterised by individual entrepreneurs who either smuggled the cigarettes into Germany by themselves or bought them from smugglers and illegal distributors. A change occurred only after increased law-enforcement pressure forced vendors into more complex enterprise structures comprising a division of labour. In order to safeguard against raids, look-outs were positioned around vending locations. To minimise losses from confiscations, the contraband cigarettes were kept separate from the vendor. This required stock-keepers for guarding the merchandise and to hand out cigarettes once the vendor had come to an agreement with a buyer. Likewise, to avoid the forfeiture of monies, cash had to be kept separate from the cigarettes which required the position of cashier.

It is not clear how durable the co-operation of a given team of street sellers tends to be and to what extent the positions are part of a hierarchical structure. In any case, the differentiation of roles is a remarkable response to an increasingly hostile environment, making the organisation of the street sale more complex and sophisticated. Usually, the reverse is true for criminal enterprises as fewer participants mean less risk of detection and betrayal (Southerland & Potter, 1993). In the case of street vending operations these considerations probably do not apply for the simple reason that all participants are by nature visible to outsiders.

## **The structure of the clandestine retail market**

Parallel to the structural changes in the street sale of cigarettes, more clandestine forms of distribution have apparently spread in East Germany and also in the Western parts of the country. According to surveys conducted among East German Smokers, purchases in Poland and the Czech Republic as well as at the workplace and in bars and restaurants have become significantly more important since 1995 (MSI Market Services, 1998).

In West Germany, a similar development can be observed. The seizures of contraband cigarettes have increased, especially since 1997, and anecdotal evidence point at the extension of clandestine distribution networks into West Germany, either from East Germany or from countries like Poland and Lithuania.

One reason for the apparent shift towards clandestine forms of distribution is that street vendors have adopted more discrete methods like home deliveries.

Another reason is the fact that the trafficking of untaxed cigarettes has attracted entrepreneurs, who have avoided public exposure from the beginning. Some of these entrepreneurs are members of pre-existing criminal networks, who find the cigarette business a profitable and relatively safe alternative to other illegal activities such as fencing stolen goods. Some distributors of untaxed cigarettes have no prior criminal record. They operate within social networks that are otherwise not entangled in illegal activities.

The structure of the clandestine retail market, by nature, is less transparent than the structure of the visible street market. However, individual entrepreneurs seem to be most common, while there are no reports of more complex enterprises similar to those currently characterising the street sale of contraband cigarettes.

### **The structure of the wholesale distribution**

In contrast to the sales outlets, the upper levels of the business, the smuggling and wholesale distribution of untaxed cigarettes, have not only become much more sophisticated over the years. They also show clear signs of a concentration process. However, at present there is no evidence of the exercise of market power.

Following the initial phase of the open market for untaxed cigarettes in East Germany, a specialisation between smugglers, primarily from Eastern Europe, on the one hand, and vendors, mostly Vietnamese, on the other could be observed. Along with this division of labour the smuggling of cigarettes took on new proportions. While individuals have continued to bring small amounts of cigarettes across the border, reports on the confiscation of contraband cigarettes indicate that soon the major supply for the German consumer market came from bulk shipments. These range from the size of a full car trunk, about 50,000 cigarettes, to containers with several millions of cigarettes, being brought into the country in all imaginable forms of disguise.

Parallel to the extended use of traditional smuggling methods more elaborate schemes to put large quantities of untaxed cigarettes on the black market evolved. Dummy corporations were set up to purchase legally tax-free cigarettes per truck loads from companies in Germany and other Western countries, including the U.S., supposedly to be exported to Eastern Europe. Before the cargo reached the border, however, it was unloaded and sold to illegal wholesale dealers. The trucks were then either supplied with false documents or customs officials were bribed to issue genuine documents in order to maintain the impression that the cigarettes had actually been exported. In one of the few

discovered cases, Polish smugglers reportedly had paid two German customs officers 10,000 Deutsche Marks each per truck for confirming the proper crossing of the border.<sup>13</sup> In recent years wholesale operators seem to have turned to exporting bulk shipments of legally purchased cigarettes to Eastern Europe, most notably Poland and Lithuania, only to smuggle them back into Germany later with false customs declarations. The chance of discovery is rather small in view of the enormous volume of cross-border traffic and the limited capacity of the customs service to conduct thorough searches.

The legal procurement of large quantities of untaxed cigarettes is apparently linked to a concentration process on the upper levels of the black market. While it is the cheapest and potentially most profitable way to obtain untaxed cigarettes, it is open only to a few more or less sophisticated and well funded operators. A carton of 200 cigarettes designated for export to a non-EU country costs between 6 and 9 Deutsche Marks and can be resold to illegal wholesale dealers for between 12 and 25 Deutsche Marks. A truck load of cigarettes, including the service of drivers, carriers, forgers and various small time accomplices, according to one estimate, costs about 500,000 DM and produces net profits of close to 1.5 million Deutsche Marks.<sup>14</sup>

In Berlin, during the mid 1990s the wholesale market was reportedly divided between three so-called cigarette syndicates. From the information provided to journalists by a high level insider<sup>15</sup> one can surmise that this oligopoly had come into being only because of the economies of scale involved and not through deliberate efforts to restrict access to the market. No indications exist of any violent competition or, reversely, of any cartel agreements. From the data collected for this paper, only one reported incident of violence could be interpreted as related to a dispute directly connected with the black market for cigarettes. In 1996, a group of five Poles assaulted four Vietnamese in an apartment in the East German town of Guben and took away money and passports. In the press this event was ascribed to 'gang wars over illegal trade deals at the German-Polish border'.<sup>16</sup>

In the last years, the concentration process seems to have trickled down to the level of Vietnamese wholesale dealers. In an interview given to a TV-reporter in 1999, a Vietnamese informant claimed that in Berlin there are three

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<sup>13</sup> Plarre, P., Lukratives Geschäft mit illegalen Fluppen, in: *die Tageszeitung*, 23 February 1993. On corruption in the German customs service, see also Bruhn (2000).

<sup>14</sup> Wittmann, K., Perfekt, blitzschnell und dreist, in: *Die Zeit*, 3 May 1996.

<sup>15</sup> Nie Fragen gestellt, in: *Der Spiegel* 27/1997, p. 25-26.

<sup>16</sup> Von Polen überfallen, in: *die tageszeitung*, 23 July 1996.

groups of former street vendors, who are capable of purchasing bulk loads from smugglers to the amount of several hundred thousand contraband cigarettes. They in turn supply groups of intermediate dealers with up to 100,000 cigarettes at a time who then sell smaller amounts to street vendors.<sup>17</sup>

The fact that the concentration process has extended from the top level can be interpreted as a natural development. It seems unlikely that truckloads of untaxed cigarettes would be sold directly to great numbers of vendors. For practical reasons and to reduce the risk of detection, top level operators will be inclined to deal with as few customers as possible.

## Conclusion

Despite the incompleteness of the available data and the sketchiness of the above description, some cautious remarks can be made concerning the nature of the illegal cigarette market in Germany.

The first observation that has to be made is that the trafficking in untaxed cigarettes is a classic example of the provision of an illegal good to a demanding public. The criminal activities involved are characterised by the absence of direct victims, by continuity, and, with regard to the street sale, by a high visibility to outsiders. In contrast to other illegal markets, however, which come into being by means of morally induced prohibitions of goods and services, the illegal market for cigarettes deals with a substantially legal commodity and promotes an activity –the smoking of cigarettes– which is neither illegal nor even deviant.

A combination of social, economic, political, legal and cultural factors has contributed to the emergence and continued existence of a large scale black market in Germany, which is centred around the street sale of untaxed cigarettes in East Germany.

In each phase of the historical process, market participants have taken advantage of pre-existing circumstances and have adopted to changes, rather than having attempted to alter the conditions. The assumption that the provision of illegal goods and services on a continuous basis requires systematic corruption is not supported. Likewise, the black market for cigarettes does not fit the stereotype of violent competition and a tendency towards monopolisation. While the upper and intermediate levels are characterised by an oligopolistic market structure, this concentration merely reflects economies of scale in the bulk procurement of untaxed cigarettes. There are

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<sup>17</sup> Althammer, R., Ein mörderisches Geschäft, B1, 15 October 1999, 20.15-20.45 h.

no indications that entrepreneurs strive for a monopoly to secure monopoly profits, neither by use of force, nor by any other means. This calls into question the widespread notion that the maximisation of profits through attempts at cartelisation or monopolisation is a defining characteristic of organised crime.

Finally, there is no evidence of the emergence of an illegal power structure overarching the illicit cigarette business. Such a monopoly of power could either evolve in response to a demand for non-violent dispute settlement mechanisms (Reuter, 1984), or in an effort to internalise the external costs of the use of violence (Hellman, 1980; Luksetich & White, 1982). As indicated, both factors do not seem to be relevant for the illegal cigarette market.

The extortion of street vendors is a different issue. Rivalling extortion gangs have used violence to exact 'protection' payments and to enlarge their respective areas of influence by eliminating competitors. But they have refrained from any direct involvement in the day-to-day routines of the cigarette business.

In the light of a continuously high level of law-enforcement pressure and the progressing consolidation of government structures in East Germany, it is unlikely that the visible black market will regain the proportions it had reached in the early to mid 1990s. At the same time, the clandestine distribution of cigarettes may well continue to expand in East and West Germany as long as tobacco taxes remain high and no efficient means are found to prevent legally manufactured cigarettes from entering the black market.

More research is needed to explore the basic conditions and inner workings of the illegal cigarette market. Some of the aspects that require further investigation are, for example, the role of the legal tobacco industry, the relation between the legal and illegal cigarette market with regard to pricing and brand popularity and the involvement of legal businesses in the illegal distribution of cigarettes. In addition, insight must be obtained into the structure of illegal businesses involved in the black market, the norms and values regulating transactions between market participants, the overlap with other areas of crime, and the position of Germany within the broader context of cigarette smuggling in Europe and around the world.

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# Some Policy Implications of Various Patterns of the Supply Side of Illicit Drug Market <sup>1</sup>

Matja Jager<sup>2</sup>

‘According to the story, he [*i.e. Thales of Milet*] knew by his skill in the stars while it was yet winter that there would be a great harvest of olives in the coming year; so, having a little money, he gave deposits for the use of all olive-presses in Chios and Miletus’. When the harvest-time came and many were wanted all at once and of a sudden, he let them out at any rate which he pleased’. (Aristotle, *Politics*, 1259a7-17)

## Introduction

The drug policy debate usually does not pretend to be cold, academic and abstract. On the contrary, the arguments are, as Garland observed, most of the time ‘...open-ended, trailing off into the journalistic, the commonsensical, and the everyday understanding of lay people’ (Garland, 1992, 420). I intend to venture more in the opposite direction. My aim is to show some examples of the way abstract economic models may provide useful clarifications for drug policy.

In general, economic analysis of drug policy can be described as an attempt to identify and explain how various participants on this particular illegal market react to various prices (in the widest meaning of the word) they confront, in particular to prices created by the legal rules. This consequential approach aims to map the incentive structure of the main participants on the illegal market. Once identified such incentive structures/maps may provide a useful tool in forming policy decisions.

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I am focusing on the supply side of the illegal drug market – or better – on various distinct (although also interrelated) markets for illegal drugs. In this respect I first describe two stylised illegal supply market models, i.e., pure competition and monopoly. Of these two the former is normally the analytical departing point since the monopoly is most of the time observed as a (socially) negative mutation of pure competition. After describing the basic mechanics of these two models I speculate on their feasibility. In particular I discuss pros and cons of the monopoly/organized crime model in case of illegal supply of hard drugs. Finally, I present some interesting policy implications of the monopoly/organized crime model. Perhaps the most important (and counterintuitive) one is that for any prohibition enforcement level the monopoly on the supply side ought to be in principle preferred to pure competition market.

What follows first is the pure competition model. As an example I will assume that the supply of marihuana can fruitfully be modelled in this way.

### **Supplying marihuana in pure competition**

The textbook analysis of the market morphology normally starts with the imaginary ideal case of the so-called ‘pure competition’. We are told that the competition on the supply side is ‘pure’ if the industry in question is composed of a great number of small firms. In addition each firm produces/sells such a small amount of the whole industry’s output/sale that the supply side is said to be ‘atomistic’ in structure. Further, the good supplied has to be homogeneous, i.e., the good supplied by various sellers has to be believed by buyers to be identical. In that case customers buying a homogeneous good have no preference for a particular supplier. The good and the price are the same wherever they buy. And finally, in order to speak of pure competition, the ‘atomistic’ suppliers have to be completely mobile, i.e., they have to be able and willing to move and join the supply at any particular location of the pure competition market. Any time new suppliers are free to enter (or to leave) the market and join the existing suppliers.

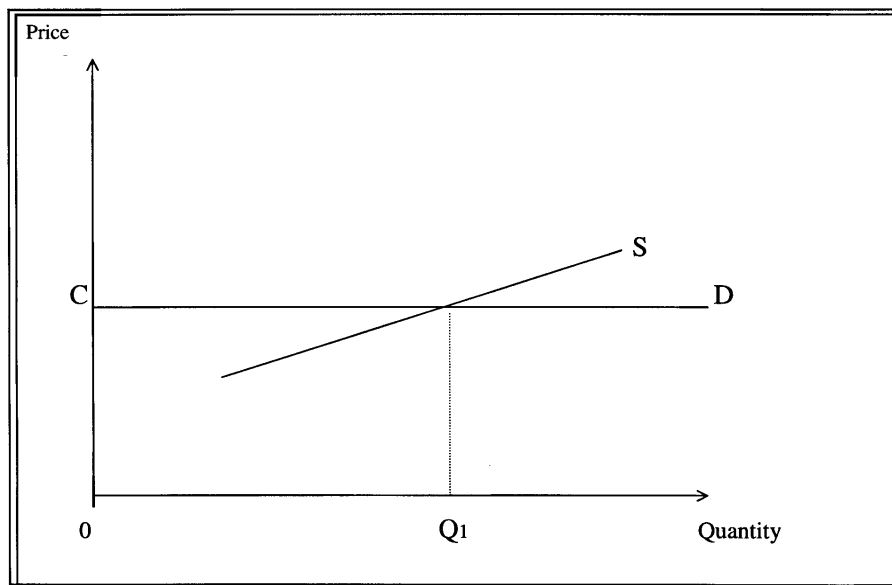
What is important however, is that their entry does not influence the market price of the good, since each individual firm produces only a tiny fraction of the total output.

Each firm as an ‘atomistic’ seller in the pure competition can sell only at the price other small supplying firms in the industry sell the same product. Therefore, each firm is, as they say, a ‘price taker’. At the given price on the

market each firm is able to sell all it can produce. This stylised, ideal situation is illustrated in figure I below.

**Figure I**

**The Quantity of Marihuana Sold by a Small Firm in Pure Competition**



The horizontal axis denotes the quantity of marihuana sold and the vertical axis its price. For the market price  $C$ , the firm can sell as much as it can. The fact that the market price is given does not mean that it can not change with time; it can change, but not as a consequence of the activity of any-one individual firm.

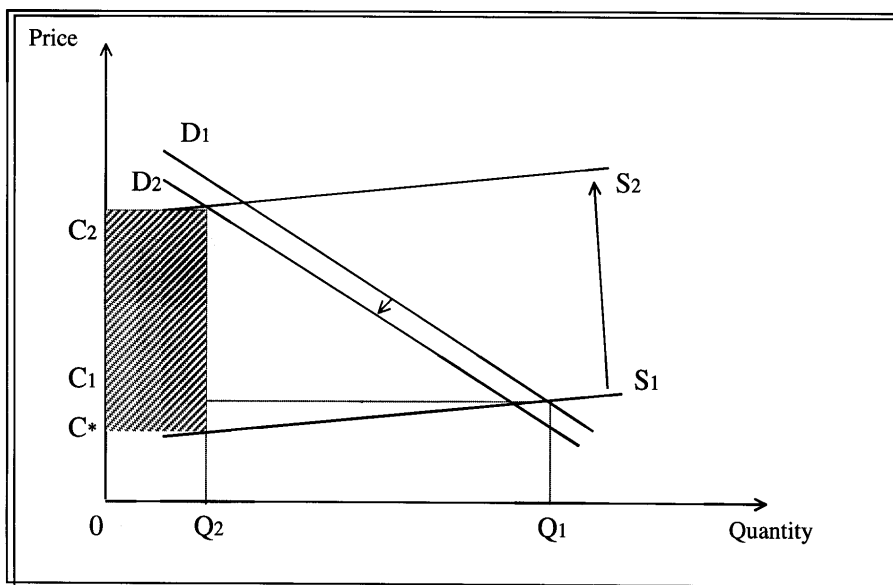
We can now identify the consequences of a change in legal regime. Let us assume that the supply of marihuana, for example in a country like Slovenia, is a reasonable approximation of pure competition model. This may be reasonable since marihuana is easy to produce in small quantities and almost everyone can produce it; the number of producers/sellers can be expected to be high. Further, the costs of production are relatively low, the barriers to entry the market very low or not existent, the product relatively homogeneous and many small suppliers presumably mobile. In such a case little power is concentrated in the hands of an individual supplier or a small group of suppliers.

The consequences of a change in legal regime (from legal market to prohibition) on a pure competition market are pointed out in figure II below:

Figure II

The Marihuana Market, Legal and Illegal

(Compare Rogers III., p. 81)



Suppose that the demand curve  $D_1$  and the supply curve  $S_1$  reflect the situation on the imaginary legal market for marihuana. The demand curve  $D_1$  is typically downward sloping to the right reflecting the idea that the quantity demanded ought to rise as the price goes down<sup>3</sup> The supply curve  $S_1$  is sloping slightly upward to the right as the quantity offered rises with the rise of price. The equilibrium price is  $C_1$  and the whole quantity sold on the market at this price is  $Q_1$ .

Let us now imagine the sudden change in legal regime introduced by prohibition. On the one hand the mere fact of imposed prohibition, i.e., the mere illegality of the drug may cause the shift in consumer's tastes away from

<sup>3</sup> Marihuana is not considered to be a very addictive drug and has available substitutes. On the aggregate one could say that the demand for this drug is elastic. The elasticity of demand measures the response of the quantity bought in relation to the change of price of the good. If the percentage change in quantity bought exceeds the percentage change of price, the demand for that good is said to be 'elastic'. If the opposite is the case the demand for the product is 'inelastic'.

this drug. Such reduced level of demand is reflected in the shift of the demand curve down and to the left, i.e., from  $D_1$  to  $D_2$ . This shift is due to the presumed normative or 'psychological' effect of prohibition on consumer's tastes (demand) which ought by itself cause the reduction in the amount of drug demanded at any price.<sup>4</sup>

More importantly, full costs of supplying marijuana will rise considerably when the government starts enforcing the prohibition. The new legal regime causes the shift of the supply curve up and to the left from  $S_1$  to  $S_2$ . The total supply of the whole industry is reduced from  $Q_1$  to  $Q_2$  and the price goes up from  $C_1$  to  $C_2$ . The initial supply curve  $S_1$  (i.e., the one before the prohibition) reflects the costs of production if the product is legal. After prohibition the new supply (cost) curve  $S_2$  reflects the risen costs of producing and selling marijuana at various quantities. From this point of view the difference between the new higher and the old lower costs is, *ceteris paribus*, the direct consequence of the new illegal status of the good. When the market becomes illegal the price of the good simply goes up. The increase in income flow of suppliers described in literature also as the 'crime tariff' or the 'black market profit' is graphically represented by the shadowed rectangle  $C^*-C_2$  (the rise in price) times  $0-Q_2$  (the quantity sold).

It is important to understand that in economic terms higher suppliers' income flow is a necessary compensation for the new much higher level of risk involved in producing/selling marijuana. This compensation level is determined by supplier's subjective assessment of the increase in risk, i.e., by his subjective estimate of the money in return, that would compensate him for taking this risk. Hence the real net profit from the marijuana trade can rightly be considered only after the compensation for increased level of risk takes place.<sup>5</sup>

To summarize: the imposed prohibition on the imaginary legal market raises the full costs of supply as reflected in the shift of the supply curve up and to the left. The higher income flow however, does not automatically mean higher profit. The difference between the market price before and after the prohibition takes place is basically the compensation to the (now illegal) suppliers for the increased full costs of supply. An overwhelming part of these 'costs' is a

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<sup>4</sup> It can also be the other way around. The drug becomes more attractive due to imposed prohibition (the potential forbidden fruit effect).

<sup>5</sup> 'bribery costs' can be seen as an insurance device against the increased risk connected with enforced prohibition.

reflection of their subjective assessment of the perceived threat of apprehension and punishment as a consequence of a new legal regime.<sup>6</sup>

After briefly presenting the basic mechanics of such a stylized marijuana/pure competition model we can now turn to the monopoly model. Many experts believe that monopoly (or its variation - a cartel) may be a predominant supply pattern on the market for illegal 'hard' drugs. I will presume that the supply of heroin is a good illustration of this thesis.

### **Monopoly? The case of Heroin**

As Gary S. Becker points out in his 'Crime and Punishment: An Economic Approach', the competing criminal firms would, just as firms in the legitimate business, have a 'normal' incentive to collude in order to exploit the opportunities of the illegal market to the fullest, i.e., to gain monopoly profits (Becker, 1968).<sup>7</sup> The competitive criminal firms would in principle rationally opt for collusion when the perceived benefits offset the perceived costs of colluding and maintaining the new organizational structure. On the supply side this kind of collusion can result either in one firm's monopoly or, on the other hand and in the case of heroin supply more probable in the form of a trade association or a cartel.

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<sup>6</sup> From the customer's point of view the full price of drug use includes the market price, the cost of time spent in buying drugs (so-called 'search costs'), the danger of being arrested and punished or victimized as a participant on the illegal market and other costs. More on these elements of the full price see, e.g., Rasmussen, Benson, *The Economic Anatomy of a Drug War*, Rowman and Littlefield Publishers, Lanham, 1994, pp. 39-65

<sup>7</sup> In an interesting recent attempt to portrait the 'captains' of the organized crime industry from the psychological point of view, Bovenkerk suggests that the personality traits that predict success and 'exploitation of the market opportunities to the fullest' are the same as in the legitimate business. The traits that count are: extraversion, controlled impulsiveness, a sense of adventure, megalomania and Narcissistic Personality Disorder (*sic!*). See, Bovenkerk, 'Wanted: Mafia Boss' Essay on the Personality of Organized Crime, *Crime, Law and Social Change*, Vol. 33, 2000, pp. 225-242.

The heroin monopoly is defined as a type of black market where one supplier sells heroin to many small buyers.<sup>8</sup> The criminal cartel in particular is an agreement among the criminal firms about elimination or restriction of the competition in the certain industry.<sup>9</sup> Following Stigler there are three main elements of a cartel agreement: the rules to be followed, the ways violators are to be detected and the agreement on how the violators are going to be sanctioned.<sup>10</sup> As to the first element an agreement can be made about the minimum price below which the parties of the agreement should not sell their goods or, on the other hand, about the maximum amount of the good that is allowed to enter the market. Yet another option is to agree to divide the market (usually by territory) so that each of the parties becomes an exclusive monopolist on its designated share of the market (Bajt, 1979, p.181)

Analytically, the monopoly and cartel can basically be treated equally in respect to the way extra monopoly profit is extracted.

The so called 'extra' or above normal profits resulting from colluding are the consequence of the reduction of quantity sold and of the increase in the price of the good.<sup>11</sup> The following section is going to show in detail how monopoly is able to extract such above normal profits.

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<sup>8</sup> If the barriers to entry (and the barriers to leave - on the side of the demand) the market are very high, if the good in question is very homogeneous (i.e., it does not have close substitutes) and if it is of the same quality, than the monopoly is very strong. See, e.g., Bajt, p. 159.

<sup>9</sup> We take an industry to be the sum of all firms that produce the same product or service.

<sup>10</sup> Gambetta and Reuter for example have analyzed these three points in case of Mafia influence in legitimate business. See, Gambetta, Reuter, *Conspiracy Among the Many: the Mafia in Legitimate Industries*, in *The Economics of Organized Crime*, Fiorentini G., Peltzman S. (eds.), Cambridge University Press, 1995, pp. 116-139.

<sup>11</sup> See, e.g., Luksetich, White, *Crime and Public Policy*, Little Brown, Boston, Toronto, 1982, p. 203. The other potential benefits besides monopoly profit are the internalization of external costs and benefits, and the potential economies of scale in the production and distribution of illegal goods (on both points see below). *Ibid.*

## Squeezing Out Extra (Monopoly) Profit

Suppose that organized crime is selling to the independently acting customers an addictive drug that has no close substitutes (in our case we suggested heroin).<sup>12</sup> The drug in question is supplied either by one firm (monopoly) or a group of firms that cooperate and coordinate their activities in order to extract monopoly profit (a cartel). This market structure is just the opposite to our previous example of a competitive industry with a large number of small firms selling the good. In the case of monopoly there is, so to speak, only one firm (or a group of cooperating firms in a cartel) in the industry.<sup>13</sup> The big firm is the whole industry.

The important consequence of this arrangement is that the one supplying firm is by itself able to influence the market price of the good (that can never happen in a pure competition model). The essential features of such monopoly market are illustrated in a figure below.

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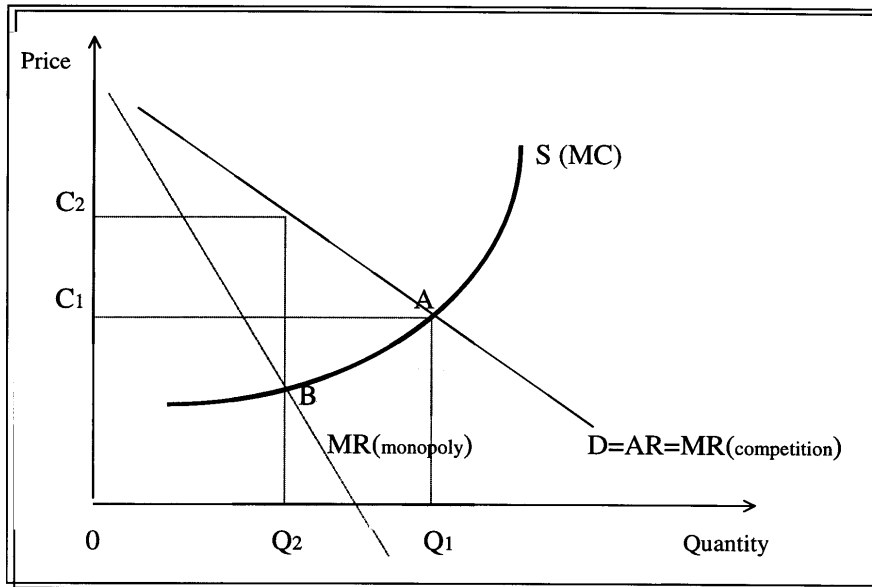
<sup>12</sup> The point that the good in question is addictive suggests that the profitability of a supply side cartel depends to the great extent on the price elasticity of demand of the good. The more the demand for a good is inelastic the greater the potential for the increase of the monopoly profit, as will be shown below.

<sup>13</sup> I follow the basic analysis of the monopoly market that can be found, e.g., in Bajt, pp. 169-186; Varian, *Intermediate Microeconomics: A Modern Approach*, 3rd. ed, W.W. Norton & Company, New York, London, 1993, pp. 399-415. I also drew upon the accessible elaboration of the heroin monopoly market in Rogers III., *The Economics of Crime*, The Dryden Press, Hinsdale, Ill., 1973, pp. 80-97 and upon elaboration of organized crime analyzed as a monopoly in Luksetich, White, op. cit., pp. 203-233.



Figure III

A Monopoly (Cartel) Market in the Case of Heroin  
(Compare, Rogers III., p. 83)



The horizontal axis measures the quantity of heroin and the vertical axis its price. Graphically a monopoly can best be illustrated as the deviation from a competitive market situation. In the case of a competitive market the demand curve  $D$  reflects the aggregate demand for heroin. It also shows the average revenue (denoted  $AR$ ) that many small firms in a competitive industry will receive for various levels of output, i.e., the average prices for all output produced at various industry output levels.

On the other hand, the supply curve  $S$  indicates the sum of the marginal costs of all firms in the competitive heroin industry, again at various levels of the whole industry's output. In the case of a competitive market the output of the good will rise to the point  $A$  where the marginal costs equal the average revenue (i.e. price) the firms get for the product. The quantity sold will therefore be  $Q_1$  for the price  $C_1$ .

As we remember each individual 'atomistic' firm in a competitive market acts as a 'price taker', since it produces such a small portion of the total output that it can only sell at the same price the other firms sell. In addition to that it is able to sell all it produces at that particular price. Each firm's output is too small to have an effect on the total output in the industry and the market price

can not be effected by a single firm's action. Thus the marginal revenue of such a small firm on the competitive market equals the average revenue of all firms, i.e., it equals the price. For this reason the demand curve D in Figure III does not reflect only the average revenue (AR) of the whole industry but also the marginal (MR) of each single firm within that industry as well. Indeed one doesn't have to differentiate between these two in the case of pure competition (and that is why the equation  $D=AR=MR(\text{competition})$ ).

As we know in general the profit of the industry is maximized at the point where marginal revenue equals marginal cost. It is therefore profitable for the industry to increase the output up to the point A.

In the case of monopoly the situation changes. One single firm (or a group of cooperating firms a cartel) takes over the whole market. By definition and in the same way as many small firms on the competitive market, this particular firm will try to maximize its profit.

Before we present the solution for the monopoly profit-maximization problem let's first make some additional assumptions. First, let's assume that the change on the supply side from pure competition to monopoly will not affect the demand. We will assume that the demand for the product of a monopoly is the same as it was on the competitive market. Second, we will assume that the cost curve S that the monopoly faces is the same as in the competitive market. Both assumptions are reflected in figure III above.

Now back to the problem of monopoly and profit maximization. The same as in the case of a competitive firm the optimal amount of monopoly output is determined by the point where the marginal revenue equals the marginal cost, i.e., graphically, at the point where marginal revenue curve MR and marginal cost curve MC intersect. If the marginal revenue is less than the marginal cost, the profit maximizing firm will decrease output as that would increase its profit. On the other hand, if marginal revenue is greater than are the marginal costs, it would be profitable to increase the amount of the drug supplied. Only at the point where marginal revenue equals marginal cost the amount of output (the quantity sold) is optimal from the point of view of profit maximization.

As the monopoly/cartel is the whole industry, the quantity sold by one firm is the quantity sold by the whole industry. The market supply is thus easily controlled. Because of this the monopoly can directly determine the market price of the monopoly good.

However, in this case the marginal revenue is not the same as the going price but for the first unit sold, the only point where the demand curve D and the monopoly's marginal revenue (revenue received for the additional units of output) curve MR intersect. The first additional unit sold lowers the price at

which these both two units are sold. Marginal revenue for the additional unit sold is consequently less than the revenue received for the first unit. It is actually getting lower and lower as the output is rising.

The marginal revenue curve of the monopoly MR shifts from the D curve back and down. As the amount of output rises the marginal revenue is declining and consequently equals zero at a certain point. Even before reaching that point the marginal revenue intersects the supply (marginal cost) curve S; in figure III at point B. Since at that point marginal revenue equals marginal cost, the profit of a monopoly is maximized at that point. It can also be seen from figure III that at quantity sold  $Q_2$  the difference between the total revenue (price time quantity sold) and the total costs is greatest. Thus at that particular quantity of output the profit is maximized. In our case this maximization occurs at the quantity  $Q_2$  with the respective price  $C_2$ . All eventual additional units sold would lower the total profit as costs would exceed the revenue. Illustrated graphically, at any amount sold that goes beyond quantity 'Q2' we can see that the marginal cost curve S (MC) is above the monopoly's marginal revenue curve MR.

As the optimal quantity sold in the competitive market is  $Q_1$  and – as we saw – the optimal amount marketed in monopoly is at  $Q_2$ , what we witness is the reduction of quantity sold and the increase in price. The declining demand curve, typical for the monopoly position on the market, enables the monopoly to rise the price and still remain in the business as all the numerous small buyers will not be lost (in particular if the demand for the good is very inelastic as presumed in the case like heroin). The monopoly cannot be competed away as there is no competition.

Thus, as a general rule, the monopoly output level is always less than the one in the competitive market, given the same supply (cost) curve. The monopoly as a rule supplies smaller quantities than the competitive industry and the consumers of a monopoly good are normally worse off than in a competitive market.<sup>14</sup> In our case the monopolization of a heroin supply has resulted in first, a decrease of quantity sold and second, in the rise of price.

Finally, one more thing is important. In order to be able to extract extra monopoly profits it is not necessary that the whole production and distribution chain is organized by a single provider. A monopolist situated at every distribution stage can appropriate for itself the above mentioned monopoly

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<sup>14</sup> For a demonstration of a Pareto inefficiency in this case see, e.g. Varian, op.cit., pp. 406, 407. The monopoly firm is the only one who is better off due to the explained extra monopoly profit.

profits.<sup>15</sup> In such a case mutually profiting monopolists can coexist at different stages of a supply chain.<sup>16</sup> This can in principle be done by paying a sufficiently low price to those higher in the chain and by charging a sufficiently high price to those lower in the chain.

### **Monopolist's incentive to discriminate prices**

In our explication we have so far assumed that the monopolist sells all its output at the same price. Yet a monopolist as a monopolist can charge different prices to different customers and thus enhance his market power still further and gain still additional profits. In other words if the monopolist is able to sell different units of heroin at different prices, i.e., if it can discriminate prices along different consumers, it can gain extra-extra profits above the 'normal' monopoly profit.

The heroin market gives the monopoly supplier an excellent opportunity for price discrimination. The main reason for this is the fact that heroin is a

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<sup>15</sup> See, Rubin, *The Economic theory of the Criminal Firm*, in *The Economics of Crime and Punishment*, Rottenberg, S. (ed.), American Institute for Public Policy Research, Washington D.C., 1973, p. 162; Luksetich, White, pp. 218-220.

<sup>16</sup> It is often estimated that the supply of heroin unites many stages between the initial producer and the final customer. What is the optimal length of this chain from the point of view of the supply 'machinery'? It is obvious that the rational distribution chain ought to minimize the costs perceived by the suppliers of the product. The optimal length of such a chain will in part depend on the size of the market as its size affects the level of specialization that takes place (Rottenberg, p.79). Very important component of the perceived costs would be the expected cost of legal punishment. Analytically the optimal length of the chain will reflect the point at which the reduction of risk from adding an additional stage is outweighed by the costs of adding this new stage to the chain. Bearing this in mind we can expect that the illegal supply chain will be longer than the respective legal chain for the same product.

Let us assume a scenario in which the structure of the illegal supply chain is a matter of deliberate design and control by the 'people at the top'. As the length of the chain increases, the number of persons who have to be detected before the people at the top are detected rises. Consequently, it is in the interest of the latter to lengthen the chain. The length of the distribution chain will, in the end, reflect the changing trade-off between the need to avoid risk and the costs of maintaining such an expended chain. The risk of apprehension is decreasing with the reduction of transactions each dealer makes. And the lengthening of the chain decreases this number of transactions.

highly addictive drug. Its addictive nature suggests that the price elasticity of demand can vary considerably among the customers. Some need the drug badly 'no matter what costs' and in such cases the demand is said to be inelastic. The other 'less hooked' buyers may be more sensitive to market price and their demand is said to be more elastic in response to changes in price (the same quality of the product assumed).

If, for example, the retail dealer knows his customers well (and we suppose that this is more probable than not since the risk the dealer is facing is thus lower), he may practice such price discrimination. Ideally for him he is going to charge each customer a different price according to the customer's level of addiction, i.e., according to how badly each particular customer needs heroin. The most addicted among them will still be willing to pay a very high price and the retailer, knowing that, is going to charge them the highest price these very addicted customers will still be willing/manage to pay. And so on in this pattern the dealer is going to charge each customer the maximum price that each of them is willing to pay. The case of such perfectly discriminating monopolist is illustrated in the figure IV below.

**Figure IV**

**The Perfectly Price Discriminating Monopolist**

*(Compare, Rogers III, p. 90)*

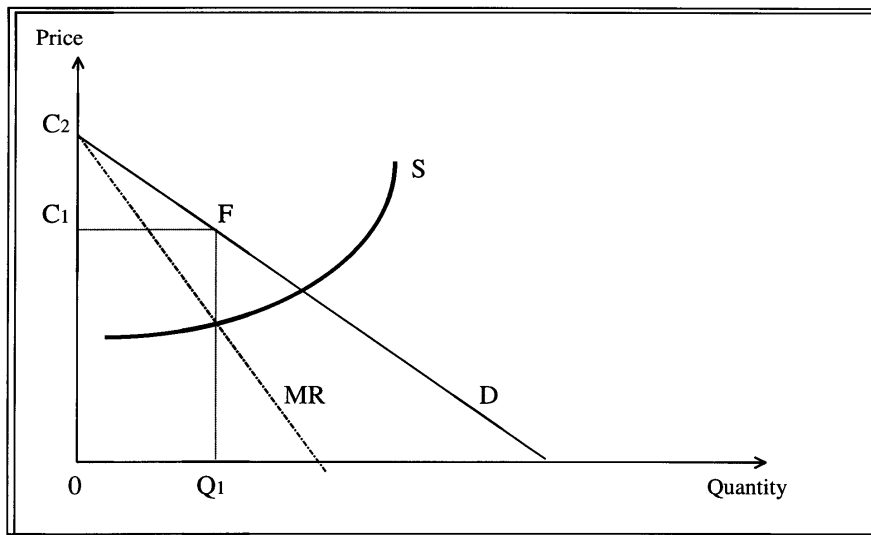


Figure IV models the perfectly price discriminating monopolist 'in action'. This is the ideal case of the largest possible price fragmentation of the retail market for heroin. In this kind of price discrimination prices may literally differ from one customer to another.

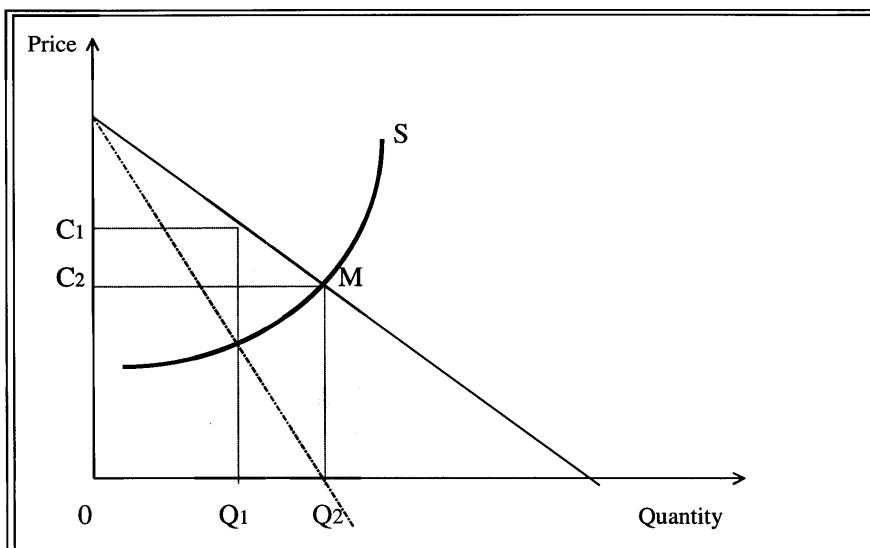
If the monopolist does not discriminate prices it charges the same price to all of its customers and collects only its base monopoly profit discussed previously. This is illustrated by price  $C_1$  and the amount sold  $Q_1$ . Now, in the case of perfect price discrimination the most addicted customer is not going to pay  $C_1$  but rather  $C_2$ . The next one - less addicted - is going to be charged slightly less, the third one again slightly less and so on until the last customer is going to pay the price  $C_1$ , which is the last price at which the monopolist is willing to sell even to the least addicted customer. The additional monopoly profit extracted by the way of perfect price discrimination can be seen graphically in the figure IV above as a triangular  $C_1$ -F- $C_2$ . The whole monopoly profit thus equals the usual monopoly rent plus the rent extracted by price discrimination.

And even more. In case of perfect price discrimination the marginal revenue curve MR becomes again the same as in perfect competition, i.e., it becomes identical with the market demand curve D. The reason for that is that the perfectly discriminating monopolist does not have to cut the price for all units in order to sell additional units of the product, as he can discriminate prices perfectly among the customers. He is able to lower the price for an additional unit(s) without having to lower the price of the units originally sold.

Like all profit maximizing firms this monopolist will continue selling up to the point where marginal costs equal marginal revenue. As the marginal revenue curve MR has now shifted to the right and is identical with the market demand curve D, the new optimum point has emerged. On figure V below this new optimum is denoted M.

Figure V

**The Profit Maximizing Output of a Perfectly Discriminating Monopoly**  
(Pindyck, Rubinfeld, p. 376)



Perfectly price discriminating monopolist is thus able to capture all of the so called 'consumer surplus'. As each consumer in this scheme pays the maximum price that he/she is willing to pay (i.e., the so called 'reservation price') he/she does not get any excess of value over the price. The surplus created by the exchange is thus not divided; it goes entirely in the hands of the perfectly discriminating monopolist. As the market is illegal the customers have no legal recourse against price discrimination.

On the other hand, in the case of a non-discriminating monopolist, the consumer surplus is still present, as there is only one price at which the monopolist is selling the product. Those consumers that value the product very much (in our case the most addicted customers with the least elastic demand curves), i.e., whose reservation price is well above the market price, are able to capture a positive consumer surplus.

It is important to note that the necessary condition for the smooth functioning of the perfect price discriminating monopoly is that buyers do not have contact between each other, i.e., that no reselling is going on among them. Attracted by the difference in prices on the market new middle – men

occur who – by being able to resell the product - capture a part of the discriminating profit.

Finally, of course, one has to stress that the presented model is an ideal abstract concept.<sup>17</sup> However, I believe it is of value as it puts light on the specific incentives that ought to develop in case the supply of heroin (at any stage) is monopolized and ‘the market opportunities exploited to the fullest’.

## **Reasons in favour of a monopoly on the heroin market**

It is usually presumed that the supply of heroin is monopolized at least on the wholesale level. What makes this presumption reasonable?

In general the monopoly is said to be stronger the fewer sellers are on the market, the fewer and weaker the substitutes of the good, the higher the barriers to entry, and the less mobile the buyers. The presence of these monopoly-enhancing factors is, of course, rarely undiminished; it is, most of the time, a matter of degree and changes with time. These elements can be present cumulatively or alternatively and, of course, in different possible combinations (Bajt, 1979, pp. 159,169).

Economic theory suggests that one important element that may lead to monopolies is the so-called minimum efficient scale, i.e., the level of output that minimizes average cost, relative to the size of demand (Varian, 1993, pp. 412-415). We speak about economics of scale when, as the supplying firm gets bigger in its operations, the average costs of supplying decline. In other words, due to the nature of underlying technology, the average cost of one additional unit of output is decreasing as the scale of production increases. If total market demand for a product is very large in comparison to one firm’s optimal level of output (i.e., the level of output that minimizes this firm’s average costs), then the monopoly is unlikely to result. However, if the opposite is true, i.e., if the total market demand for the product is not much larger than one firm’s optimal level of output, this may present an incentive to organize as a monopoly or a cartel. In the first case there is room for many small competitive firms that produce at a relatively small scale. In the second situation, the monopoly is

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<sup>17</sup> Varian (1993) presents one additional realistic real-life example of a perfectly price discriminating monopoly. This might be the case of a small-town doctor who charges his patients different prices according to their ability to pay (Varian, 1993, p. 421). On the other hand I remember myself being told once from an attorney from Ljubljana that he also sometimes deliberately practices price discrimination among his clients (in this case in a way as a member of a ‘legal profession cartel’).



likely to emerge as there will be a strong incentive for bigger firms to 'swallow up' smaller ones, since the larger firm can produce the product cheaper, i.e., at lower costs per unit (compare Rogers III, 1973, pp. 87-89). The monopoly is therefore likely to arise where the minimum efficient scale (determined by the production technology, transportation,...) is large relative to the size of the market.

Indications that heroin supply is indeed a decreasing cost industry are manifold. First, the sources of raw material (opium) are not as abundant as for instance in the case of marihuana. In addition the import/transportation of opium or heroin may be connected with substantial costs and risks.

Further, one could say that monopoly makes law enforcement efforts more easily focussed and thus law enforcement comparatively easier (compared to, for instance, marihuana). As a consequence, a need for substantial financial resources to secure police inaction, i.e., to 'buy non-enforcement' will arise.<sup>18</sup> High bribes necessary to secure protection of high-level law enforcement officials will be made if and only if they are perceived to be profitable. Thus in order to reduce transaction costs the corruption will be centrally managed.<sup>19</sup> In this respect corruption is therefore a decreasing cost activity and economy of scale exists.

The relevant cause of the increasing returns in the case of corruption is most probably due to the so-called 'indivisibility'. Indivisibility in this case means that an official bribed for one purpose can easily be bribed also for another purpose (Rubin, 1973, 156). This led some scholars to conclude that only large-scale operation can economically achieve a comprehensive protection system.<sup>20</sup> Small firms might simply not be in a position to offer high enough bribes and

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<sup>18</sup> Law enforcement is concerned. The system of overlapping jurisdictions, that might partly be a result of the design to prevent corruption, undermines the monopoly on the side of a certain law-enforcing unit. Nonetheless, the unit in question remains a monopolist as to non-enforcement it 'provides'. See, Anderson, Comment, in *The Economics of Crime and Punishment*, Rottenberg, S. (ed.), American Institute for Public Policy Research, Washington D.C., 1973, p. 170.

<sup>19</sup> Anderson (1973) also believes that centralized management of corruption enhances its effectiveness since 'individual policemen are not faced with the problem of trying to protect different operators'.

<sup>20</sup> See, Rogers III, p. 89; Luksetich and White, p. 216; Hellman, *The Economics of Crime*, St. Martin's Press, New York, 1980, p. 173. But see, Reuter, *Disorganized Crime: Economics of the Visible Hand*, The MIT Press, Cambridge, Mass., London, 1983, *passim*, arguing at great length against the pervading claim that in general the illegal markets are monopolized by organized crime.

to finance the distribution to the world markets.<sup>21</sup> These factors then impose a high barrier to entry for relatively small firms.

Yet another very interesting implication of the financial ability to corrupt the law enforcement is that this may impose additional barriers to entry the market.<sup>22</sup> As much as effective bribing is used as an insurance against the enforcement of prohibition, the enforcement will focus on those ‘remaining’ that could not afford this kind of insurance. As Anderson describes this particular situation clearly:

‘[t]he police must produce some arrests, but the number and spectacular character of these may be a function of public demand. These arrests will come from those without police protection or they will be arranged by the corrupting group; thus corruption provides the means of using the police, either directly or through their concentration on the remaining arrestees, as a method for controlling the entry of independents into an illegal market’ (Anderson, 1973, p. 171).

Finally, once the transaction takes place at every level of the illegal distribution chain, parties may have a considerable incentive to stick with the connection established. This is so because dealing with new connections brings in substantial additional risks. Because of this and due to the relative immobility of buyers a supplier at any stage can exercise a certain amount of a monopoly power. This power is reinforced if a cartel agreement about the division of the territory takes place. And this is very likely to happen. In such situation, as Luksetich and White observed ‘...every seller has some price range over which price can be increased before customers begin to actively search for a new connection’ (Luksetich and White, 1982, pp. 253, 254). If the price range in question is substantial the monopoly profits are extorted.

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<sup>21</sup> The great import operations may require considerable financing as the transaction costs are normally high and therefore the amount of drug smuggled has to be big enough to offset these costs. Also inevitable personal contacts have to be made. As Rubin illustrated; ‘[b]ecause of the illegal nature of the traffic, purchase arrangements are usually made by dealers through personal visits. This practice increases the costs of the transactions and as a result large shipments are imported’. Rubin, pp. 158, 159.

<sup>22</sup> The traditional way of preventing the entry of a hostile competitor on the illegal market is, of course, use of violence.

## **Is Organized Crime a Blessing?**

On the level of abstract models the analysis of a monopoly - the market for heroin is taken to be an example - produces some striking criminal policy implications. First, in comparison to pure competition the monopoly market produces less output and increases the price of the good. This is most obvious in the case of a non-discriminating monopoly. In the case of a perfectly discriminating monopoly, the profit maximizing level of output is nonetheless the same as in the case of a perfect competition (i.e. at  $Q_2$  on Figure V) but the price is much higher. It is higher than on the competitive market as the competitive price only equals the price the discriminating monopoly is willing to charge to the last least addicted customer (i.e., in our case price  $C_2$  on Figure V.).

Since in the case of heroin the 'good' sold is considered 'a bad' by a society, the reduction of the amount of heroin sold and the rise of its price (or only the latter in the case of a perfectly discriminating monopoly) clearly goes hand in hand with the supply-reduction effort of law enforcement. Economically speaking law enforcement wants to achieve the same goal, i.e., to reduce the supply of this illegal drug and hence its availability.<sup>23</sup> The thinking behind the supply reduction enforcement strategy is namely simple; the less drugs are there on the market and the higher their price the lower will be the level of

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<sup>23</sup> The idea of the 'organized crime blessing' was first put forward by James M. Buchanan in his provocative article 'A Defense of Organized Crime', in *Economics of Crime and Punishment*, Rottenberg, S. (ed.), American Institute for Public Policy Research, Washington D.C., 1993, pp. 119-132. The presumption behind is of course that the legal prohibition of certain drugs is a welfare enhancing policy. For the willing participants in this trade the welfare would be maximized if the drugs in question would be legal. However, if the prohibition is the case the consumers would prefer the competitive market to monopoly. From the point of view of the willing consumers, as Buchanan says, '...restrictions on industry output would be welfare-reducing. Hence for this subset of the population, monopoly control is less desirable than competition.' Buchanan, op. cit., p. 124, n.8.

consumption.<sup>24</sup> For the purpose of this article I simply assume a wide spread existence of this repressive supply reduction policy - I leave its evaluation aside.<sup>25</sup>

Based on the above models we could indeed formulate a rule that 'for any given enforcement level, ..., monopoly output would fall short of the competitive'.<sup>26</sup> For any given enforcement level it ought to be the case that (*ceteris paribus*):

Monopoly (non-price discriminatory) is preferred to  
Monopoly (price discriminatory) which is preferred to Competition (pure)

Due to transitivity it follows that also non-price discriminatory monopoly is preferred to pure competition. Bearing this formula in mind Buchanan suggested that when dealing with evident social evils, 'freedom of entry, the hall mark of competition, is of negative social value here, and competitiveness is to be discouraged rather than encouraged' (Buchanan, 1993, p 131). He went on and suggested, rightly we believe, that the fact that monopoly is socially desirable 'may be recognized implicitly by enforcement agencies that may

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<sup>24</sup> See, e.g., The US National Drug Control Strategy 1997, p. 32: 'Since a permanent though varying demand for illegal drugs is likely to persist, we must reduce the supply of available drugs. History has demonstrated that the more plentiful drugs are, the more they will be used. Conversely, the less available drugs are, the fewer people use them. Therefore we should cut the supply of drugs to our citizens.' Compare also the US National Drug Control Strategy: 2000 Annual Report.

<sup>25</sup> For the evaluation see, e.g., Chambliss (1995, pp. 101-124). On the assumptions and problems of this kind of reasoning see, e.g. Jager, Namen represivne zakonodaje v zvezi z drogami z vidika domnevne racionalne izbire, Revija za kriminalistiko in kriminologijo, Ljubljana, 45/1/1994/3, pp. 232-240. On the important unintended consequences of the repressive supply reducing policy (in order to offset the effects of enforcement new defensive strategies on the supply side are developed: new substitutes on the input and output side, innovative marketing, etc.) see, Rasmussen, Benson, pp. 67-92. On such unintended byproducts on the global scale see, McCoy, Coercion and its Unintended Consequences: A Study of Heroin Trafficking in Southeast and South West Asia, Crime, Law and Social Change, 33; 191-224, 2000.

<sup>26</sup> Buchanan, (1993, p. 126). See also Luksetich and White, p. 220-223, Hellman, pp. 173, 174. A variation of this notion is the so-called 'tragedy of the commons' idea about the fate of communally held resources. Victims can be observed as a kind of 'common property resource' to the criminals and can be 'overused'. The idea is that the competitive industry will tend to 'overuse' this commonly owned resource, i.e., the victims of crime. Monopoly will do no such thing but will, by reducing the 'excessive use' enable a long-term stable income. For further elaboration on this point see Luksetich, White, pp. 210-213.

encourage or at least may not overtly and actively discourage, the organization of such industries' (Buchanan, 1993, p 119).

What we witness is the unexpected and unprecedented 'joint venture' of organized crime (monopoly structure on the supply side) and (traditionally understood role of) law enforcement. The reduced output of the product considered a notorious social bad ought to be to the benefit of the society. In addition to the reduction in output (and higher price) there may be still other advantages of a monopoly (i.e., organized crime structure on the supply side).

One benefit may be the reduction of violence. Since the organized crime monopoly *is* the whole industry it is able to internalise previously external costs. In the case of a competitive market one small individual firm would make decisions about its level of violence output not taking into account the potential costs that such increased level of violence will have on the whole industry. In this case an increase in the use of violence by many individual firms may invite increased level of law enforcement on the whole industry and thus such additional costs are imposed on the whole industry. On the other hand a criminal organization in a monopoly position can control the level of output of the whole industry (as it *is* the whole industry) including an important element - violence. It thus can, to some extent, predict the response of law enforcement and by doing this avoid unnecessary costs. Various otherwise external costs are in this way internalised and subject to control.

### **To what extent is the monopoly model adequate?**

Although basically intuitive the monopoly model of the heroin market may turn out to be more or less inadequate. Obviously, there are additional factors beside those pointed out in the model that shape the structure of the illegal supply side. In some cases other entrepreneurial forms prevail over monopoly.

It may be the case for example that due to specific circumstances the market does not create any specific barriers to entry. The recent research on the illegal drug market in Frankfurt suggests that this has direct consequences for the business (Paoli, 2000). Many users and small to medium size dealers take the supply in their own hands and travel routinely to the nearby Netherlands to buy 'soft' and/or 'hard' drugs. As a consequence in a case of such relatively small quantities the 'distribution' chain is very short. It is at the maximum composed of three levels: the importer, the dealer and the consumer. The Frankfurt supply side of the market for hard drugs turns out to be very open and thus far from the monopoly and associated organized crime model. As Paole summarizes the peculiarities of the Frankfurt case in economic terms:

Given this convenient and easy-to-reach source of drugs ‘next door’, Frankfurt has always remained an open market, in which anybody can try to earn his/her fortune, selling, importing, or producing drugs. No single dealer, group or ethnic community has ever succeeded in setting up a monopolistic regime over any drug market in Frankfurt. As a result, though there are some large importers and wholesalers, the city’s drug enterprises have always been price-takers rather than price-givers. That is none of them are able to influence the commodity’s price appreciably by varying the quantity of the output sold.<sup>27</sup>

These and other empirical findings suggest that in case of hard drugs the monopoly model must not be generalized or presumed. Another research done recently by Zaitch comes to similar conclusions.<sup>28</sup> He focused on perhaps the most notorious drug suppliers in the world the so-called ‘Colombian cartel’ (Zaitch, 2001, p. 357-360). It turned out that the popular depiction of this supply enterprise as a ‘cartel’ is not appropriate at all. Evidence suggests that the monopoly model of a hierarchical organized crime supply of Colombian cocaine is inadequate. Instead, the manufacturing and distribution is organized in a much more loose, fluid and flexible way. Also, contrary to analytical expectations of the hierarchical organized crime model the organizational ‘structure’ is much more precarious. In the Colombian case:

‘The risk minimizing strategies that must be followed to make an illegal operation successful encourage a loose structure, in which it is not possible to plan production levels, to achieve economic agreements and to give orders to be carried out through several layers of production and distribution’.<sup>29</sup>

The Colombian cocaine supply is not hierarchical or very highly organized, on the contrary, it relies mostly on various networks based on diadic, face-to-face relational ties that are able to change quickly to suit new conditions or situations. Basically all levels of supply can be described as competitive and the whole market remarkably open to newcomers. The only sector that is not highly competitive is the intermediary, oligopolist area of large exporters to

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<sup>27</sup> Paoli (2000, p.52) She notes that the dealers in Frankfurt and in whole middle Germany have to set the price on the basis of the Dutch prices. If they do not they may be easily bypassed by the users who go to Holland and buy the drug directly.

<sup>28</sup> Zaitch (2001) warns that the monopoly model may uncritically be favored on political grounds as it implies, among other, legitimization for increasing resources in a fight against highly organized criminal monopolists.

<sup>29</sup> Thoumi, cited in Zaitch (2001, p. 358).

America and European markets. These large exporters allow smaller suppliers to send their cocaine through their channels in exchange for a charge. Due to specialization and experiences that enhances their ability to reduce risk they can also offer insurance in case the cargo is seized by the enforcement agencies. In case nothing happens these large exporters get a percentage. Nonetheless, Zaitch suggests that even this oligopolist sector does not rely on some kind of trade cartel agreement. At best such agreements are highly precarious. Violent competition – in various forms ranging from direct wars to cooperation with law enforcement – takes place even among these large-scale exporters (Zaitch, 2001, p. 360).

## **Conclusion**

I have presented some selected basic economic elements of the supply side of the illegal drug market, both competitive and monopolized. The introductory short description of a free, competitive market was taken as an analytical prelude in the monopoly model analysis. I have pointed to factors suggesting that the illegal market for heroin may be monopolized at least at one level of the distribution chain. I also discussed structural reasons that enable the above normal monopoly profit to be gained on the illegal market.

After that I briefly elaborated on the monopoly's ability to discriminate market prices of a strongly addicted drug to different groups of buyers or ideally (for the monopolist) to every single buyer in order to gain yet additional 'price-discriminating' monopoly profits.

The inherent mechanics of a monopoly reduces output and increases the price of heroin. I find this result to go unintentionally hand in hand with traditional policy aims of the supply reduction activities. This brings us to the important criminal policy conclusion that monopoly ought *ceteris paribus* be preferred to pure competition because of its inherent incentive to reduce the quantity sold and to increase the price of the drug. Law enforcement agencies have, considering the supply side of the market, exactly the same aim, i.e., to reduce the amount sold and to push the price up, or in short, to reduce availability.

Describing these two models and their implications for the illegal market for heroin I pointed out reasons why the emergence of a monopoly (organized crime) in this setting may not be the worst possible scenario, but actually quite to the contrary.

Finally, I have pointed out empirical findings that suggest the monopoly/cartel model sometimes turns out to be completely inadequate. This real

life testing simply suggests that the implications of 'ideal-type' economic models should not automatically present a blueprint for structuring policy responses. They need to be empirically tested 'on the ground' and in case of continuous empirical falsification perhaps abandoned all together. One of the basic values of models is in fact their frank description of the underlying assumptions, sincere display of implications and their ability to be empirically tested. The more they enable crisp predictions to be derived from them the more valuable they should be from the point of view of potential verification (or better following Popper's falsification approach).

If empirical findings suggest that a monopoly model of illegal drug supply is inadequate in some and useful/adequate in other cases, research ought to focus on factors that determine why these differences in seemingly similar circumstances occur. The particular form in which the paradigm of entrepreneurial and profit driven behaviour of supply side actors is shaped in various circumstances remains to be empirically verified case by case.



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# Afterword

## Organized Crime Research in Perspective

*Klaus von Lampe*

A glance at the international criminological literature conveys the impression that along with increasing concerns over the negative side effects of globalization there is a growing interest in the subject of organized crime, particularly in its cross-border variety. The Colloquia on Cross-Border Crime can be seen as another manifestation of this trend. At the same time one might wonder whether there is more to it than just talking and writing about this phenomenon. Despite an ever expanding volume of publications there is still little in the way of interrelated empirical research and theorizing in response to the excitements, uncertainties and anxieties characterizing the public perceptions on organized crime. What is needed, or at least appears to be desirable, is a concerted effort by interested scholars to confront media and politically induced imagery with well researched data and sober analysis. One may wonder why the scientific community has so far done so little in this direction. On the contrary, it has even added to the confusion by coming up with a myriad of conflicting definitions and conceptualizations. In this afterword, I take the opportunity to reflect briefly on the state of affairs of organized crime research and to discuss its prospects for the future.

### **The predominance of popular imagery**

The first study on organized crime dates back to the year 1926 when Frederic Thrasher completed work on his epochal book *The Gang*, which included a chapter on 'The Gang and Organized Crime' (Thrasher, 1927: 409-451). Pioneering as his writings were, Thrasher faced the same difficulty all other scholars have been dealing with ever since: the pre-existence of popular concepts of organized crime. When Thrasher examined adult criminal gangs in Chicago in the 1920s he adopted the concept of organized crime from a civic association, the Chicago Crime Commission, whose members had coined the term in 1919. What has changed over the years is not the predominance of popular imagery over scientific conceptualizations, but the content and shape of these popular conceptions. In the announcements of the Chicago Crime

Commission, 'organized crime' referred to the orderly fashion in which the so-called 'criminal class' of Chicago's estimated '10,000 professional criminals' allegedly pursued 'crime as a business' (von Lampe, 1999: 29-38). Organized crime was treated from the perspective of the old established protestant middle class as just one facet of Chicago as a city which, after years of rapid growth and cultural change, was seen to be 'drowning' in crime, corruption and moral decay. Fortunate for Thrasher, this holistic perspective was not far away from a sociologist's point of view. Later generations of scholars have been less fortunate. Beginning around 1950 the *Mafia* as an alien conspiracy became the focal point of organized crime imagery in the United States. Soon after, through the double channels of Hollywood movies and international law enforcement cooperation, other countries followed suit.

Today, the same Mafia imagery still haunts the minds of law enforcement officials and policy makers around the world. However, the contemporary criminal policy debate, not the least in Europe (see Adamoli and Vermeulen in this volume), is more complex. On the one hand, the American concept of organized crime with its emphasis on ethnically homogeneous 'crime syndicates' still sets the tone. Attention is particularly paid to traditional crime societies such as the American and Sicilian Cosa Nostra and the Japanese Yakuza, as well as to more recent phenomena like the Colombian and Mexican drug 'cartels' and rather ominous entities such as the 'Russian Mafia'. On the other hand it is widely acknowledged that stereotypical criminal organizations are not necessarily behind every sophisticated criminal activity. Consequently, the concept of organized crime is extended to include patterns of criminal cooperation that do not qualify as organizations in the true sense of the word. This conceptual ambiguity provides opportunities for a 'flexible' use of the concept of organized crime to accommodate a diversity of political and institutional interests. For example, the debates preceding the implementation of anti-organized crime legislation are rich in warnings of the dangers constituted by well organized, powerful crime syndicates. Nevertheless, criminal statutes aimed at organized crime tend to apply to a wide range of criminal activities and types of criminal cooperation, including those not considered organized crime.

## Challenges to sober analysis

The predominance of media and politically induced imagery poses three major challenges to the sober and thorough analysis of the underlying phenomena that serve as empirical reference points for the debate on organized crime.

First of all, there is the problem of delineating organized crime as an object of study. Organized crime is neither a clearly discernable empirical phenomenon, nor do we find an agreement on what its 'essence' or 'nature' might be. Rather, a broad range of people, structures and events are in varying degrees and combinations subsumed under this umbrella concept. Due to this elusiveness, the phrase 'organized crime' was allowed to take on an existence of its own quite independent from the social reality it supposedly relates to. Social scientists, then, not only face the challenge of nailing a 'conceptual pudding' to the wall. They also have to deal with the duality of organized crime as a facet of social reality and as a *social construct*. In the latter capacity its associative and luring power strongly influences public perceptions, policy making and law enforcement towards a warlike attitude.

The second difficulty has to do with the lack of a concise terminology. For example, basic concepts such as those of 'criminal organization' and 'criminal network' are sometimes used interchangeably and at other times are treated as analytically distinct categories (see Williams, 1998). As a result there is a great deal of confusion and misunderstanding. The use of specific terms does not guarantee a common level of understanding just as differences in terminology may give the false impression of disagreement in substance.

The third problem arises where commonly held views on the reality of organized crime are contradicted by empirical research. Often enough what is considered by the media, politicians and law enforcement officials as an established fact, under closer scrutiny turns out to be a misconception. For example, the existence of complex criminal organizations in illegal markets may be falsely assumed where in fact numerous independent actors cooperate within network structures (see e.g. Adler, 1985). Similar misconceptions and the fabrication of 'facts by repetition' can be found with regard to the informal financial sector (Passas, 1999a) or the effects of illegally obtained profits on the legal economy (van Duyne et al., 2001). Researchers are therefore potentially at odds with the media, politicians and law enforcement officials. Consequently –if the latter read their work at all– they run the risk of being blamed for arrogant intellectual denial or not knowing the hard reality of the workforce. This in turn may lead to difficulties in obtaining support in the form of access to data and research grants. Perhaps due to these pressures towards conformity

a considerable share of research and academic writing obediently follows the beaten tracks of popular imagery and official parlance.

### **The potential merits of international cooperation**

Against this rather bleak background we can observe the emergence and extension of communication and cooperation networks that link organized crime researchers from various countries. These contacts, which are continuously intensified through meetings such as the Colloquia on Cross-Border Crime and journals such as 'Transnational Organized Crime' and 'Crime, Law and Social Change', may lay the foundation for more self-confident empirical research and theory construction in the future.

There are a number of apparent benefits from international scientific cooperation. First of all, organized crime researchers tend to be rather marginalized and scattered within their respective national scientific communities so that only on an international level can there be a sufficiently large forum for discussion. Secondly, international cooperation, especially among scholars from countries other than those with a 'traditional organized crime problem', may give rise to concepts and models which are better adapted to social reality than cliché-ridden conceptions of Mafia. Third, international cooperation facilitates and potentially enhances the quality of comparative research, which in turn promises deeper insights than research conducted within regional or national contexts. Fourth, international cooperation potentially gives more weight to researchers when it comes to obtaining data, including data on politically delicate issues such as government corruption and criminal conduct of large corporations.

For these opportunities to be fully exploited, however, researchers have to find some common framework beyond the mutual interest in the same-vaguely defined-subject.

### **Competing Paradigms**

In the long run, I would suggest, the fruitfulness of cooperation will depend on whether or not there is—at least potentially—a general understanding of organized crime in the sense of a cumulative body of knowledge to which everyone may contribute. The problem is that thus far the common ground of organized crime research is more or less restricted to the term 'organized crime' itself, so that conceptually it has remained a non-committal label.

A certain degree of reciprocity of research has only been achieved either by taking Mafia imagery as a common point of departure or by reducing the concept of organized crime to partial, easier definable components, most notably illegal markets and illegal enterprises. Both approaches represent competing paradigms with conflicting implications for the study of organized crime. However, they perform a similar function in narrowing down the broad radius of application of the concept of organized crime.

*The Mafia paradigm*

The Mafia paradigm puts the focus on structural aspects. Organized crime is equated with criminal groups that display certain defining organizational attributes. Research conducted within this conceptual framework is in essence descriptive and compares the characteristics of a given criminal group with those ascribed to the American Cosa Nostra or Sicilian Mafia. The advantage of taking stereotypical images of Mafia as a yardstick is that everyone can relate to it. The heuristic value, however, of treating organized crime as an honorary title awarded to criminal groups that display a certain degree of organizational sophistication is rather limited. In addition, this approach depends very much on the validity of 'Mafia as yardstick'. There are solid reasons to question this validity (see Haller, 1990; 1991; Reuter, 1983).

*The enterprise paradigm*

In contrast, the enterprise paradigm rests on a dynamic perspective of organized crime. Action, not structure, is taken as a starting point. The question is not how criminal organizations take control of illegal markets, but how participants are *organizing* their crime-trade and adapt to and survive in illegal markets. Unlike the Mafia paradigm, the enterprise paradigm offers a set of abstract concepts-borrowed from economics, that can serve as building blocks for theory construction (see Smith, 1994). Therefore, the enterprise paradigm does provide a basis for the cumulative generation of knowledge. Economic concepts, however, have only a limited value for a comprehensive analysis of organized crime. Just as the Mafia paradigm tends to ignore the dynamics inherent in collective criminal behaviour, the enterprise paradigm is at risk of disregarding criminal structures that exist or emerge, due to other circumstances than the dynamics of illegal markets. These structures, which are crucial reference points for the organized crime debate, include criminal

fraternities (Paoli, 1998a) and criminal groups involved in non-market crimes such as fraud.<sup>1</sup>

## **An Agenda for the Study of Organized Crime**

Confining the analysis either to specific types of criminal structures or specific types of criminal activities, i.e. those in the context of illegal markets, may be a tenable methodological decision, and even a sound one given the confusion surrounding the concept of organized crime. Against the background of the public and scientific debate, however, it means that the broad scope of the concept of organized crime is arbitrarily narrowed down. Arbitrarily, because there are no universally accepted criteria that would justify the emphasis on certain aspects while disregarding others.

In essence, calls for shunning the concept of organized crime in favour of less inclusive concepts encounter the same objections as attempts to define organized crime by lumping together a wide array of phenomena. There is simply no sufficiently thorough understanding of the pertinent phenomena and the interplay between them (or the lack thereof) to determine what needs to be viewed in context.

Hence, while it appears to be a too easy way out to simply focus on partial aspects, it seems equally unrealistic to insist that the study of organized crime can be based on a clear and precise definition of the term 'organized crime' to provide a universal reference point for empirical research and theory construction. Such a definition, instead of being the starting point, can only be expected to flow out of research through successive approximations and empirical confirmations (Kelly, 1986: 28).

If this is true, then the common ground of organized crime research has to be found not in a mutual understanding of the nature of organized crime. What is required is a research program that promises either an eventually mutual understanding or a general agreement that the construct of organized crime has no counterpart in social reality and thus is obsolete as an analytical category. This outcome is in agreement with the principle of conceptual parsimony: select always the concept or theory which either explains more and/or is simpler. The rival theory should be abandoned as redundant as a scientific tool.

Strictly following this line of reasoning, for the time being the term 'organized crime' should be removed from the scientific vocabulary. However, according to the sociology of science cherished phrases are hard to die. This

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<sup>1</sup> Notwithstanding the fact that criminal groups engaged in fraud may instrumentalize (outwardly licit) enterprise structures as is the case, for example, with most investment-fraud schemes (see van Duyne et al., 2001).



applies not least to 'organized crime'. Instead of adding to confusion and scholastic bickering, the term 'organized crime' may be used as an open, multi-dimensional and dynamic concept to mark out a field of study. Or, simpler formulated: it denotes a field of work, acknowledging that it is very wide, has much variety, while its fences are at many places absent or not clear.

In compliance with this line of reasoning, I would suggest the study of organized crime be guided by the following three notions.

First, the field of study should be outlined by the scope of the public and scientific debate. This includes just about any kind of cooperation for the rational, i.e. non-impulsive, commission of illegal acts, regardless of the social status or the motives of the perpetrators. Consequently, the distinction between corporate crime and organized crime<sup>2</sup> and between terrorism and organized crime evaporates (Passas, this volume).

Secondly, within this broad framework, there are a number of topics that need to be carefully conceptualized and classified. For example: the personal characteristics of so-called organized criminals, the types of crimes, including victimless and predatory crimes, the structural patterns of criminal cooperation, the concentration of power in criminal milieux and illegal markets, the relation between the illegal and legal spheres of society and the social embeddedness of criminal structures. Instead of scholastic fights about the 'essence of', more efforts should be invested in defining these smaller scale, 'middle-range' concepts.

Thirdly, the aspects that are subsumed under the umbrella concept of organized crime should not be treated as static. It is preferable to emphasize the fluidity and diversity characterizing collective criminal behavior. This contrasts with the tendency to focus frantically on only one specific constellation of these aspects, namely complex criminal organizations using violence and corruption to attain monopoly control over illegal activities and to undermine legal institutions.

This entails exploring in as many social and historical settings as possible how the pertinent phenomena, such as criminal cooperation and legal-illegal-interfaces, vary in time and space and in what combinations they appear. For example, it would be interesting to compare the fraudulent schemes described by Baloun and Scheinost (this volume) as characteristic of societies in transition with business crimes committed in Western European countries. The comparison may encompass the ways cultural traits, socio-political conditions and the legal framework influence the willingness and capabilities of

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<sup>2</sup> Ruggiero (1996) convincingly argues that the distinction between white-collar crime and organized crime is unwarranted. Instead, it is a matter of degree to what extent economically motivated offenders are involved in the legal as well as in the illegal spheres of economy.

businessmen to engage in collective criminal behavior. Likewise, it appears to be promising to investigate the same type of illegal market, for example drugs (Paoli, 1998b) or contraband cigarettes (von Lampe, this volume), in different socio-cultural contexts. From this kind of research it might be possible to build a typology of different constellations of organized crime. Such a typology will for example highlight the fact that contrary to Mafia imagery, it does not always take complex organizations to put criminals in a position to exert influence on legal institutions (Passas, this volume), just as it is not always required to influence legal institutions to engage in continuous criminal activity.

The following step may be the construction of a typology, which may serve as the basis for creating an analytical model of organized crime. This would comprise a set of concepts and indicators for the interrelations between characteristics and how they relate to the basic conditions of organized crime.<sup>3</sup>

This research agenda, of course, rests on the fundamental assumption that despite cultural differences and constant social change there are general patterns of human structure and behavior to be uncovered. The enterprise paradigm, for one, implies this notion with regard to the inner workings of illegal markets (see van Duyne and Jager, this volume). There is no reason to assume beforehand that the same is not true for the non-economic aspects of organized crime.

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<sup>3</sup> See von Lampe (1999:305-331) for a more detailed discussion of the possibilities to construct an analytical model of organized crime.

## **Conclusion**

In sum, I would like to argue that research on organized crime should be coordinated on an international level. For this purpose studies on organized crime will have to be designed so that they are reciprocally meaningful in order to contribute to a cumulative body of knowledge about the phenomena subsumed under the pre-scientific umbrella concept of organized crime. In order to obtain this compatibility, two requirements have to be met:

1. Middle-range concepts well below the lofty level of 'organized crime' need to be defined and agreed upon, for example the concepts of 'criminal organization' and 'criminal network'.
2. The phenomena defined by these concepts need to be investigated in one context and in as many social and historical settings as possible.

Eventually, 'organized crime' may evaporate in the hands of diligent researchers but a lot will have been learned along the way about patterns of criminal cooperation and about illegitimate power in the hand of those who systematically and collusively violate or circumvent<sup>4</sup> the law to the detriment of the common good.

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<sup>4</sup> See Passas (1999b) on the concept of 'crimes without lawbreaking'.

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