

*Criminal finances*

*and*

*organising crime in Europe*

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# **Greasing the organisation of crime-markets in Europe**

Foreword by

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## **Criminal battlegrounds: the crime-markets**

Looking back at the history of fighting crime, one may get the impression that law enforcement efforts have progressed both quickly and slowly. The solemn declarations and the action plan against organised crime adopted by the European Council at its Tampere meeting in 1998; the convention of the United Nations in December 2000, and other firmly expressed intentions: all these events look like the pinnacles of a decade which saw the ‘global’ emergence of a united will to fight ‘organised crime’. However, overlooking the ‘battlefield’ –to retain the widely used military metaphor– little seems to have changed. The police, while perpetually complaining that they do not have enough ‘tools’ (that is, sufficient investigative powers), continue to convey the impression that they are involved in a never-ending ‘war against organised crime’. The struggle continues without interruption on the old battlefield of drugs, while ‘organised crime’ is alleged to have moved into new profitable markets, such as human trafficking. All the same it is a strange ‘war’, for ‘organised crime’ apparently refuses to engage in battle, succeeding, instead, in remaining elusive. To this the police (and public prosecutors) have seemingly only one answer: ‘The criminals are way ahead of us’. To this there is seemingly only one rejoinder: ‘We will give you more tools’. Since it is politically highly incorrect, if not

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politically dangerous, not to respond positively, the police often gets its tools without too many questions being asked. Yet one question that should be asked in such situations is: 'How have you used the tools available to you thus far?' Unfortunately, however, such efficiency directed questions are rarely posed. Yet even such 'daring' questions miss the most significant point. That is, the work of police and other law enforcement agencies is hampered not mainly by shortages of tools or weapons, but by the fact that they are deployed on the wrong battlefield, namely, the market for prohibited goods and services, and the market for legal goods supplied cheaply because of fraud. Such illegal markets are not the realm of sinister, evil forces, but dynamic, interactive places in which criminal entrepreneurs meet the demands of many ordinary, usually law-abiding citizens. Such markets do not provide the conditions for resounding successes.

It is ironic that in this regard the western, capitalist world betrays its basic capitalist principle: 'Do not fight the market'. This principle goes very much against the traditional 'war-on-crime' philosophy of generations of policy makers and crime-fighters. In this philosophy there is no space for capitalist, let alone liberal viewpoints. If there is a market for forbidden commodities, it is a wicked one in which unscrupulous merchants seduce and corrupt citizens, particularly young ones. In addition, the very fact of the continued existence of such markets, together with the success of many criminal adventure-capitalists, is taken as evidence that they have been penetrated by Organised Crime. This almost tautological conclusion emphasises the immorality and danger of the phenomenon.

Empirical research carried out in the Netherlands, Germany and the United States, fails to support the law enforcement and policy maker's view. Reuter's well-known research on Cosa Nostra in the US suggested that the latter's most salient characteristics were best captured by the term 'disorganised crime' (Reuter, 1983). The term should not be taken to imply chaos. Rather, it is intended to draw attention to the dynamics of unregulated underground markets (Adler, 1985; Van Duyne et al., 1990; Van Duyne, 1996). Such markets are the hunting grounds of criminal freebooters who are continually organising their enterprises (Block and Chambliss, 1981). In the process they usually operate (and improvise) within flexible trading networks (Rebscher and Vahlenkamp, 1988; Zaitch, 2000).<sup>2</sup> Thus far these findings have had little impact on the conventional images held by policy makers, though they are very much recog-

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<sup>2</sup> This has again been confirmed by Kleemans et al. (2002).

nized by detectives at grass-roots level.<sup>3</sup> Is the weight of evidence still insufficient, or is it based on the investigation of phenomena too broad to allow it effectively to convey this alternative view?

## **Evidence from crime-markets**

If the weight of evidence is insufficient, then the accounts of the research projects covering the drugs markets in Frankfurt am Main, Milan and Russia, by Letizia Paoli, and the illegal cigarette market in Germany, by Klaus von Lampe, make up for this deficit. Paoli's research demonstrates that the drugs trade, with its many sources of supply and trade routes, constitutes a flexible, many-sided network within which there is little potential for monopolisation. Even the participation of the dreaded mafia groups has not resulted in a trading monopoly. Granted, they were very active –and in some areas dominant– traders, who had the advantage of a criminal infrastructure, mainly consisting of convenient social networks. Despite this advantage even the mafia heroin enterprises were far from being stable, centralised units. Many of them remained clearly independent of the mafia group or *Cosca* to which the mafia-trafficker belonged. In Germany the drugs market is very open and likewise operates within horizontal networks. Stable hierarchical structures or family organisations are not often observed, though they do occur. Moreover, such stable, usually small organisations, are dependent on other networks for supply, distribution and other *ad hoc* tasks. The most commonly occurring drugs enterprises can be described as 'crews': loose associations of participants between which the trading structure is not vertical, but horizontal. This observation applies to Germany and Italy as well as to Russia.

Despite the suggestions emanating from reports and studies of the feared Russian *mafīya*, a close analysis of the phenomenon does not support the image of huge, vertically structured syndicates under a strict leadership. Rawlinson (1998) has already pointed to the myth-making –perpetuated by gullible Western journalists as well as the Russians themselves– surrounding the Russian *mafīya*. Many so-called syndicates, sometimes named after their leaders, prove

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<sup>3</sup> It is the author's experience that discussing concrete cases with detectives, the stereotypes (after an initial obligatory citation) are soon replaced by more lively representations of the exploits of offenders as streetwise, pragmatic entrepreneurs. Back again on the political stage, these insights are soon replaced by the conventional images.

to be less stable than the term suggests. They are rather like umbrellas, encompassing various (youth) gangs. With regard to the drugs market, the latter is less profitable, as far as the high-level criminal organisation is concerned, than the legal markets to which they apply their parasitic skills. The drugs market is left to the smaller, more flexible crews.

Such commercial flexibility and uncoordinated dynamics leads to the conclusion that the drugs market is a very open one. This is not a new finding. Some twenty years ago New York's Police Commissioner compared the drugs business with the open garment industry: 'Organisation in the drugs industry is largely spontaneous, with everybody free to enter any level if he has the money, the supplier and the ability to escape arrest or robbery' (Block and Chambliss, 1981, p. 57). This relative openness and irregularity does not imply that criminal entrepreneurs operate without constraints. The Police Commissioner's observation already indicates that criminal entrepreneurs require specific skills to avoid the dangers inherent in operating in a generally hostile commercial environment (Van Duyne, 1998). The skills concern the effective management of human resources and information. Paoli correctly concludes that –the current fear of 'transnational crime'<sup>4</sup> notwithstanding– such management encourages small and local organisations, rather than international organisations. It goes without saying that distant agents are needed for the cross-border transport of contraband, but at the same time they are difficult to control. Therefore a prudent criminal entrepreneur limits his cross-border human resources (and thus the potential information risks) to only a few trusted go-betweens.

A final implication of the information risk concerns its influence on the nature of the market. As Paoli indicates, illegal trades are denied all the supply-side techniques of their licit counterparts: they cannot advertise nor create their own brand images to bind customers to them. Therefore, the illegal commodity market is essentially a *demand* market, which takes us back to our starting point. To combat illegal markets from the side of supply only is to ignore the real driving force: the demand for commodities on the part of numerous ordinary citizens. This demand is not organised or channelled towards a few main suppliers, but fragmented. And so is the supply side. As far as law-enforcement efforts are concerned, this does not look very promising. It is an arduous, Sis-

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<sup>4</sup> It is interesting to observe the power of common language to further a collective representation. The dreaded 'transnational crime' has found its way into a large number of political and law enforcement phrases, and it has even found an outlet in the *Journal Transnational Organized Crime*.

phean task, a bit like that of the mythical king who had to push a stone uphill, but which always rolled back each time he got within a few yards of reaching the top. This Sisyphean task has been carried on since 1914.

Another illegal market is the one described by Klaus von Lampe: the market for untaxed cigarettes in Germany (Von Lampe, 2002a). The author provides a proper theoretical rationale for the selection of a specific illegal market (Von Lampe, 2002b). The discourse on organised crime is saturated with broad concepts and phony definitions, while a researcher should study organised crime at a specific time, in a specific place. This provides the data needed to describe and analyse the *modus operandi*, the social relationships and the interactions of organised crime with the upper world, as well as the legal institutions.

As suggested above, findings from previous research indicate that observations in this area may be most fruitfully interpreted from a 'network' perspective. From such a perspective, the form –such as the strength of a relation– and the content –for example, the nature of transactions or communication– of dyadic ties can be analysed. From such a perspective, Von Lampe gives a detailed account of four cases selected from the pilot phase of his on-going research project. The first group of smugglers, which could be described as having a 'flat' network with no clear division of labour or hierarchy, seems typical of the first phase of the illegal cigarette trade. The group constitutes a short-term combination of three to five persons, formed on the basis of kinship or other social bonds, living in the same neighbourhood or vicinity. Some differentiation of tasks, based on previous experience of smuggling, can be discerned.

In the second case description Von Lampe takes us to the next phase of the smugglers' development, one in which we see the structure of the enterprise network grow. There is a leading personality; underlings are paid to carry out menial tasks, and a kind of foreman oversees them. Such small groups with a 'boss' and a few aides may be the most typical form of criminal enterprise, as is suggested by Paoli's study as well as others that have been carried out over the past fifteen years (Rebscher and Vahlenkamp 1988; Van Duyne et al, 1990; Van Duyne, 1996). These trading organisations differ sharply from those suggested by the threatening image of 'organised crime-on-the-march', which policy makers have successfully conveyed to legislators, the media and the public (Van Duyne, in preparation).<sup>5</sup>

The simple structure of these groups does not prevent them from forming complex trading alliances and patterns of cooperation while operating in the

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<sup>5</sup> Legally these organisations can be regarded as belonging to the category of 'organised crime', much to the surprise of their sponsors.

illegal market. Most alliances are shifting affairs, being brought about by operational requirements. If the operations become more diverse than the simple smuggling and delivery of goods, then the network organisation too becomes 'complex' as is demonstrated by the third case. This illustrates the consequences of operating in illicit and licit settings at the same time. Though it sometimes happens unwillingly and unknowingly, often the legal business structure *is*, or overlaps with, the criminal structure. This underlines once again the regular occurrence of interaction between upper-world and under-world operations (Passas, 2002).

Do these empirical findings disprove the thesis of a hierarchical 'organised crime'? The field of criminal businesses is too heterogeneous to support such a firm conclusion. At the level of retail sales, Von Lampe identifies a sizeable Vietnamese group operating on the basis of a discernable division of labour. There are sellers, keepers of cash and merchandise, lookouts etc. One of the circumstances that contributed to the emergence of such an organisation was the need for mutual protection against extortion gangs, not against the police. It also illustrates the thesis that criminal organisations are generally not premeditated or planned entities, but action structures which come into being around and in accordance with the needs of a core business operating in a hostile environment. More often than not it is a haphazard process.

## **Crime-money and criminal finances**

In talking about illegal markets, one cannot avoid talking about what they are all about: crime-money. This topic is surrounded by many fears based on few facts. Perhaps fears run so high *because* of the scarcity of facts. It cannot be denied that the authorities have done virtually nothing to supply themselves, legislators or the public with proper insight based on facts. If the phenomenon is considered global, its related policy can be described as one based on global ignorance – making it not much different from policies against economic crime in general (Van Duyne, 1999).

The fear of crime-money has as its twin the equally dreaded phenomenon of money laundering. In his contribution Van Duyne raises the question of whether after ten years of anti-laundering policy some clarity about the concept of money laundering has developed. Do prevailing definitions, such as those of the Council of Europe or the European Commission, delineate the concept unambiguously? Close scrutiny shows that they encompass all and sundry acts

following the advantages acquired by crime. Since laundering clauses are, in most jurisdictions, *reflexive*, applying to the perpetrator of the predicate crime too, no offender can escape this comprehensive laundry net. The only way out is by destroying the loot, giving it away (for free!) or turning oneself in to the police. In the field of (tax) fraud one may deduce a virtual fusing of the act of committing the fraud and the act of laundering, as the false document is also the very instrument by means of which the laundering takes place. In this way the offence of laundering is ‘canned’ into the predicate crime.

The ‘comprehensive laundry net’ is not just some legal scholastic sophism. Applying it to determine the extent of crime-money and laundering, policy makers can yield staggeringly high figures, which cannot but underline the apparent magnitude of the evoked threat. However, even a superficial analysis of the Financial Action Task Force (FATF) data evokes an ‘Enron-like’ feeling that the figures are willfully inflated. However, unlike Enron, the FATF has never been held accountable for its misleading presentations. The deployment of a thorough, conscientious methodology to ascertain the real nature and extent of this new menace appears to be lacking.

The University of Tilburg and the Research Department of the Dutch National Detective Service have carried out investigations to obtain more insight into the nature of the crime-money threat. The simple question was, ‘What do criminals do with their ill-gotten profits?’ This implies, of course, the more evaluative question concerning the nature of the potential threat posed by the money-management of criminals. Depending on the level of criminal money-management (a more neutral term than money laundering) the threat can range from ‘corruptive permeation’ to ‘life style expenses’ (assuming one considers the high spending of criminals a ‘menace’).

The outcome of the project sheds some light on two repeatedly expressed concerns: the *sophistication* of the ‘money launderers’ and the *interweaving* of crime-money with the upperworld, particularly the financial system and trade and industry. But first a preliminary remark about the ‘money launderers’. The researchers did not find ‘launderers’ to be a separate group, who stealthily ‘cleaned’ the dirty money of the big criminal earners. As a matter of fact, in only one case did a different suspect act as launderer, revealing real sophistication in the finishing touch: the *false justification*. In three other cases assistance was obtained in *channelling* the monies to a foreign destination: a small accountant’s office and two bureaux de change were observed. The outcome of the project compares poorly with the many warnings: ‘The Launderers come’, which has acquired a narrative reality of its own.

As far as the level of sophistication is concerned, elaborate forms of money-management, like criss-crossing between numerous accounts, putting the money together again and fabricating a justification, were not frequently observed. Of course, the tried and trusted, but clumsily executed, *loan-back* constructions were resorted to a few times. In most cases the money was simply exported or placed in the name of another person. This ownership disguise proved dangerous for the straw man because he could not justify *his* acquisition of the assets. The expectation that fraudsters would show more sophistication in laundering than drug dealers was not fulfilled. Actually, the laundering depends on the nature of the predicate offence. If the offence consists of accumulating (tax) debts with the bankruptcy of the empty front firm as the final event, no one, least of all the straw man, bothers about laundering. The only equipment used is the paper shredder. Only if it is intended that the firm will live on, is laundering vital. But in these cases the false bookkeeping (the predicate crime) *is* the laundering at the same time.

The level of financial penetration, the other big worry, was not impressive either. In a few cases sizeable real estate investments were made. Whether these amounted to a strategy to obtain a power position in the upper world is difficult to assess. In one case there was a high level form of corruption, indeed. Investment in shares hardly differed from normal investments undertaken for the purposes of speculation or of earning interest. An attempt to become a partner in a legitimate business failed.

To summarise: in general, criminal financial management displays much pragmatism, little strategy and little, or at best moderate, professionalism, while penetration of the underworld looks shallow. Comparison with other, scarce research and the meagre enumeration of the FATF annual report (the so-called typology) did not falsify this finding. If the threat of the deluge of crime-money really warrants the building of a global legislative Maginot line, its costs have to be justified by more facts established with greater methodological rigor. Thus far the FATF and legislators seem more concerned to maintain fears than to find facts.

Apart from these critical comments and whatever the actual laundering taking place in the crime-market, the phenomenon has become a political and penal law reality. Michael Levi provides a succinct account of that reality, to which he adds the all too realistic terrorist financing, though that may not involve money laundering. Levi makes clear that the concern about money laundering has transcended the widespread fear about crime-money. Concern about a lack of financial transparency; tax evasion masquerading as tax avoidance,

and the harmful effects of corruption on fair competition (of the rich countries) and dissipation of the development aid (from the same rich countries) have been added to the driving forces behind the global anti-laundering drive.

The terrorist attacks on 11 September 2001 gave a new momentum to the anti-laundering policy. The FATF agreed to new international standards to combat terrorist financing. With this new policy the FATF has entered a new field, as terrorist money may stem from quite legitimate sources. This means that though some of the tools used to identify terrorist money and prevent its use are the same as those used in the fight against crime-money, terrorists have no intrinsic need to launder. Of more importance seem to be the non-profit organisations that may be instrumental in channeling money to terrorist cells. At this point Levi gives a sobering warning in view of the relatively moderate sums needed for terrorist actions. If most banks failed to discern the provenance of the millions of dollars held in accounts in the names of the sons of the late Nigerian dictator, how can we be confident that they will spot the much smaller sums belonging to non-profit organisations whose activities are otherwise legitimate?

Levi's analysis reveals a contrast. On the one hand, the world's legal landscape has changed profoundly within just one decade. Owing to the FATF's 'black-list' system, most tax havens had to accept minimum anti-laundering standards and this has allowed them, with their good reputations and high standards, to advertise themselves as the sites of *really* honest banks. On the other hand, on the level of visible enforcement, the author characterises efforts as having been 'extremely modest'. This applies to the impact of such efforts as well. Nevertheless, financial institutions have become more careful and the price for secret financial management has risen too: allegedly from 6-8% in the early 1980s to approximately 20% in the mid-1990s. Even if scepticism is justified, law enforcement and the criminal landscape have changed.

The changing legal landscape in Central Europe, as far as the Slovakian Republic is concerned, is described by Colonel Jozef Stieranka. He relates money laundering and crime-for-profit to the extensive shadow or underground markets in economies in states of transition. The shadow economy is not considered a neutral phenomenon, which merely provides scarce goods and services. It is embedded in the general criminal landscape of a country: it fosters petty as well as economic and financial crime, facilitated by a lack of awareness of its illegality on the part of profiteering citizens. It also furthers organised crime, which in Slovakia is closely connected to the underworld economy. To combat the development of organised crime and to nip it in the bud by reducing

money laundering, a new system of laws has been enacted. Not only has the penal law been amended in such a way as to oblige purchasers of property from the National Property Fund to prove the origin of their purchase capital, but also a law against the legitimization of income from crime has been enacted. This aims to prevent laundering in the strict sense of the word.

The law has also established institutions with responsibility for guarding, supervising and reporting financial transactions in suspicious cases. The Financial Police Administration is the central body charged with the task of investigating suspicious transactions and ensuring compliance with the law. In order to ensure the maintenance of this policy the three ‘pillars’ – (a) financial institutions or entities, (b) financial intelligence units and (c) the law enforcement agencies– will have to work together closely. However, due to lack of experience, efficacy is still less than optimal. Though Stieranka’s complaint concerns Slovakia only, it has a much wider application. As remarked above, the successes of the fight against laundering are internationally moderate at best. Simple theories like the lack of experience, the smartness of criminals or the lack of really ‘tough’ laws fail as credible explanations. We lack a solid empirical foundation on which we can evaluate interaction between the law, organisations and the criminal landscape. As long as not even initial attempts have been made to obtain better insight, more ‘tough-against’ measures, like more severe laws, may harm the fabric of civil liberties more than they bring the ‘struggle’ closer to success.

It goes without saying that this is not to advocate a relaxed, *laissez faire* attitude. The economic and financial crime depicted by Vladimir Baloun and Miroslav Scheinost in their chapter on financial crime in the Czech Republic, and by Jan Vittek in his chapter on serious economic and financial crime in the Slovak Republic, requires serious attention and law enforcement efforts. This attention is frequently lacking because the ‘fight against organised crime’ tends to become biased towards ‘heavy’ (that is violent) crime. However, as Baloun and Scheinost observe, business criminals are generally not violent. This does not imply that their undertakings are invariably peaceful. Regularly, though not very often, they do resort to violence, albeit in a delegated way by hiring ‘muscles’ from the ‘classic’ criminal milieu (Paoli, 1995; Passas and Nelken, 1993; Van Duyne, in preparation).

In the Czech Republic criminological research on financial crime is still in its infancy but it is developing. A previous research project by Baloun and Scheinost (2002) had already thrown light on cases such as systematic oil fraud. In their contribution to the present volume they elucidate the Czech financial

crime scene, which includes not only the criminals but also the problems of badly formulated laws and the large turnover of staff. These problems impede the development of professionalism.

The share of financial and economic crime in the total number of offences in the Czech Republic has steadily increased since 1993, only slightly declining in 2000. The damage caused by economic crime in 2000 amounted to about 80% of the damage caused by all forms of delinquency. The delinquents did not consist of hardened criminals, but of 'first offenders' (or rather, of the 'first convicted') aged between 30-39 years of age, with middle or higher levels of education.<sup>6</sup> The opportunity structures for committing economic crime were evidently present, given the inexperience of staff, including the police. As has been regularly observed, the criminals' success depended not only on these circumstances or on the supposed sophistication of their scams. In fact the decisive factor appeared to be the greed and gullibility of ordinary citizens, seduced –in the case of one of the credit co-operatives analysed by Baloun and Scheinost– by the promise of a 20% increase in the value of any deposits they made with the institution.

The sloppily managed institutions making such unrealistic promises soon fell victim to the phenomenon of 'tunneling'. Though the word is derived from the Czech language, it is not an exclusively Czech phenomenon. Its profitability rests on the difference between the value of the management's share in the company and the value of the assets that the management misappropriates, or rather, embezzles. After the act follows bankruptcy. Typical examples of Czech tunneling concerned the mutual savings and credit co-operatives, which suffered damage estimated at 8 billion Czech crowns. The authors provide an extensive and fascinating description of a case with ramifications not only for the Czech Republic, but also for Austria, Russia, Uzbekistan, the Slovak Republic and Poland. It demonstrates the general finding that financial crime aimed at acquiring the really big money is rarely committed in one jurisdiction only. The authors correctly point to the disparity between the seriousness of the damage and the repeatedly proclaimed 'high priority' of the fight against economic crime, on the one hand, and the (in)efficacy of law enforcement efforts on the other. This disparity is certainly greasing the organisation of economic crime.

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<sup>6</sup> In Dutch cigarette smuggling cases the average age appeared to be 39 years (Van Duyne, in preparation). Economic crime does not seem to be a crime committed by juveniles.

Is the situation in the neighbouring country, the Slovak Republic, better? Though Jan Vittek's contribution does not provide an empirical overview, his indication of the lack of preventive measures against fraud and embezzlement in the business community gives ample cause for concern. In one report by Price Waterhouse, which surveyed 15 Western and Central European countries, 51% of Central European corporations had been the victims of crime by an external offender as against 39% of West European firms. This implies that the entrepreneurial landscape is much more 'hostile' in Central Europe.

Vittek drafts a solid set of rules and principles to prevent the occurrence of financial and economic crime. An important component of the action plan is a set of rules for reporting and handling unusual transactions. Basically they can be considered the operationalisation or the derivatives of the requirement of financial and business transparency.

## **Corruption: a market commodity?**

Transparency will, as indicated above, disrupt the crime-market, certainly in the field of (licit) trade and industry. However, whether transparency has a market value or not depends on how general or scarce it is. When transparency is more general than obscurity, the latter may become a valuable 'service'. Non-transparency or even corruption may function as a market commodity instead of honesty. However, it feels very contradictory to 'sell' an honest service saying: 'I will be honest if you pay me something extra'. Honesty should not be sold, but 'sell itself', having a priceless value. Only corrupt services require an extra, the bribe, which is their inherent trait. In an intriguing essay Matjaz Jager elaborates the idea of a corruption market. In doing so he starts by abandoning moral frameworks for thinking about corruption.

Jager juxtaposes two points of view: the moral and the economic. The moral angle is widely discussed and accepted: 'thou shalt not illegally sell goods and services to be dispensed to the public'. However, the dispensing of these goods and services may be so inefficient that the consumer is glad if he can speed things up by 'greasing' the procedure. In addition, corruption can function as a counterweight when sections of society left out of the distributive circle of the administration, buy their way in through the backdoor of corruption.

Granted, this is too good a scenario. Corruption has an epidemic potential. In addition, there is no such thing as an 'open' corruption market with pure competition. The value of the economic perspective is that it opens up new

fields of study and comparison, while remaining unencumbered by *a priori* moral standpoints. Even if it is claimed that corruption alleviates the deficiencies of bad governance from which it originates, it is correlated with all sorts of negative economic and financial indicators, such as low economic growth, low quality education and deficient health care. Interestingly, however, ‘regular’ and predictable forms of corruption may co-exist with prosperity and economic growth, as can be observed in the case of Italy and before that of Hong Kong. Should corruption therefore be considered benevolently, perhaps out of fear that suppressing it might lead to a reduction in income or higher prices to compensate for the enforced renunciation of corrupt practices? Apart from morals, the experience of tackling of corruption in Hong Kong and Singapore has shown that minimising corruption leads to better payment structures for civil servants and more efficient services (Quah, 1994/5).

A widely used model to describe corruption is the *principal-agent* model, which starts from the recognition that persons and organisations are frequently unable to do everything themselves and have to delegate tasks to someone else. The latter has his own interests, separate from doing what he contracts to do, and may fill his pockets beyond the contracted reward. Economically, the principal can in response opt for a policy of ‘zero tolerance’, only to find that the agent becomes less motivated because fewer fringe benefits are available. This may induce the principal to try to find a balance between the agent’s enthusiasm on the one hand and his acquisition of (corrupt) fringe benefits on the other. Historically, such a balance has deep roots: the mercenary army system and the tax farming of the *ancien regime* are good examples of this efficiency versus corruption trade-off. The seventeenth century the Dutch *Estates General*, as principals of the motley mercenary armies of the Dutch Republic, soon learned how to cope with the captains as corrupt agents, who themselves were principals to lower-level agents (Schulten and Schulten, 1969). Nevertheless, the model becomes unsatisfactory when the principal himself succumbs to corruption. Or is there a higher principal who is beyond the reach of corruption? At this point the decision making approach and the concept of corruption as a leadership disease may provide a simpler model (Van Duyne, 2001). The sole but corrupt trader, without a principal, provides another example that is not covered by the principal-agent model. The example is interesting as corrupt traders are usually not labeled as such because of their venality, but because they tamper with their books, which is called *fraud*.

The implications of the possible spread of corrupt relationships throughout the whole fabric of society is discussed by the last two authors, Igor Osyka

dealing with Ukraine, and James Newell describing the Italian case. Both jurisdictions may be considered examples of instances in which state principals have themselves become the main corrupters. Ukraine is an example of a society characterised by economic destitution and chronic mal-governance. Italy on the other hand, one of the affluent G-7 countries, is headed by a prime minister who is alleged to have entered politics in order to ward off corruption charges.<sup>7</sup> In both cases one may paraphrase the biblical injunction concerning the sinner and say: 'let he who is without corruption cast the first stone'. Reading the contributions on Ukraine and Italy leads one to think that in these two cases only a few stones will be thrown. Nevertheless, both countries excel in drafting elaborate anti-corruption laws and regulations.

In Ukraine a few stones against corruption were in fact thrown initially. Then, in 2002, the Ministry of the Interior launched a special anti-corruption operation that resulted in 1,600 cases being investigated. In 16% of them, the outcome was a conviction, while in only 2% of the cases did the alleged corruptor lose his or her job. It goes without saying that much corruption consists of petty street-level offences, committed by civil servants earning equally petty salaries. More worrying is the higher-level corruption endemic within the political leadership, which is itself the producer of elaborate anti-corruption laws and measures. It is telling that members of Parliament and judges involved in the attack on corruption soon find that they are indicted for corruption themselves. 'Throwing stones' at highly placed corrupters becomes increasingly risky the higher one throws.

Such a comprehensive set of anti-corruption laws has been enacted that theoretically venality would seem to have become one of the most risky forms of criminal conduct in Ukraine. Only accusing the President of corruption or other misconduct would seem to be riskier. Whether or not it was in order to counter such allegations, in 2002 the President issued a number of tough decrees against corruption, and these were followed by a government resolution, other proposals presented to Parliament, and further presidential edicts. The question is not whether there are sufficient laws and regulations, but whether there is the political will to make them work. The author concludes that while tactics have been outlined, a strategy appears to be absent. Instead of an all-out attack on corruption generally, effort should be concentrated on its higher-level manifestations. Reduction of corruption in broader segments of society will take

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<sup>7</sup> Within the European Union, he allegedly finds himself in the company of French President Chirac, who has for the time being escaped corruption charges by managing to get himself elected to a second term of office.

time given its embeddedness. But one does not need to focus on the less well off counties of Eastern Europe to realise that the process of reducing corruption is a long one. The case of Italy, discussed by James Newell, provides a good example of the difficulty of reducing corruption in an *affluent* society.

The example of Italy is extremely perplexing. Instead of undermining the institutions of democracy, the numerous scandals – showing that corruption still has the power to shock – might be taken as evidence of the strength of democracy in that country. In that respect, it could be said to compare favourably with Belgium, where – until the Augusta and the Dassault affairs – society proved to be much less sensitive to revelations of a scandalous nature. On the other hand, the spread of corruption observed since the mid-1970s can also be considered a democratisation of venality. In various areas of public administration, ranging from the allocation of public money, to legislation in favour of ‘friends’, corrupt services became a veritable commodity. Any feelings of moral unease was neutralised by the sophism that ‘since everybody was corrupt, nobody was corrupt’.

Within a social landscape in which ‘everybody’ seemed prepared to buy or sell illegal favours (though sufficient ‘white knights’ were left to fight the phenomenon), the already existing exchange relationship of patronage and clientelism provided a basic underpinning. The importance of clientelism should not be underestimated, socially or psychologically. Clientelism is not a relationship of trust and mutual devotion. Its core is an exchange of interests: I will protect you if you support me. Favour for favour. The more favours a person of power can bestow, the more support he obtains. In this regard Italian society as described by Newell resembles more the *ancien régime* of the last French kings than a modern society. However, in contrast to pre-revolutionary French society, which felt little compunction in selling jobs and favours, in modern society this conduct remains illegal despite the ‘everybody-does-so’ argument. This implies that one cannot easily walk away from this market relationship: once bought, one is hooked, because the reverse side is the threat of revelation. It does not help to reveal the corrupter’s conduct, and thereby one’s own involvement. This would not only entail one’s own public disgrace, but –more important in a society full of powerful corrupters– exclusion by the innumerable remaining corrupt persons from the bestowal of future favours. By a mixture of rewards and threats such a market tends to perpetuate itself.

However, no market is stable. At the end of the 1980s the Italian corruption market started to change. In the first place, with the collapse of the Berlin Wall and the disappearance of the Communist Threat, the position of the traditional

parties of government became less secure and they suffered election losses. The position of the Christian Democratic party was also eroded because of increasing secularisation. The traditional parties' influence within the judiciary began to decline and the latter was in the meantime rejuvenated. These processes were mutually reinforcing and contributed, from 1992, to the Milan corruption revelations acclaimed by the Italian population. While the established parties and their corrupt relationships were swept away, it also looked as though the corruption market would disappear with them.

In fact this expectation was far from being fulfilled. The social underpinning of the market appears to be as much engrained as the roots of corruption in Ukraine, even though the social and economic conditions of the two countries differ widely. Nevertheless there are similarities and these may be important conditions for the continuity of the corruption market. One concerns the scarcity of positive attitudes towards the state, which a large part of the population still considers as something 'alien'. The state is not experienced as the 'commonwealth' of the citizens; it is not experienced as something that belongs to 'us'. Another condition concerns the 'leadership disease', elaborated in Van Duyne (2001) as one of the main causes of corruption or at any rate one of the conditions rendering the illness of corruption incurable. When the Prime Minister of Italy and the President of Ukraine, supported by a servile parliament, succeed in protecting themselves from the legal consequences of their alleged misconduct, provoking only a temporary stir among a part of the population, one can only expect that individuals located at lower levels of the hierarchy will find a ready excuse for their own participation in the market for corrupt favours.

To what extent does this rampant corruption grease the crime-markets? That depends on the nature of the crime-markets. The lower-level street markets may be 'greased' by the pettier types of corruption, while economic and fiscal crimes are more likely to lean towards protection from those occupying positions higher up the political and social hierarchy. And what about the feared Mafia? Is there a connection between the rise of Berlusconi, and the silence, over the last few years, surrounding the fight against the Mafia? Lack of empirical data means that any answer to this question is bound to be speculative. Greasing the economy of crime by corruption or a venal attitude is not a kind of conduct that is open or easily observable. Penetrating this opaque interaction is thus difficult and challenging. Given the social importance of this issue, it is hoped that scholars will continue to step forward to face this challenge.



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# **The ‘invisible hand of the market’: the illegal drugs trade in Germany, Italy and Russia**

Letizia Paoli<sup>1</sup>

## **Introduction**

The present chapter is inspired by Karl Popper’s recognition that scientists cannot verify hypotheses but only falsify them. From this perspective it aims to disprove the widespread conviction, succinctly expressed by the Russian Ministry of the Interior in a recent publication, that ‘Drug crime is always organised’ (MVD 2000: 5). What the Russian Ministry intended to say and what many other practitioners and ordinary people believe is that large-scale organisations dominate the production, distribution and sale of illegal drugs all over the world. Indeed these organisations are frequently portrayed, by law enforcement officials, drug treatment providers and drug users alike, as the source of all drug evil.

It exceeds the scope of this chapter to falsify the above thesis world-wide. The chapter merely aims to demonstrate that the thesis has no empirical backing in at least the three countries in which its author has carried out field research over the past ten years: Italy, Germany, and Russia.

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## The Fieldwork

In the following pages, the findings of three different research projects will be discussed and compared. The first project is a long-term study of the Italian mafia, which was the topic of my PhD dissertation (Paoli 1997a). To gain insights into Italian mafia groups, I worked for about three years as a consultant to the Italian Ministry of the Interior and the Direzione Investigativa Antimafia, an interagency the police force set up in 1991 to fight organised crime. During those three years, I was able to read the statements of more than forty former mafia members who had defected and become government witnesses (the so-called *pentiti* in Italian); to analyze more than two hundred criminal cases, and to interview at least one hundred law enforcement officers. The results of my investigation into the Mafia were published in *Fratelli di Mafia: Cosa Nostra and 'Ndrangheta* (Paoli 2000a), and *Mafia Brotherhoods: Organised Crime, Italian Style* (Paoli 2002a) and summarised in several articles (Paoli 1998; 1999; 2002b).

The second project I will draw upon concerns a study of the illegal drugs trade in Russia which I carried out in 1999 and 2000 on behalf of the United Nations (Paoli 2001a). Under my co-ordination, fieldwork was carried out in nine different Russian cities, including Moscow, St. Petersburg, Nizhniy Novgorod (Russia's third largest city), Krasnoyarsk in Siberia as well as Khabarovsk and Vladivostok in the Far East. All together, ninety key witnesses, as well as over thirty drug users were interviewed. Together with the Research Institute of the Prosecutor General's Office, I was additionally able to analyze over fifty drugs-related criminal cases (see Paoli 2001b).

The third project that will be drawn upon is still in progress: since 2000 I have been co-ordinating a study of illegal drugs markets in two European cities: Frankfurt (Germany's fifth largest city) and Milan (Italy's second largest city). The first phase of this research project was financed by the European Monitoring Centre on Drugs and Drug Addiction. Thus far at each location, my research associates and I have carried out more than sixty interviews with drug users and dealers, interviewed over thirty key witnesses and analysed at least fifty drug-related criminal cases. We have also collected and are reviewing the drug-related clippings of at least one major local newspaper in each city over the last thirty years (Paoli 2000b). In all these projects standard secondary sources were also resorted to.

## Plurality of independent traffickers and dealers

On the basis of these research projects and other researchers' studies, the initial hypothesis can be restated as follows:

the great majority of drugs deals, even those involving large quantities of drugs, are carried out by numerous, relatively small, and often ephemeral enterprises.

In other words, to quote Adam Smith's famous saying, in Milan and in Frankfurt, in Moscow and in Vladivostok, the 'invisible hand of the market' – not large-scale organisations – governs drugs deals. As a Moscow police officer put it, 'there are no Colombian drug cartels here. Instead there are many small groups that are constituted of people belonging to the same nationality or ethnic group. There is not one single river, but many streams that flow independently on one another' (Paoli 2001a: 101-2).

A plurality of independent traffickers and dealers supply with illegal drugs the markets of the three localities I studied. These drug distributors can be categorised as follows. Some drug-dealing enterprises are veritable family businesses: that is, they are run by the members of a blood family, who may resort on an *ad hoc* basis to a network of non-kin for execution of the most dangerous tasks (PPF, 1996: 36). Caddy, a former Frankfurt wholesale dealer, for example, recalls,

We were a small organisation that I had built and was composed of six persons: relatives and very close friends. It was organised according to the drugs. My wife and I dealt hashish, my brother-in-law and his wife traded cocaine, heroin, and speed. A friend of mine and his wife sold drugs at lower levels. The group members had a differentiated clientele. Women were usually in charge of taking appointments. The organisation broke down when my brother-in-law was arrested (Paoli 2000b: 63).

Some enterprises are non-kin groups, which are formed around a (charismatic) leader and then manage to acquire a certain degree of stability, developing a rudimentary division of labour. As a German trafficker, interviewed in prison, explained: 'there is a chief dealer who has God knows how many smaller dealers working for him on the street or in private settings' (Paoli 2000b: 69). The German origin of the foregoing quote notwithstanding, this type of stable relationship actually seems to be more widespread in Milan than in Frankfurt. In Italy's second largest city most retail distributors of heavy drugs, at least during the 1980s and early 1990s, were linked to a supplier in a stable way, implying

a credit line. They received drugs from their dealers on a regular basis without paying upfront or else paying only a small advance and then bringing the remainder of the money to their suppliers when they received a new lot. The usual way in which such a relationship is described in Italian is to say that each dealer had his own *cavalli* (i.e. horses). In Frankfurt, by contrast, despite the presence of small groups such as those described by the interviewee quoted above, most user-dealers have always been free to buy drugs from whomever they want and usually have more than one supplier at a time (ibid.: 101ff.).

In Germany as well as in Italy and in Russia, many drugs enterprises are ‘crews’: loose associations of people, which form, split, and come together again as each opportunity arises. In crews, positions and tasks are usually interchangeable and exclusivity is not required. Indeed, many crew members frequently have overlapping roles in other criminal enterprises. One of the officers working in the organised crime section of the Frankfurt police commented on this state of affairs thus:

The structures, the stable hierarchic structures or family structures that are frequent in Italy, do not exist in Germany. . . . As far as organised crime in Germany is concerned, specialists talk about a network structure (*Netzstruktur*) and this is a correct representation that we can prove in our investigations. If some people want to commit a crime, they look for people specialised in the required tasks; the latter are asked and eventually recruited. Afterwards, the booty is divided and each of them goes their own way. Very, very rarely you can find steady gangs, which for a long period commit a series of crimes (ibid.: 67).

This analysis was confirmed by an experienced wholesale dealer, who maintained: ‘there are no vertical drug trafficking structures in Germany. Only horizontal ones. This means: «I know this person», «let’s make a deal»’ (ibid.: 68). Finally, as we shall see in the following sections, many distributors work alone, especially those with no previous underworld connections or dealing with relatively small quantities of drugs.

As the German police officer indicated, illegal enterprises often appear to be associated with networks. In fact, crews, and small groups of narcotics producers and dealers, are linked to final consumers through chains of individuals. The same applies to other illegal commodities, ranging from stolen cars to women to be exploited as prostitutes, that are moved from one country to another. In Germany, for example, several studies have come to the conclusion that net-

works are the typical manifestation of organised crime in that country (Reb-scher and Vahlenkamp 1988; Weschke and Heine-Heiß 1990).

The concept of network proves to be a useful construct to describe the distribution systems of illegal commodities. The strength and cohesion of most illegal networks, however, should not be overestimated. Although long term relationships may develop among network members, the majority of them are arm's-length buyer-seller relationships, which are neither exclusive in any sense nor centrally organised. Each illegal entrepreneur is free to look for other partners to execute the next transaction and usually belongs to more than one network at the same time, since he has contact with several suppliers, while he has numerous customers to whom he can sell his merchandise. Moreover, at any point of the network, the actors generally know only their immediate supplier(s) and buyer(s) and have no idea of its overall extent and structure. Finally, it must never be forgotten that illegal networks are volatile relationships. They constantly change their form and extension, as new partners are included, others are occasionally or permanently discarded, and still others are replaced because they have been targeted by the action of law enforcement agencies.

### **The Supposed 'Big' Players: Southern Italian Mafia Associations**

To say that the supply of drugs is, as described in the previous section, 'disorganised' (Reuter 1983) is not to deny the existence of large criminal groups or their involvement in the illegal drugs trade. Southern Italian mafia associations, for example, are today present at different levels of the drugs distribution system, both in their original areas of settlement as well as in Northern Italy. In their Sicilian and Calabrian villages and neighbourhoods, mafia groups –above all, those belonging to Italy's largest and most powerful criminal organisations, the Sicilian Cosa Nostra and the Calabrian 'Ndrangheta (see Paoli 2000a; 2002a)– are even able often to monopolize drugs trafficking or at least to regulate and 'tax' the operations of independent drug dealers. However, in the rest of the country they cannot exercise such control. Here they must deal in drugs alongside large numbers of other operators.

Though some members of Sicily's Cosa Nostra (a confederation of about one hundred Sicilian mafia families) had organised illegal drugs transactions from the 1940s (CPMS [1972] 1976; 1976), it was only thirty years later that drug trafficking became an ongoing and economically significant activity for large numbers of mafia families and individual members. It was thanks to the importing and processing of morphine and the export of heroin between the late

1970s and the mid-1980s that, in the words of a mafia defector, ‘richness came, we all became rich. With cigarettes we had earned well, but it was not an abundant source [of income]; what changed Cosa Nostra’s life was drugs, which drove them crazy and allowed them to earn a huge amount of money’ (CPM 1992: 319).

In the case of the Sicilian Cosa Nostra, drug trafficking represented the main source of revenue at least up to the mid-1980s, when it was supplanted by the manipulation of public works contracts (Paoli 2000a; see also 2002a). From the early 1980s onwards the trade in illegal drugs also became a relevant source of income for the members of Italy’s second largest and most powerful mafia consortium –the Calabrian ‘Ndrangheta– as well as for a variety of mafia and pseudo-mafia groups located in other parts of Southern Italy.

Drug dealing, like most other profit-making activities, is not, however, systematically planned or co-ordinated by each mafia group *qua* enterprise, even less by two or more mafia consortia as a whole. Indeed, there is a high degree of variability and flexibility in the development and management of business activities, so much so that no dominant model can be discerned. Granted, illicit activities are sometimes run by the heads of separate families and the profits divided more or less equally between the affiliates. In the ‘Ndrangheta this practice has become institutionalized to such a degree that nowadays members receive a monthly salary of at least three million *lira* (about 1,500 euros) (Paoli 2000a: 197-203).

Some enterprises even encompass more than one family. Investigations carried out during the 1990s revealed numerous joint ventures created by several coalitions of Calabrian mafia families to import huge quantities of drugs. An inquiry by the Direzione Distrettuale Antimafia in Reggio Calabria, for instance, revealed that in 1989 a ‘cartel’ of ‘Ndrangheta families had been set up to finance and organise the import of several shipments of heroin, each of which weighed about five hundred kilograms, and cargoes of cocaine of up to three hundred kilograms at a time (PrRC, 1993). Investigations carried out by the Turin Prosecutor’s Office showed that the 5,490 kilograms of cocaine seized on the outskirts of the city in March 1994 (up to 1999 the largest seizure ever made outside production areas) had been purchased by a coalition of seven Calabrian mafia families originating from villages on the Ionic coast of the province of Reggio Calabria: the Mazzaferro, Pesce, Ierinò, Cataldo, Barbaro, Morabito and Romola families. In the two years preceding this seizure these groups financed some seven shipments of drugs, totalling at least eleven tons (TrTO, 1994).

On some occasions Cosa Nostra's superordinate bodies of co-ordination, the so-called 'commissions', have themselves collected money from mafia families in order to invest in large-scale business activities. This happened most frequently in the 1970s, when Cosa Nostra members entered the international wholesale trade in heroin and were for some years able to refine and export large quantities of the drug to the United States, allegedly satisfying up to 30 percent of the local demand (Arlacchi, 1988: 196).

In many other cases, however, single 'men of honour', as fully initiated members of the Mafia call themselves, run illegal businesses on their own, entering into partnerships with members of their own or other mafia families and even with non-affiliates.

Emblematic in this respect are the large-scale, transcontinental, heroin-trafficking activities reconstructed during the first Palermo *maxiprocesso* (maxi-trial). The descriptions provided by the media often suggest that this business was dominated by Cosa Nostra as a single organisation. However, a careful reading of the trial papers reveals that the various stages of the production and distribution process were organised by members of different families. The latter, far from considering themselves as part of a single economic unit, were very jealous of their own networks of clients and/or suppliers and of their particular specialisations. On this matter, the public prosecutors belonging to the first pool of anti-mafia investigators stated:

Inside Cosa Nostra, structures having de facto autonomy, but which are functionally linked, have been created to organise the different phases making up the complex drugs trade, while the 'men of honour' who do not have operational responsibilities in the trade may contribute to it financially, sharing profits and risks to different degrees (TrPA 1985: 1887).

By creating a climate of trust, common membership of Cosa Nostra enhanced the development and consolidation of business exchanges. However, these can hardly be compared with the relationships between the departments of a normal corporation. Instead they were transactions taking place between distinct enterprises in such a way that, despite the mafia brotherhood ties, compliance with the contracts was guaranteed by all the means typical of the Mafia, including the threat and the use of violence.

The import of large consignments of morphine had been begun by Nunzio La Mattina, a former smuggler and resident of the working-class Kalsa neighborhood in Palermo, who had been introduced to the Porta Nuova family by Pippo Calò because of his connections in international illegal markets. Anto-

nino Rotolo, Tommaso Spadaro, and Giuseppe Savoca soon joined La Mattina, but ‘each worked on his own, and they kept the secret of their own organisations jealously to themselves’ (ibid.: 1879-80).

Some other mafia members were responsible for the processing of drugs in clandestine laboratories, working for themselves as well as for other enterprises. According to the *pentito* Salvatore Contorno, there were at least seven drug laboratories in Western Sicily in the early 1980s, each of which was run by a Cosa Nostra family or a group of ‘men of honour’ (TrPA 1985, IX). Francesco Marino Mannoia, who was then very much sought after because of his chemical competencies, recalls that he worked in several laboratories, processing morphine belonging to different members (TrPA 1989).

Finally, other ‘men of honour’ were in charge of the transportation of the heroin and its wholesale distribution, in the United States. Among them, a pre-eminent role was played by the Bontade, Inzerillo and Badalamenti families, which had extensive blood and mafia branches in North America. The heroin was wrapped in cellophane packages, which were marked in such a way as to distinguish them according to their owners. This was mainly because each owner was responsible for the quality of his own cargo. The freedom enjoyed by participants was such that, according to Buscetta, whoever wanted to do so could pick up his share of the processed product in Sicily and arrange distribution independently (TrPA 1985 IX).

Far from being stable and centralized entities, many of the enterprises founded by ‘men of honour’ resemble what anthropologists call ‘action sets’: temporary coalitions that are formed to pursue specific goals and, once these are achieved, are disbanded (Schneider and Schneider 1976; Blok 1988: 136ff.). Sometimes the *cosca* (i.e. the mafia group) runs an illicit business directly. More often, however, its members set up illegal enterprises, which –due to their heterogeneous composition, short average life-span, and financial and managerial independence– usually remain sharply distinct from the mafia group(s) to which these ‘men of honour’ belong.

Though they may be strengthened by their members’ violent reputations, the action sets formed by ‘men of honour’ operate by and are largely similar to the ‘crews’ set up by non-mafia members. As much as the latter, the former ‘quasi-groups’ are also obliged to operate in a competitive setting. As mentioned earlier, only in some villages and neighbourhoods of Southern Italy can mafia groups exercise tight control over the local drugs trade. In most of the country, and especially in the wealthier Northern regions, which host the largest retail

markets, the drugs enterprises of mafia members are just a few of the many players present (see Paoli 2000a; 2000b: 100-17).

### **. . . and the Russian Mafiya**

The Russian Mafiya appears even less able than the Southern Italian mafia to control the domestic drug market. Most of the large criminal organisations, portrayed by the domestic and foreign press as the dreadful ‘Russian Mafiya’ (Rawlinson, 2001) seem at present to be uninterested in the drug business, though some of their younger affiliates may deal drugs. As a matter of fact, even these groups do not constitute unitary, hierarchical bureaucracies that can be compared to legal multi-national corporations. As a Russian law enforcement officer explained, these groups are ‘much smaller and more loosely organised than foreign journalists often maintain’ (Paoli 2001a: 116). Contrary to the statements made in media reports and academic works alike (see, for example, Roth and Frey 1992; Handelman 1995; Lallemand 1997), there are no groups consisting of several thousand members.

These organisations – be they the Solntsevskaya, Ismalovskaya or Kurganskaya in Moscow, or the Tambovskaya, Malyshev’s or Kazanskaya in St. Petersburg – can rather be considered loose confederations of a number of independent groups that are united either by the same geographic origin, by their location or by their recognition of the same leader. The Kurganskaya, for example, draws its name from Kurgan, a city in the Urals, from where most of its members came to Moscow. Likewise, most of the members of the Kazanskaya come from Kazan, the capital of the Republic of Tatarstan. The famous Solntsevskaya takes its name from Solntsevo, a south western district of Moscow; the Ismalovskaya from the Ismailov open air market in North-eastern Moscow (Gilinsky *et al.* 2000: 54-84; see also Paoli 2001a: 113-21).

Even when crime groups draw their names from their leaders, the latter are far from having absolute powers. Malyshev’s organisation was actually founded by A. Malyshev, but it soon grew to become a confederacy of several dozen groups that operated independently under one ‘roof’. Originally, the leaders of these groups were supposed to pay money for the use of Malyshev’s name, a kind of ‘McDonald-isation’ of Russian organised crime (see Abadinsky, 1987). Over time however, this practice diminished, as decreasing numbers of gangsters recognised Malyshev’s ‘property rights.’ The other criminal syndicates cannot be regarded as unitary Molochs either. According to Gilinsky, Kostjukovsky and Rusakova, for example, the Kazanskaya

is not an united organisation with one leader. There are several independent groups (Kinoplyonka, Zhilploschadka, Al'metievskaya, Chelninskaya, and some others), which co-operate every now and then. . . . Most of the groups consist of mobile commandos, which operate only for a while in St. Petersburg. These gangs commit a series of crimes and then retreat to Tatarstan and their place is taken by the following crew (*vakhta* method). Only 'residents' live in St. Petersburg (Gilinsky *et al.* 2000: 53-54).

The same can be said of one of Moscow's best-known criminal organisations, the Solntsevskaya. The name itself is an umbrella term, encompassing a variety of small youth gangs that developed in the 1980s in the Solntsevo district to commit acts of extortion and theft. In the late 1980s and early 1990s some of the group leaders were able to earn large sums of money by importing computers and other electronic equipment and later on by organising fraud schemes and running casinos. For several years Sergej Michailov was considered the leader of the group, though it is not clear how extensive his powers ever were. Furthermore, as a Russian law enforcement officer pointed out, 'the Solntsevskaya no longer exists as a single organisation' (Paoli 2001a: 117-8), but has split into several smaller groups, which compete for control of the territory and its resources. In the late 1990s there were several shootings among rival fractions of the Solntsevskaya, one of which, spectacularly, took place next to the Kremlin (*ibid.*).

Like the Solntsevskaya leaders, the high-ranking leaders of most of the other prominent organised crime associations earned fabulous wealth in the 'no man's land' left behind when the planned economy came to an end in the late 1980s and early 1990s. Though they also established protection rackets and organised fraud schemes, the bulk of their wealth came from the import and sale of perfectly legitimate goods and services. By using a variable mix of corruption, violence, and entrepreneurial skill, they merely supplied the Russian people with commodities and services they had long dreamt of, and which were still desperately scarce in the last phase of the Soviet command economy and its immediate aftermath: computers, vehicles, electronic equipment and gambling. According to some interviewees, the extraordinary opportunities for enrichment offered by the transition to a market economy explain the lack of interest of the largest criminal groups in drug trafficking. As one law enforcement officer stated, 'they have such huge opportunities to make money in the so-called legal economy, that it makes no sense for them to deal drugs' (*ibid.*: 118).

Despite the Russian mafia's lack of interest, since the collapse of the Soviet Union there has been a phenomenal growth in the consumption and trafficking of illegal drugs as there has been in most other countries of the former Warsaw Pact (Paoli 2001a; 2001c). Illegal psychoactive substances were used even prior to 1991, but during the Communist regime both the number of consumers and the range of available substances were limited. Due to travel and trade restrictions, the former USSR neither constituted a single drug market nor participated significantly in international narcotic exchanges as a consumer or supplier of illicit substances. However, this pattern of relative self-sufficiency changed drastically during the 1990s, as Russia rapidly became integrated into the international drugs trade. Today, large quantities of illegal drugs are shipped across Russian territory to reach final consumers in Western and Eastern Europe. The rising domestic demand is also increasingly fed by more powerful and easier-to-use drugs (such as heroin, but also, though to a lesser extent, cocaine and ecstasy) imported from abroad.

The growth of drugs consumption and the Russian drugs trade in the 1990s led to the emergence of a nationwide drugs distribution system, delivering illicit drugs from producers to consumers thanks to the mediation of full or part-time traffickers and dealers. The latter roles did not exist in Russia prior to the early 1990s, comparable to the situation in Western Europe and the USA up until the mid-1970s. It was not until the drugs supply diversified and Russia entered the international drugs trade that the drug distributor, as a professional role, emerged to link producers to consumers and regularly to supply large urban centres with a variety of illegal drugs from distant regions. But even today consumer demands seem to be neither satisfied nor promoted by large, hierarchically-organised firms that monopolize local markets. This is the clear and consistent finding of the fieldwork in the above-mentioned nine Russian cities (ibid.).

Evidence of large-scale trafficking organisations does not emerge either from the fifty-two drug-related criminal cases, which were analyzed by the author in collaboration with the Research Institute of the Prosecutor General's Office (Paoli 2001b). Although defendants frequently received draconian sentences because suspected of belonging to an 'organised group', the existence of such groups remained for the most part unproven or just a juridical construction. As a matter of fact, in Russian jurisprudence a drug transaction between a buyer and seller, or even the straightforward purchase of illegal drugs by two users, is considered sufficient to justify applying the aggravating 'organised crime group' clause. This assumption holds even when the other components

of the group remain unknown: in thirty-six of the cases analysed there was only *one* defendant. Likewise, although aggravating circumstances were often applied due to the ‘extremely large quantities’ of the confiscated drugs, in most cases the amounts were minimal, at least according to Western standards. Defendants were sentenced to more than five years imprisonment for buying and partially selling amounts ranging from 3.3 ml of *vint*,<sup>2</sup> 0.15 and 0.17 grams of opium and 0.091 and 0.0058 grams of heroin (Paoli 2001a: 91-101).

### **Ethnic minorities and ordinary people**

The members of some ethnic communities are over-represented in the drug distribution systems of many European and Russian cities. In both Frankfurt and Milan, for example, the street drugs markets are largely dominated by foreign dealers, as both police statistics and interviews with key witnesses, drug users and dealers indicate. In recent years, a substitution process appears to have taken place: the lowest and most dangerous positions, which used to be occupied by the most marginalised Italian/German drug users, are now assumed by foreigners, particularly those who have immigrated recently, are applicants for political asylum or do not have residence permits. As Andrea, a 39 year-old former heroin and current crack user explained, ‘in the beginning my dealers were German, later on the situation changed, a Yugoslav came in and . . . now, on the cocaine market, they are Arab and African’ (Paoli 2000b: 58). The same development has taken place in Milan: as a former Italian hash and cocaine dealer put it, ‘ten years ago, the dealers were mostly Italian, now they are predominantly foreigners’ (ibid.: 112).

Like other forms of crime in the past, immigrants use their involvement in today’s largest illegal market as a ‘queer ladder of social mobility’ (Bell, [1953] 1988). To a greater extent than in the past, present-day migrants have a harder time accessing the legal economy and, due to the restrictive policies adopted by most Western European states, are likely to find means of survival in the informal and illegal economies only. Many of them, finally, are also drug users, who have begun to deal drugs in order to finance their own consumption.

Even in Russia, both the retail and wholesale levels of the local drug distribution systems are often occupied by dealers belonging to ethnic minorities, most notably members of the Roma community, Caucasians, and Tajik and Afghan nationals. According to several sources, the lion’s share of the booming

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<sup>2</sup> *Vint* is a methamphetamine solution that can be produced domestically by users themselves and used to be very popular in Russia in the late 1980s and early 1990s.

heroin market, in particular, is currently dominated by Tajik dealers. The latter, coming from a former Soviet republic, have no problems entering the country, usually speak Russian and have either many contacts or even a residence permit in Russia. As a 19-year-old Russian drug user notes, 'in Moscow there are a lot of Tajik dealers by now' (Paoli 2001a: 105). As a rule, these are far from experienced offenders, but instead are farmers and traders who resort to drug trafficking to make ends meet. The huge profits to be made from heroin smuggling are a powerful lure for impoverished Tajik and Afghan citizens. A gram of heroin, for example, costs as little as US\$3 (86 rubles) in Tajikistan and even less in Afghanistan. In Moscow or any large Russian city, the same amount can be sold for at least 400 rubles (US\$10.50) at wholesale level, or for 1,000 rubles (US\$35) retail (*ibid.*; see also Paoli 2001c).

Illegal drugs are, however, far from being produced and sold exclusively by members of ethnic minorities. In all three of the environments we have investigated, drug suppliers are also people belonging to the mainstream population with no previous underworld connections. This type of drug entrepreneur is most frequently to be found in the retail selling of cocaine, hashish and party drugs, above all in closed scene settings. Most of Raffaele's six cocaine suppliers, for example, are 'normal people, they deal to supplement their salary. They are all Italian and Milanese' (Paoli 2000b: 115). Likewise, the hash dealer of another Milanese interviewee is

a serious person, though it seems a bit funny to say that about a drug pusher, he is not a hot head, he reasons, he has a job, a girl-friend, two dogs, he is a body-building fan, he is as normal a person, as I am: I smoke, he deals (*ibid.*).

Not only are small quantities of drugs traded by people considered beyond suspicion; two of the largest cocaine importers active in the Milanese area in recent years were not mafia members, but belonged to bourgeois or white-collar circles. The first was Umberto Orio, from Milan, who invested money earned from loan-sharking in the drug business and was able to import, directly from Colombia, six to eight hundred kilograms of cocaine at a time. The second one was a former bank manager from Naples, Pasquale Centore, who was responsible for several four to seven hundred kilogram cocaine shipments. Both of them supplied a multitude of wholesale traffickers, including members of Southern Italian mafia groups, who resided in several parts of the country (TrMI, 1999).

Similar observations can be made about Russia. As Ludmila Markoryan from Balakovo, a Southern Russian city close to the border with Kazakhstan,

points out, 'it is not easy to refer the drug dealers of our city to specific social groups. A dealer might be a housewife, a jobless person, or a businessman. The age range of middle and high-ranking drug dealers also varies tremendously: there are young people as well as retirees' (Paoli 2001a: 110).

### **Open markets, short distribution chain**

The drug markets of the three environments we have investigated are open markets: the relationships between drug dealing enterprises usually more nearly resemble competition than collusion. There is virtually no barrier to entry. Although some suppliers (such as Italian mafia groups) may occasionally enjoy considerable monopolistic power over *local* (usually small) markets, in most European and Russian cities drug enterprises seem to be price-takers rather than price-givers. This means that none of them are able to influence the commodity's price appreciably by varying the quantity of the output sold. It is no coincidence that in Italy as well as in Germany and Russia the wholesale and retail prices of all the main substances, with the exception of cannabis, have decreased steadily (Paoli 2000b: 69-74; 118-24; Paoli 2001a: 101-12).

Neither in Milan nor in Frankfurt, for example, has a crime-entrepreneur ever succeeded in controlling the city's market for any illegal substance. This is true despite the fact that during the 1980s several mafia and underworld drug enterprises operating in Milan tried to exercise monopoly claims over their neighbourhoods of settlement, obliging the local intermediate and street dealers to buy drugs from them. None of these groups, however, ever succeeded in controlling the whole city market or even relevant portions of it. As the Chief of the Milan Police Narcotics Squad candidly put it, 'the market is free, the drug is not' (Paoli 2000b: 101-102). The drug markets of both cities have always been open markets, in which anybody can try to earn his or her fortune, selling, importing, or producing drugs.

Especially in Frankfurt, the openness of the illegal drug market is guaranteed by the city's vicinity to the Netherlands. Ever since the 1970s, dealers and users alike have been crossing the Dutch border to supply themselves with illegal drugs. Among our interviewees, there were quite a few who used to or still make such trips. Many others buy (or bought) their doses from people who supply themselves just over the Dutch border. How easy it can be, is clearly described by Luigi, a part-time dealer, who regularly went to Amsterdam to buy ecstasy, amphetamines and LSD.

On a weekend night you can be in Amsterdam in four hours. You leave at 4 o'clock and arrive at 8 o'clock. It is already dark, you can drive home very well. You are back at midnight or 1.00 a.m. You hand the drugs out or whatever. At 7.00 a.m. I go to work as usual (ibid.: 50 ff.).

Indeed, many German respondents no longer seem to regard the Netherlands as a true 'foreign' country and consider it 'normal' to go there to buy drugs. Asked if they had ever bought drugs abroad, a number of respondents spontaneously replied that they had not and, only after thinking about it twice, recalled that they had been to the Netherlands to buy heroin, hashish or other drugs (ibid.).

Given this widespread practice, the drug distribution chain in Frankfurt is often very short. Actually, if consumers themselves buy drugs in the Netherlands, there is then *strictu sensu* no national distribution system at all, as all German wholesale and retail dealers are bypassed by these entrepreneurial user-importers. In any case, due to the vicinity of the Netherlands, a few transactions are sufficient in order for the illegal merchandise to be passed from the importer to the final user, even when the latter does not cross the border himself.

Even in other contexts besides Frankfurt the local drug distribution chain tends to be rather short and usually entails no more than three to four transactions. This means that the drug distribution chain hardly resembles the six-level hierarchical outline developed by Preble and Casey (1969) in the late 1960s for the New York heroin market, and which has for a long time been considered a reliable approximation of the structure of heroin markets in Europe. In most Western European as well as Russian cities, the length of the distribution chain—the numbers of transactions occurring between the importer and the final user—depends most of all on the amount of the imported commodity and in the second place on the connections of the importer, the intermediate dealer(s), and the user. Only in some cases, there are numerous transactions and the drug distribution system tends to approach Preble and Casey's six-level hierarchical model. In most cases, however, especially in the market for party drugs, but also increasingly in the heroin market, the distribution chain is much shorter and two, at most three, transactions link the importer to the final users.

Even the present heroin distribution system is much shorter than it used to be. This is due to the fact that Kosovo Albanians, who currently play an important role in the heroin smuggling business throughout Europe, do not import large quantities as many Turkish smuggling rings used to do. Albanians deposit the drugs in Eastern European countries and have the contraband smuggled into the EU by Western European couriers, who travel with Western European cars

carrying relatively small quantities of drugs. These lots of heroin are quickly distributed and reach final users after at most two transactions (see PrMI 1998). As a Milanese police officer put it, ‘the Albanian importer sells heroin in Italy to the North African dealer, who buys half a kilogram and re-sells it to the pusher. The latter supplies the end-customer’ (Paoli 2000b: 117).

Far from being a blueprint, the six-level hierarchical model developed by Preble and Casey seems to be only one of the possible forms a city drugs market may assume. Moreover, even when this model applies, it is worth keeping in mind that it does not imply a static role for the participants. Individuals and groups may quickly change positions or play different roles in the distribution chains for different drugs. The crew headed by Salvatore Di Marco and Antonino Guzzardi, two Sicilian Cosa Nostra members living in Milan, for example, was able to import cocaine directly from Colombia in hundred-kilogram lots. At the same time, however, the leaders of the crew used to sell one or two kilograms of heroin to a plurality of smaller dealers (TrMI 1996).

## **The Constraints of Illegality**

Why is the drug market ‘disorganised’ (Reuter 1983)? Why do drug enterprises not follow the same paths of development as those followed by large-scale legal corporations?

Illegal markets –specifically drugs markets– have much in common with their legal counterparts. As Pino Arlacchi puts it, ‘there are buyers and sellers, wholesalers and retailers, go-betweens, importers and distributors, price structures, balance sheets, profits and, though less frequently, losses’ (1998: 204). In addition to similarities, however, there are also relevant differences. Drugs markets, in fact, have some peculiarities that argue against simplistic analogies with their legitimate counterparts. Nor can drug-supplying enterprises be represented as following the same evolutionary trends as licit firms or even be roughly equated to multinational corporations, as is often done in much contemporary discourse about organised crime. Although drug entrepreneurs often seem to embody the ‘animal spirits’ of capitalism in their fullest form, they are subject to powerful constraints, which derive from the illegal status of the products they sell. These constraints have to do with the fact that all illegal market actors – particularly drug traffickers and dealers– are obliged to operate 1) without and

2) against the state, operating in a hostile entrepreneurial environment (See Van Duyne et al., 2001; Van Duyne, 1998).

Since the goods and services they provide are prohibited, illegal market suppliers cannot resort to state institutions to enforce contracts and have the violation of contracts sanctioned; nor does the illegal arena host an alternative sovereign power to which a party may appeal for redress of injury (Reuter 1985). Exchange of illegal goods and services among extraneous actors is thus bound to occur only on the fragile basis of trust developed over the course of repeated exchanges. Still, deceit, violence and betrayal always remain options. Like the pirates of antiquity and the Middle Ages, illegal entrepreneurs are usually pleased to take whatever they can get by force and deceit and resort to peaceful dickering only where they are confronted with a power equal to their own or where they regard it as shrewd to do so for the sake of future exchange opportunities (Weber 1978: 640). As a result, property rights are poorly protected, employment contracts can hardly be formalized and the development of large, formally organised, enduring companies is considerably hampered. The absence of a formal apparatus guaranteeing the security of contracts also prevents the rise of external capital markets, further constraining the growth of illegal enterprises. The latter are unlikely to have audited books providing sufficient evidence of collateral, while potential creditors are discouraged from lending to illegal entrepreneurs, because they lack court protection. Furthermore, since the enterprise does not exist independently of the entrepreneur, the creditor may have difficulty regaining his capital in the event of the entrepreneur's death or incarceration (Reuter 1985).

All suppliers of illegal commodities –especially illegal drugs– are obliged to operate under the constant threat of being arrested and having their assets confiscated by law enforcement agencies. This is a consequence of the fact that they do business ‘on the wrong side of the law’, the products they deal in being, by definition, either *tout court* prohibited or heavily restricted. In reality, the effective risk of being arrested and having assets confiscated varies according to the situation and the counterparts involved. Some illegal entrepreneurs are so successful in bribing representatives of state institutions, and/or the latter are so weak and inefficient, that the risk is strongly reduced. In most Western countries, however, and to a lesser extent in Russia as well, the risk of being arrested and losing one's assets can hardly be disregarded in the long run. To varying degrees, all illegal market actors risk imprisonment and the seizure of their properties by law enforcement agencies and must take precautions against such events. Incorporating drug transactions into kinship and friendship net-

works and reducing the number of customers and employees (which are vulnerable points of information leak) are two of the most frequent strategies that drug entrepreneurs employ to reduce their vulnerability to law enforcement efforts (Reuter 1983; Moore 1974: 15-31).

For the same reasons, opportunities for vertical integration are likely to remain limited. Illegal firms have few incentives to integrate either upstream (that is, to produce raw materials and semi-fabricated products that might otherwise be purchased from independent producers) or downstream (that is, to move further towards the finishing of semi-fabricated products and the wholesaling and retailing operations that put manufactured goods in the hands of consumers) (Scherer and Ross 1990: 94). Irrespective of the direction of integration, internalising a function implies higher risks of arrest and seizure of assets and the higher costs of managing an expanded and more diverse workforce. The latter costs, in particular, are likely to escalate rapidly. In fact, it is very difficult to monitor the performance of employees who, given the illegal nature of the business, also need to work in covert settings and minimise the production of written documents that can become evidence of their illegal activity. This, of course, increases the attractiveness of buying the same illegal services on the market.

The constraints imposed by product illegality also drastically reduce the geographical scope of illegal enterprises. Because of the difficulty of monitoring distant agents and the higher risks associated with transportation, and communication with distant locations, illegal enterprises tend to be local in scope; that is, they usually do not include branches in more than one metropolitan area. Furthermore, outside their home regions, illegal entrepreneurs may have problems in securing the passivity of law enforcement agencies. Since such passivity constitutes a significant advantage, entrepreneurs may find it convenient to restrict their businesses to the areas where they know the local police personally (Reuter 1985). This contrasts sharply with the image conveyed by the widely proclaimed threat of 'transnational organised crime' that has been the subject of such political concern in recent years.

Due to the threat of police intervention, whether it involves the seizure of assets or the imprisonment of, the time horizons of illegal entrepreneurs are likely to be much shorter than those of entrepreneurs operating in legal markets (Van Duyne, 1998). Since an illegal enterprise can hardly be sold as the entrepreneur ages, he is likely to divert increasing shares of his profits into legal assets, which can be passed on to heirs.

Finally, since they are operating against the law, illegal firms are prevented from marketing their products. They cannot create their own brand image and try to bind customers to it. Strong economies of scale, however, are associated with advertising, and the advantages linked to the nation-wide marketing of one's own products have long been recognised as a very important factor in the rise of modern large-scale corporations. According to most economists, for example, advertising represents the single most important basis of large-firm advantages (Scherer and Ross 1990: 130-38). However, illegal firms are by definition excluded from the possibility of exploiting these advantages because, by doing so, they would obviously attract law enforcement attention and damage their own businesses. Hence these markets are not supply, but demand, oriented (Van Duynne et al. 2001).

For the reasons mentioned in the previous section, it is rather unlikely that large, hierarchically organised firms will emerge to mediate economic transactions in the illegal marketplace. The factors promoting the development of bureaucracies in the legal portion of the economy – namely, the advantages associated with economies of scale and the specialisation of roles – are outweighed in the illegal arena by the very consequences of product illegality. The listing of these constraints thus leads to the conclusion that, within the illegal economy, there is no immanent tendency towards the consolidation of large-scale, modern bureaucracies.

As discussed above, even Southern Italian mafia families are subject to the constraints deriving from product illegality. When they deal in drugs or other illegal commodities, they do not operate like monolithic productive and commercial units. On the contrary, their members frequently set up crews like joint ventures with a few other mafia affiliates or even with external people to make drug deals. These crews are far from being stable working units that could be compared to the branch offices of a legal firm. Their composition frequently changes depending on the moment at which deals take place or on the availability of single members. After one or a few drug transactions some teams are disbanded, while others continue to operate for a longer time, eventually changing their composition to some extent (Paoli, 2000a ).

## **Concluding Remarks**

Law enforcement agencies often resort to the spectre of large-scale criminal organisations to back their requests for extra funding. As a matter of fact, it is the ‘invisible hand of the market’ that reduces the effects of their repressive actions near to zero. At the retail level, the ‘industrial reserve army’ willing to sell drugs seems to have no end. As a Milanese drug user noted, ‘for every five Moroccans who are arrested, there are at least fifty ready to do the same job even at less’ (Paoli, 2000b: 118). Even the arrest of wholesale dealers or the seizure of large amounts of drugs rarely has a significant impact on drug availability, because the market is supplied by a plurality of traffickers, each with his or her own independent channels. As mentioned above, in 1994 over five tons of cocaine were seized on the outskirts of Milan. As a key expert put it, ‘the news of the day was not the seizure, but the fact that the Milanese market did not run out of cocaine even for half a day’ (ibid.).

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# **Organising the nicotine racket Patterns of cooperation in the cigarette black market in Germany**

Klaus von Lampe<sup>1</sup>

## **Introduction**

How organised is ‘organised crime’? This question probably lies at the heart of most studies of organised crime (see Paoli, this volume). More often than not the underlying notion appears to be a dichotomy of well-discernable criminal organisations on the one hand and fragmentary structures on the other. As is the case with any social phenomenon, however, there are various shades of grey that have to be taken into account. The purpose of this chapter is to present an ongoing research project on the illegal cigarette market in Germany and to discuss its potential for a better appreciation of the variations in the patterns of criminal cooperation that characterise ‘organised crime’.

The first section attempts to explain why the market for contraband cigarettes has been chosen for a case study of organised crime. In the second section, a general classificatory scheme is proposed for analysing criminal structures, while in the third section, this classificatory scheme is applied to the illegal cigarette market.

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## **The illegal cigarette market and studying organised crime**

### **Choosing the cigarette black market as an object of study**

Choosing the illegal cigarette market to study organised crime is premised on two assumptions:

1. that there is –at least potentially– a general understanding of organised crime in the sense of a cumulative body of knowledge, and
2. that the illegal cigarette market can in some way or other be considered a part of or a manifestation of organised crime so that examination of such a market can contribute to this body of knowledge.

These assumptions, of course, are not unique. They arise with any study that sails under the flag of organised crime research, and have to do with the difficulties of translating ‘organised crime’ from a heterogeneous socio-cultural and political construct into a scientific concept.

So far, attempts to overcome these difficulties have been primarily aimed at finding a generally accepted definition of organised crime. Not surprisingly, these efforts have proved futile as such a definition would require a thorough understanding of the wide range of potentially relevant phenomena and the interplay between them that is currently not available. It is even questionable whether a scientific –i.e. empirical– definition is attainable at all (van Duyne et al., 2001; Von Lampe, 2001).

Where ‘organised crime’ is not just used as a non-committal label, a certain degree of reciprocity of research has only been achieved by either taking mafia imagery as a common measuring rod or by reducing the concept of organised crime to partial aspects, namely illegal markets and illegal enterprises (Smith, 1994). The enterprise model allows valuable insights, not least when –as in our case– an illegal market is chosen as the object of study. However, against the background of the public and scientific debate it means that the scope of the concept of organised crime is arbitrarily narrowed down to exclude, for example, criminal structures not directly affected by market dynamics such as criminal fraternities and deviant subcultures and groups engaged in non-market crimes like fraud (von Lampe, 1999; Paoli, 2002).

In the absence of universally accepted defining criteria, it seems that the common ground of organised crime research has to be found not in a mutual understanding of the nature of organised crime but in an agreement on how

eventually to reach such a mutual understanding. In other words, instead of engaging in circular debates over the nature of organised crime, a research program should be devised that in the end will allow one to come to such a mutual understanding or, alternatively, to a general agreement that the construct of organised crime has no counterpart in social reality and thus is obsolete as an analytical category. As I have argued elsewhere (von Lampe, 2002a), three notions should guide the study of organised crime:

1. The *field* of study should be determined by the scope of the public and scientific debate on organised crime. Organised crime as a field of research, then, contains what people so label. This would include just about any kind of cooperation for the rational commission of illegal acts, and certainly the illegal cigarette market would fall within these parameters;
2. within this broad framework there are a number of recurring issues that need to be carefully conceptualised: for example, the structural patterns of criminal cooperation and the concentration of power in criminal *milieux* and illegal markets. Instead of indulging in circular debates on how to define organised crime, more efforts should be invested in defining these middle-range concepts;
3. the aspects of the social universe that are subsumed under the umbrella concept of organised crime should not be treated as static. Whereas definitions of organised crime have a tendency frantically to focus on one specific constellation of these aspects, namely, complex criminal organisations using violence and corruption to attain control over illegal markets and legal institutions, it seems preferable to place the emphasis on the fluidity and diversity characterising collective criminal conduct.

This entails exploring, in as many social and historical settings as possible, how the phenomena in question vary in time and space and in what combinations they appear. Ideally, organised crime research would take a given geographical area as an object of study to determine what people, integrated into what structures, are involved in what types of rational illegal activities, applying what *modus operandi*, exerting what influence on legal institutions and being supported and influenced by what kind of basic conditions. Because of the broad scope of the subject, however, vast amounts of data would have to be collected and in the end, given the scattered data sources, it is most likely that still only a very fragmentary picture would emerge.

Taking a particular illegal market in a particular country such as the illegal cigarette market in Germany as the object of study is an attempt to minimise these methodological problems. It allows a close-up look at a clearly defined

detail of the overall conglomerate of people, structures and events without reducing the conceptual frame of reference.

It could be expected beforehand that in the analysis of the cigarette black market many facets of the imagery associated with the term 'organised crime' would be encountered. Moreover, choosing the illegal cigarette market in Germany appeared particularly appealing given the limited time frame of about 10 years within which it has emerged and apparently gone through several distinct phases of development. This promised to provide a good opportunity to study the dynamics to which the phenomena are subjected.

### **Data sources**

The study of the illegal market on which this chapter is based draws on a variety of sources, including media reports, public documents, court files and interviews conducted with law enforcement officials and informants. The following discussion, which focuses on the structures within which market participants operate, reflects preliminary findings from a pilot study. This comprises the analysis of 14 cases investigated by the Berlin branch of the German customs service between 1990 and 1997.

The analysis of criminal files has obvious limitations just as does any analysis of law enforcement records due to the selectivity regarding the transgressions and the aspects thereof that come to the attention of law enforcement agencies, and the information that is eventually processed and recorded. However, there is no other source that would provide a similarly broad set of more or less standardised data on market participants, their relationships, their modus operandi and the responses from the criminal justice system. The data obtained from these case files appear to be an appropriate basis for scrutinising and supplementing official and media accounts of the cigarette black market.

The customs service is a federal agency with exclusive jurisdiction over investigations relating to offences in connection with the smuggling and distribution of untaxed cigarettes. The investigations are recorded in a central database containing information, for example, on the number of offenders and the amounts of cigarettes. The cases selected for the pilot study were taken from the ten cases for each year involving at least three offenders and the highest amounts of cigarettes. The intention behind applying these criteria was to select cases that deal with the most complex and most relevant criminal groups that have come to the attention of the customs service.

## **A classificatory scheme for analysing criminal structures**

There are a number of deficiencies in the European and global debate on organised crime that stand in the way of a better understanding of how criminals are organised and how they are organising crime. These deficiencies include a fixation on mafia imagery, a tendency towards over-simplification, and a lack of precise terminology (van Duyne et al., 2001:50-57).

In order to rectify these problems it appears necessary to develop concepts and classifications that capture the full range of phenomena that fall under the umbrella term 'organised crime'.

With regard to the analysis of criminal structures I propose a two-dimensional classification as a starting-point. This classificatory scheme accounts, on the one hand, for the diversity of functions that criminal structures may serve, and, on the other hand, for the different degrees to which criminals may be integrated into criminal structures.

### **Functions**

The first dimension takes into account that criminal structures typically serve one or more of the following three functions: economic, social and quasi-governmental.

- Economic structures aid criminals in achieving material gain. A cigarette smuggling ring falls into this category just as does a gang of burglars or an illegal casino.
- Criminal structures that serve social functions but no immediate economic functions, include fraternities such as the Sicilian mafia or North American Cosa Nostra (Paoli, 1998) and, to a certain degree, also deviant subcultures such as those emerging within marginalised ethnic communities (Bovenkerk, 1998). These structures support their members only indirectly in illegal economic activities, for example, by establishing contacts, promoting solidarity, creating a sense of belonging, giving status, reinforcing deviant values and providing a forum for the exchange of information. In the illegal cigarette market in Germany, certain ethnic networks may be of relevance in this regard.
- Quasi-governmental structures support illegal economic activities in a more abstract way by establishing and enforcing rules of conduct and by settling

disputes. These legislative and judicial functions are not for members only but, by definition, affect all criminal actors operating in a given territory or market. Here, too, Cosa Nostra is a good example (Anderson, 1979). As we shall see, in the context of the illegal cigarette market in Germany, Vietnamese extortion gangs who prey on Vietnamese vendors of contraband cigarettes, are the closest to structures serving quasi-governmental functions to be found. While they levy a 'street tax' on vendors, however, they do not provide any real service in return.

These three core functions are not empirically independent, i.e. a criminal group may serve, for instance, both social and economic purposes. However, given the different structural and logistical demands one is unlikely to find economic and quasi-governmental functions coinciding (Block, 1983; Skaperdas and Syropoulos, 1995).

### **Networks and organisations**

The second dimension pertains in the first place to the distinction between networks and organisations (or groups) and secondly to different levels of organisational sophistication.

A network is a web of dyadic ties connecting two or more persons (Knoke and Kuklinski, 1982:12). Accordingly, a criminal network can be defined as a set of actors who are linked by criminally exploitable ties (von Lampe, 2001). The scope of action of each network member is determined by the quality of his or her dyadic ties and the position occupied in the overall network. A criminal network, therefore, demarcates the social space in which criminal cooperation is a viable option. The cooperation can take on various shapes and forms, from sporadic communication to continuous collaboration within organisational structures. In this sense, networks and organisations may overlap.

An organisation also consists of a combination of individuals, but in contrast to a network it is more than just the sum of its parts as it entails a certain degree of integration. An organisation takes on an existence of its own by representing a system of more or less persistent norms, expectations and procedures that permit coordinated, purposeful action (Hall, 1982:28-47).

### **A two-step analysis of criminal structures**

The distinction between networks and organisations leads to a two-step analysis of criminal structures. First, a given set of offenders is examined for the dyadic

ties through which they are connected, distinguishing between various *forms*, and the *contents* of the ties. Relational form refers to aspects such as the intensity or strength of the link between two actors and the level of joint involvement in the same activities. Relational content refers to the substantive type of relation represented in the connections. Possible types of content include transactions, communication, sentiment, authority and social bonds, for example kinship, but mutual membership in an organisation such as Cosa Nostra would also fall into this category (see Knoke and Kuklinski, 1982: 15-16).

The analysis of dyadic ties is followed by an assessment of the extent to which these ties constitute an integral part of organisational or group structures. This is a question of whether or not actors are subordinate to a collective will, and if so, in what way and to what degree. A wide range of concepts borrowed from organisation theory and group sociology provide a basis for a concise analysis and pave the way towards overcoming empty phrases such as ‘loosely structured’ and ‘tightly organised’. The concepts to be considered include size, complexity<sup>2</sup>, formalisation, centralisation, vertical integration and the means and pervasiveness of internal control (see Etzioni, 1964; Hall, 1982; Scott, 1981).

## **The illegal cigarette market**

With the classificatory scheme providing a conceptual framework, we can now turn to the empirical data collected on various sets of offenders involved in the cigarette black market in Germany between 1990 and 1997.

### **Overview**

The cigarette black market in Germany is part of what van Duyne (1999: 433; 1996: 356) has called the ‘price-wedge market’. It is constituted by the abuse of the cost-price changing regulatory system of taxes, excises, levies and subsidies. The commodities traded on this market, including cigarettes, are per se legal. What makes the dealing in cigarettes illegal is the circumvention of taxes and customs duties.

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<sup>2</sup> Complexity is defined by horizontal differentiation, i.e. division of labour, and vertical differentiation, i.e. hierarchy, and by spatial dispersion (Hall, 1982).

As I have elaborated elsewhere in greater detail (von Lampe, 2002b), there are roughly three channels through which cigarettes are procured for illegal distribution. Domestically manufactured cigarettes destined for export may either be directly diverted to the black market or illegally re-imported by smugglers. A smaller share of contraband cigarettes comprises merchandise produced and marketed in low-tax countries.

Once untaxed cigarettes have been procured for illegal distribution they are either sold to consumers through clandestine networks or in public, by illicit street vendors. The latter are mainly of Vietnamese origin, who have established themselves in various parts of East Germany, most notably East Berlin. One remarkable feature of the open market for contraband cigarettes is the victimisation of Vietnamese peddlers by rival Vietnamese extortion gangs who in the past have waged gangland-style wars over territories.

In recent years there has been a substantial decline in the street sale of cigarettes. At the same time Germany has increasingly become a transit country for shipments of contraband cigarettes going to Great Britain, where higher taxes promise larger profits. In 2000 and 2001, half of the cigarettes seized by the German authorities were destined for the British Isles.<sup>3</sup>

The illegal cigarette market can be roughly divided into three levels: procurement from legal sources, wholesale distribution, and retail sale. Each of these levels is characterised by specific though not necessarily invariable conditions and demands on market participants.

The 14 cases included in the pilot study encompass – to varying degrees – all three market levels: six involve primarily the procurement of untaxed cigarettes, five primarily the wholesale level and three the retail sale. The amount of cigarettes handled at one time ranges from 37.000 to 11.5 million (median: 137.500). Four of the cases pertain to the early phase of the black market during 1990 and 1991, six to the time period 1992-95, which was marked by a significant expansion of the market volume, and another three to the years 1996 and 1997, when the market volume apparently declined as a result of intensified law enforcement efforts.<sup>4</sup> One case, involving a group of Germans engaged in the smuggling and retail distribution of cigarettes, stretches from 1995 to 1997. Overall, the files contain information on 70 likely offenders (i.e. persons who presumably participated in the respective schemes), belonging to 18 different

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<sup>3</sup> On the European dimension of the illegal cigarette trade see Joossens (1999) and van Duyn (forthcoming).

<sup>4</sup> For a more detailed account of the historical development of the cigarette black market in Germany see von Lampe (2002b).

groups or sub-networks of between two and eight known members. 14 of these collectivities were ethnically homogeneous, having exclusive Polish (n=6), Vietnamese (n=5), German (n=2) or Yugoslavian (n=1) membership.

### **Four case studies**

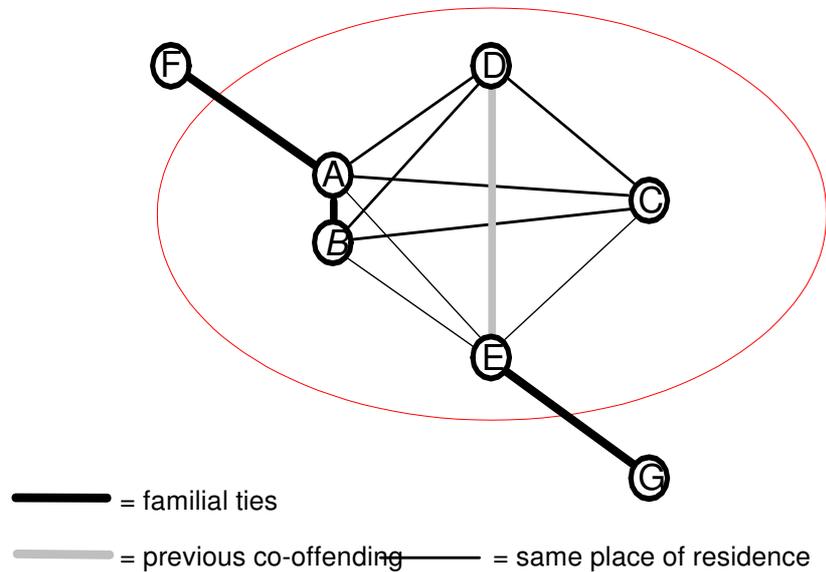
Four of the cases analysed will be presented here to illustrate some of the consistent patterns that have (or seem to have) emerged in the course of our research so far.

#### *Case no. 1*

Originally, all stages of the black market, from procurement to retail sale, lay in the hands of the same small groups or individuals operating from neighbouring Eastern countries, most notably Poland. They would purchase cigarettes, smuggle them across the border and offer them on the streets in Germany. However, retail sales were soon taken over by former Vietnamese guest workers in East Germany, who had become unemployed in the course of the industrial restructuring that began in 1990. The appearance of Vietnamese vendors led to a differentiation of market levels between Eastern European suppliers and Vietnamese retail dealers.

#### *Figure 1*

### Case 1: Procurement and Whole Sale Distribution (93.000 cig.)



The first example (fig. 1) involved a group of Polish suppliers who tried to sell 93.000 cigarettes to Vietnamese customers in East Berlin in May of 1991.

The persons *A*, *B*, *C*, *D* and *E* were arrested by the police while driving two cars loaded with Marlboro and Golden American cigarettes to a Vietnamese dormitory in East Berlin. Despite contradictory statements it seems safe to assume that the cigarettes were purchased in Poland for a price of DM 15 per carton, brought across the border and transported to Berlin with the intention of selling them for a profit of about DM 2-3 per carton to unspecified Vietnamese buyers. Had it been successful, the endeavour would have produced a total profit of around DM 800 (€400).

In several respects the case is typical of the early phases of the cigarette black market, when short-term combinations of 3-5 persons formed on the basis of kinship or other social bonds supplied Vietnamese dealers in East Germany (see also Gosztonyi, 1994). In this case, all five participants, except *E*, lived in the same town close to the German border. *A* and *B* are a married couple. *C*, *D* and *E* are also married and, like *A* and *B*, they all have children. At least two of the five have a regular job, so that their involvement in the cigarette business

is aimed at supplementing legal income. The main motive for cooperation, it seems, is mutual moral support and the pooling of financial and logistical resources. The participation of *A* and *E*, for example, might in part be explained by the fact that they were able to borrow cars from *F* and *G*, respectively. It is not clear to what extent the latter two persons were aware of the purpose for which their cars were used.

Within this and similar groups neither a firm division of labour nor a hierarchy of authority is discernible, i.e. decisions were jointly made and jointly implemented. A certain degree of differentiation existed only insofar as participants with experience of previous endeavours tended to be entrusted with certain tasks such as negotiating with potential customers. In this example, this role might have been assumed by *D* and *E*, who in the previous year had already been apprehended smuggling cigarettes.

#### *Case no. 2*

The second case (tab. 2), dating back to the autumn of 1992, also refers to the supply of Vietnamese customers. In various respects, however, it becomes apparent that changes had taken place since the early phases of the black market represented by the first example. The procurement and distribution of cigarettes were no longer in the hands of the same face-to-face groups. Instead, different sets of actors with little overlap operated on the procurement and distribution levels. In addition, at least on the wholesale distribution level, horizontally and vertically differentiated structures had evolved. Finally, with the emergence of a separate wholesale distribution level, the base of operation had been partly transferred to Germany.

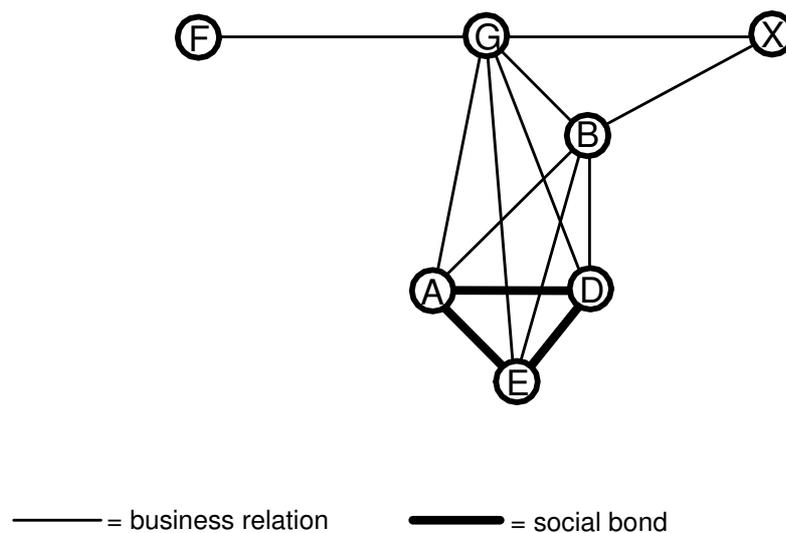
In the second example, *G*, a Pole, had been in Slovakia on assignment as a construction worker where he met three Slovaks, *A*, *D* and *E*, to whom he offered a chance to earn some money by transporting cigarettes in Germany. The three, two of them unemployed at the time, went to Berlin, first in October and then again in November of 1992, where they were put up and provided for by *G* in a summerhouse in East Berlin, which *G* had rented from the German *F*. *G* had *A*, *D* and *E* drive cars to a highway parking lot outside Berlin to meet him and to receive loads of between 160.000 and 320.000 contraband cigarettes of various brands. *A*, *D* and *E* then brought the cigarettes to the summerhouse where they re-packed and reloaded the cargo and delivered it to a Vietnamese dormitory in East Berlin with the assistance of another Slovak, *B*, who had also been recruited by *G*. *B* would go to the dormitory before each delivery, appar-

ently to make arrangements with the Vietnamese customer or customers (*X*). The task of *A*, *D* and *E* was to bring the cigarettes and pass them on to *B* standing on a dormitory balcony. While the cigarettes were transported from the parking lot to the summerhouse and on to the dormitory, *G* was not present. Only a while after a delivery was made, did he allegedly come by the dormitory to pick up the money.

In sum, we find a three level hierarchy with *G* at the top and *B* acting as some sort of foreman while *A*, *D* and *E* carried out menial tasks under the direction of *G* and *B*. *G* paid *A*, *D* and *E* DM 50 for each delivery. *B*, according to his less credible and contradictory claim, received only between DM 10 and DM 20 per delivery or per day. A horizontal differentiation manifested itself in the different ways *B* and *A*, *D* and *E*, respectively, participated in the deliveries.

Figure 2

### Case 2: Whole Sale Supply (320.000 cig.) in 1992



It is not clear how durable this structure was meant to be. At least *A*, *D* and *E* seemed to have had no plans to work for *G* on a permanent basis. On the other hand the summerhouse rented by *G* had come to the attention of the customs service before as a reloading station for contraband cigarettes so that the possi-

bility cannot be ruled out that *G*, perhaps with the assistance of *B*, had run the same scheme on a long-term basis with a changing staff of helpers that he recruited for shorter periods of time.

The recruitment of helpers is a phenomenon that deserves separate attention, not only because ‘criminal workers’ are employed and paid wages somewhat similar to the way workers are in the legal economy (Ruggiero, 1996:119), but also with a view to the fact, that in several of the cases analysed there are only weak links and sometimes, such as in the case of the three Slovaks *A*, *D* and *E*, no pre-existing ties between recruiter and recruit. This is remarkable considering the widely held assumption that a certain degree of mutual trust is required to minimise the risks inherent in criminal cooperation. On the one hand there is the risk of detection and apprehension by law enforcement agencies, which increases with every additional accomplice. On the other hand, criminals are particularly vulnerable to dishonest behaviour as they cannot seek protection from the authorities and the courts (see Reuter, 1985:7).

The calculation behind such arrangements seems to be that the perceived risks of having others perform exposed tasks despite uncertainty regarding their reliability are lower than the risks the illegal entrepreneurs would expect to incur if they carried out the tasks themselves. In fact, in the case of the three Slovaks *A*, *D* and *E*, as well as in similar cases, the hired hands willingly testified after being arrested. The information they were able to supply, however, was found to be insufficient for an indictment and in some cases, including the example of *G*, even for an identification of the relevant employer. This probably has to be attributed in part to the limited resources available to the customs service for conducting more complex investigations.

### *Case no. 3*

The third example (fig. 3) is the only one in the sample which covers the path of the cigarettes from production to the lower levels of the black market. The case involves a container load of cigarettes officially going from the English manufacturer (*Z*) to a company (*L*) in Kaliningrad, Russia, via Portugal and Germany. Apparently the initiators of the purchase had intended all along to divert the cigarettes to the black market and to use false customs stamps to fake a proper export to a non-EU country.

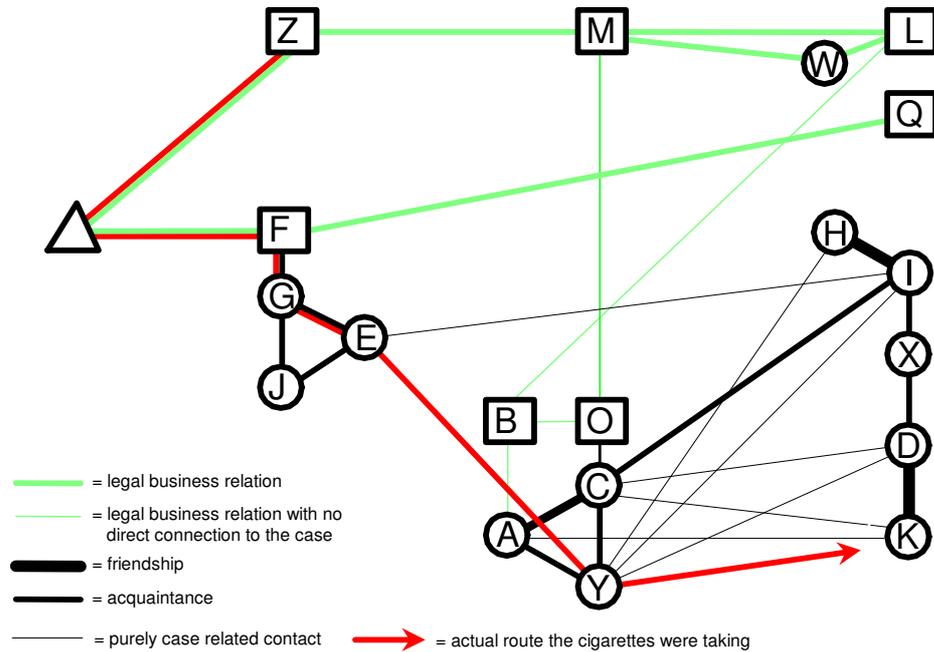
The course of events is as follows: *L* purchases from *M*, a trading company in Hamburg, Germany, a consignment of 11,5 million Golden American cigarettes for a cash price of US\$174.800 (DM 280.000). The money is delivered

to *M* by *W*, a Lithuanian, on behalf of *L*. The trading company *M* orders the cigarettes from *Z* for shipment to a bonded warehouse in Portugal where the cargo is picked up by *E*, a Polish truck driver working for the Dutch haulage company *F* of *G*. This haulage company *F* has been hired by *Q*, a company based in Riga, Latvia, in order to transport the cigarettes from Portugal to Kaliningrad across the German-Polish border, but on condition that the driver awaits further instruction once he has reached the Berlin area.

At the same time as these arrangements are made through legal business channels a group of three Poles, *A*, *C* and *Y*, living in Braunschweig, Germany, begin to look for a potential buyer for the 11.5 million cigarettes. For this purpose, *C* contacts *I* whom he has recently met. *I* lives in Szczecin, a city in Western Poland. Through another unknown Pole, *X*, he gets in touch with *D*, who also comes from Szczecin, but has obtained German citizenship and lives in Berlin. *D* has spent time in prison for involvement in trafficking in stolen motor vehicles. In prison he has befriended *K*, a Vietnamese convicted of trafficking in contraband cigarettes. *D* has financial difficulties and hopes to earn money by finding suppliers of untaxed cigarettes for *K*. *D* is unaware that his Vietnamese friend has become an informant for the customs service and has no real interest in purchasing contraband cigarettes.

*Figure 3*

### Case 3: Sale of a Container Load of 11.5 Million Cigarettes in 1994



*C* and *K* enter into negotiations in the presence of *I* and *D* and come to agree that *K* will buy the 11.5 million cigarettes for a cash price of DM 713,000. This would have left the actors on the supply side with a total profit of about DM 420,000 DM (€210,000) after deducting the freight charges of about DM 13,000 that *F* and *Q* had allegedly agreed on.

When *E* in his truck approaches Berlin he is advised by *J*, another employee of *F*, that upon request of the client the cigarettes are not to be brought to Kaliningrad, but to a highway service area near Berlin. There he is met by *I* and by *H*, a friend of *I*'s who had volunteered to drive *I* from Szczecin to Berlin, allegedly without knowing the purpose of the trip. *Y* is also present, but remains in the background by giving *I* a cellular phone to receive further instructions. *E* is guided to a warehouse where *E*, *H* and *I* begin unloading the container until the customs service steps in. In the meantime *C*, *D* and *K* are in a hotel in Berlin where the money is supposed to be handed over. *C* monitors the rendezvous with *E* via cellular phone. When difficulties arise in unloading the truck because the warehouse proves to be too small for the truck, *A* appears who until

then has only communicated with *C* by phone. *A* takes over the direct negotiations with *K* before they, too, are arrested.

It remains unclear who initiated the procurement of the cigarettes through *L* and *Q* and what the relations are to the Braunschweig group of *A*, *C* and *Y* and the Dutch haulage company *F*. It is certain, however, that the shipment of the 11.5 million Golden Americans was not an isolated case.

Investigations by the customs service found *M*, the trading company based in Hamburg, to be involved in several similar shipments officially going from Portugal to Eastern Europe, including to *L* in Kaliningrad, for which the transit system procedures were not completed, i.e. the shipments were not processed for leaving the EU. In two of these cases the cigarettes were transported by *F* with *E* as the driver.

The Braunschweig group of *A*, *C* and *Y* also seems to have had prior involvement in the cigarette business. First of all, it is noteworthy that ties existed to *M* as well as to *L*. *A* is part owner of *B*, an Import/Export company based in the same building as the trading company *O*, which in turn is supposedly owned by *C*'s sister. In August 1994, one month before the attempted sale of the container load of cigarettes took place, *B* sold *L* salad oil, *B*'s major line of official business. According to customs service investigations, 'intense business contacts' exist between *M* and *O*, whereas *O* is also directly linked to the failed cigarette deal through the ownership of one of the cellular phones that *A*, *C* and *Y* have used for communication.

A strong indication of the continuous entanglement of *A*, *C* and *Y* in the illegal cigarette business are documents seized from *A*. Aside from a notebook containing the addresses of several suppliers of cigarettes to the Eastern European markets, a letter written in Polish is especially incriminating and informative. In this letter *A* is asked to let the sender know if he is ready to take a container of cigarettes on short notice. If not, the sender explains, he will come over 'to settle up'. This gives ground for speculating on the relationship between *A* and the Eastern European suppliers of cigarettes. Apparently, *A*, *C* and *Y* were not integrated into a larger, vertically integrated enterprise, but instead sold container loads of cigarettes on a case-by-case basis on commission.

The case is illustrative of a number of aspects. The most significant, however, seems to be that on the procurement level actors can operate within the framework of legal businesses. As far as criminal structures are concerned, they coincide with legal business structures or are run parallel when employees unwittingly participate in illegal activities. *J*, for example, the employee of the haulage company *F*, claimed that he was ignorant of the wider implications

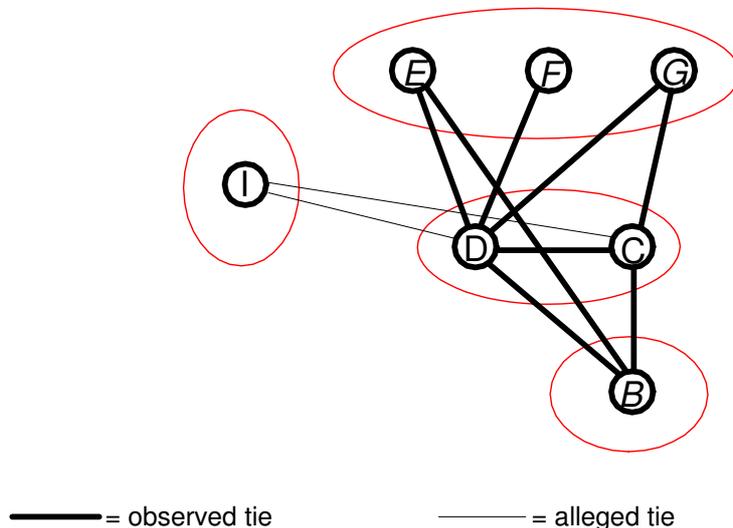
when he passed on the order to *E* not to drive the truck to Kaliningrad but to the service area near Berlin.

*Case no. 4*

The fourth example (fig. 4) features the sample's most complex group structure in terms of horizontal and vertical differentiation. Ironically, we find it on the most exposed market level, the street sale of contraband cigarettes.

*Figure 4*

Case 4: Retail Sale in 1996



The case involves Vietnamese, who were the object of a long-term surveillance operation conducted by the police at one of the busiest selling places in East Berlin in 1996. From time to time, the Vietnamese believed to be connected to the sales activities were rounded up and arrested. This resulted in the apprehension of up to 16 individuals at a time, of which at least seven can – with some certainty – be assigned to a group of offenders who collaborated on a continuous basis in a division of labour.

The group's operations comprised four different tasks. The actual selling was done by *B*, and sometimes by *D*. The cigarettes were stashed away in remote hiding places and retrieved when necessary by *D* and *C*. The cash proceeds were kept by *E*, *F* and *G*, well separate from the sales activities. Finally, *I* functioned as a lookout, apparently to warn the others of raids staged by the police or the customs service. Within the group there existed at least a two-level hierarchy of authority. The safe keepers of the money, *E*, *F* and *G*, as well as the sales person *B* and probably also *I* and other look-outs were employed on fixed salaries with regular working hours. Based on the observed money flows, *D* seems to have been the key figure in charge of the overall operation and therefore to have functioned as an employer. The nature of the relationship between *D* and *C* remains unclear.

Given the widely held notions that the complexity of criminal groups is inversely related to the risk of detection and apprehension (see Paoli, this volume), it is surprising to encounter these comparatively complex structures in connection with the street sale of contraband cigarettes, i.e. the most exposed market level. Even more astonishing is the fact that these complex structures emerged under increased law enforcement pressure.

Originally, illegal street sales were carried out by individual entrepreneurs or small groups without internal differentiation. These individuals combined to form more sophisticated structures only after violent confrontations between rival extortion gangs provoked a relentless law-enforcement campaign against the illegal cigarette business in the mid 1990s.

One explanation for the emergence of complex retail enterprises in an increasingly hostile environment is suggested by the fact that these structures are not so much designed for protection against apprehension and conviction. In this regard they may even be counterproductive. Rather, the separation of cigarettes, cash proceeds and selling activities, which is achieved by establishing specialised positions for store keeping and safekeeping, minimises the risk of seizure and forfeiture of cigarettes and especially cash proceeds. This means that the potential damage resulting from the seizure of assets is deemed more severe than the consequences to be suffered when group members are arrested for participation in the sale of contraband cigarettes. This is plausible insofar as the sanctions imposed on the street sale of cigarettes are mostly confined to fines and suspended sentences so that vendors are quickly able to return to their business after each arrest. In addition, the potentially effective instruments provided by immigration laws, namely extradition, cannot be fully brought to bear on Vietnamese vendors, because the Vietnamese government is reluctant

to readmit citizens who face extradition for involvement in the illegal cigarette business.

### **Links between market levels**

Apart from the structure of individual enterprises a crucial aspect in the analysis of the patterns of criminal cooperation in illegal markets are the ties connecting actors on different market levels.

Generally speaking, it seems that the procurement, wholesale and retail levels of the market are connected by the same type of ties that connect participants on each level: economic ties embedded in friendship and familial ties or some lesser forms of social bond. The third example is illustrative of this point. The procurement level, represented by the companies *L*, *Q* and *M*, and the wholesale level, represented by the Braunschweig group of *A*, *C* and *Y*, were apparently connected through legal business contacts. The contact with *K*, the supposed Vietnamese customer, on the other hand, was initiated through a chain of contacts within an ethnically homogeneous social network, consisting of Poles and a German of Polish descent (*I*, *X*, *D*), and through a friendship tie between *D* and *K* that was established in prison. Within this network the participants obviously felt safe to disseminate the information that a supplier and buyer of contraband cigarettes was wanted. The case conveys the image of far reaching social networks with a rather low density that either can be activated for illegal purposes when the need arises or provide the basis for more durable patterns of cooperation. This assessment is in line with general expectations that criminal cooperation is embedded in pre-existing bonds of trust.

One constellation, however, is different and deserves particular attention: the business relations between Polish wholesale suppliers and Vietnamese dealers. Unlike the example of *D* and *K*, who established a (one sided) bond of trust in prison, the available evidence suggests that initially there were no pre-existing ties of any kind connecting both sides. In the legal economy, such business contacts across ethnic, cultural and language barriers are believed to be especially problematic and susceptible to interference (Neubauer, 1997). In the illegal economy, at least as far as the cigarette black market is concerned, the opposite may be true. It seems that Polish suppliers of contraband cigarettes have taken the risk of directly and quite arbitrarily approaching Vietnamese without prior introduction by a third party or any other preceding contact. They simply set out to solicit customers at Vietnamese dormitories. Both sides, one can surmise, were similarly confident that members of the other ethnic group

could be trusted. If this supposition is true, then a certain level of trust existed precisely because of the ethnic distinction, by allowing 'positive' stereotypes. One such stereotype, for example, is that Poles or Vietnamese can generally be expected to behave in an agreeable way, because they are known for their participation in underground business.

A similar mechanism may be in place where German customers and Vietnamese street vendors meet. But in this context, ethnic distinction could be relevant for yet another reason. Their distinct appearance makes Vietnamese vendors more easily identifiable for customers and thereby facilitates the initiation of contacts.

### **Network and group structures**

Taken as a whole, the cigarette black market in Germany seems to be characterised by low-density networks comprising small, simply structured enterprises and individual entrepreneurs, who perform relatively simple tasks. Group structures, to the extent they become visible, in general display little vertical or horizontal differentiation. This seems to be true even where 'criminal labourers' are employed, because they tend to be hired only for one specific task or, as in the case of the Slovaks, only for a limited period of time. Therefore it is difficult really to consider them parts of durable enterprise structures. One reason for this phenomenon may be that more sophisticated structures are not required to meet the demands of the cigarette black market as there is, for example, no complex technology to be handled.

Core groups that make up criminal enterprises tend to be based on strong ties such as kinship, marriage or friendship, but employer-employee and buyer-seller relations can be found that are rooted in weak ties or even lack any basis in pre-existing contacts.

The apparent ease with which social bonds can be exploited and new contacts can be established for participants in the illegal cigarette market is not necessarily representative of all illegal markets. Whatever furthering factors are at work, one crucial aspect is probably the fact that the risks inherent in involvement in the cigarette black market are relatively low compared, for example, to the drug market. The highest sentence documented in the 14 case files analysed was 2 years and 9 months prison without parole for participation in the failed attempt to sell a container of 11,5 million cigarettes. Against many offenders no sanctions were imposed at all, for example for lack of evidence or because the authorities failed to identify and apprehend the suspects. Overall,

of 70 likely offenders appearing in the proceedings analysed, only 34 were convicted. Of these only 9 received a prison term without parole, another 13 were sentenced to prison with parole, and 12 received fines. The proceedings against the remaining suspects were suspended or ended in an acquittal or, in the case of 12 likely offenders, the files contain no information on any formal response by the criminal justice system.

### **Criminal fraternities and criminal subcultures**

Where social networks provide a basis of trust for cooperating market participants there is no indication whatsoever that they are reinforced by membership in mafia-type criminal fraternities or secret societies.

In this context it is also interesting to note that most market participants apparently lack any involvement in other areas of crime. Criminal records are either clean or show offences such as traffic violations and violations of immigration statutes. Even *D* in the third example, who had served a prison term on charges related to trafficking in stolen motor vehicles, does not seem to be a hardened 'career criminal'. In fact, he had been a dentistry student who simply appears to have been a bit down on his luck. Thus, patterns of cooperation among participants in the cigarette black market do not tend to be embedded in criminal subcultures either.

### **Monopolisation**

Regarding specific market levels and the cigarette black market as a whole, there is no evidence that the criminal structures that evolve around specific activities are subject to a monopolisation process. Neither do we find any indication that individuals or groups of market participants have undertaken efforts in that direction by removing competitors and blocking market access.

What can be observed though, is a concentration process on the upper levels of the illegal market due to economies of scale. Originally, the procurement of cigarettes from legal sources had been open to virtually all market participants when the primary sources of supply were legal outlets in low tax countries such as Poland. In later years, most cigarettes appear to have come from bulk purchases made directly from manufacturers and trading companies within the EU. While this is potentially the most profitable way to obtain cigarettes for the black market, it is open only to a few more or less sophisticated and well-funded entrepreneurs. In Berlin during the mid 1990s, for example, the large-

scale supply of cigarettes was supposedly confined to just three groups of offenders.<sup>5</sup>

Eventually, the concentration process seems to have trickled down to the level of Vietnamese wholesale traders. According to a Vietnamese informant interviewed by a TV-journalist in 1999,<sup>6</sup> three groups of former street vendors had acquired the financial capacity to buy entire shipments of contraband cigarettes from Polish smugglers to pass them on to several groups of mid-level dealers, who in turn supplied the larger numbers of retail dealers. This implies that not only on the procurement level, but also on the wholesale level a limited number of actors is responsible for a relatively large share of the market supply.

There is likewise no evidence of the emergence of an illegal power structure overarching the illicit cigarette business. Such a quasi-governmental monopoly of power could be expected to evolve either 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 and White, 1982). Both factors do not seem to be relevant for the illegal cigarette market.

## **Extortion**

A different matter is the phenomenon of the systematic extortion of street vendors by Vietnamese extortion gangs. These gangs are not directly involved in the day-to-day routines of the cigarette business and appear to be purely predatory in nature (Laudan, 1999). Therefore it is difficult to classify them as performing quasi-governmental functions.

Unlike illegal markets, we do find violent competition for control over territory as a natural by-product of extortion. In the long run, it can be argued, extortion works only if the extorted is convinced that by paying one extortionist the overall risk of extortion is covered. The creation of a monopoly of violence, therefore, is a necessary condition for extortion gangs to survive (Schelling, 1971:76-77). In the case of the Vietnamese extortion gangs, however, no single gang managed to achieve supremacy and the warring factions also failed to come to a peaceful division of territories. Instead, the bloody feuds continued until they provoked a relentless concerted response by the police and the customs service. This response not only led to the dismantling of the major rival

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<sup>5</sup> Nie Fragen gestellt, in: *Der Spiegel* 27/1997, p. 25-26

<sup>6</sup> Althammer, R., Ein mörderisches Geschäft, *B1*, 15 October 1999, 20.15-20.45 h.

extortion gangs, but also to a significant reduction in the street sale of contraband cigarettes (von Lampe, 2002b).

### **Interfaces between the legal and illegal spheres of society**

One final comment should be made on the interfaces between legal and illegal structures. There are numerous constellations that have to be taken into account, including the corruption of public officials and the use of legitimate businesses. Analytically there are some similarities to the linkages between different market levels, as in both cases there is a great likelihood that actors with different socio-economic and cultural backgrounds meet. Nevertheless, the cleavages that have to be overcome might be greater when participants in the black market and representatives of legitimate institutions get into contact, as in the case of the procurement of untaxed cigarettes from manufacturers and trading companies. In other regions of the world, such as in North and South America, cigarette manufacturers have been found to have colluded with smugglers and black marketeers (Dantinne, 2001). A similar claim has been made by the European Commission with regard to Western Europe,<sup>7</sup> while the industry insists that it is in its own best interest to cooperate fully with the authorities to curb the illegal distribution of cigarettes.<sup>8</sup>

The above mentioned case of the failed sale of a container load of cigarettes provides some indication that at least certain European cigarette manufacturers may have turned a blind eye to the diversion of their products to the black market.<sup>9</sup> The container load in this example was officially destined for a company in Kaliningrad, but was to be delivered to a bonded warehouse in Portugal. Such a detour only made sense because the cigarettes were never meant to leave the EU. Instead, the buyer of the cigarettes intended to use forged customs stamps to fake proper export from the European Union and probably expected the Portuguese customs service to be unfamiliar with the stamps used at the German-Polish border and therefore to be unable to identify the forgery. It is hard to believe that the British manufacturer was unaware of these implications. In any case, a complete picture of the cigarette black market will not be obtained unless the contacts between black marketeers and the legal tobacco

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<sup>7</sup> See the complaint filed with the U.S. district court for the Eastern District of New York, dated 3 November 2000.

<sup>8</sup> Ernst Brueckner, managing director of the German association of cigarette manufacturers (VdC) in an interview with the author on 14 September 2000.

<sup>9</sup> See also van Duyne (1996:360).

industry are thoroughly examined, in particular, the chain of intermediaries who mask the transfer of cigarettes to the eventual smugglers.

## Conclusions

The illegal cigarette market is a case in point for the diversity of criminal structures. On the one hand, it provides empirical evidence to refute popular impressions that sophisticated mafia syndicates monopolise illegal markets. Rather than continuous criminal organisations shaping their environment, the patterns of criminal cooperation that characterise the cigarette black market are apparently shaped by the basic conditions under which contraband cigarettes can be procured and distributed. On the other hand, the structural diversity of the cigarette black market is illustrative of the fact that the mere debunking of myths falls short of a complete and exhaustive analysis. Indeed, fairly little is learned about criminal structures by saying what they are not. Instead, a sufficiently differentiated set of concepts and classifications needs to be adopted to account for the various shades of grey and the dynamics of criminal cooperation. Certainly, the efforts that have been made in the last 20 years to raise the level of scholarly debate by introducing concepts from economics and organisation theory have not been in vain. They have allowed 'organised crime' to be seen more in terms of 'organising crime' (Block and Chambliss, 1981). This angle allows us to shift the focus from allegedly static criminal organisations to the constraints placed on collective criminal behaviour (Reuter, 1985; Smith, 1994; Southerland and Potter, 1993).

These concepts, however, still have to prove their value for explaining the emergence of specific structural arrangements under specific conditions. Even the small sample of only four illustrative cases that are presented in this chapter raises a number of questions that cannot readily be answered in terms of what has come to be known as 'enterprise theory'. Such questions include: why complex structures evolve under increased law enforcement pressure, as in the case of the street sale of contraband cigarettes, or how it is possible that illegal business contacts seemingly take shape out of nowhere across cultural, ethnic and language barriers. This suggests that the fragmentary set of concepts currently used in the analysis of organised crime needs to be incorporated into a more comprehensive theoretical framework, one that better accounts for the myriad of economic, social, cultural and psychological forces that appear to shape the way actors operate and cooperate under conditions of illegality.



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# **Money laundering policy**

## **Fears and facts**

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### **Pretensions and expectations**

It is difficult to argue about the nature of smells. Some of them do not even have names. But one kind of smell has certainly been nominated and changed in our appreciation: the ‘moral smell’ of money. Today the adage ‘money does not smell’ does not apply any more. Now we have all kinds of money smells: the pleasant one of ‘white money’, the somewhat debatable smell of ‘grey’, tax evasion money, the bad odour of drug money and the indisputably repulsive stench of terrorist money. Irrespective of the validity of this metaphor, the issue of ‘dirty’ money, or in legal terms, the ‘proceeds of crime’ and the related money laundering has grown into a policy with global dimensions. In less than ten years we have witnessed radical changes in the penal law systems of all the industrialised countries and beyond. Most countries have established a Financial Intelligence Unit (FIU) or otherwise have taken measures to prevent ending up on the notorious list of the ‘uncooperative countries and territories’, the ‘red card’ system of the Financial Action Task Force (FATF).

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With such an important issue, in which so much effort and money is being invested, one would or should expect, in the decade of its existence, a proper knowledge of its nature and extent to have been developed and such knowledge to have been fostered. After all, the FIUs are to be considered *knowledge* centres and the various systems of information exchange are or should be tantamount to the exchange of knowledge. If that expectation is justified, how can this fostered knowledge be addressed and consulted? In the light of the so-called ‘terrorist finances’ this question has become more pressing.

The question about the state of our present knowledge can be dealt with very simply: there is *no* hoard of fostered knowledge. Neither the FATF, the US administration, nor the FIUs have invested in converting the image of threat into a something approaching insight into the phenomenon itself (Van Duyne, 2002). Every member state portrays the laundering phenomenon as a global menace, but none has thought of a multi-country integrated strategic information management system (Van Duyne and De Miranda, 2002; Van Duyne et al., 2001). The inherent opacity of money laundering is matched by lack of unity and transparency on the side of the FIUs, a state of affairs which did not go unnoticed by the Money laundering Experts Group of 1998. However, this awareness has not been translated into any further action thus far.

Albeit there is little empirical knowledge, we should at any rate agree on what money laundering is supposed to mean. However, as is the case with the phrase ‘organised crime’, the substance of a collectively perceived phenomenon is often taken for granted. Is money laundering really as clear a phenomenon as legislators and jurists think it is? That is an important question, because if the phenomenon is ambiguously defined, we cannot determine the volume or extent of this financial threat. Apart from this uncertainty, there still is the (politically) *experienced* threat of the impact of the crime-money. But how does this experience relate to reality? If we want policy makers to take measures which are commensurate with the actual dimensions of the threat, such questions cannot be left unanswered.

## **Delineating the concept**

A good definition functions as a *decision rule*, which determines the circumference of application: it includes or excludes phenomena by allocating them (or not) to the set or class of application. Is there such a decision rule for money laundering? The casual way in which the phrase ‘money laundering’ is used in

various contexts suggests that it is a clearly delineated phenomenon, which implies such a solid decision rule. Before answering the question about such a decision rule I will first carry out some semantic and phenomenological analysis.

### ☛ *Semantics and the phenomenon*

Semantically, the meaning of the phrase ‘money laundering’ hinges on the component ‘laundering’. It is alleged that the phrase derives from the habit of the gangster Al Capone of funnelling his ill-gotten gains through laundrettes to construct the pretense of a legitimate income. One can say that this is still the core meaning of money laundering: washing something, in this case ‘dirty’ or criminally acquired money, until it becomes ‘white’. In virtually all European languages one finds this element: ‘witwassen’ in Dutch, ‘waschen’ and ‘blanchissement’ in German and French. In short: ‘to whitewash’. This is a metaphor for constructing an apparently legitimate source, thereby legitimising illegal profits. This can be considered a strict or narrow description of money laundering. As long as crime-money has not become clean and ‘white’, i.e. legitimised, or if there has been no attempt to do so, there is *no* laundering. One may call the handling of the objects hiding, exporting, spending, etc., but not laundering.

The adoption of this narrow phenomenological interpretation of the meaning of laundering leads to a simple and unambiguous definition:

- Laundering is falsely claiming a legitimate source for an illegally acquired advantage. ▪

The acts of falsehood may range from simple lies to highly sophisticated administrative constructions. ‘Advantage’ covers any material possession or (immaterial) right. In this article I will use the short phrase *crime-money*.

This definition of the meaning of laundering abstracts from the person who performs the act. Applied in this abstract form the definition must be considered too broad when it is applied in a penal law context. Should it include the perpetrator of the basic facts if it contravenes other legal interests and principles, particularly the principle of self-incrimination. After all, can we reproach a criminal for making attempts to hide his deeds? As a penal concept it may have to be restricted to the laundering of the criminal advantages of *another* person. The reasons for this restriction will be elaborated in the following sections.

True, this delineation and restricted application leave out a lot of mischief related to the illicit acquisition of advantages, like all forms of hiding, transport-

ing or using the ill-gotten profits. These may be covered by other penal clauses, like complicity or receiving stolen goods. Unfortunately, legislators sometimes behave like fishermen who cannot stand the fact that some fish may escape their nets. This leads to an ever greater widening of the nets of the penal law in order to catch the last remaining fish. From the point of view of a strict law enforcement policy this may be adequate, but it has not only inflated the very meaning of money laundering. Worse, as we will see, it has also jeopardised *lex certis* and brought us to or even over the brink of self incrimination.

### • *The comprehensive laundry net*

When we look at the ‘mother’ of the laundering definitions, that of the Council of Europe Convention on Laundering of December 1990, we find the elements which are bound to appear in all the consequent laws of the member states that ratified this convention. The definition is a very broad one covering not only the act of ‘making white’ in the strict sense of laundering, but also all the related follow-up activities after the successful perpetration of a predicate crime for profit.<sup>2</sup> The components of the crime of money laundering are described, in chapter II article 6, as:

- 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.

The wording of the articles excludes very little and shows considerable overlap with fencing, receiving and handling stolen property. Property or profit from crime (including advantages, such as saved taxes) is redefined as ‘proceeds’ and receiving and handling such proceeds is ‘laundering’. This is extended to any

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<sup>2</sup> The elements of this definition are in their 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.

form of hiding, disguising or concealing the identity or the hiding place of any crime-derived proceeds.

If this is a decision rule, what does it exclude as *non-money* laundering? This question leads to remarkable answers if the penal clause is applied *reflexively* to the perpetrator of the predicate crime, which is what happens in most jurisdictions. This reflexive application implies that the offender who conceals or disguises the true nature, source, location etc. of his proceeds is guilty of laundering. The question is: can the offender after the commission of the predicate crime avoid committing the subsequent crime of laundering? This point has been elaborated elsewhere (Van Duyne, 2002), and the conclusion was that after the illegal acquisition of ‘proceeds’ only the immediate destruction, giving away or turning oneself in to the police, may prevent someone from laundering. An example may clarify this statement.

A man commits social security fraud. This immediately triggers a chain of consequential offences: tax fraud because of the need to *disguise* the income, and laundering, not only because of the very act of disguising but also because of the act of *using* these proceeds for household expenses. His wife does not escape unscathed either: after all, she benefits from this crime-money. If they are parsimonious spenders and hoard the net savings, that hoarding is also laundering. Most systems of law do allow immediate relatives to avoid incriminating members of their family, which means that the wife can keep silent about the location of the loot. However, if she happens to be just the partner of the offender, whether a thief, fraudster or smuggler, she may have a laundering problem by protecting her friend.<sup>3</sup>

The comprehensive reflexive coverage of the laundering clause is also evident when the proceeds concern stolen objects. For example, the thief having stolen an antique art object, faces the choice between risking exposing himself by *not* disguising the object or committing the laundering offence by hiding it and/or changing its identity. The first choice is tantamount to going to the police or the customs saying: ‘I have a stolen picture in the back of my car’. Composing a false document of origin or changing part of its appearance, which is a prerequisite for marketing the object (Conklin, 1994), is laundering too. It does not

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<sup>3</sup> In some jurisdictions the laundering clause only applies to offences mentioned in a list of predicate crimes. Tax crimes may not (yet) be included in all the lists of predicate crimes, though that may be a matter of time. In the Netherlands the (reflexive) laundering clause applies to all crimes.

matter whether someone else composes the false document. Using the document is enough to fulfil the requirements of laundering.

A problem which does not seem to be addressed in the literature on laundering is the issue of making false statements to the police or fiscal authorities during an investigation. Does the suspect commit a laundering offence if he makes a false statement? According to the letter of the Council of Europe convention and many national laws, one has to conclude that lying is laundering. This seems virtually to amount to enforcing self-incrimination: during the investigation, the offender when being interviewed has a choice between confessing or committing an additional offence (apart from the ‘possession or use of the property’).

I should like to emphasise that these clauses –though intended to combat so-called big crime and big money– have a general application. The student who paints his stolen bike white is literally laundering. The same applies to a car mechanic who changes the identity of a stolen car. Adding the criterion ‘serious crime’ merely dilutes the whole concept. What is serious? Cannabis trafficking, while the international debate on decriminalisation is gathering strength? The illegal traffic in endangered species, depleting our collective natural heritage? (Who cares?) Or the huge savings (also proceeds) due to systematic environmental crime? Using a list of predicate crimes does not solve the problem of definition either, as the description of crimes does not differentiate between ‘serious’ theft or fraud and less serious forms. Moreover, such lists of predicate crimes tend to be extended with every complaint by disappointed law enforcement agencies or politicians, who think the law and its enforcement are not yielding enough.

So we set out with the firm conviction that we know what laundering is. After a brief inspection we observe a blurring of the edges of the concept, which leads to an increasing widening of the legal circle of application.

#### • *‘Canned’ laundering*

The laundering offence can be completely ‘canned’ in the predicate crime if by the very act of committing the crime, the proceeds become automatically ‘white’. This is often the case with documentary fraud, when the false document is at the same time the instrument by which monetary advantage is acquired *and* the tool to disguise the illegality of the act. This applies to most cases of fraud against public funds. For example, submitting a false tax form for the reimbursement of VAT or to receive an EU-subsidy may result in the docu-

ment's official endorsement by the tax or EU officer and the subsequent dispatch of the money. With the approval of the document the crime-money is immediately laundered too.<sup>4</sup> Therefore I call this complete overlap 'canned' laundering.<sup>5</sup>

When there is such a complete blending of criminal acts, there is a fundamental difficulty of distinguishing them. For the daily practice of prosecution this may not pose great difficulties if the system of law allows alternative charges. However, to determine the nature and extent of the phenomenon of laundering, one ends up with indeterminable and ambiguous statements for the simple reason that there is no clear answer to the question: Where does the circle surrounding money laundering exclude *non*-laundering phenomena?

One may wonder whether this ever broadening extension of the circle of the application of money laundering was intended by legislators. There is no clear answer to this question, because it depends on how various forms of law breaking are valued. There is a global agreement on offences like trafficking prohibited goods, theft, robbery and human trafficking. Tax fraud may create conflicting opinions, because of conflicting interests: it could turn respected tax havens like Liechtenstein into money laundering dens. The handling of illegal party and election funds will certainly create difficulties, even if such transgressions can only be performed by the application of the techniques used by fraudsters and money-launderers. Are the legal monies that are fraudulently funnelled out of the till of a firm to the party chest 'proceeds'? That may be the case if these illegal contributions are connected with illegal tax reductions. It is a challenging thought to consider, from this perspective on laundering, the party financing of the erstwhile Kanzler Kohl, the Elf-company, some of the previously questionable US presidential election funding (Liddick, 2000) or the Dutch Royal Telecom-company's involvement in Czech party funding.<sup>6</sup>

To return to the opening question: has a decade of anti-laundering policy clarified what the phenomenon is? Reviewing the arguments in this section I think the answer is clearly 'no'.

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<sup>4</sup> Justifying this increased illegal wealth by including this document and the related paperwork of the approving agency implies continued laundering.

<sup>5</sup> The FATF money laundering typology and internal report of the Egmond Group, *FIS in action* by Blezzard and Koppe (2001) provides numerous examples of the overlap of tax fraud and laundering charges.

<sup>6</sup> It is interesting to note that virtually *all* major corruption cases in the industrialized world that have been revealed in recent decades, concern not crime-monies from traditional gangsters and the like, but licit funds from 'respectable' firms.

## Determining the extent

Uncertainty about the first question has an immediate bearing on the second one: how much laundered money is there? The answer to such a question is very important in relation to the efforts to be deployed. Commercial enterprises need to relate the scale of their investments to the projected yield of such investments. Let us apply such a basic commercial rule to our area. Our targeted yield is crime-money, either confiscated or prevented, and our investments consist of legislation, law enforcement efforts and the costs of legal obligations imposed on third parties, such as financial institutions. What is the extent of money laundering and is there any responsible way of 'tuning' the investments designed to combat it?

The first attempt to estimate the amount of crime-money liable to be laundered was that of the FATF. Methodologically it was a disgraceful undertaking, based on untenable assumptions (Van Duyne, 1994; 2002). I have recalculated the figures contained in the statistical addendum of the FATF-report, which was supposed to be the underpinning of claims that US\$300 billion of drug money were floating around the globe per year (Van Duyne, 1994). The results of the recalculation suggest that this section of the FATF report is no more trustworthy than the bookkeeping of ENRON or Worldcom. Apart from these serious defects, nobody has thus far put forward an economic explanation of how so much money, generated year after year and which is now estimated at US\$1 trillion per year, is laundered and subsequently reinvested in the underworld without creating a worldwide revolutionary change in property relationships. Despite all the methodologically well founded reasons to reject the validity of the FATF's quantitative claims, these figures have acquired a life of their own to be inflated with every new politically motivated estimate (Naylor, 1999). If we bear in mind that the circle of the concept of money laundering can be expanded at will, we can look forward to new astronomic figures. As pointed out above, commercial fraud and tax fraud automatically imply acts of money laundering. The same applies to brand piracy, art crime, corruption, embezzlement and environmental or labour safety infringements, if that results in illegal savings. Similarly the proceeds from property crime like theft and burglary may be included in the laundering estimate. Either (using the legal definition) the full value of the loot is considered *potentially* 'launderable' or the value for which it has been 'fenced' is the laundered money. The rate of resale may be determined at will, sometimes at an unrealistically high rate of 50 % (Levi,

1997).<sup>7</sup> Suggestions have also been made to include the Heads of State-embezzlements also in the orbit of money laundering: the billions of Suharto, Mobutu, Abache or Milosović.

As a matter of fact, all these attempted estimations are mere manifestations of muddling for lack of a suitable methodology, strict analysis and proper strategic information management. Van Duyne and De Miranda (1999) have shown that applying proper assumptions to the data could result in a substantial downsizing. In the Dutch case, this would be of the order of 48 %. One may wonder how much the application of a proper methodology to other cases will yield similarly downsized figures.

## What is the threat?

The next question to be addressed concerns the supposed threat of money laundering. Any law enforcement policy is based on the protection of an interest. The interest which is supposed to be protected is the *integrity of the financial system*, which should not become corrupted by crime-money. This protection should also be instrumental in the fight against crime. This is usually qualified by adding: 'Serious and organised crime'.

This threat has provided the justification for far reaching legislation in numerous jurisdictions and legitimised the actions of the democratically unaccountable FATF watchdog. Therefore it is important to examine this threat more closely. The previous section demonstrated that the range of application of the legal concept of laundering is very comprehensive. So is its threat. However, this threat is not an undivided one: it is composed of all sorts of components or 'sub-threats', the nature of which may be very different. This difference may be due to the *kind of people* who launder their ill-gotten profits, to the *source* of the money or to what people actually *do* with their money.

There is a bias towards the assumption that the threat comes from criminal, 'evil' offenders: bad people are assumed to do bad things with their crime-moneys. Another association connects the wickedness of the source of the money to the wickedness of the offender, who is subsequently supposed to do bad things with his ill-gotten wealth: drug money is supposed to be a bigger

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<sup>7</sup> As a matter of fact, the same stolen object may create in a sequence of transactions more criminal income and related laundering. A stolen watch of €100 may be sold for €20. The fence may sell it for €60 to a second fence who resells it for €90. How much has been laundered? €170, 270 or 70?

threat than fiscal fraud money. But what if the ‘wicked’ offenders spend their crime-money in the ways ‘normal’ tax evading citizens do (or would like to do)? After all, according to the legal definition of the Council of Europe, tax evasion money is crime-money too. Do the billions in drug money corrupt the banks more than the billions from tax evasion? This money is usually not buried as cash in the garden or hidden in mattresses, but is spent in our economy or simply held in bank accounts. However, the role of this tax evasion money in the financial institutions does not differ much from the money from that of normal legitimate income put in bank accounts. The banks do not hoard that money, but loan it to companies and citizens for investment in businesses and mortgages for family houses. The same may apply to drug money: it may be directly be spent on taxed goods or held in foreign bank accounts to be repatriated later for similar consumptive spending.

If we want to answer the general question of the threat and the functioning of the crime-money we must differentiate between the various ways in which the crime-monies may jeopardise society. Some forms of that threat may be of a higher level than others. The following levels can be differentiated:

### **Levels of criminal money-management**

❧ *Corruptive permeation*: crime-money enters the veins and nerves of the ‘control rooms’ of the upperworld.

Crime-money enters the fabric of the upperworld through participation in strategic positions which may influence decision making in trade and industry or the administration. Recent examples are Russian banking (Rawlinson, 1996; Burlingame, 1997), Banco Ambrosiano (Cornwell, 1983), BCCI (Adams and Franz, 1992), Banque Crédit Lyonnais: the case of Parretti and Fiorini (d’Aubert, 1993), the findings of the ‘clean hands’ operation: for example, the Craxi case.

❧ *Criminal upperworld subsidy*

The crime-money is used to establish uneconomic firms or to sustain loss making enterprises. There are two variations:

- An existing *legitimate* loss making enterprise is sustained by money derived from (tax) fraud;
- A new enterprise is legitimately established and maintained for other than rational commercial reasons, like prestige or to provide relatives or friends with a job.

- The sponsoring of sport clubs is also a frequently observed phenomenon. Boxing was often sustained by American mobsters, while in the present tainted figures like the prime-minister of Italy supports AC-Milan.

• *The once only crime-money 'impulse': defusion by integration.*

The crime-money is invested in a legitimate firm once only, after which the enterprise is able to function on a commercially rational and legitimate basis. By its full integration in the upperworld order, the crime-money ceases to be a potential threat. Hence the expression, 'defusion by integration'. As this label is always applied with the 'wisdom of hindsight', I can only provide some historical examples: the US robber barons; legitimised rum runners (dad Joe Kennedy). The money returned to drug producing countries may be invested in the local economy and boost the industry. Anderson (1979) also provides examples of such 'gentrification' of mafia money in New York.

• *Criminal reinvestment*

The crime-money is reinvested in the offender's own crime-enterprise for the continuation or expansion of the crime business.

• *Rainy day provisions*

However hectic and hedonistic a criminal's life may be, some may also consider that they will have to retire one day. This may be prepared for by means of normal savings in bank accounts, hoarding or investment, such activities constituting a sort of criminal pension scheme.

• *Life style expenses*

The daily expenses associated with running a household and maintaining a certain lifestyle. This hardly needs explanation.

On the face of it the order of this typology may reflect a decreasing scale of seriousness, though this depends on one's value judgements. For example, the third level represents the perfect laundering operation, one that amounts to a 'defusion' of the threat and a 'gentrification' of the crime-money: after full integration there is only the murky history left. Such a 'happy ending' may nevertheless be considered a moral 'evil', because it amounts to 'absolution without penance'. With corruptive permeation such integration is not achieved, while the threat may be of a deeply rooted and disguised nature. The criminal connection remains in the background and even when well hidden, criminal aims are still pursued by the manipulation of the 'respected' members of society. Maintaining loss-making businesses can hardly qualify as a type of social

and economic integration. It requires continuing dependence on crime-money and an on-going laundering process, while it disturbs fair competition and market relationships.<sup>8</sup>

Aside from such value judgements it may be more interesting to find out how prevalent these levels of criminal financial management are. I will address this question by surveying the findings of the research projects that have been carried out in the Netherlands.

## **Criminal money-management observed**

In order to obtain insight into the financial management of the crime-entrepreneurs from which the supposed menace to society stems, the National Detective Service of the Dutch police extended the pilot project carried out by the University of Tilburg (Van Eekelen, 2001). Given the results of the latter project the new research project involved selecting cases in which the CID or fiscal police assessed the criminal profit at €450.000 (*f*1.000,000) at a minimum. The reason for this base line selection is the experience that criminal income below this amount is usually used for daily ‘needs’, which may not or incompletely be recorded in the criminal files.

From among the 159 criminal recovery cases investigated since 1993 and involving an amount of assessed crime-profit of at least €450,000 (police assessment) 52 cases were selected, comprising 139 suspects and 37 ‘legal persons’.<sup>9</sup> In 49 cases the police estimated that the illegally obtained profit was more than €450.000. The total sum was €200 million with a median of €2 million. In three cases the fiscal police determined that there was additional tax to be paid of at least €450.000. The highest fiscal additional tax was €134 million, which has not been paid thus far. When more suspects were involved, not all them netted €450.000, though the majority (82) were in this category. In the cases of 15 persons and 15 legal persons the illegal profits could not be determined. The two biggest crime categories concerned drugs and various

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<sup>8</sup> This criminal subsidy does not differ essentially from the agricultural subsidy policy of the EU in subsidising loss-making farmers. The difference is that the distortion of fair competition by the EU is far greater and more detrimental to numerous farmers elsewhere, and it is maintained by means of public funds.

<sup>9</sup> The Dutch, and many other continental systems of law, differentiate between ‘natural persons’ and ‘legal persons’. In this article we will denote legal entities, like firms, corporations, foundations, associations and so forth using the phrase ‘legal person.’

forms of fraud: 25 and 21 respectively. One case concerned money laundering (or rather channelling the money out of the country) and four cases concerned various crimes like trading in women, hormone swindles, organised car and cargo theft. This division did not differ much from the distribution among the total set of cases involving €450.000 and more comprising the judicial database.

In 23 drug cases the offenders were foreigners or members of ethnic minorities from Morocco or Turkey. These minorities were primarily involved in drug trafficking. The Turks mainly trafficked heroin, while the Moroccans were engaged in cannabis, cocaine and heroin alike. Foreigners were also active in 9 other cases. These involved trading in women (Hungarian), excise fraud (Italian mafiosi), investment fraud (Israeli), a mortgage swindle (Surinam), and organised excise and VAT scams (Belgian).

The 22 fraud cases involved 11 fiscal fraud schemes: 9 organised VAT and excise fraud schemes and two corporate tax fraud cases. The 11 remaining cases comprised mortgage and investment fraud schemes, long firm fraud, embezzlement and large scale swindling of diamond dealers and banks. A motley array of crooked entrepreneurs indeed.

From our angle the most interesting aspects of the findings concern the criminal financial management and its potential threat to the upperworld. In other words: how was the money handled, and subsequently laundered, and what use was made of it in the upperworld.

#### • *Handling crime-money*

The routinely made statements of law enforcement agencies is that they are fighting an increasingly sophisticated enemy, particularly in the field of finances. By way of axiom or by simple association it is assumed that sophisticated money-management should therefore reflect *organised* crime (Adamoli, 2001) and the other way round. By implication organised crime is supposed to possess or to hire the skills and the intelligence of ‘facilitators’ to abuse, mislead, corrupt or deceive experts in the upperworld and (it goes without saying) it knows how to operate ‘transnationally’ (not a great feat in the European Union).

Given these assumptions, what did we glean from the criminal files? We first tried to fit the ways in which the offenders handle their crime-money into the usual FATF representation of the phases of laundering, which –with minor

variations— is still used today (Van Duyne et al., 2001). For convenience I summarise these as follows:

- *placement*: money is put into the financial system;
- *layering* and ‘*criss-crossing*’: the sum is divided into smaller amounts for smooth handling and criss-crossed between numerous bank accounts;
- *integration*: the smaller amounts must be put together again;
- *justification*: the crime-money must be justified (this is the actual laundering in the narrow sense);
- *embedding*: the money is woven into the upperworld economy.

Though these financial transactions look like successive phases of making the crime-money ‘white’, the process may stop at any phase or earlier phases may be repeated. The actual sequence depends on the nature of the crime-enterprise or the administrative requirements. For example a trader in second hand and stolen goods, who eschews financial institutions, has little to do with financial constructions. He may only have to justify his illegal income, which may (partly) be achieved by means of inflating the turnover of a front firm.

The actual pattern of the handling of the money is represented in table 1.

**Table 1**  
**The handling of crime-moneys: the FATF classification**<sup>10</sup>

<i>FATF-categories</i>	Number of records of handling crime money in the three crime categories		
	Drugs	Fraud and economic crime	Other forms of crime for profit
Cash phase: Placement/withdrawal	14	5	1
layering/criss-crossing §	—		
integration	2		
justification	12	9	
embedding	21	5	
Total	49	19	1

§ The numbers do not represent criminal files or suspects: one or more suspects in a criminal case may perform various money laundering operations.

<sup>10</sup> To these scores no figures for money totals could be added. The files were very unsystematic in connecting observed ways of handling money with the amounts of money involved.

§ The often mentioned layering-phenomenon was not observed. In two cases forms of disguising the crime-money were observed.

As the table shows, the number of observations in the files which could be categorized is lower than the number of cases and suspects. This is due to the contents of the criminal files: if a particular behaviour was not mentioned, it was not scored, even if one could assume that it had very probably taken place. Such instances were due not only to negligent omission on the part of the (fiscal) police. Some criminals simply refused to make statements. In 14 cases the police could only conclude that ‘the money had disappeared’ without leaving any trace in the banks or elsewhere.

It is not surprising to observe the highest frequency of *placement* of cash in the drug cases, as this is a cash based business. As a rule, the observations end with this phase. The reason for this limited observation is not always that the monies are subsequently concealed by some sophisticated method, but the simple fact that the money was still in the bank account at the time of arrest. If the money was transferred to a foreign bank, it was still in that financial institution, either in the form of a savings account or in the form of financial products. The more elaborate forms of money-management, like integration, and justification (strict laundering), were much less frequently observed. Criss-crossing between numerous accounts to obscure the paper trail was not observed.

In the cases of fraud and economic crime the cash or placement phase could better be termed ‘*displacement*’, as the concern of the business crime-entrepreneurs was to get the money *out* of the financial system. After all, to blend into the legitimate world of trade and industry fraudsters may eschew suspicion arousing cash payments. In accordance with this supposition the first concern of the fraudsters may have been to withdraw the monies from the bank accounts at the right moment in order to avoid confiscation when their scam was busted. In 21 cases some form of *justification* of the criminal income could be observed. Economic *embedding* or *weaving* of the crime-money in upperworld enterprises could be observed in 12 cases. This precipitation of the crime-money in the upperworld will be discussed in later sections.

Analysis of criminal financial management in terms of the FATF categorisation does not appear to provide much insight. The reason may be that it has been designed from the law enforcement perspective on the underground (drug) economy, not from the perspective of the acting criminal, who has a surplus money problem. From the perspective of criminal behaviour, the classification shown in Table 2 may be more appropriate. It classifies ways of handling

crime-money according to the methods used to hide it from investigators. On the basis of a strict interpretation of the meaning of money laundering, only the category ‘justification’ may be considered ‘white-washing’: falsely claiming a legitimate source for the acquisition of the money or assets. The categories in table 2 are not mutually exclusive as in the same case and with the same money more than one way of handling the crime-money may be employed. For example, a portion of the money may be exported, and part of it subsequently brought back by means of a loan-back construction, while an expensive car may be paid for in cash to be subsequently put in the name of a relative.

**Table 2**  
**Ways of disguising proceeds: number of observations**

Forms of concealment/disguise	drugs trade	fraud & economy	other crimes for profit	Total
Export	31	9	2	42
Ownership disguise	10	5	4	19
<u>Justification:</u>				
loan back	3	3		6
payroll	2			2
speculation				
bookkeeping	7	4	2	13
‘Untraceable’	4	8	2	14

*Exportation of crime-money*

As can be observed in Table 2, in most cases the money was simply exported. In the cases involving Turkish or Moroccan offenders this appeared to be an obvious option. Either through exchange offices or by means of physically transporting the cash, the crime-moneys were brought to safety in the home countries. There are no reports of extra laundering activities in the relevant countries. It is a safe assumption that in the receiving countries the hard currency is gladly accepted without any additional justifications being required. In the drug trafficking cases about €15 million had been exported to Turkey and

Morocco. Dutch entrepreneurs invested only €0,9 million abroad as against €2,3 million in the Netherlands.

#### *Disguise of ownership*

The second most frequently used means by which assets can be safeguarded while still remaining available for use is the simple *disguise of their ownership* by putting them in someone else's name. This ownership disguise did not appear to be very sophisticated. The obvious defects were the closeness of the relationship between the nominal owner and the beneficiary and the nominal owner's difficulty in proving that s/he had the means to acquire the assets. Though corporations had been used fraudulently to acquire, or to channel, the money, few corporations were set up for the purpose of disguising ownership. For most crime-entrepreneurs this way of disguising their proceeds seemed to be beyond their entrepreneurial capacities. Nominal owners were frequently persons, some of whom found themselves the involuntary owners of unknown property, like the mother of one middle level Dutch cocaine trafficker, who got into trouble with the Inland Revenue Service. In other cases relatives were (ab)used by having (moveable) assets or bank accounts put in their names. Natural persons as nominal owners appeared to be used by default or as an emergency measure. The exceptions were a British crime-entrepreneur and two Dutch cannabis traffickers, all of whom invested in real estate and used corporations for the purposes of beneficial ownership.

#### *False justification*

From the point of view of 'real' laundering, *justification* of the acquired monies or assets is of course the real craft: proving that the increase in wealth, whether in terms of money, assets or valuables, has a legitimate source. One of the constructions most frequently used and most frequently mentioned, is the well trusted *loan back method*. Given the many references to this construction it was surprising to learn that (a) its frequency was low and (b) its sophistication extremely shallow. Van Duyne et al. (1990) described a professional provider of loan back constructions, who designed professional contracts, complete with a related correspondence and real flows of interest and repayments to the loaning corporation in order to imitate perfectly real loan transactions. The loan back provider saw to it that his clients did indeed make the required monthly pay-

ments of interest and capital.<sup>11</sup> Such sophistication could not be observed in the cases included in this study. Loan contracts were sometimes missing or the ‘contracts’ did not mention the repayment and interest terms, let alone make provisions for ensuring that the required ‘flow back’ of interest and capital payments took place.

In two cases laundering by means of paying a salary could be observed. In one case the modest sum of €75.000 was loaned to a small firm which handed out a monthly salary. Obviously, this laundering was not intended to justify proceeds of substantial size, but to placate the Inland Revenue Service.

‘Real’ laundering by *phony bookkeeping* was a technique that was mainly used by crime-entrepreneurs who operated with registered firms. It goes without saying that this form of money laundering related to the way in which their firms functioned as covers for the illegal activities. For example a florist using his floriculture as a cover for growing cannabis plants, needed to cover expenses as well as the income from the cannabis sales. In the cocaine traffic, involving Colombians, phony paperwork relating to commodities (sugar) on the parallel market was designed to justify the return flow of the money to Colombia. Such covers were easily busted. One hash entrepreneur, who was also the owner of a transport firm, had the intention of making a settlement with the tax inspector by reporting his black money (or part of it) and working out a compromise. However, he was arrested before he could realise his plan.

One would have expected to find the crime-entrepreneurs using additional laundering techniques by including false invoices in their paperwork. As a matter of fact, that was not always observed. The ‘bust firms’ in the VAT and excise scams did not leave much paperwork to justify anything. The concern of the organising crime-entrepreneurs in this field was not to justify their illegal income, but to withdraw the money and disappear as soon as they knew it was their turn for a visit by the tax man – as could be deduced from the last row of Table 2, denoting the *untraceability* of the proceeds of crime. The profits of six fraud entrepreneurs, one investment fraudster and two ‘traditional’ crime-entrepreneurs (car theft and fencing) could not be traced. The investigators found either front firms or straw men, but no paperwork (except false invoices in the bookkeeping of other firms), or any money. The latter had just ‘gone with the wind’.

The situation is different in the tax fraud cases where the management intended the continuation of their firms, albeit in a fraudulent way. The forms of

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<sup>11</sup> This money-launderer was caught not because of laundering (not punishable at that time) or tax fraud, but because he cheated pensioners.

fraud consisted usually of dodging employers' social security contributions and withholding the tax of their staff (thus perpetrating 'black wages' fraud). In these cases the false bookkeeping *is* the laundering, even if the withholding tax fraud consists of a mixture of omissions and false invoices. However, such documents did not cover all the ill-gotten proceeds. Therefore, in the same way as the drug money, the contents of the 'black till' had to disappear to foreign banks.

### **Levels of penetration**

The previous section provided an impression of the ways in which the crime-entrepreneurs managed their ill-gotten profits in order to remain able to use them without alerting law enforcement agencies. Some laundering could be observed, but pragmatic (or perhaps shortsighted) as many criminals are, most of them appeared to be satisfied with bringing their crime-money to safety or just spending it as they saw fit. Crime-moneys end up in the legal economy, where they are not only used for the pleasures of life, but also to penetrate the upperworld for purposes other than consumption.

Before analysing the levels of penetration of the upperworld it may be instructive to provide a quantitative overview of what is known of the spending of criminals. This may provide an aggregate indication of the ways in which the crime-moneys are handled and spent. In the Netherlands the information available for such an analysis is derived from the Judicial data base '*Rapsody*'. Granted, such information has certain methodological flaws. First of all the objects confiscated have to be registered and secondly their value has to be determined. Furthermore, not all such confiscated objects need be derived from crime as confiscation aims at safeguarding any property belonging to the criminal for the purposes of making redress after conviction. Finally, as analysis of the criminal records showed, in many cases the objects of spending are known, but the objects in question have been used up, sold or are located in a foreign jurisdiction, which may create juridical or practical problems for confiscation. In such cases these objects are not recorded. Therefore, Table 3 should be read with caution: it provides an indication and a rank order of 'material matters of interest' to the criminals, not their actual wealth.

**Table 3**  
**Confiscated assets of criminals in two ‘income categories’**  
**and file analysis. 1993-2000**

Categories of property	€ 45.000-450.000	> € 450.000	cases from file analysis
Dutch cash: N	210	56	28
Median	6.239	20.641	25.473
Sum	4.791.698	5.690.836	1.569.084
Foreign cash: N	98	37	18
Median	574	1.610	1.795
Sum	442.057	1.410.343	825.713
Bank acc.: N	21	11	3
Median	5.347	18.056	26.910
Sum	451.208	506.325	73.453
Bond & shares: N	-	34	-
Median		94	
Sum		34.173	
Claims: N	28	22	11
Median	2.274	3.996	1.533
Sum	21.1473	6.849.818	302.100
Real estate: N	25	13	8
Median	49.414	123.535	167.391
Sum	2.237.228	6.476.544	62.566.540
Vehicles: N	126	39	18
Median	6.177	16.060	14.579
Sum	1.461.200	1.573.107	1.122.534
Boats, planes: N	19	6	5
Median	12.354	7.520	15.039
Sum	409.939	112.385	112.385
Jewellery: N	124	48	23
Median	1.393	3.869	4.338
Sum	646.101	825.681	505.176
Other goods: N	37	19	8
Median	-	-	-
Sum	797.383	30.315	10.194
Total Median Sum			

In order to remain our focus on the category of wealthy subjects we have analysed hitherto, only the confiscations of offenders with an estimated illicit profit of between €45.000 and €450.000, and more than €450.000 have been included in the analysis shown in Table 3. The absolute numbers in the table do not indicate persons, but the value of confiscated items, whether these concern bank accounts, treasures hidden in the ground, claims or earrings. It should be noted that the patterns of spending of the less and more wealthy do not differ much.

Inspection of the table shows that on average most money is spent on real estate. Next comes everything that rolls, floats or flies. In addition much cash was found and confiscated. As far as investment in the financial upperworld is concerned, the criminals showed very little interest indeed. As we will learn from the qualitative analysis carried out in the following sections, the confiscation data-base could be biased if, for example, the shares and bonds were held abroad and thus were not confiscated or if they had already been sold. To anticipate our analysis: investing in these financial products did occur, but very infrequently.

In an earlier section, a typology of the penetration of crime-money was suggested. This typology has been applied to the data contained in the criminal files, with the results being presented in the following table.

**Table 4**  
**Levels of penetration of crime-money in the upperworld:**  
**number of observations from the file analysis**

Levels of penetration	Drugs	Fraud and economic crime	Other forms of crime for profit	Total
Corrupting permeation	3	3		6
Criminal subsidy	6	3		9
Once only-infusion	8	2		10
Investment crime firm	9	4	1	14
'Rainy day' provision	20	9	1	30
Life style	9	6	2	17

Elaborating the material summarised above we get the following picture:

• *Corruptive permeation*

The cases we categorised as examples of corruptive permeation did not involve so-called 'executive corruption', required for the ongoing crime-business, but 'strategic' penetration. An example of 'executive corruption' was the corrupt relationships that some offenders maintained with bank clerks in Dutch and related French banks to prevent suspicious transaction reports being issued. As far as strategic penetration is concerned only a few cases could be identified.

- One Dutch middle level cocaine trafficker and swindler obtained an interest

in a *bureau de change*, which was not a stable ‘upperworld bridgehead’: it was closed down after a killing on the premises.

- Another Dutch cocaine wholesaler (importing from Colombia) tried to invest €450,000 in a firm of car dealers. The offer was rejected and a few days later he was arrested.
- An notorious British drug dealer residing in the Netherlands, bribed a detective (possibly also a judge) and is alleged to have an interest in an English football club (Barnes et al., 2000).
- A withholding tax fraudster paid large bribes to firms willing to support him by, for example, providing false invoices. He also loaned much money to small firms of friends.
- One of the investment fraudsters had bought shares in a supermarket chain, though this was possibly only an investment.

#### • *Criminal upperworld subsidy*

Crime-entrepreneurs appeared to take little interest in subsidising other (legitimate) firms.

- A Dutch-Moroccan combination invested in a restaurant and a sports school in the Netherlands, and seems to have invested €450.000 in Morocco in a fish processing factory (soft information).
- A Dutch hash wholesaler is alleged to have invested in a garage. The amount of money is unknown.<sup>12</sup>
- The tax fraudster mentioned above loaned €975.000 to a group of friendly, legitimate, entrepreneurs. The soft loans were only partly repaid.

The contents of the criminal files provided no evidence about the distortion of ‘fair competition’ arising from investment of the illegal profits in the firms mentioned above. As a matter of fact, the companies had little economic weight.

#### • *The once-only money influx: defusion by integration*

In six cases, enterprises were set up with the intention of operating legitimately. In the absence of information to the contrary, it was assumed that they actually functioned legitimately.

- Three ethnic drug entrepreneurs established regular companies in their home

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<sup>12</sup> This investment was apparently little liked by competitors, who launched two grenades into the building. They failed to explode.

countries. Little is known about the degree of their success.

- The Dutch hash wholesaler who invested in the garage mentioned above, also took over an international telephone sex line (operating in Eastern Europe), which went bankrupt due to its over optimistic management.
- Two business-crime entrepreneurs established companies. One VAT racketeer established a sausage factory, which was about to succeed when he was arrested. A married couple who invested the proceeds of embezzlement very successfully on the stock market used part of their profit to buy a cosmetics boutique. Maybe the latter was a toy for the wife.

#### • *Reinvestment in one's own crime-enterprise:*

Concerning the re-investment in one's own crime-enterprise a distinction must be made between traffic in prohibited substances and business crime. Reinvestment in a drug-smuggling firm (aside from purchasing new shipments) is a discernable act: for example a new boat is bought. In the area of business crime many fraud schemes result in cost price reductions, which are at the same time criminal re-investments, unless the accrued profits are siphoned off.

- The drug enterprises invested mainly in means of transport: boats and a camper. It was not always possible to differentiate between investment for smuggling or recreation: for example the yacht could be used for both purposes. An oil firm involved in excise fraud invested in a lorry for the transport of gas as well as in a device for inflating the latter with air.
- Three traffickers invested in sales outlets like pubs and coffee shops, where besides coffee or other drinks the contraband (hashish) could be sold under the counter.
- Corporate entities were established to disguise the ownership of assets, like boats (two drug cases) or were used as front firms for VAT fraud schemes.
- 'Black' wages can be considered as examples of re-investment, as they are instrumental in reducing business costs.

#### • *Rainy day provisions:*

The cases in this category are ambiguous, as their categorisation is partly the product of interpretation. After all, crime-entrepreneurs do not state to the police that (part of) the observed or confiscated assets were intended as a 'pension' or a 'retirement fund'. In addition, cash money hoarded at home, at friends or in a bank safe may represent a 'retirement fund' as well as working capital. There is also overlap with the categories of criminal upperworld invest-

ment: a hotel in Istanbul may be established as a licit upperworld enterprise, but may also be intended as a place to which to retire after a life of crime.

- Nine drug entrepreneurs invested in real estate, mainly abroad, one in the Netherlands. In seven cases the investment countries were Turkey and Morocco. To this effect the Turks exported around €6,6 million. Though the Moroccans exported €3,6 million, there was no demonstrable connection between these money flows and identifiable real estate investments. In only two cases could real estate investments with a total value of over €1 million be identified.
- Sums totalling €6,5 million were exported, either in the form of cash or by means of opening foreign bank accounts. Of this total, €4 million were exported to Morocco, Turkey and in one case to Thailand (where the girl friend lived).
- Capital accumulation for a 'rainy day' was less clearly discernable in the cases of (organised) business crime. Only the embezzling couple mentioned above and two brothers involved in a €100 million underground banking case invested heavily in real estate. The embezzlers even succeeded in obtaining a mortgage of €2,25 million for the construction of a block of apartments. Two 'conservative' crime-entrepreneurs bought bonds.

#### • *Lifestyle*

The criminal files turned out to be less informative about the lifestyles of the crime-entrepreneurs than we expected. Maybe the investigators did not always think that the offenders' spending patterns were interesting enough to record. Despite this limitation, patterns of lavish spending could be deduced from a number of cases, though not to the extent stated by Van Duyne (2000). Much depends on the crime-entrepreneur's social circle and on his assessment of the usefulness or the risks associated with conspicuous consumption. One of the Moroccan hash wholesalers, who had invested heavily in Morocco, complained that he could not live according to his means in the Netherlands as he knew he might attract police attention thereby. Also, some other ethnic crime-entrepreneurs allegedly lived parsimonious lives in the Netherlands, going on sprees as soon as they were in their home countries.

Otherwise we encounter here a wide variety of forms of spending: beauty farms and the expenses associated with plastic surgery for a girl friend; horses for a daughter; (soft) loans to friends and acquaintances; precious objects (crystal and jewellery); an odd piece of very expensive antique furniture (a clock

valued at €160.000), and 26 antique watches, which may also be interpreted as speculative investment.

One type of use of the proceeds of crime that cannot be considered as an instance of penetration of the underworld, but which certainly constitutes an important reserve, are the savings, held either in cash at home or in bank safes, or in bank accounts (or buried in the gardens of relatives, as in the case of the British suspect). These savings may be kept as reserves for later criminal investments or as a nice little nest egg. The files contained no indications that these monies were held for strategic purposes. Whatever the possible interpretation, these 'nest eggs' amounted to €24 million.

### **The abuse of corporate entities**

Another worry concerning the relationship between the crime-entrepreneurs and the underworld is the abuse of corporate law structures: limited liability companies, associations, foundations or various kinds of off-shore facilities. Questions of interest are:

- In what kinds of cases have corporate entities been used?
- What was the nature or legal status of the entities?
- How or for what purposes were these entities (ab)used?

#### *• Cases with legal entities*

Inspection of the data showed that the extent to which corporate entities were used in drug cases and in business crime cases hardly differed. In 18 drug cases legal entities were used; in the business crime cases the score was also 18.

The number of legal entities being used in the operations of the crime-enterprises differed, though the criminal files did not always mention the exact number of entities. Despite this, we can safely assume that the number of legal entities used in the business crime cases was much higher. This is because of the need for strings of 'bust-firms' in the VAT cases, of which the investigators mentioned only the relevant ones. Drug dealers appeared to be in need of one or two legal entities for special reasons such as putting a hotel in the name of a company. The cross-border investment swindlers used a total of 12 companies.

#### *• The legal status of the entities*

In most cases the legal entities used were limited liability corporations, as such organisations may help offenders to avoid creditors and/or to hide the chief architects of acts of fraud by using straw men as company directors. However, even if the limited liability company was a kind of standard, some crime-entrepreneurs used partnership firms, co-operatives, associations, foundations and one-man businesses, running the risk of personal liability.

In the context of the threat of ‘global’, cross-border crime, one would expect to find many examples of the use of foreign legal entities, particularly in tax haven jurisdictions. Foreign entities were actually used, though much less in off-shore centres than one might have expected. In three cases *Panamanian* and *Arubian* corporations were mentioned. Otherwise, there was a prevalence of Dutch corporations with limited liability (*besloten vennootschappen*). The foreign bases of the other non-Dutch corporations were: Belgium, Germany, Switzerland, the United Kingdom, the USA (Delaware) and Turkey.

### **The (ab)use of legal entities**

It goes without saying that the functions of the legal entities were a reflection of the requirements of the crime-enterprise. In accordance with our rough division between drug enterprises, business crime-enterprises and other crime-enterprises for profit (long firm fraud, theft, receiving stolen goods and trafficking in women), we make the following distinctions:

#### *• Drug enterprises*

In these cases, legal entities were used for the following functions:

- Regular production:

This function was apparent only in the case of the enterprise that grew cannabis plants. The nursery had a legitimate output, but financially, cannabis production proved more rewarding, while the firm’s books were used to disguise illegitimate expenses and sources of revenue.

The other cannabis nurseries did not make use of this type of cover, but nevertheless used corporate entities

- as sales outlets

Sales outlets in the Dutch cannabis market are invariably coffee shops. Such firms had the legal status of partnerships (with personal liability).

- as transport covers

For wholesalers, the transport of large cargos usually requires a legitimate cover. This applied to the cocaine wholesalers, who imported quantities of coal, and to three hashish exporters, one of whom hid the contraband in

butter, the second who put his ocean-going vessels in the name of various corporations, and the third who ran a loss-making touring car company as a cover for drug shipments.

- for the purposes of money-management

Some, but not all drug entrepreneurs used corporations for the management of crime-money (not money laundering in the comprehensive meaning). Typical activities included: shipping the purchase price of drugs back to Colombia; making money available for the purchase of transport; investing in the touring-car firm mentioned above.

- for the purposes of investment and laundering

Some of the crime-money was invested in corporations. Such moves were not always accompanied by laundering activities – as they were not in the cases of the moderate investments made in a sports school and a pool room by two Dutch hash entrepreneurs. Investment in, *and* laundering through, legal entities could be observed in the cases of higher-level dealers, for example, who placed assets in the names of corporations.

- as an instrument of crime

Only in one case was the legal entity itself the instrument by which crime was committed. This case involved not the drug business, but the sideline job of long firm fraud.

#### • *Business crime*

Corporate entities also have a range of uses in the area of business crime that only partially overlap with those found among the drug entrepreneurs.

- The (criminal) enterprise

Some of the excise fraudsters used their own, otherwise legitimate, firms. These were abused in all kinds of ways, but were not designed to go bankrupt. In terms of Van Duyne's (1997) typology they were *criminal* enterprises, not *crime*-enterprises.

- The legal entity as 'jemmy'

The corporation can be set up as an instrument for the commission of crime: it is the figurative jemmy of the fraudster. As the victimisation alert rate in business crime is high, such companies are usually 'bust firms'. This applies particularly to firms used to cover bogus transactions in VAT and excise scams. In the investment fraud cases the legal entities were used for creating the well-known labyrinths designed to lead investors astray. The embezzlers

established a corporation to divert the money unnoticed from their employer.

- Money management

As stated before, legal entities can be used for handling proceeds of crime, and eventually for the finishing touch, its 'cleaning', but that final stage was not always to be found. In four cases firms were established for *moving* money only. The underground banking case was not so completely 'underground' as to be in need of corporations for this function. The large amounts of money generated by the Italian mobsters in their excise scam needed to be rushed out of the country by means of a Dutch limited liability company. The investment fraudsters resorted to a Panamanian company.

- Money laundering

Cases where legal entities were used with the objective of 'real' laundering (in our strict meaning) were found much less frequently than expected, unless we also include the 'adjusted' paper work of the criminal enterprises, which mixed fraudulent activities with otherwise 'clean' bookkeeping. Indeed, the international investment fraudsters did establish a corporation for this laundering function. Numerous entities were used by other VAT and excise fraudsters to 'park' their acquisitions in the name of the entities. The defrauding interim manager used corporations to purchase paintings.

The general picture that emerges from our analysis of the financial management involved in 52 high-level criminal cases, suggests much pragmatism and little strategy. The level of financial laundering skills displayed cannot be rated very highly, while penetration of the upperworld looks shallow. The police usually claim that if criminals have no brains of their own, 'they hire them'. This could be observed only in two cases – one where the crime-entrepreneurs were supported by a real estate expert they had befriended; and in another case where the assistant in a law firm helped to establish a corporation. Otherwise, the crime-entrepreneurs simply trusted (or overrated) their own cunning and skills. Business crime entrepreneurs relied on their accountant or company secretaries, who were not separately hired as criminal financial advisors, but who were already there and seemed to be looking at the paper work with the expected 'Nelsonian eye'.

## **Comparison with other research**

The findings of this research do not seem to square fully with the threatening images routinely conveyed by law enforcement agencies, nor with the regular press reports concerning the activities of the very wealthy drug barons. It goes without saying that the phenomenon of extremely wealthy drug barons should not be dismissed as a mere media fiction, but they may not be representative of crime-entrepreneurs. This raises the question whether the results of this research hold true only for the Dutch case, or whether they have wider applicability.

To answer this question we searched for comparative material. This proved difficult for the simple reason that comparative research has not been carried out thus far. Even if there are scattered data, the different ways of collecting and processing them render direct comparison well-nigh impossible. As a matter of fact all we have are the 'typology reports' of the FATF and a recent German study on money laundering (Suendorf, 2001). Despite this difficulty we nevertheless reviewed the data from the perspective of the question: If there is so much money laundered so widely and so professionally, what do the examples tell us? Underlying this question is the assumption that if (organised) criminals do succeed in acquiring predominant (financial) positions in the upperworld, it will not take long before they are spotted, to be subsequently included in the semi public 'threat catalogue' of the law enforcement agencies. These 'threat catalogues' are to be compared with the empirical findings.

Suendorf's (2001) study of money laundering in Germany contains some 40 examples that conform to the broad juridical meaning of that concept, namely, handling the proceeds of crime. The examples are taken from interviews with expert law enforcement practitioners and cover a time span of about ten years, though one example stems from the mid-1980s.

From this set of examples two cases can be considered thorough organised money-managements: the *Bosphorus case* and the *Mozart case*. Both cases concerned separately established organisations to move the crime-monies of heroin wholesalers to their respective home countries. In the Mozart case about DM 60 million had been transported.

The *Bosphorus case* involved an extensive network of exchange bureaux directed by an entrepreneur living in Iran, who served a Kurdish heroin wholesaler exporting to Germany. The monies were collected in various cities in Germany, and taken to branches of the Iranian, or associated but independent, bureaux de change. Subsequently the monies were placed in German banks and transferred to the bank accounts of allied money

change offices in New York. From these accounts they were diverted to Dubai and – if required – back to Germany or Turkey. To lull the German police, the bureau de change submitted occasional suspicious transaction reports.

The *Mozart case* involved a similar network of currency exchange offices. These were working on behalf of Turkish heroin wholesalers and were fed with crime-money from Italy and Spain. The handling of the crime-money appeared to be even more integrated into the legitimate cross-border trade system of Turkey with Europe. Turkish traders who were in need of EU currency could circumvent exchange controls by balancing their payments in Germany (made through the exchange office in there) with the placement of Turkish money in Istanbul. This legitimate money could be intertwined with the crime-money.

These examples, which represent quite professional schemes, still do not clarify what is actually done with the crime-money, let alone that the money is ‘cleaned’ and integrated in the legitimate economy.

When we inspect the examples provided by Suendorf of investment in the underworld, we get the following picture. There were (attempts to make) an investment in the underworld in eleven cases, though these were made with changing success and professionalism.

- Real estate: there are three examples of insolvent enterprises, including a construction firm that obtained a suspicious infusion of Italian money, but which nevertheless went bankrupt (p. 208/210).
- A green grocer, whose son was involved in heroin trafficking and who invested part of the proceeds in his father’s firm, which expanded quickly (p. 207).
- Some small, unspecified enterprises that obtained suspicious money. One was abused by Russians who acquired a share of 10 %. The owner succeeded in buying them out (p.207).
- A bathroom design store, whose Russian owner was pressurised into accepting a compatriot as manager. Money laundering is suspected (p. 208/9).
- Three attempts were mentioned, among others by the suspects involved in the above mentioned *Mozart case*, to establish a partial credit firm (*Teilzahlungsbank*), but such attempts were to no avail (p. 213).
- A pizza bakery, established by a mafia family that had fled to South Germany because it was being threatened by fellow mafiosi. The firm expanded quickly due to extortion involving local restaurants and pubs (p. 234).

- A steel firm run by a female manager, who indicated that '*she did not understand much of economics*', something that was clearly manifest from her suspicious transactions (p. 235).
- A car dealer whose enterprise is supposed to have grown thanks to the investment of Italian crime-money (p. 171).

These case descriptions recorded in interviews with German investigators should be interpreted with great care. In only a few cases is it clear that the description is based on the outcome of a complete investigation or trial. In addition, in many cases it remained unclear whether the monies that were supposed to be invested had been fully laundered. Most of the other examples only concerned the channelling of suspected monies. The sophistication and professionalism displayed did not look overly impressive (the exceptions mentioned here).

This picture seems to underline the thesis that 'only stupid criminals are caught'. Despite this stopgap argument used to explain away the modest results of law-enforcement efforts, if every offender, including the clever ones, has a certain statistical chance of being caught – a chance that increases with the extent of the offender's wealth and the length of time for which he has been operating – why do we not find more examples of those clever guys after ten years of chasing for the 'big money'? One elusive 'Scarlet Pimpernel' may dodge the law, but a supposed host of Pimpernels?

In its annual reports from 1997 to 2000, the FATF presented various 'typologies' of 'laundering', again according to the broad legal meaning of the expression. These typologies, 28 all together, are actually intended as instruction material. For a direct systematic comparison they are not useful. This is partly due to the way the examples have been collected. The cooperating countries of the FATF are requested (through their representatives) to submit striking examples from which the secretariat of the FATF can compose its annual reader of laundering cases. The emphasis is on those transactions that may have some educational value for the financial institutions, and to which are added warning notes containing serious comments like: 'In this way legal persons may be abused for the purposes of laundering'. The cases concern mainly the moving of suspicious funds through the financial system. Only three of the 28 'types' or case descriptions mentioned the 'cleaning' of crime-money or its precipitation in the upperworld economy. A number of cases actually did not concern money laundering, but fraud (e.g. VAT-evasion in the gold trade), again demonstrating the overlap between the two. Reading those 28 'typologies' intended to convey the really serious cases, one may again raise the ques-

tion: 'If so much crime-money is threatening the underworld economy, where is it and where are the really clear examples of that menace?'

Other research findings do not provide much material for comparison either. The studies concern the summary and survey of official statistics, such as those maintained in England and Wales (Levi, 1997), by the US bureau of judicial statistics (Tonry, 1997), and by the Central Directorate of the Judicial Police in Italy (Paoli, 1997). The articles show that the researchers had to rely on rough descriptive statistics with very few distinctive features or variables. The gross totals reveal enormous catches by the US customs and the Drug Enforcement Administration (DEA): US\$520 million by customs and US\$60 million by the DEA). Compared to this the amounts in England and Wales (£12 million in 1993) are very modest. However, from these figures little or nothing can be deduced regarding the way in which criminal finances are managed or their relationship with the underworld. For example, in the US, the fact that an object is confiscated does not necessarily imply that it has been acquired with crime-money. Objects can be confiscated if they are involved in the perpetration of a crime, even if they have been purchased with 'clean' money. For a car or house to be confiscated, it is sufficient to possess a small amount of drugs or to make telephone calls from a house to a buyer of drugs.

## **Conclusion**

Surveying the findings of this research project about the financial management of crime-money, it appears that real financial acumen and skills are not widespread, while very few crime-entrepreneurs venture into the legitimate underworld of trade and industry, let alone higher spheres of influence. Very little crime-money was really 'cleaned' or laundered in the strict meaning of the term by constructing a phony legitimate source. In the few cases in which this was attempted, for example by means of the *loan back construction*, it proved to be rather primitive. The proceeds of crime were rather moved around and spent than integrated after 'white washing', into the economy. If that happened the coveted assets were real estate, and these were bought not to establish real estate firms, but to own the assets for their own sake. Some made more conservative investments by buying safe bonds and securities or, more rarely, bought speculative shares on the stock market. With the exception of one failed attempt, there were no initiatives to penetrate or take over established firms.

Within this general picture some differences must be noted. Some ethnic minority crime-entrepreneurs did make sizeable investments in their home countries, again mainly in the hotel branch and in one case (allegedly) in the fishing industry. Dutch, indigenous, crime-entrepreneurs were big spenders, but shallow investors. This applies even to the (organised) business crime-entrepreneurs. Contrary to expectation, they did not defraud with the aim of extending their market share or commercial power. Though some reduced their cost price and did better than they would have done otherwise, the files contained no evidence of a criminal market extension.<sup>13</sup>

The fear that big crime-money inevitably leads to corruption could not be substantiated either. Corruption did occur and in a few cases the accounts managers of banks were made accessories to 'laundering' through channelling the crime-money out of the country. One business crime-entrepreneur paid handsome bribes to his business associates. However, these cases were few and remained on the level of 'executive corruption'. Higher level strategic corruption could only be observed in the case of the notorious Englishman Curtis Warren (Barnes et al. 2000).

The corruptive situation and penetration of the underworld may be different in the economies of the home countries of some ethnic minorities. Reports about economic development in Northern Morocco mention a profound change in the property relationships, particularly in the real estate sector, but also in economic relationships generally (De Mas, 2001). The massive influx of money from abroad has contributed to much inflation in land prices and often to the establishment of enterprises without any economic viability. A large part of this influx consists of income from drug trafficking and from the smuggling of other (legal) commodities to circumvent import levies, but much legal money is also remitted home by labourers in Western Europe. It is therefore difficult to conclude that *crime*-money as such is playing havoc with the underworld economy.

Other factors can contribute to the unwanted effects, the most important being unregistered inflows of money, too large for the local productive infrastructure. As this influx is unregistered, economic policy cannot take it into account and is, as a consequence, based on the assumption that the volume of money in circulation is smaller than it is in reality (Hallett, 1997). However, it

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<sup>13</sup> In other research such a criminal market extension has been observed: in the catering business the expansion of the Van der Valk empire was based on long term systematic tax fraud (Bogaarts and Van Gelder, 1996); in the meat production sector one processing firm still succeeds in dominating the wholesale market (Van Duyne, 1997). The former has been prosecuted to receive a 'slap on the wrist', the latter escaped prosecution until recently.

is open to debate whether this is the consequence of money laundering or bad governance and the mismanagement of public funds.

Surveying the established facts about crime-money in relation to its economic role, we face a dilemma. On the one hand, due to the apparent indifference of the law enforcement agencies and policy makers to the development of proper analysable statistics, we are in a state of virtual ignorance in the face of a proclaimed global threat. This casts doubts on the reality of such a menace. On the other hand it cannot be denied that the observed flows of unaccountable or very suspicious monies are occasionally very voluminous. In the underground banking case analysed as part of this research project, the two Pakistani brothers did handle well over €100 million, a sum comparable with that involved in the so-called Ramola case at the beginning of the 1990s. In every jurisdiction there is also anecdotal evidence of crime-entrepreneurs who – like Michael Michael or Curtis Warren in the UK, Zwolsman and Verhoek, alias the Stutterer, in the Netherlands or his Pakistani ally, the money manager Abbas in Belgium (De Stoop, 1998) – amassed staggering amounts of money.<sup>14</sup> Similarly organised VAT and excise fraud cases generate hundreds of millions of euros (Van Duyne, in preparation). Therefore, our findings do not necessarily lead to the conclusion that the amount of crime-money in circulation should be considered negligible. All we can establish is that of all these flows of supposed crime-money only a small part can be identified in the form of assets. These assets hardly ever consist of production factors that may have an impact on the economies of the industrialised world. Their dimensions cannot provide the empirical basis for the threatening images that are usually presented to the public and adopted by legislators as the basis for ever more severe laws against money laundering.

## **Discussion**

More than ten years have passed since the US and the FATF launched their programme against the threat of money laundering. Despite an avalanche of (usually normative) literature and threat assessment reports, the number of

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<sup>14</sup> See Barnes et al., (2000) for an overview of the ‘rise and fall’ of the Liverpoolian crime-entrepreneur Warren, at present detained in the Netherlands. The Dutch hash wholesalers Zwolsman and Verhoek netted €35 million and well over €50 million respectively. Zwolsman’s ill-gotten proceeds were invested in hand made cars. Of Verhoek’s wealth only some €7 million could be traced.

empirically based research reports is still small and is confined to the ones mentioned in the UK, the Netherlands and Germany. As a matter of fact we are still in a state of ignorance as far as the nature and extent of the phenomenon is concerned. The lack of interest in empirical research has already been commented upon in the previous sections.

One may think us better informed on the clear issues of *principle*, like the corruptive effects of crime-money and the related laundering, and the negative economic impact that crime-money is bound to have on our economy. However, the degree of clarity of these issues is open to debate. One of the dogmas fuelling the fight against laundering is the frequently repeated claim concerning the corruptive impact of crime-money and laundering on the integrity of the financial system. In a broad ethical sense this dogma looks irrefutable, though it can become meaningless if it is expanded to every sphere of life that may be touched by the ill-gotten profits of criminals. If it applies to the financial system it also applies to the automobile industry, real estate, tourist offices or the neighbourhood in which any criminal buys his daily bread with his crime-money. In principle there is no limit to the application of such a dogma, as is revealed by the spread of reporting measures to lawyers, notaries, real estate agencies and other traders of valuables like jewellers.

Even more debatable, when tested against the evidence, are the claims that laundered money leads to corruption. What is the corruptive effect on the official financial institutions, when – without their knowing – crime-money flows through their ‘arteries’, and how are they threatened by this flow? Looking at the ways the financial institutions are used, it is difficult to differentiate between crime-money flowing through banks and criminal information flowing through the cables of a telephone company. Apart from fraudsters, criminals have more to gain from a well-functioning and secretive banking system than from an ill-functioning one. Some of the affluent offenders with a conservative economic outlook bought and resold safe bonds in exactly the same way as the usual conservative citizen would do. How did that corrupt the banks involved? All they asked from the banks was a normal efficient service. If we take the argument a step further, we may raise the question whether the financial integrity dogma is not just an opportunistic argument to stifle potential doubts, as the dogma may be applied quite selectively. For example, during the Latin American debt crisis Colombia succeeded in remaining solvent and paying off its debts. Though it was known to them that they were (partly) paid in cocaine dollars, no western bank or government had any qualms about this or felt corrupted (Strong, 1995; Verbeek, 2001). Granted, corruption remains a problem-

atic area, involving more than crime-money (Van Duyne, 2001). As a matter of fact, virtually all the grand corruption in the industrialised countries in the past twenty years has involved the payment of *white* money by ‘respectable’ captains of industry to equally ‘respectable’ politicians, some having become heads of government or heads of state.

Another issue concerns the big gap between the huge sums of crime-money that are thought to exist on the one hand and the relatively small sums that are actually traced assets on the other hand. There may be two explanations. One is the quite predictable law enforcement explanation: ‘We do not trace much of the money and assets because the criminals are too smart. So we need more tools’. This amounts to the demand for more severe laws, more investigative powers, fewer civil rights, more funds and more staff. Another, not implausible, explanation is that much of the crime-money remains homeless money and instead of threatening our society keeps floating around. However, to use another metaphor, this is comparable to migrant cattle, which only lose weight while being on the move, usually to the advantage of the stopping places where they rest for a while. The financial stopping places are the banks, which gain while the herds of crime-money are passing through them. It requires more than metaphysical dogma and rhetorical repetition of the evil of crime-money to clarify the corruptive impact of these passing criminal financial herds. At any rate proper research is required to test this thesis.

Maybe this mixture of economic argument and dogma (behind which one can discern a heavy dose of opportunism) is not the most appropriate perspective. The principle at stake is much more basic than some economic threat supposedly posed by elusive crime-money. The fight against criminal money-management, including laundering, should be driven by the simple desire to see the *restoration of justice*. The offender should not retain the money or any other criminal advantage in the first place. To uphold the basic principle that ‘crime should not pay’ we do not need additional dogmas, witch-hunts or cries of wolf, but sufficient insight into the phenomenon to obtain a well-balanced application of the necessary legal tools.

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# Following the Criminal and Terrorist Money Trails

Michael Levi<sup>44</sup>

## Introduction

‘Money laundering’, like ‘organised crime’, evokes images of sophisticated multi-national financial operations that transform the proceeds of drugs trafficking into clean money. However, although the drugs issue has dominated international legal changes in laundering and other arenas, since 1977, Grand Corruption has also been important in this field. For example it contributed to the shaping of special – though fallible – Swiss measures for due diligence, as we have seen in the cases of dictators from Bokassa to Abacha, who stashed loot from their respective countries in the safe vaults of the Swiss banks. Since 11 September 2001, terrorism has been a principal driver of the police and of action.

Even before ‘9/11’, few bankers or politicians were prepared to assert publicly that preserving financial privacy was much more important than fighting the menace of drugs. The same is not yet true of corruption, but the combined pressures of measures against all-crimes laundering (as adopted in most countries following Financial Action Task Force (FATF) recommendations in 1996), transnational bribery, transnational organised crime and ‘harmful tax competition’, and the pressure for transparency in offshore finance flows to protect against systemic financial risks, mean that the beginning of the 21<sup>st</sup> century has seen us draw closer to this objective than ever before. It is now taken as axiomatic that money laundering opportunities constitute a key facilitator of the inter-

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national drugs trade. However, one of the unintended benefits of the Abacha/Bank of New York/Bhutto scandals over the past two years is that they have highlighted *corruption* (and the capital flight/white-collar crimes that sometimes hide corruption) rather than simply drugs as a core problem of international crime control. This is especially the case in the private banking sector, where the assets of the richest 'High Net Worth' people typically end up.<sup>222</sup> Whether this awareness has yet extended to the use of corporations as secrecy vehicles is less certain. In this chapter, I review briefly some of the key events and changes in recent years, though it is often difficult to tell the extent to which changing laundering patterns reflect a changing underlying reality or merely our altered awareness or willingness to do something about it. In this sense, a rise in official corruption and laundering prosecution rates can be an index of increased morality rather than social decay.

## **What is money laundering?**

What is money laundering and why is it important? In essence, criminal laundering is any concealing of the proceeds of crimes (though some countries include drugs trafficking only) beyond putting the loot under the bed or in one's domestic safe. It is important because without it, corruption and other crimes, which generate too much money to spend wholly and immediately on the High Life, would become unattractive. In the case of transnational corruption by otherwise legitimate corporations, bulk cash in volume might be harder to explain away for accounts purposes. The financial system is not the only storage medium. There are readily movable valuables, like gold, diamonds and art, that, as potentates of old appreciated, are quite good. (Though falling diamond prices make them less useful than in the past, global uncertainty has driven gold prices up again.) Corrupt public officials seek from bankers both integrity in the handling of their funds and an unwillingness to assist any criminal investigations that might arise in their home countries. Since Switzerland has begun to open active investigations into money laundering even where primary crimes

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<sup>222</sup> Many of the successive scandals in Switzerland, the UK and US involve the export of bribes given by transnational or domestic corporations for contracts or for some other preferential treatment by the government. It now appears that outflows of Russian funds to London and New York branches of the Bank of New York were not from the so-called Russian Mafia, but constituted capital flight from Russians seeking less risky places to deposit their funds and seeking to avoid or evade high Russian taxes.

have occurred abroad, this has become a less attractive place to deposit the proceeds of Grand Corruption and other crimes. (See also van Duijne, this volume).

Changes since 1999 (and in some cases, earlier) make these objectives harder to achieve. Around the world, most money laundering prosecutions involve the proceeds of drugs trafficking, but, due to pressure from the FATF and the OECD Corruption Convention, corruption and fraud have increasingly been criminalised as money laundering predicates. These offences normally have to be proved in order to sustain a conviction for laundering. However, to the extent that this may involve cooperation from, say, Indonesia, Nigeria, Pakistan, the Philippines or Russia, this may be hard to get where the key suspects and their associates still exercise local power. Nevertheless, on the creative interpretation of prosecutors and judicial investigators in France, Italy, Spain and Switzerland connected with the *Appel de Geneve* (most notably the former Chief Prosecutor Bertossa at Geneva) the indictment of laundering does open the possibility for proceedings in countries other than those where the bribes came from or generated the contracts, thus sidestepping legal protection for offenders. This in turn can lead to the freezing of assets, even if there remain difficulties in returning the illegally appropriated funds where the regime is still suspected to be corrupt. The identified Marcos funds, for example, have been sent back to the Philippines, but remain in an escrow account pending legal determination that they are proceeds of crime.

There are at least two senses in which laundering could be described as important to Central and Eastern Europe. First, placement of funds offshore enables monies derived from whatever origin (corruption; legal funds fleeing from bad governance; capital flight escaping galloping inflation or inefficient, ill-regulated banking) to be insulated from local politics. This reduces the interest of the citizens involved in creating a fair and just local 'settlement'. Second, it can have a corrosive impact on financial institutions and other political parties, requiring them to engage in illicit financing in order to compete with others in society, who also have access to illicit or secret finance. I am not arguing here that all laundering *inherently* harms financial institutions. For decades, onshore and offshore bankers have been tolerantly laundering the proceeds of many crimes from many countries without obvious harm to themselves or to their economies. However in a world where anti-laundering measures exist at the level of the nation state and at the level of the financial institution, laundering can bring serious harm if detected, not least because of international politi-

cal reactions to states that ‘sponsor’ the laundering of terrorist and other criminal funds.

If corrupt public officials consume their profits on party-going, expensive dining, drinking and drugs-taking, and on flashy cars and yachts, they have no need to launder directly through the financial system, unless the valuables are such that the acquisition requires laundering. (Though evidence of lifestyle can be used in some jurisdictions to prove they are living above their official means, and even the use of proceeds can constitute ‘laundering’ in some jurisdictions). If the proceeds of crime are too great to be spent or distributed as ‘salaries’ to the members of one’s network (as with various terrorist groups as well as conventional crime syndicates and political parties), some safe storage medium from criminal competitors and the law enforcement authorities is necessary.

Laundering only needs to be good enough to defeat the financial investigation skills and burden-of-proof requirements in any of the jurisdictions along its economic path. These have been subject to enormous change since 1999, largely due to the Non-Cooperating Countries and Territories initiative of the FATF, which remains an informal body with a renewable 5-year mandate created by the G-7 in 1989 to further the cause of anti-laundering measures around the world. In the first round, 15 jurisdictions were declared in 2000 to be ‘uncooperative’ according to a set of core criteria set out by FATF (see <http://www1.oecd.org/fatf/>). Thereupon treasury advisors in the First World required financial institutions to take ‘special measures’ to ensure that all transactions from, say, the Bahamas, Cayman Islands, Israel, Nigeria and Russia were legitimate. This led to an enormous effort by some of the countries to reform their laws and, to some extent, their practices. It also placed a great strain on monitoring processes, as many EU applicant countries can find themselves almost continuously reviewed by the Council of Europe, EU and FATF.

The review of money laundering and its control conducted for the UN (Blum et al., 1998) illustrates the use of trusts, international business corporations, and free trade zones for laundering schemes. The report also indicated that the proceeds of corruption and other crimes can be used by Third World businesspeople to avoid exchange control restrictions in their home countries by paying funds in their domestic currencies (such as the peso) to the criminals as an illicit exchange for the use of dollars made available in the US and elsewhere. Devices such as ‘walking trust accounts’ –which move automatically to another jurisdiction when enquiries or mutual assistance requests are made in one jurisdiction– clearly act as facilitators of crime. They are also inhibitors of

responses by making it much more expensive, if indeed possible at all, to pursue defendants, either for evidence or for recompense.

## **Money laundering and anti-crime strategies**

FATF and its regional associates in different parts of the world (starting with the Caribbean and expanding to include Asia-Pacific and Latin America, with Africa developing a regional body), alongside the Council of Europe, the European Union and the UN, have moved away from the initial exclusive drugs focus in anti-laundering policy towards an all-crime (including tax crime) and ‘transnational organised crime’ focus. The aim and effect has been to pressurise every region of the world to act against the ‘abuse’ of financial systems to facilitate crime. There is now an extraordinary level of global acceptance of the limits to sovereignty, without the issue being defined in those terms.<sup>3</sup> Gilmore (1999) and this author’s interviews for a UK Economic and Social Research Council project ‘Following the Money Trail’ indicate that the policy drivers for a global anti-laundering and mutual legal assistance policy are:

1. An international focus on supply-side narcotics control;
2. concern about the use of overseas jurisdictions and their legal instruments (among which are to be numbered trusts of various secrecy levels and International Business Corporations)
  - a. to hide beneficial ownership of both the companies/institutions and their assets, making proof of drugs or other forms of money laundering difficult; and
  - b. to frustrate asset recovery on behalf of governmental agencies (and, where identifiable, specific crime victims);

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<sup>3</sup> There has been no attempt to justify such intrusions philosophically, but one possible line is to take John Stuart Mill’s classic liberal doctrine that the State has no right to intervene in self-regarding actions and turn it on its head to argue that where the exercise of rights has deleterious consequences for others, the ‘international community’ has the right to take action against the facilitation of the internal crime business.

3. concern about the lack of transparency in derivatives<sup>4</sup>, hedge funds<sup>5</sup> and other high-value instruments held in offshore finance centres, creating systemic risk in the event that they are unable to pay for contracts when payment falls due;
4. concern about tax evasion masquerading as tax avoidance by sheltering the locus of control via trust companies and international business corporations;
5. concern on the part of the US and some other governments (a) about a 'level playing field' in business competition for contracts and, arguably, (b) about the loss of welfare in less developed countries arising from high-level corruption, leading to an extension of US Foreign and Corrupt Practices Act-style liabilities upon the rest of the world by the mechanism of the OECD Convention on Combatting Bribery of Foreign Public Officials in International Business Transactions. This was signed by all OECD countries (with varying degrees of enthusiasm) in December 1997 and came into force in February 1999.
6. Concern about terrorism, mostly on the part of elite Western powers, but with an impact that is truly global.

These influences interact in the same direction. Even if they did not, then there would be a tendency for all-crime coverage of anti-laundering legislation to develop, since few bankers know what types of crime – if any – their customers may be engaged in. If clients fool bankers or lawyers into believing that at most, their funds constitute 'merely' tax 'dodging', then no suspicious transaction report of drugs trafficking, Grand Corruption or terrorism will be made. Therefore, it is only if all crimes are included within the obligation to report suspicions that the layer of rationalisations falls away (save, perhaps, for labelling the behaviour tax avoidance).

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<sup>4</sup> Financial *derivatives* are financial instruments that are linked to a specific financial instrument or indicator or commodity, and through which specific financial risks can be traded in financial markets in their own right. Their value derives from the price of the underlying item (i.e. the reference price) and, unlike debt instruments, no principal amount is advanced to be repaid and no investment income accrues.

<sup>5</sup> A hedge fund is a pooled investment vehicle that is privately organised and is administered by professional investment managers. It is different from another pooled investment fund, the mutual fund, in that access is available only to wealthy individuals and institutional managers. Moreover, hedge funds are able to sell securities short and buy securities on leverage, which is consistent with their typically short-term and high risk oriented investment strategy, based primarily on the active use of *derivatives* and short positions. US hedge funds have been exempt from Securities and Exchange Commission reporting requirements, as well as from regulatory restrictions concerning leverage or trading strategies.

The favoured international model to supplement Treaties and Conventions and regulatory agreements – which merely set out a permissive framework, but do not indicate the levels of actual action – has been the ‘mutual evaluation’ strategy. This provision has recently been extended to mutual legal assistance and proceeds of crime confiscation, though transnational bribery is dealt with more by OECD expert evaluations rather than by ‘mutual’ money laundering evaluations.

## **Terrorist finance: the new goal of financial policing**

At an extraordinary Plenary on the financing of terrorism held in Washington, D.C. on 29 and 30 October 2001, the FATF expanded its mission beyond money laundering. It will now also focus on the world-wide effort to combat terrorist financing, though beyond, ‘that which is against the interests of the Western powers’ the definition of terrorism in this context is far from obvious.

The FATF agreed to and issued new international standards to combat terrorist financing, which it calls on all countries to adopt and implement. The agreement on the Special Recommendations commits members to:

1. take immediate steps to ratify and implement the relevant United Nations instruments (passed with far less interest and argument than was the Transnational Organised Crime Convention);
2. criminalise the financing of terrorism, terrorist acts and terrorist organisations;
3. freeze and confiscate terrorist assets;
4. report suspicious transactions linked to terrorism;
5. provide the widest possible range of assistance to other countries’ law enforcement and regulatory authorities for terrorist financing investigations;
6. impose anti-money laundering requirements on alternative remittance systems;
7. strengthen customer identification measures in international and domestic wire transfers;
8. ensure that organisations, in particular non-profit organisations, cannot be misused to finance terrorism.

In order to secure the swift and effective implementation of these new standards, FATF agreed to the following ‘comprehensive’ Plan of Action:

- By 31 December 2001, all FATF members would assess themselves against the Special Recommendations. This would include a commitment to come into compliance with the Special Recommendations by June 2002 and to draw up action plans aimed at the implementation of Recommendations not already in place. All countries around the world would be invited to participate on the same terms as FATF members.
  - By February 2002, additional guidance for financial institutions on the techniques and mechanisms used in the financing of terrorism, would be developed.
  - In June 2002, a process to identify jurisdictions that lack appropriate measures to combat terrorist financing would be initiated and there would be discussion of subsequent steps, including the possibility of counter-measures, for jurisdictions that do not counter terrorist financing.
  - Members would regularly publish the amount of suspected terrorist assets frozen, in accordance with the appropriate United Nations Security Council Resolutions.
  - FATF members would provide technical assistance to non-members, as necessary, to assist them in complying with the Special Recommendations.
- FATF also agreed to take into account the Special Recommendations as it revises the FATF 40 Recommendations on Money Laundering and to intensify its work with respect to corporate vehicles, correspondent banking, identification of beneficial owners of accounts, and regulation of non-bank financial institutions. As time goes on, these provisions will become increasingly delicate politically, and indeed various powers – China and Russia are not currently members of FATF, though Hong Kong is – have expressed their disagreements over what constitutes a terrorist group and what should be prioritised.

## **Approaches to money laundering regulation**

Although auditing compliance presents difficulties, the aim is to enable the tracking of individuals, corporate bodies and their economic relations, thus requiring financial and other designated institutions to identify *all* their customers and to keep all transaction records. Testing compliance can sometimes involve ‘sting’ operations and ‘mystery shopping’ system integrity tests. Apart from any preventative effects that they may have, such controls are useful

primarily for *ex post facto* audit trails, partly because of the sheer volume of reports which, without electronic delivery and some good analytic software programs, is too slow to be dynamically useful.

What is seen as suspicious by bankers depends on training and on stereotypes. Money laundering Reporting Officers are required to be appointed by regulated institutions and, depending on the bewildering variety of legal regimes in different jurisdictions, are legally liable if they fail to report their suspicions that the proceeds of crimes are being laundered. In an attempt to cut across the multiplicity of jurisdictional issues and reduce their regulatory costs and the serious reputational damage they were suffering in the media, a number of international banks agreed at Wolfsberg in 2000 to establish a common *global* standard for their private banking operations (that is, those for very wealthy clients). These 'Wolfsberg Principles' include common due diligence procedures for opening and keeping watch over accounts, especially those identified as belonging to 'Politically Exposed Persons' (i.e. potentially corrupt public officials) who may sometimes combine corruption with drugs money laundering. These were subsequently revised in the light of terrorist finance controls.

## **The effects of anti-laundering measures**

The pressure not just to find terrorists, but also to incapacitate some or all terrorism has given a renewed impetus to the regulation of money laundering, which has always represented an attempt to swim against the tide of globalisation and to deal with its 'dark side'. 'Money laundering' evokes images of sophisticated sinister multi-national financial operations. This sophistication is not always the case. Let us consider what terrorists' economic needs are. First, how much do they need to spend to reach their objectives? A rough figure for the total cost of setting up and executing the September 11 massacres is US \$500.000 (though sustaining the training and support of a core network for a long time requires a lot more). This is a sum beyond the reserves of most people, but it is not a lot of money for businesspeople or major arms or drugs dealers, such as those with some control over Afghan or other poppy fields. It requires just a tithe from the 'commission' paid by cross-border corporations for arms deals or construction contracts. With a network of companies in the names of nominees, especially if they are doing genuine business, sums of this magni-

tude can be easily handled. After all, if most banks did not pick up the Abacha millions held in the names of his sons –failing to check whether they could plausibly have earned those sums legitimately and without apparently knowing that Sani Abacha was head of the Nigerian military– smaller amounts are going to be hard to spot in advance, unless the network operators are on some proscribed list of terrorists circulated around the world by the Americans and are stupid enough to put the money into accounts in their own names.

Old-established ‘slush funds’ (in which corporations, wealthy entrepreneurs and even some politicians keep funds they want to use for facilitating their operations) are very rarely subject to know-your-customer rules set up as part of anti-laundering regimes. Recently, concern about corrupt potentates (or rather, about the reputational risk arising from being found to have helped them), has already encouraged banks to look for such old customers. So funds required can still be transferred unnoticed through the banking system. Alternatively the so-called Hawala or – see Passas (2001), FINCEN (2002) – ‘Informal Value Transfer Systems’ may be used. This informal, but not necessarily criminal, system provides the financial service of transferring funds from, say, a gold shop in Pakistan. They match those transfers to the US against funds that Pakistanis working there want to repatriate to feed their families at home, to buy houses, etc. There are seldom records of the latter. Or network members or their couriers can simply carry the money across borders in cash: countries vary in the extent to which they require and enforce the reporting of large cash amounts coming *into* the country. If the ‘money importers’ are working, they will have some income anyway, but they may also be involved in some crimes locally (though this could damage their cover and investment, if detected). The IRA and groups elsewhere have tended to be involved in protection rackets, transportation, fraud and – where allowed on religious or pragmatic grounds – gambling and narcotics. These are all sources of considerable funds in cash, and may also involve corporate fronts through which money can be channelled.

Terrorists may not need to transform most of their funds into apparently legitimate ones, since giving their activists spending money, renting safe houses, even buying or renting cars and so forth, may require (forgeable) identity documents, but can be paid for in cash. Though they would need an address to receive cards and statements, identity theft may also permit them to generate a phoney ID to get credit cards, which can be used instead of cash to reduce suspicion.

If the terrorists are disciplined, their costs of living can be quite low. Looked at in this way, we can see how difficult it might be to choke off the

financial lifeblood of terrorism. Likewise, the effects of restrictions on the money transmission services, formal and informal, on innocent third parties such as Somalia and Pakistan to which expatriates send home the proceeds of their employment remain to be seen, but are likely to be severe.

Given the political and social importance of this area, the absence of evaluation research on it and organised crime generally is remarkable and may even evoke cynicism about why this should be. What sorts of effects might one seek to identify? These may be divided into effects on the civil, criminal and regulatory processes and those on the impact of those processes. The latter in turn is separable into impact on (a) private and public enforcement practices (on banks and the police, for example); (b) the prosecution or other incapacitation of offenders; (c) the organisation of crime; and (d) levels of crime (corruption, drugs, fraud, tax evasion and terrorism).

In terms of process, the world's legal landscape has been transformed in just over a decade. Almost every country and territory –including almost all offshore financial centres – have adopted laws permitting or requiring disclosure and mutual legal assistance, even though their conformity with the 40 measures (or 'principles') mandated by FATF may vary. Usually following a major scandal, some countries and financial institutions have sought to become 'market leaders' in compliance with measures against drugs money laundering, thereby *intentionally* creating an un-level playing field. Territories such as the Cayman Islands ('blacklisted' in 2000 and de-listed in 2001) or the Channel Islands (now accepted as well-regulated) attempt to persuade wealthy corporate investors to do business there, 'because' they can offer better 'value for money' *and* now have a good reputation in regulating money laundering and fraud and in responding to international mutual assistance requests in relation to drugs trafficking.<sup>6</sup> Conversely, and now mostly at the bottom end of the market, other jurisdictions market their privacy and 'asset protection trusts' which are impenetrable to inquisitive countries, especially to their tax inspectors. It goes without saying that none openly market a safe haven for drugs traffickers, though corruption and links to known amoral entrepreneurs can effectively communicate such 'availability'. Yet while compliance might be excellent generally (and banks might even refuse bribes from undercover Drug Enforcement

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<sup>6</sup> I have chosen these jurisdictions because they have both suffered serious reputational damage for drugs and fraud scandals in the past.

Administration agents<sup>7</sup>), a favoured client – an influential politician and/or drugs trafficker in Colombia, Mexico or Peru – may be given special treatment (e.g. General Accounting Office reports on Salinas). Hence the importance of the Wolfsberg Principles generated by a select number of global private bankers as a counter-weight to local temptations to service powerful clients or potential clients, whether narco-kleptocrats or ‘merely’ corrupt heads of state and their families.

Levels of *visible* enforcement of anti-laundering provisions – prosecutions or de-authorisations of financial and professional intermediaries for money laundering or failing to institute proper measures of regulation – have been extremely modest. Special interest groups, especially lawyers citing client confidentiality, have lobbied, sometimes successfully, to exempt themselves from coverage: examples include Australia and the European Union.<sup>8</sup> Furthermore, those prosecuted – like BCCI and the Mexican banks after the controversial Operation Casablanca in which American agents organised a sting against Mexican banks in Mexico and the US – or those de-authorised tend to be foreign or marginal banks rather than mainstream global banks. The private ‘pre-Wolfsberg’ banking operations of the latter have been particularly prone to abuse, in the sense that they have failed to take sufficient measures to stop allegedly corrupt politicians, drug traffickers and their families from opening and maintaining accounts. There is little doubt that scandals such as that engulfing the Bank of New York over the alleged laundering of ‘Russian mafia’ money have a powerful effect on refocusing the compliance function of that bank and of other banks with known Russian clients.

As for the impact on enforcement, the amount of extra resources devoted to financial policing has been modest in most countries, since it has been difficult to find police support for radical shifts in staff from equally prized and media-supported areas of crime and public disorder. ‘Equitable sharing’ and state confiscation laws have led to a high dependence on income from forfeiture for many US state and local forces. There is some modest evidence of goal displacement as enforcement agencies target forfeitable assets rather than serious

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<sup>7</sup> We may hear about institutions that *do* take bribes in undercover sting operations, but no details are available of those that do not, leading to a perceptual imbalance in judgements about how corruption-prone institutions are. Even the Miami branch of the Bank of Credit and Commerce International (BCCI) initially refused the requests of undercover operatives to launder money for them.

<sup>8</sup> In the UK, the greatest devotee of anti-laundering provisions within the European Union, lawyers have been included since 1986, though the number of suspicious transactions they report remains very low. In the UK, strong efforts were made from the start to involve all financial and professional bodies cooperatively.

offenders (Levy, 1996; Blumensen and Nielsen, 1998). With the possible exception of the Irish Republic, this has not happened elsewhere, partly because post-conviction reversal of the burden of proof typically yields modest results and crime proceeds income is not redirected towards the police or to development agencies (Freiberg and Fox, 2001; Kilchling, 2002; Levi, 2001, 2002; Nelen and Sabee, 1998). As for impact on territories and on the private sector, few high integrity/capital security places offer high secrecy any more, imposing informational uncertainties and extra costs on launderers. Globalized banking does permit service arbitrage to international criminals: prior to the Wolfsberg agreement, some Swiss banks and lawyers responded to domestic restrictions by relocating marginal business to other jurisdictions (such as, at least until the NCCT – Non-Cooperative Countries and Territories– blacklisting, Liechtenstein, which has now been delisted). Jersey willingly lost substantial business when it tightened its criminal and regulatory regime (and raised its fees) in the aftermath of the critical review of its governance for the UK government.

There is no hard evidence of ‘what works’ against basic criminal phenomena, such as fraud, corruption and drug trafficking. Apart from that ultimate effect, the efforts made in Australia, the Netherlands and the UK to develop good collaborative relationships with the financial sector in the early years produced a greater willingness to respond positively. The efforts made by Australia to develop good inter-agency relationships with law enforcement bodies likewise produced greater acceptance of the value of their work. However, the impact of this on corruption investigations is negligible, as these usually relate to crimes outside the jurisdiction, and it is difficult for financial investigators to know to whom they can turn for cooperation, especially in states that have high scores on the Transparency International Corruption Perceptions Index.

In spite of the high-flown rhetoric of politicians and agency heads, it is easy to be unduly negative about the direct, short-term impact of money laundering reporting on prosecutions and on confiscation. Given more general difficulties (in identifying who ‘the criminals’ are, in keeping surveillance, and in developing and making use of informants) *any* ‘untainted’ and non self interested source of information is important. This is particularly so when the information is ‘proactive’ (i.e. it arrives *before* the police have gleaned the news that a crime has been committed or that the person whose transactions are reported upon is a suspected offender). Given the relative impermeability of many Afro-Caribbean, Asian, and Balkan drug trafficking subcultures to undercover surveillance by police, the use of financial institutions as information sources goes some

way to breaking through some of the data-gathering barriers. This has its limits, however: there are well established Arabic and Asian underground banking mechanisms or Informal Value Transmission Systems that predate banking and that are also relatively immune from surveillance by the police and tax authorities, though the focus on terrorist finance has turned up the heat on official and unofficial money transmitters.

These modest results are not illustrative of the *potential* of reporting systems, for they reflect the equally modest amount of resources put into the system by bankers, financial investigators, and prosecutors, as well as the legal framework which then requires proof of the predicate offence. The scale of corruption and other crimes for profit potentially requiring laundering is so vast, and the sums confiscated are so tiny as a *proportion* of the estimated total proceeds of crime, that impact judgments should be cautious. Even in the US, where the headline figures for forfeitures – almost US\$1 billion annually – much of them from laundering prosecutions, are larger than the rest of the world combined, the impact must be rated modest at best.<sup>9</sup> If financial investigators cannot find out where the assets are or who owns them, they can make it hard for the traffickers and launderers to collect the money, but this may not show up in the authorities' confiscation yields. Van Duyne (this volume) concludes that these secret proceeds are unlikely to exist at all. It is indeed unlikely that the vast laundering sums guesstimated by the FATF and other bodies exist, although it is also unlikely that global saved proceeds of crime total anywhere near as little as the US\$1 billion confiscated annually. It is precisely for this reason that global action is a prerequisite of laundering reduction strategies that succeed rather than simply evoking displacement strategies.

The use of particular money laundering techniques is a function of the need to launder and the skill set and contacts of particular offenders, which may change over time. However, although one would expect people to adapt their techniques to regulatory changes (just as they do with serious crime for gain generally – see Ekblom, 2000; Levi, 1998; Levi and Maguire, forthcoming),<sup>10</sup> it is not self-evident that changes in techniques, reported in successive FATF

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<sup>9</sup> The anti money laundering measures have certainly had some impact on the crime-markets themselves. For example the prices of all psychotropic substances have steadily decreased since 1986, with the exception of cannabis (Van Duyne, Paoli and Levi, in preparation)

<sup>10</sup> This makes the ordering of this chapter difficult, since 'incidence and causes', on the one hand, and 'control measures' on the other, interact dynamically. Nevertheless, it would be too confusing to run them together, especially since the evidence of direct interactive events is poor.

money laundering typology exercises, always reflect changes in criminal methods. They may just as easily reflect improvements in enforcement awareness or even luck. One would have to follow the altered behaviour (or inability to change) of the same or similar offender groups to examine the impact of anti-laundering measures.<sup>11</sup> Even the most sceptical can expect a certain amount of change over time in the techniques adopted, or at least in the *places that are used* as intermediaries or ends at the layering and integration stages (where these are distinct).

It would be strange, though theoretically possible, if there were no effects at all on laundering behaviour of the anti-laundering measures and of offender *perceptions* of those measures. This may be manifested in increased laundering costs, which allegedly rose from 6-8 % at the beginning of the 1980s to up to 20 % by the mid-1990s (UNDCP, 1997: 141), and (according to US law enforcement sources) are substantially more today. (Though in a rational economic world, the price of laundering would vary according to the risks that launderers took, and this would be affected by how seriously the authorities took the particular source of funds that were being laundered.) However these assumed increased costs do not tell us whether the *amount* of laundering has changed, or even whether people are doing the same sort of thing but demanding more 'rent' for taking on heavier risks.<sup>12</sup> We should keep in mind that the launderer must launder the proceeds of laundering as well if he is someone other than the offender earning the crime-money.<sup>13</sup>

Even if the money laundering issue should be dealt with seriously, its projection must remain within realistic proportions, taking into account the scarcity of knowledge. Typical offender flexibility and acumen – in techniques for offence commission and with money-management – may be much lower than we believe (van Duyne, 1998). Although an attempt has been made to develop money laundering typologies by and for the FATF and other bodies such as the Council of Europe (see also Department of Justice, 2001), it is as well to admit that despite this work, we lack more than a modest understanding of the incidence and prevalence of current techniques even from the *systematic* analysis

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<sup>11</sup> Interviews and intelligence from the UK suggest that larger volumes of cash have to be stored, since placement within the UK has become more difficult.

<sup>12</sup> To the extent that offenders are well informed, how do we find out about the extent of what they have done, except where the flows are so gross – for instance, the flows of money into Austrian banks from Indonesia in the first quarter of 1998 – that they cannot be accounted for except arguably as illegal capital flight?

<sup>13</sup> The potential involvement of new 'financial service' providers to handle the crime-money leads to an enlargement of the circle of offenders, though the amount of crime-money remains the same.

of detected cases, let alone from those that are *undetected*. Instead of overly ambitious global ‘data’ and pattern estimates critiqued elsewhere (van Duyne, 1994; van Duyne and Miranda, 1999; van Duyne, this volume) – however organisationally and politically useful – it may be better to build up from the ground more modest analyses of what we can plausibly know about criminal money management.

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# **Protecting against money laundering in the Slovak Republic**

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## **Money laundering and the (criminal) market**

Money laundering is a very serious criminal offence of an organised and international nature, that is committed all over the world, including the Slovak Republic. The roots and causes of this type of crime are above all the presence of organised crime and the existence of a shadow economy.

Money laundering may be a by-product of organised crime or other profit oriented crimes. It is undoubtedly one of the most dangerous, negative phenomena of the age. It reinforces the position of organised crime structures and their impact on the legitimate institutions in the economy, the state and society by interrelating with corruption. Money laundering is closely related, and in fact directly connected, to other criminal activities, thus helping to create further resources for the expansion of organised crime.

The presence of this type of crime in the Slovak Republic is strengthened by the fact that the economy of this country is undergoing a transformation to a market economy, resulting in changes in ownership relations, the liberalisation of economic relations, and similar issues. In addition to the positive aspects that have been, and are still being, brought about by these changes, negative aspects have also emerged, including a growth in all types of crime and the emergence of 'black' or 'shadow' economies. The latter phenomenon is the result of various illegal activities, while it also encourages the perpetration of crime.

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The 'shadow' or 'black' economy represents a grave problem in many countries, especially in economies undergoing transformation. The shadow economy is the unregistered part of the economy, in which the provision of goods and services is hidden from the authorities. The goods and services themselves need not be illegal, but the money earned is withheld from the authorities and needs to be laundered. The 'shadow' economy is an illegal or hidden economy, which exists and emerges in every country with a more or less developed economy. Its extent varies from country to country; in many states it achieves vast dimensions. For instance, according to official sources, the estimated turnover of the 'shadow' economy in the Russian Federation is as much as 40 per cent of the gross domestic product. Experts believe that this hidden economy constitutes approximately 15 to 17 per cent of the gross domestic product in the Slovak Republic, which is about SKK 80 to 90 billion.<sup>2</sup> In general, it may be stated that, in countries with a stable economic and legislative environment and in countries with a well-developed economy, the turnover of the 'shadow' economy expressed as a percentage of the legally generated gross domestic product is lower than in countries undergoing economic transformation.

The 'shadow' economy creates conditions for, and to a great extent affects the quantity and quality of, crimes committed in the economy. As the number of economic crimes increases, such transgressions may acquire an increasingly organised nature thus becoming more dangerous, as well as having a significantly negative impact on the economy as a whole.

An increase in the overall crime rate, especially the economic and financial crime rate, is a negative by-product of economies undergoing transformation. The issue of increases in criminal activity concerns society as a whole. The social threats posed by criminal offences have grown; new forms of the most serious offences have emerged, and the aggressiveness of criminals has increased. In the area of economic crimes, accumulated economic and social problems, as well as the absence of mechanisms able to control the pace of economic reform, significantly affect the crime rate and cause it to rise. Insufficient legal awareness on the part of citizens, as well as loopholes in laws and regulations, also contribute substantially to a rise in the crime rate. The pursuit of profit at any cost comes to the forefront. A change in the structure of criminal offences – a change in the criminal scene – is characteristic of all countries in transition. In addition to classic forms of criminal activity, new forms of crime and organised crime are coming to the fore. Criminal offences are plan-

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<sup>2</sup> It is not possible to determine the exact figure resulting from the shadow economy. Estimates vary depending on the methods of statistical estimation used.

ned and committed on a long-term basis and are focused on high levels of profit, while measures against exposure and punishment are also taken. Vast amounts of illegally acquired money end up in the hands of organised groups and strong internal bonds are created, resulting in complex, almost impenetrable criminal groups.

The basic features of organised crime are as follows:

- a high level of professionalism (involving sophisticated planning; good technical equipment; discipline);
- a hierarchical organisational structure with precisely defined and consistently monitored tasks;
- precisely established and monitored standards of group behaviour;
- considerable wealth;
- the effort to penetrate official structures of society and acquire decision-making power ensuring exemption from punishment and the minimisation of risk;
- international connections and operations.

The main objective of organised crime is to achieve the maximum financial profit, regardless of the means applied and the area of business concerned. A large number of the new forms of organised crime are of an economic nature (tax evasion and fraud, crimes related to the privatisation process, credit and loan frauds, insurance frauds, subsidy frauds, fraudulent bankruptcies, etc.), or are closely connected with the economy (for instance debt recovery, illegal job mediation, 'protection rackets' and so on). High levels of latency, organisation and professionalism among the perpetrators are typical of organised economic crimes. That is why these crimes are frequently called 'white collar crimes', committed by professional persons in organisations.

Organised crime differs from traditional forms of crime in various ways:

- The profit is vast and incomparable with the proceeds of traditional crimes.
- There is a need to transfer the proceeds into the legal financial system and to invest them in profitable sectors of the economy, or to capitalise on them in another way. The proceeds of crime are obtained not with a view to immediate consumption, but on the contrary, to ensure their growth by 'laundering' them.
- Financial transactions that put 'dirty money' into the legal financial system are mostly very inconspicuous and differ very little from common bank transactions. The main players in these transactions are not 'typical crooks', but often very intelligent, 'decent', 'white collar' citizens.

It is necessary to combat organised crime and money laundering simultaneously. The fight against organised crime is most efficient if we are able to have an influence on the greatest power of organised crime – the proceeds acquired through this criminal activity; that is, if we can prevent the proceeds from being legitimised.

## **Laws for fighting organised crime and money laundering**

The Slovak Republic bases its fight against legitimisation of the proceeds of crime on international agreements that have been incorporated into the following national laws and regulations:

- Act 140/1961 Coll. Penal Law as amended
- Act 141/1961 Coll. on Judicial Proceedings as amended
- Act of the National Council of the Slovak Republic 221/1994 Coll. On Proving the Origin of Funds Used for Privatisation
- Act 367/2000 Coll. on Protection Against the Legitimation of Income from Crime and the Amendment of Some Acts

### *Act 140/1961 Coll. Penal Law as amended*

The legal instruments enabling the ascription of criminal liability to those who attempt to legitimise the proceeds of criminal activities, or who fail to report this activity, are the provisions set out in Sections 252 and 252a. These provisions enable sanctions to be imposed against all forms of legitimation of income from crime, as well as against the failure to comply with the reporting obligations imposed upon particular bodies by the Act in question.

In addition, the Act also enables the punishment of a perpetrator who has acquired or striven to acquire pecuniary benefits through:

- the seizure of property (Sections 51 and 52),
- financial penalties (Sections 53 and 54), and
- the seizure of possessions (Sections 55 and 56).

### *Act 141/1961 Coll. on Judicial Proceedings as amended*

The Code of Criminal Procedure also includes legal instruments assisting the fight against the legitimisation of income from criminal activity (seizure and provisional remedies), especially those of its provisions that enable:

- the surrender and seizure of possessions (Sections 78 and 79),

- the freezing of an account (Section 79c),
- the enforcement of property seizure (Section 347 to 349),
- the recognition and execution of decisions concerning the seizure of property (Section 384e).

*The Act of the National Council of the Slovak Republic 221/1994 Coll. on Proving the Origin of Funds Used for Privatisation*

The Act of the National Council of the Slovak Republic 221/1994 Coll. on Proving the Origin of Funds Used for Privatisation is a further instrument used to combat money laundering. This Act places an obligation on both individuals and organisations to prove the origin of funds that they intend to use to acquire ownership of property belonging to the National Property Fund of the Slovak Republic or to the Slovak Land Fund as a part of the privatisation process. The Purchaser proves the origin of funds by means of a declaration as to the source of these funds.

*The Act 367/2000 Coll. on Protection Against the Legitimation of Income from Crime and on the Amendment of Some Acts*

Act 367/2000 Coll. on Protection Against the Legitimation of Income from Crime and on the Amendment of Some Acts represents a basic, and at the same time special, regulation in the fight against the legitimisation of the proceeds of crime. This Act lays down a set of special provisions aimed at the prevention and detection of cases involving the legitimisation of income from crime and regulates the rights and duties of a number of persons and organisations.

The legislative framework regulating the fight against money laundering in the Slovak Republic has undergone a process of change that has led to the drawing up of an Act that reflects real needs, while enabling the efficient performance of tasks in the prevention, detection, and penalisation of money laundering. In view of the Slovak Republic's ambition to join the European Union, its legislative framework had to meet all the criteria and requirements set out in the relevant EU documents regulating this area, as well as being fully compatible with EU laws and regulations.

The main pillars of Act 367/2000 Coll. on Protection Against the Legitimation of Income from Crime are as follows:

- I. The definition of basic concepts, namely,
  - the legitimisation of income from criminal activity (Section 2);

- obliged persons (Section 3) – this section establishes the types of individual and organisation (financial, loan-providing, and other institutions), to which the general and specific obligations stipulated by the Act apply;
  - unusual business transactions (Section 4);
  - identification (Section 5, par.1);
- II. Provisions concerning the prevention and detection of money laundering. These provisions set out the rights and duties of obliged persons in relation to the goal of preventing and detecting money laundering activities (Section 6, par. 1, subpar. a), as well as specific obligations. These include the obligation to provide identification (Section 5, par. 2), to maintain records (Section 6, par. 1, subpar. b), to maintain confidentiality (Section 8), and to report (Section 7). There is also a right to delay unusual business transactions (Section 9).
- III. Provisions concerning the tasks and obligations of the Financial Police Administration as the central body for the verification of unusual business transactions and the simultaneous verification of observance of this Act by obliged persons (Sections 10 and 11).
- IV. Provisions concerning sanctions (Section 13 and Section 8, par. 6) and liability for damages (Section 12).
- V. Elimination of the possibility of utilising funds or securities without proof of the client's identity, as set out in Art.IV.

## **Institutions involved the fight against money laundering**

If we want to fight money laundering successfully and ensure its efficient elimination, a coherent, and compact, system of instruments, means, and procedures at various horizontal and vertical levels should be created. The overall efficiency of the process of eliminating money laundering depends upon the efficiency of individual subsystems. Attention should be paid to this problem at each vertical stage, and the corresponding institutional background that will effectively assist in the fight against money laundering should be created. Overall, the fight against money laundering involves three vertical levels, namely:

1. individuals, or the constituent, legally specified, units of financial institutions;
2. financial intelligence units;
3. law enforcement bodies (such as the police, police investigators, public prosecutors, the courts).

### *Level 1*

The functioning of the first vertical level is very important, and it is very positive that those involved in the fight against money laundering perceive the latter not only as the product of organised crime, but also as a highly organised criminal activity in itself. The strategic focus of the fight against money laundering should concentrate on the control of cash flows. There should be effective channels for the passing on of information about suspected cases of money laundering in the legal financial system so that functional institutional barriers against the crime can be created. In other words, all the entities operating within or relating to the financial system in its entirety should be involved in this system from the very beginning. This concerns, in particular, banks, trustee companies, the organisers of the securities market, securities brokers, the Commodity Exchange, the security exchange, insurance companies, gaming houses, exchanges, casinos, lotteries, betting shops, estate agencies, pawnbrokers, auditors, tax advisors, etc.

### *Level 2*

The second vertical level, one that is extremely important in the fight against money laundering, is the financial intelligence unit, the central body that receives, records, analyses and otherwise utilises reports of unusual business transactions received from persons obliged to make such reports. This unit plays an indispensable role in the whole system of protection against money laundering by evaluating all relevant information related to possible cases of attempts to legitimise income from crime. Many countries have faced the decision as to whether existing administrative control bodies or police investigators should be authorised to process such information, or whether a completely new body or institution should be established for this purpose. Naturally, effectiveness in the fight against money laundering depends vitally on the efficient operation of this body. The role that it plays is also very important, whether this is merely to receive and analyse information, or whether it also verifies it. Its position in the system set up to combat money laundering depends on the tasks it is called upon to perform.

A financial intelligence unit has been established within the police force of the Slovak Republic. The main reason was that an operational unit in the police force already existed – the Financial Police Administration of the Police Force – which had a great deal of experience in the verification and documentation of cases of fraud. It also had its own database, and information on entities committing crimes involving finance and loans. The staff of this unit also had the

necessary knowledge of how financial intelligence units in other European countries operated, and had developed secondary legislation based on the basic law regulating the fight against money laundering in the Slovak Republic. For this reason, and also because of the low costs of establishing an operational unit, a Financial Intelligence Section was constituted within the Financial Police Administration on 1 November 1996. It complies with the recommendations of the European Community and Interpol, as well as the criteria specified by the international organisation, The Egmont Group of Financial Intelligence Units. That is, it complies with criteria stipulating the operation of one national authority for the reception and processing of reported information. The experience of the British National Criminal Intelligence Unit was drawn upon in establishing the unit.

### *Level 3*

Law enforcement bodies (police investigation authorities, the Public Prosecutor's Office and the courts), which perform functions related to the final phase of documenting and proving cases involving the legitimisation of income from crime, represent the third vertical level in the system of protection against money laundering. Police force investigators investigate crimes of legitimising income from crime within the meaning of Sections 252 and 252a of the Penal Act, pursuant to Act 141/1961 Coll. on Judicial Proceedings. As a part of the overall investigation process, they are authorised to apply all the provisions of the Code of Criminal Procedure, including those that allow the use of agents, pursuant to Section 88b. It is very important that, during the course of investigations, those provisions also apply that temporarily or permanently prevent the use of the proceeds of crime, or ensure their permanent handing over and seizure (the provisions of Sections 78, 79, 79c, 347, 348, 349, and 384e). The application of these provisions, together with the principles of speed and timeliness, is always of great benefit, especially when fulfilling the most elementary objective of the fight against organised crime; that is, seizure and forfeiture of the proceeds of crime. Prosecutors oversee the investigation of criminal offences.

Despite the fact that the Slovak Republic has all the legislative and institutional conditions in place for efficient protection against the offence of money laundering, the application of individual laws and regulations is inefficient in practice. This is the case at all three levels. Since 1 January 2001, financial institutions have been obliged by law to possess their own programmes to fight money laundering, to implement their own control systems, and to report un-

usual business transactions, along with other obligations. Yet many do not yet have the required experience to fulfil all of these obligations efficiently. In addition, no pressure is exerted that would compel them to pay serious attention to the problem, to create specialised departments or to appoint employees, with the specific task of actively tackling money laundering. This is especially true with respect to the identification of unusual business transactions where personal interests still take precedence over the interests of the state in combatting organised crime and money laundering. Therefore, it will be necessary in the near future to ensure that the financial intelligence unit exerts pressure by performing the checks required to ensure the efficient fulfilment of all the obligations stipulated by law.

The financial intelligence unit – the Financial Intelligence Section of the Financial Police Administration – has the most experience in fighting against the legitimisation of income from crime, including the verification of unusual business transactions. The Section has developed a detailed system of financial investigation and verification; it has the required powers, and to a great extent, good international contacts. The small number of police officers still constitutes a problem, something that is reflected in the workloads of financial intelligence unit staff. The staff of the Financial Police Administration only utilise some provisions of Act 367/2000 on Protection Against the Legitimisation of Income from Crime (such as the delay of unusual business transactions); use them to a limited extent, or do not use them at all, something that is due especially to their lack of experience.

With regard to law enforcement bodies, a lack of experience in the effort of proving the perpetration such serious crimes as money laundering is also evident. The highly sophisticated nature of this type of crime and the presence of an international element also plays a significant role. Some provisions of the Code of Criminal Procedure, such as the freezing of an account pursuant to Section 79c, the seizure of property pursuant to Section 79, or the recognition and execution of a decision concerning the seizure of property pursuant to Section 384e, are utilised to an insufficient extent. However, the time-consuming nature of proving a case also rests in the fact that, in most cases, evidence must also be acquired abroad by means of legal assistance, which is a lengthy process. This is one of the reasons why it will be necessary to intensify international cooperation at all levels.

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# **Financial crime in the CR**

## **Its features and international extension**

Vladimír Baloun, Miroslav Scheinost<sup>1</sup>

### **The concept**

Before we explore the characteristics of financial crime in the Czech Republic (CR) it will be useful to try to define the concept, at least for the purposes of the analysis that will be undertaken in this chapter. There is no single, broadly or internationally accepted definition of financial crime. This is due not only to differences in legislation across jurisdictions, but also to the nature of the phenomenon itself. This creates problems both for legislators as well as for those charged with the enforcement of legislation, and it has led to an ongoing debate about the so-called ‘criminalisation of the economy’ in the sense of the excessively tight regulation of economic behaviour by the statutes of criminal law. This debate is continuing in the CR and probably in other countries as well. For example, the authors of *Tunnelling* (Johnson et al., 2000) state that the Anglo-Saxon judicial tradition emphasises so-called ‘fairness’, a concept that may be understood to reflect a perceived need to maintain a kind of ‘entrepreneurial ethics’. Continental judicial practice, on the other hand, is not based on such vague concepts but mainly on the ‘letter of the law’. The consequences of these different perspectives for a definition of the phenomenon of financial (or in a broader sense economic) crime are ‘law-based’ and ‘spirit of the law-based’ approaches.

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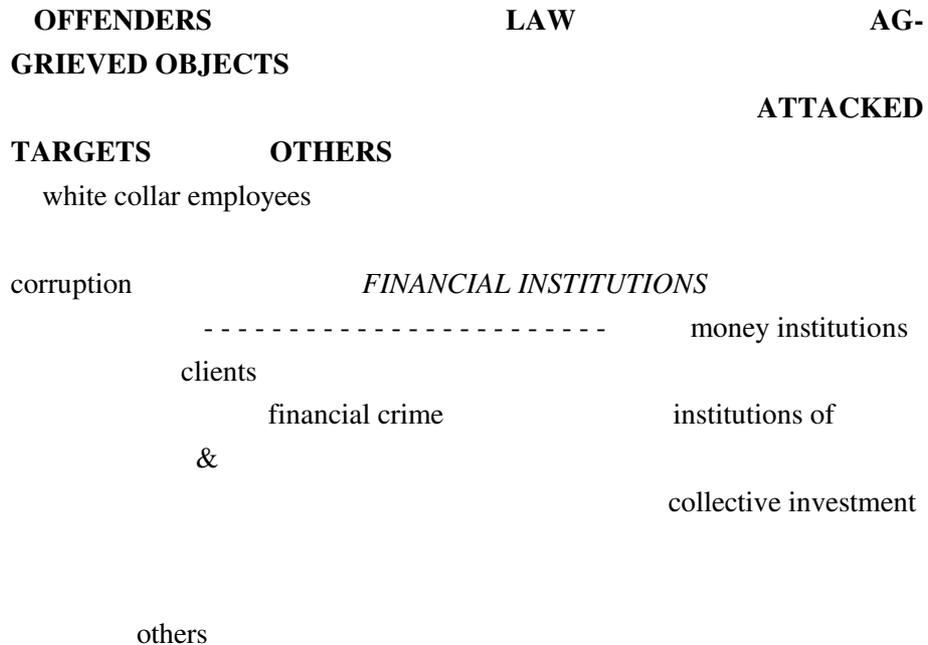
We define financial crime as an intentional and unlawful activity against the interests of financial institutions (banks, savings banks, savings co-operatives, credit co-operatives and insurance companies), collective investment institutions (investment companies, investment funds) and the system of public finance (that is, the agencies associated with tax, customs, social security allowances, subsidies and grants). Thus, our definition stems from the nature of the jeopardized interests and from the nature of the economic area in which this kind of criminal activity takes place (the area of financial flows; Baloun, 2001b).

Given this broad view of the phenomenon, we must also take account of other issues that are the objects of our interest, that is, the so-called ‘money laundering’ and corruption. It is obvious that the problem of money laundering falls outside of the category of financial crime. Nevertheless, since money laundering activities may use the same financial mechanisms, instruments and institutions that are used for the perpetration of financial crime, its overlap with the latter is apparent.

Our understanding of financial crime can be illustrated by means of the following framework:

**FINANCIAL CRIME**

**ECONOMIC ENVIRONMENT**



money laundering

public budgets

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criminal subjects

## Typical features

Although there are differences of view about how to conceptualise ‘financial crime’, opinions about its empirical features and impact are rather similar. This type of criminal activity causes very significant damage; it is usually highly professionally carried out and mostly very well organised (in the sense of being well thought out), and it may consist of a functional sequence of operations directed against the targets of the criminal activity. This does not mean that financial crime necessarily requires a criminal organisation in order to be carried out. The perpetrators may act separately; they can misuse existing legal organisations and institutions both from the outside or as insiders; they may collaborate on the basis of mutual benefit or corruption without establishing any stable criminal groups or organisations. It does not mean, of course, that the activities of ‘organised crime’ are excluded from the field of financial crime.

The typical perpetrator of a financial crime is someone recruited from the so-called ‘white-collar’ professions, who has the necessary financial know-how at their disposal. In addition, he or she often occupies some formal position that enables him/her to influence or to make decisions linked to financial operations. Jacques Guimezanes (vice-president of the French judicial police) argues that ‘financial criminals’ prefer intelligence to force as the means to achieve their goals and that at least the more serious financial crimes are committed by persons sufficiently well qualified to exploit the complicated provisions of commercial law and to oversee the highly specialised processes involved in fraudulent financial operations. Nevertheless, he also points out that some ‘professional’ (i.e. lower class) criminals may switch their focus from violent or other traditional criminal activities (usually after having accumulated sufficient capital) to financial crime. They are either able to carry out these new activities themselves or they use (and pay) qualified specialists (see also Savona, 1996). Financial crime represents for them a less risky area from the point of view of the likelihood of being charged or threatened physically, and at the same time it is an area of activity which, on the basis of rational cost/benefit analysis, is at least as lucrative as the traditional areas (Kuhl, 1997).

Guimezanes mentions forgery, the counterfeiting of payment instruments, fraud and large-scale international embezzlement as the typical activities of delinquents who move to financial crime from the 'classic' areas of criminal activity (Guimezanes, 1997). On the other hand, Paoli (1995) reminds us that people and enterprises involved in economic crime do not have the capacity to combine the economic, physical and political resources that are typical of large-scale criminal formations. They lack their polyvalence, flexibility and capacity to shift from one preferred sphere of action to another. Their most important weakness is their very limited access to the resources of violence. Therefore they are forced to hire a 'criminal work force' drawn from members of the more violent criminal groups (Paoli, 1995). Thus, financial and 'classic' or organised crime may often be forced to collaborate and sometimes to merge, and this is obviously so when it comes to the process of legalising or laundering the proceeds of crime.

One of the characteristic features of financial crime –a highly specialised, complex and organised activity– is its well hidden quality. Guimezanes suggests that the crimes uncovered by the special task forces of the French judicial police represent only 15 to 20% of the economic and financial crimes actually committed. He also estimates that the total amount of damage caused by economic and financial crime has reached more than FF180 billion per year while the damage caused by other kinds of crime oscillates around FF20 billion per year. These estimates refer only to the direct damage. They do not take into account the indirect damage, which, from the social as well as the economic point of view, is extensive. It includes, for example, the effects of firms' insolvency; damage to the clients and shareholders of financial institutions; the shortage of public funds caused by their illegal depletion or by the non-payment of taxes and obligatory allowances; the burden imposed on the public purse by the necessity to draw on it in order to cover the damage caused by financial crime. The victims of financial crime are thus not limited to the direct targets of attacks only, but they also typically include a large number of institutions and citizens who are indirectly affected. Given the involvement of public finance both as a target of attacks and as a resource that is drawn upon to cover the damage caused by this kind of crime, we may even state that all taxpayers can be enumerated among the victims of financial crime. We should also take account of the international extent of financial crime, as this becomes an additional characteristic feature due to the globalisation of financial flows.

Hence, the intrinsic qualities of financial crime (its highly specialised, complex and organised character); the profiles of offenders and victims; the extent

to which it remains hidden; the amount of damage it causes and its growing impact: all these can be considered typical features of the phenomenon.

## **The situation in the CR: an overview**

The systematic criminological study of financial crime in the CR is in its infancy, for which reason we shall not attempt any general assessment of the current situation. Nevertheless it is more than plausible that the common hallmarks of financial crime, as they have come to light elsewhere, are more or less applicable to the CR as well, and often in a heightened form due to the specific circumstances of the CR's transitional economy.

Over a relatively short period of time a fundamental change in the nature of property relationships took place, not only with regard to previously state-owned property, but also with regard to co-operatively and communally-owned properties. This change was brought about by the various forms of privatisation. These included the transformation of public enterprises into new types of commercial companies; direct public sales; the offer to citizens of ownership participation in selected economic entities by means of so-called 'coupon privatisation', and so forth. Property that had been confiscated by the communist state was returned to its original owners. At the same time, the relevant legal frameworks underwent changes. In particular, it was necessary to establish a new tax system, new regulations for the stock market, and new trading regulations. It was also necessary to change the law regulating banking, and the regulations governing the bills of exchange, as well as to adopt a new Act on Bankruptcy and Settlements. The need to have good bankruptcy laws is self-evident (see Keh, 1996), but up until now the Act has been amended eleven times since it came into force in 1991. Not even the most recent changes make sufficient provision to meet the needs of creditors or enable those declared bankrupt to be discharged efficiently. Moreover, it was necessary to adopt provisions against money laundering and to adapt the criminal law in such a way as to respond to a range of additional new activities in the economic sphere.

While these imperfect laws were being enacted, a large number of staff changes took place in the state administration including the institutions regulating the economy and the institutions of law enforcement. New institutions were established. Newly established entrepreneurs got acquainted with the tools and the possibilities of the market economy only slowly, while the state did not

have sufficient professionals available to protect its interests effectively or to enforce the regulations that were required if the market economy was to function equitably and without friction.

Let us leave aside for the moment the question of whether there was sufficient political will to enact and enforce regulations with the required degree of severity. The strength of this will was a function of the prevailing political and economic priorities, and of more or less liberal views concerning how wide ranging the regulations governing the economic transition process needed to be. Nevertheless, the combined result of the above mentioned influences was to create a large space for illegitimate activities detrimental to the economy. While it is unclear whether this space was or was not larger than is the case in the established market economies, the transition process itself, the attendant legislative problems, and the lack of experience or the underestimation of the risks associated with marketisation undoubtedly had a negative impact, as Douglas Keh (1996) has remarked. It is common knowledge that breaches of laws and regulations, including the criminal law, take place more often in developing than in established markets.

A good example concerns the Act regulating the so-called mutual savings and credit co-operatives. These co-operatives represent a kind of financial institution with a long tradition in the Czech Republic and they were re-established after 1989. Regrettably the Act was formulated so badly that it enabled anyone –even persons with criminal records– to establish them, while it was quite easy to evade the Act. Particularly inadequate was the section concerning the management of financial assets entrusted to the co-operatives. The Act made it illegal to carry out certain risky operations using such assets, but co-operatives were free to establish fully owned subsidiary companies, which could perform any operation without limitation, hence also the risky ones. To embezzle co-operatives' assets was therefore easy, and it was made even easier by the initially insufficient supervision of the co-operatives' activities on the part of the relevant state authority. The total damage caused by various fraudulent activities inside the co-operatives has been estimated at about eight billion of the twelve billion Czech crowns entrusted to these co-operatives overall.

## Financial crime: incidence, types, damage and offenders

It is very risky to base the analysis of financial crime on data relating only to reported instances. Moreover, we do not have data allowing us to separate, from those for other offences or alleged offences, figures for financial crime as we have defined it above. We therefore present only a small quantity of illustrative data on economic crime in general in the CR.

**Table 1**  
**Total number of crimes and economic crime in the Czech Republic**  
**1996-2000**

	1996	1997	1998	1999	2000
<b>Total number</b>	394.267	403.654	425.930	426.626	391.469
<b>Economic crime</b>	25.539	30.156	36.031	42.907	37.632

**Table 2**  
**Economic crime as a proportion of the total number of crimes**  
**1993-2000 (%)<sup>22</sup>**

	1993	1994	1995	1996	1997	1998	1999	2000
%	4,64	4,95	6,77	6,48	7,47	8,46	10,06	9,61

The increasing share of economic crime in the total number of registered crimes reached about one tenth in 1999 and 2000. A more significant indicator is the amount of known damage. This shows that, despite the slight decrease in the number of recorded economic crimes in 2000, the estimated damage caused by such crime was higher than ever before and that, at 50.2 billion Czech crowns, it was more than twice as high as in 1999 (when it had been 21.1 billion crowns). In the same year, the damage caused by crime in general was estimated at 63.4 billion Czech crowns. This means that in 2000, the damage

<sup>22</sup> Source: Statistics of the Czech Police and Kadeřábková (2001).

caused by economic crime constituted about 80% of the total damage caused by crime. The situation in the CR concerning the damage caused by crime appears to correspond to the findings concerning the established economies mentioned, for example, by Guimezanes.

Up to 1999, the largest part of the total damage was caused by offences classified as fraud. In 2000 the largest proportion of the damage –amounting to about 35 billion crowns– was caused by the criminal activity classified by the Czech penal code as the crime of breaching the duties connected with the administration of another person's property, especially while representing his business interests in commercial matters. Criminal offences classified as fraud –especially the making of fraudulent contracts; the misuse of revenues, fees and deposits, and the cheating of creditors– caused damage amounting to 8.1 billion crowns. The damage caused by tax fraud amounted to 2.7 billion crowns; embezzlement created a loss of 1.5 billion, and infringing the rights of creditors caused damages of 1.2 billion crowns.

In 2000 about 23.000, or about 18 % of the total number of persons prosecuted, were prosecuted for economic crimes. It is significant that 78% of them were so-called 'first-time offenders', meaning that it was the first time that they had been prosecuted. In view of the low detection rate for economic crime, the 'first offender' denotation can probably be considered a euphemism. The most numerous group among those sentenced for economic crimes are people from 30 to 39 years of age: sophisticated fraud is not a juvenile sin, it would seem (Van Duyne, 2003).

This finding was also confirmed by the investigation carried out as an initial part of the ongoing research on economic crime of the Institute of Criminology and Social Prevention. The investigation was conducted using the relatively small sample of economic crime cases that ended in a verdict in court, in order to develop a hypothesis for a more extensive research project involving a representative sample. Despite the limited number of cases analysed in this pilot certain findings are interesting and correspond with the previous findings.

Comparing the perpetrators of 'common' fraud schemes with the offenders involved in other types of financial crime (that is, the perpetrators of crimes involving the targeting of financial institutions or public funds) it appears that the average age of the latter is higher. Most of them are above 30 years of age, their average age being about five years higher than that of offenders committing acts of common fraud. This tendency is even more significant for the accomplices. Therefore it seems to be confirmed that, notwithstanding the specific conditions of the CR, within financial institutions, the higher positions enabling

sophisticated crimes to be committed are usually reached after 30 years of age. Given the predominance of persons within the 30 to 40 age range it is also plausible to assume that most offenders are persons who began their professional (not necessarily criminal) careers after the so-called 'velvet revolution'. We might thus formulate the hypothesis that entrepreneurs, who are more likely to be successful not only in legal, but also illicit economic activities, have not been burdened with habits derived from the period of the planned, socialist economy.

It is also worthwhile looking at the educational backgrounds of offenders. The cases analysed show that the levels of education are significantly higher among the perpetrators of financial crimes than among the perpetrators of 'common' fraud. If the perpetrator of a financial crime had a previous criminal record it was mainly because of some minor transgressions. In general, it seems to be the case that in the 'pioneer' period, when the financial institutions were established, not even a criminal record was considered an obstacle preventing such persons from reaching positions allowing them to control flows of money.

The results of the pilot study also reveal the total lack of control of the economic relations, especially at the beginning of the transition process. The old internal system of control within the plants and financial institutions was removed, and putting in place a new control system took some time. External controls and supervisory institutions were established in the sectors of banking, investment funds and credit co-operatives, but that was all. From the beginning the relevant institutions suffered from a lack of qualified staff, insufficient capacity and inadequate legislation. Many laws –for example, the law requiring the keeping of accounts– lacked sanctions against the violations of their regulations. Law enforcement authorities were understaffed and lacked sufficient numbers of trained and experienced investigators, lawyers and so forth. Since there were few people available with prior experience of the conditions surrounding the development of a market economy, the significance of regulations and sanctions in the area of economic activity was underestimated and the financial and economic price paid for this underestimation was high.

It goes without saying that a large part of the financial crimes were also made possible by the unbelievable credulity and carelessness of ordinary citizens, who were willing to put their money into the hands of fraudsters on the basis of quite fantastic promises. For example, one of the credit co-operatives promised returns on deposits of more than 20% per annum. Not surprisingly this co-operative was later 'tunnelled' by its management. Given this credulity,

some fraud schemes were very effective, even if they were technically very primitive.

## **The so-called ‘tunnelling’**

In surveying the major forms of financial and economic crime in the CR, we cannot leave out the phenomenon of ‘tunnelling’. In neither criminology nor economics is this a standard, or commonly used, term. Derived from common parlance and the language of journalism, the word has nevertheless acquired a technical meaning. It seems to be another of those words that have been given to the international lexicon by the Czech language.<sup>3</sup> Recently, the term was used in an International Monetary Fund and World Bank report about the state of economic reforms in the CR.<sup>4</sup>

The phenomenon is not of course a Czech invention, nor does the CR have a monopoly on it as the study *Tunnelling* (Johnson, et al., 2000) illustrates. However, it is so widespread in this country that it deserves special attention. It is alleged that the CR has the highest frequency of cases of tunnelling of all the post-communist countries with the exception of Russia.

The term emerged as a word in everyday use in 1994-95 in connection with the collapse of a number of Czech banks. Its use is commonly linked to the financial institutions, but sometimes it is also used in a broader sense to denote illegal activities against commercial companies and industrial plants. Actually it consists of fraudulent operations carried out in order to siphon off secretly the assets of a prosperous company. Such operations are carried out by the functionaries of those companies, which may be banks, industrial plants or other enterprises. Due to the fact that these persons may also be owners or joint owners of the enterprises in question, such operations may seem paradoxical as they look like an attack, by the firms’ owners, on their own interests. However, the basic principle of tunnelling is that it leads to the appropriation of the difference between the value of the owners’ shares in the firm, and the value of the misappropriated funds. In financial institutions like banks or investment funds, owners’ shares confer control over the whole institution, but in terms of their value they are quite trivial compared to the institution’s total value. It means that the damage to the offender himself, consisting of the diminished value of his own

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<sup>3</sup> This is similar to the case of the word ‘robot’, coined some time ago by the Czech writer Karel Capek.

<sup>4</sup> Cited by the Czech weekly, *The Economist*, 11.12.2000

assets, is infinitely small compared to the total damage, which is the criminal profit of the fraudster. Typical examples of tunnelling in the Czech case have been the bankruptcies of the mutual savings and credit co-operatives mentioned above where the estimated damage amounted to 8 billion crowns (Baloun, 2001a).

Tunnelling is of course not a legal term and the Czech penal code does not include it. Offenders have usually been prosecuted for fraud or for the offence of violating their duties in regard to the management of property entrusted to them.

### **The case of the Commercial Bank**

The case of one of our biggest banks provides a clear illustration of the effects of becoming victimized by tunnelling. The case has caused widespread concern. The investigation has not yet been concluded, so that it is not as yet possible to be certain whether any intentionally committed criminal acts have in fact taken place. Nevertheless, the description of the case may serve as an illustration of the difficulties a criminal investigation may encounter in substantiating a financial crime and the international connections underlying it. Of course, due to the fact that the investigation is still in progress, the information at our disposal comes from open sources, mainly from newspapers. This makes it difficult to verify some of the revelations.

The case concerns the credits given by the Commercial Bank to the firm BCI Trading, based in Austria and belonging to the entrepreneur Barak Alon. In June 1996 the Commercial Bank gave this firm a so-called 'limit to an open letter of credit' of US\$100 million, despite the advice of the consultant firm, Dun and Bradstreet, not to proceed with it.<sup>5</sup> In giving its advice the consultant took into account the low level of the registered capital of BCI, its possible connection with other firms based at the same address and possible capital flows between them. The credit limit was increased to US\$150 million in 1997, despite the fact that the management of the bank already had information about BCI's connections with other firms that had previously inflicted a loss of 1,2

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<sup>5</sup> A letter of credit is a commercial document that confirms that a bank will make payments on demand, provided that certain conditions, set out in the document, have been met. Letters of credit are mainly used in international trade as a form of credit in order to ensure that bills of exchange are honoured. They serve as a guarantee both for sellers (by guaranteeing that goods will be paid for) and for buyers (by guaranteeing that payment will only be made once the seller has fulfilled the specified obligations).

billion crowns on the Commercial Bank. A subsequent increase in the credit limit to US\$200 million was granted in 1998, though this time Dun and Bradstreet recommended only US\$170.000. To begin with, the entrepreneur repaid the loans he had been given, but in order to do so he used the additional money he had borrowed from the Commercial Bank. Finally, in 1999 his repayments stopped altogether. Simultaneously, the bank suspended further letters of credit because of suspicion that the firm had falsified documents; because of the worsened credit rating of BCI and –finally– because of the acknowledged fact that Mr Alon had already caused a loss to the bank in the past. This was two years after the Austrian bank, Central Wechsel AG, had informed the management of the Commercial Bank of an allegedly false document submitted by BCI. The outstanding debts of BCI to the Commercial Bank amounted to 8 billion Czech crowns.

We may only guess whether the decision to open the letter of credit was due to professional failure on the part of the bank's management (for example, because of underestimating the risks, an insufficient level of expertise, or blatant dereliction of duty) or whether it was done intentionally (due to corruption or some other aim). Eleven people were charged with criminal violation of their duties concerning the administration of other persons' property and with breaking the regulations governing commercial relations. Some of the suspects were on the board of directors, others were middle-level managers, Some time ago the prosecution of three other persons started for fraud and issuing a false certificate.<sup>6</sup> The case of Barak Alon was transferred to Austria where the decision about his prosecution would be taken.

According to the available sources, BCI's commercial partners are based in Russia, Uzbekistan, the Slovak Republic and Poland. BCI acts as an intermediary firm for both the import and export of goods, and it was for this reason that the form of letter of credit was used. The Commercial Bank was not therefore obliged to check whether the goods for which the letter of credit was given actually existed. Only the submission of documents was required. Hence, it is possible that BCI undertook the following criminal activity: The existence of the false documents suggests that there both BCI and its trading partners intended to harm the bank substantially. What might have happened is that these partners acted in concert with BCI, arranging the production of the false documents in advance as well as the moment at which the partners would stop their

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<sup>6</sup> Source: *Právo* (daily), 18.9.2001

payments. Subsequently the liability of the Commercial Bank to pay the letters of credit came into force.

The reality could be even more complicated. According to information from foreign, mostly Austrian newspapers, the activities of BCI were investigated by Interpol and the Hungarian and Austrian police. It is suspected that the commercial activities of BCI are connected with the activities of a well-known criminal grouping headed by Semen Mogilevitch and that the aim of the whole transaction described above was in fact money laundering. If that is true, then the involvement of BCI in providing the services of money laundering to organised crime groups was by being used as an intermediary institution, in a similar way to the Banco Ambrosiano (Paoli, 1995). It has also been alleged that BCI had connections, established during the Cold War period, with the former secret services of states from Central and Eastern Europe. The truth is that Commercial Bank's management did not react to signs of BCI's untrustworthiness. What is intriguing is the fact that nobody knows where the money lent by the Commercial Bank to Barak Alon's firm has ended up. The bank's new management has said that it is trying to recover at least part of the lost money from the managers who signed the contract with Alon. The situation may be even more complicated because –according to newspaper reports– the bank is insured against losses caused by erroneous financial policies. The business with Alon was also insured, so the bank could obtain some part of the lost money as indemnification. But there is a hitch: the insurance does not cover damage caused by criminal activities on the part of the management of the bank itself.

## **Discussion**

Examining the phenomenon of financial crime, we suggest that the core of this activity consists in inflicting losses on commercial institutions by means of the manipulation of financial transactions. Its main features are to be found in the fully fledged developed form in the Czech Republic as well as in other systems based on modern market economies. In our opinion this form of crime is highly and professionally organised, but it does not inevitably require an 'organised entity', in the sense of a criminal organisation, for its execution. In most cases it involves the misuse of legal organisations and in the Czech case its spread was facilitated by the on-going transition process with its well-known concomitants.

So-called tunnelling is also characteristic of the Czech financial landscape, even though it is not a specifically Czech phenomenon. Also characteristic of this kind of crime is the size of the damage it causes. This is huge, even if attention is restricted only to its known and proven part. In 2000, for example, the damage amounted to 50 billion crowns. Some idea of the staggering size of this amount can be gleaned by considering that the Czech state budget amounts to about 650 billion crowns annually. From this point of view it is natural that the Czech government repeatedly declares the war against economic or financial crime to be one of its main priorities. The efficacy of this war is questionable, however. Nevertheless, efforts to expose and to prosecute offenders have intensified considerably in the recent past.

Many of the features of (organised) business crime can be seen in the Commercial Bank case, though we shall have to await the outcome of the investigation to be sure what regulations have been violated.

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# Precautionary measures against economic and financial crime in Slovakia

Jan Vittek<sup>1</sup>

Developments in the areas of economic and financial crime in Slovakia are affected by, among other things, the continuing process of transformation associated with the development of the free-market economy and by the social and economic changes related to this transformation. Factors which have encouraged the growth of crime that has taken place in recent years include: the social distress connected with unemployment; the passivity of citizens and their indifference to criminal activities; the low cultural and educational levels of broad strata of the population, and a frequent unwillingness or even a refusal to cooperate with the police. In addition, legal arrangements for the protection of a range of types of property are inadequate and the capacity for law enforcement is weakly developed. There has been an increase in rates of transfer of ownership of assets in Slovakia. This development has been exacerbated by such additional factors as permanent changes in the legal frameworks governing several spheres of activity.

Given the current trends in the spread of economic and financial crime, the Bureau of the Financial Police (BFP) expects there to be a growth in money laundering in the near future.<sup>2</sup> This expectation is heightened by the increase in the number of reports of unusual business transactions since the end of 1999. Moreover, the BFP also expects an increase of criminal activities in the areas of taxation and social insurance. These offences are also likely to increase because

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<sup>1</sup> The author is head of the Bureau of Financial Police, Slovak Republic

<sup>2</sup> The Bureau of Financial Police (BFP), together with other agencies of law enforcement, performs core tasks in the field of tax avoidance and illegal financial operations, including money laundering.

of the very poor economic and financial circumstances in which large numbers of individuals and enterprises find themselves. Unfavourable trends are also anticipated in the areas of fraud of various types: embezzlement, and the falsification of money and securities. A subsequent trend is likely to be a growth of economic crime in the area of e-commerce.<sup>3</sup>

Reversing these trends will require an improvement, not only in the quantity of resources devoted to law enforcement, or even improvements in its quality, but also a range of new preventive measures. The latter will need to be directed at changing the behaviour not only of government bodies but also, crucially, of the business community and of ordinary citizens. Since insufficient attention has been devoted to this issue hitherto, this chapter is focussed on the fundamental regulations, as they relate to business organisations and the protection of the assets of ordinary citizens, necessary to combat economic and financial crime in Slovakia.

Entrepreneurs in Slovakia still apparently believe that their own systems of internal supervision provide them with sufficient levels of security against fraud. Meanwhile, entrepreneurs who have never been victims of fraud apparently often feel themselves to be immune to 'attacks'. This is, of course, a kind of wishful thinking, because experience demonstrates all too often that such entrepreneurs subsequently fall victim to fraud along with others. Given the growing sophistication of offenders and their detailed knowledge of the international financial and commercial system, no organisation can be indifferent to the risks of becoming a victim of fraud perpetrated by individuals or gangs operating inside or outside the organisation. Large-scale, complex fraud schemes can put entrepreneurs out of business, especially when valuable property is at stake. Policies designed to reduce these risks need to strive for an optimal reduction of the opportunities for criminal victimisation in the first place. Given such measures, the successful recovery of stolen assets and the identification and pursuit of offenders will depend upon the relevant law enforcement officers taking the correct decisions at the right time.

The expansion of areas of business activity brought about by technological changes, together with the internationalisation of trade and industry, have expanded the opportunities for engaging in criminal activities carrying a low risk of exposure, and this has given rise to a number of new considerations that any

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<sup>3</sup> The expected trends are included in the section of the 'Report on the Activities of the Bureau of Financial Police for the year 2000' entitled: 'Expected trends in criminal activities within the operational field of the BFP'. The Report has not been published officially.

entrepreneur has to bear in mind. Each crime has its victim and each crime can in principle be committed by:

- an individual belonging to the organisation that is the victim;
- an individual from outside the organisation that is the victim;
- an organised criminal group working inside or outside the organisation that is the victim.

A recent survey carried out by Price Waterhouse Coopers in fifteen Western and Central European countries on the basis of a sample of more than 3.400 companies, non-profit organisations and government agencies, leads to the following conclusions:

- more than 42,5 % of the larger European companies have been the victims of economic crime in last two years;
- around 60 % of the frauds were perpetrated by people within the organisations concerned;
- misappropriation of assets by an employee was the most common type of crime after fraud and embezzlement;
- no industrial sector is immune from crime, but the most vulnerable is the financial services sector;
- the loss caused by fraud could be estimated at € 3.6 million per organisation;
- 58 % of known acts of fraud were detected by accident or chance;
- only 20 % of organisations were able to recover more than 50 % of their losses.

Many organisations seemed to fail to act on the lessons learned, as it appeared that more than half of them had not implemented any changes designed to improve their internal security procedures –with the result that they were still left vulnerable to fraud. 51% of the organisations in Central Europe that had been the victims of economic crime had fallen victim to external offenders– as compared to only 39 % of the corresponding organisations in Western Europe.<sup>4</sup>

If organisations and their assets are to be protected from criminal activities, internal security policies are essential. For one thing, knowledge on the part of companies' staff of the existence of action plans to deal with fraud can help to increase trust in their management. Publication of such plans within companies can help to eliminate the misunderstandings and doubts that may arise among staff when they are confronted with the problem of financial crime.

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<sup>4</sup> These data have been drawn from the report by Mr. Rick Helsby (Head of European Investigations, Price Waterhouse Coopers) entitled: 'Economic Crime Survey 2001'.

The process of identifying potential security risks requires scrutinising all aspects of an organisation, including its activities, its surroundings and its staff. Particularly important is that each employee knows exactly what his or her responsibilities are in relation to the company's security policy. Such responsibilities must include an obligation on the part of employees to report to their supervisors or security managers any incident or activity, as well as its circumstances, that appear to them to be strange or unusual from a security point of view. Crime can remain unreported for periods of time sufficiently lengthy that significant damage is caused in the meantime. A key instrument of helping to ensure that offenders' activities are reported is to hold staff responsible for the enforcement of prevention measures.

Three fundamental principles apply to the approach of an organisation's management to its staff. That is, there must be clear regulations for the prevention of criminal activity; rules for the periodic evaluation of staff, and procedures and principles for investigating suspicious activities. The first step that needs to be taken concerns the procedures concerning the recruitment of new personnel. In particular, concrete, verifiable information must be obtained about applicants, who should also be asked to fill in a 'security questionnaire'. The aim of administering such a questionnaire is to discover applicants' vulnerabilities, in particular any tendencies towards cupidity, aggression or instability. Trained experts, not only from personnel, but also from security departments, should conduct discussions with applicants.

The development of effective action plans provides a solid basis for dealing with crimes if and when they are committed or attempted; for such plans are likely to clarify for key managers what they should do and when, and what the implications of their decisions will be. Managers must be equipped, when problems relating to their areas of activity arise, to take decisions that are in harmony with the strategies and policies of the companies for which they work. Increasing numbers of companies are beginning to recognise the risks of potential criminal actions, but many lack the wherewithal to create and develop effective action plans. In most cases, such plans are developed only following large financial losses or when risky investments are being contemplated. In such circumstances, managers are forced to ask the questions:

- what measures must be taken immediately in order to prevent loss?
- what is the best way to protect the company's interests?

All aspects of an action plan must be explicitly approved by the management of a company or by its board of directors, in order to eliminate any restrictions

or uncertainties that might otherwise impede implementation of the plan. Periodic revision and updating of the plan is essential.

Errors or irregularities can occur in any system. Many of them can be eliminated by systems of dual inspection or by consultation with experienced colleagues. The initial signs that economic or financial crimes have taken place do not always or even mainly derive from conduct that deviates from standard procedures. Many sophisticated offences are committed in circumstances for which it is possible to give seemingly logical explanations appearing to suggest that normal patterns and procedures of business practices have been followed. When suspicions arise that crimes have been committed, a responsible person –who will investigate the circumstances and decide what further actions should be taken– must be involved immediately. False alarms should be dealt with sympathetically and viewed as an indicator of loyalty towards the company. Internal rules of procedure for reporting unusual business transactions can be an integral part of the action plans of companies defined as reporting entities under the Act for protection against the legalisation of the proceeds of crime (Act No. 367/2000 Coll.). Internal rules should include:

- a declaration of willingness to remain within the law at all times;
- regulations regarding the conduct of business transactions (especially foreign transactions);
- rules allowing business dealings with clients whose identities are not adequately verified, to be terminated;
- rules allowing business dealings with clients involved in suspicious behaviour, to be terminated;
- clear indications of the identities of persons responsible for responding to requests for information;
- clear indications of the identities the persons responsible for reporting unusual business transactions to the financial intelligence unit;
- clear definitions of employees' responsibilities in the area of training;
- clear definitions of responsibilities with regard to the inspection of replies to applications;
- clear definitions of disciplinary measures to be taken against staff failing to comply with the rules.

Of course, the foregoing represent only some of the necessary precautionary measures. Within the framework of an action plan it is also necessary to address questions of data protection and the movement of staff within a workplace; the security of the company's information system; systems of internal audit; co-

operation with police investigators; the protection of potential evidence, and relations with the media – to name but a few.

If the rules defined within an action plan are executed and applied consistently on a daily basis within an organisation, they will help to minimise the risks of serious economic and financial crime taking place.

# **The market and criminal law: the case of corruption**

Matjaž Jager<sup>44</sup>

## **Introduction**

At first sight the field of criminal law is anything but concerned with facilitating the mechanisms of market-exchange. The distinctive perspective of criminal law –principled, moralistic, unconditional, in essence paternalistic and backward-looking– is hard to reconcile with economic way(s) of looking at things. If anything, the latter can be described as its antithesis, i.e., as mostly pragmatic, utilitarian, in principle non-paternalistic, and individualistic. Nonetheless, the analysis of phenomena that draws on both of these disciplines is possible and even fruitful. In this chapter I will explore the contribution made by this new ‘style’ of economic analysis to the study of corruption – hitherto regarded primarily as the province of students of criminal law, public administration and policy-making.

There are many ways in which economic reasoning has produced new, alternative insights into corruption research. These include the introduction of new theoretical analogies, new achievements in the area of empirical measure-

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ment, new ideas about optimum policy responses and application of the principal-agent model. I will discuss and critically evaluate these novelties. Finally, I will discuss some of the ways in which an economic analysis of corruption might influence corruption research in the future.

## **The economic analysis of corruption**

The problem of corruption is wonderfully complex. The definition of the phenomenon remains difficult, and in a way it represents a proto-typical moving target (Nelken and Levi, 1996:1) for practitioners of the various social sciences who wish to argue for the advantages of their own specific approaches.

Economists began to be involved in corruption research in the middle of the 1960s. The principal scholars were Nathaniel Leff (1964), Susan Rose-Ackerman (1975), Edward C. Banfield (1985) and Robert Klitgaard (1988). The first formal attempt to model corruption was that of Susan Rose-Ackerman in 1975.

The economic approach produced interesting results by raising new questions and by answering old ones in new ways. Its first contribution was to change the entire conceptual framework within which discussion of corruption had until that point been couched.

## **A change of framework: new insights, new analogies...**

Traditional thinking about corruption had been framed in a moral vocabulary. Acts stigmatised as corrupt were, more or less, observed and analysed as moral deviations.<sup>2</sup> The whole approach has been termed 'moralistic' or 'moralising' (Leys, 1965) and had its own strengths and weaknesses. It represents a legitimate, but partial view.

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<sup>2</sup> For an overview and a comment on the literature espousing this view see, for example Leys (1965); Williams (1976).

In contrast to the moralistic view, the economic analysis of corruption, based on rational choice theory,<sup>3</sup> has introduced a different imaginative framework into the discourse on corruption. Let us give an example. In her latest book, *Corruption and Government* (1999), the pioneer of the economic analysis of corruption, Susan Rose-Ackerman, conceptualises the phenomenon – on a very general level – as an attempt to alter the way ‘valuable benefits are distributed and onerous costs imposed’. While focusing only on ‘public office’ corruption, she casts her discussion in uniquely economic terms:

All states, whether benevolent or repressive, control the distribution of valuable benefits and the imposition of onerous costs. The distribution of these benefits and costs is generally under the control of public officials who possess discretionary power. Private individuals and firms who want favourable treatment may be willing to pay to obtain it... (Rose-Ackerman, 1999: 9)

Or, if we take another example, this time describing the point of view of one of corruption’s *dramatis personae* –the corrupt civil servant– we find that his role has been described in entrepreneurial terms:

Thus we will conceive of corruption in terms of a civil servant who regards his public office as a business, the income of which he will, in the extreme case, seek to maximize. The office then becomes a ‘maximizing unit’. The size of his income then does not depend on an ethical evaluation of his usefulness for the common good but precisely upon the market situation and his talent for finding the point of maximal gain on the public’s demand curve (van Klaveren, 1989: 26).

In such explicitly economic terms a corrupt civil servant is simply trying to solve the perpetual maximisation problem and in doing this to be as ‘good’ as he can. It is obvious at first sight that this framework is very different from the

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<sup>3</sup> Rational choice theory is a set of conceptual tools used in economic reasoning (though it is not restricted solely to economics but is also used in social and political analysis).

traditional moralistic one. From the moral point of view, this approach and indeed economic reasoning in general, can be characterised as (seemingly) more value-neutral and detached.<sup>4</sup>

From this perspective corruption is a good example of the perverse privatization or ‘commodification’ of government by its custodians, that is, those who are entrusted with ensuring its proper functioning. Corruption turns government services into commodities that can simply be bought on the market. In this way, what was deliberately designed to be kept separate from the free market is in fact basically purchased. The illegal market for government services is a market in which the production of these services is stimulated by the willingness to pay. This kind of ‘perversion of government’ clearly undermines the very foundations of a modern concept of government and the rule of law.

However, seen from an economic perspective bribes do –whether we like it or not– fulfil several functions. According to Susan Rose-Ackerman (1999: 9-10) not less than four manifest functions can be identified.<sup>5</sup> That is, bribes

1. clear the market and allocate scarce goods and services (otherwise provided by government at below market prices) directly according to citizens’ willingness to pay criterion;
2. act as incentives, facilitating the provision of better/more speedily delivered government services;
3. lower the costs by preventing government officials from imposing additional costs on the briber;
4. enable illegal activities to take place.<sup>6</sup>

On the micro level, obviously, all four functions benefit both the giver and the receiver of the bribe, be it by facilitating the direct acquisition of a scarce commodity, the provision of a better or faster service, the avoidance of otherwise

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<sup>4</sup> And in that respect it is closer to the ideal of the so-called geometric method or ‘moral arithmetic’ cherished by some of the forerunners of those who adopt this line of reasoning, especially Beccaria and most of all Bentham. See, e.g., Jager (2000).

<sup>5</sup> On the classic distinction between manifest and latent social functions, see Merton (1968, Par. I, Ch. III).

<sup>6</sup> In line with Becker’s (1968) concept of rational crime control, bribes in fact impose an additional cost on the main illegitimate activity. In that respect they both enable it and tax it (i.e. *de facto* punish it) at the same time.

necessary costs, or by simply securing the primary illegitimate business (through, for example, acquisition of the ‘insurance’ against prosecution that comes with bribing the police).

Now –we could speculate– if this illegal corruption market were destroyed by a successful anti-corruption policy, then the benevolent functions of bribery –for example, the provision of better/more speedily delivered government services– would probably also be eliminated. Of course, the question remains what a ‘better’ or ‘faster’ government service means and above all *qui bono*. Nevertheless, assuming that the public administrator would reach the same decision even in the absence of the bribe and assuming that bribery produces quicker public decision making, its payment seems like something positive.

But traditionally –from the categorical point of view– the distribution of certain government benefits and the avoidance of costs is simply not supposed to be determined by market principles under any circumstances. In such cases, official decision-making, even if less efficient and slower than it would otherwise be, is supposed to be conducted according to other criteria, laid out in bureaucratic rules.

Such principled repudiation of corruption is in line with the Kantian notion of an *a priori* universal moral evil without exceptions. According to the prevailing understanding of Kant his ethics demands the rigorous application of the universalistic categorical imperative which says: ‘Act only on that maxim through which you can at the same time will that it should become a universal law’ (Kant, 1913, 1788, 30). According to Kant the practical test that ought to guide us in our actions implies a universalistic attitude. One has to ask oneself the following kinds of questions: What would happen if everyone did it? What would the world look like if everyone used corruption as a means of achieving their desired ends? In the case of corruption it is clear that, if a single act of bribery were to be made a universal principle ‘it would be impossible to maintain it, because the end would be known to every one’. Corruption must logically be declared immoral because its aim can only ‘cancel and destroy itself when it is made a universal rule’ (Kant, 1963: 44, emphasis mine).

Economic analysis on the other hand does not ask these kinds of questions, nor thinks in such exclusive, universal either/or categories. Precisely not asking questions like these brings us directly to the surprising ‘finding’ of ‘cold and dispassionate’ economics: there are cases where, under specific circumstances, bribery may be beneficial. And this may be so not just for those involved, but also from the point of view of the public interest.

An economist, Nathaniel H. Leff, first elaborated this idea in 1964. At the centre of his reasoning lay an attack on a dubious tacit assumption that accompanies the usual fight against corruption. This assumption is that the administration conducting public policy is ideal: ‘clean’, highly rational, efficient and eager to serve only the so-called ‘public interest’.<sup>7</sup> It is assumed that when such a Weberian ideal-type public administration makes mistakes, these are honest, *bona fide* mistakes.<sup>8</sup> Obviously, to a greater or lesser degree, this tacit assumption is inadequate.

If this is so then corrupt decisions cannot *a priori* always be worse, less efficient, less rational and less in the public interest than those made by the administration in an imaginary corruption-free environment. As Leff argues:

Corruption is an extra-legal institution used by individuals or groups to gain influence over the actions of the bureaucracy. As such, the existence of corruption *per se* indicates only that these groups participate in the decision-making process to a greater extent than would otherwise be the case. This provides information about the effective –as opposed to the formal– political system, but in itself, tells us nothing about the content and development effects of the policies so determined. These depend on the specific orienta-

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<sup>7</sup> Leff (1964). We are assuming here that the notion of the ‘public interest’ is unproblematic. We may also note in passing that economics is in general full of such Olympian assumptions, starting with its primary tool, the rational choice theory of human decision-making.

<sup>8</sup> Tanzi (1995) suggests that this fundamental assumption of ideal bureaucratic behaviour, which was first elaborated in Weber’s *Wirtschaft und Gesellschaft* (1972, 1921), is in fact very much taken for granted also in the classical economic analysis of public expenditure and public finance.

tion and interests of the groups which have gained political access (Leff, 1964: 22).

In fact we are dealing with a kind of redistribution that has been felicitously described as an example of a ‘politically efficient reallocation’ of resources. Such politically efficient reallocation means – in modified Paretian terms – that someone was actually made better off, but at the same time *no-one was aware of actually being made worse off* (Leroy in Alam, 1985: 333).

By employing corruption, disadvantaged groups or individuals who are for various reasons driven out of the game, simply reenter by the back door, the only entry point that is (arguably) available to them. For example, in a society in which clientelism governs the distribution of power and wealth, corruption enables individuals who are not members of any of the clientelist networks to participate in public affairs. Their participation would otherwise simply not be possible (Sajo, 1998: 39).<sup>9</sup> In this way –as Sajo argued for the transitional countries of Central and Eastern Europe– corruption may sometimes have a ‘democratic’ emancipatory potential. It allows the ‘outs’ to buy their way in. At the same time, however, it is also anti-democratic as those who cannot pay remain outside. Having no money they may resort to other means (for example force) or drop out.

Still other authors try to specify the circumstances under which corruption might turn out to be beneficial. Goudie and Stasavage (1998:139) argue that the decisive criterion of whether corruption is beneficial or not is the level of efficiency of the economic system. They believe that in cases of an extremely inefficient economy (and mal-governance) corrupt acts may play the role of a ‘second best’ solution if it is impossible to bring about an improvement in government policies through legitimate/legal channels. In addition, the corrupt

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<sup>9</sup> In Sajo’s words (describing the transitional economies of Central and Eastern Europe): ‘those who possessed *the relation network capital* (author’s emphasis) became the new patrons of post-communism’. Sajo (1998: 40). On the ‘suffering in silence’ of the disadvantaged, and on forgotten groups which are unable to organise and are not a part of any of the clientelistic networks, see the classic work by Olson (1965: 165-67).

act must be isolated, which means that no spreading occurs. Obviously they presume that in some cases the ‘no spreading’ scenario is possible. On the other side they believe that when dealing with relatively efficient economies, a resort to corruption is altogether detrimental and will erode or ‘eat away’ the existing efficiency.

Therefore, corrupt administrative decision-making may not always be bad. Leff argued that corrupt acts sometimes have a beneficial effect on development as they can reduce investment/legal/political uncertainty and consequently increase investment and thus raise competition. In this sense corruption may provide an insurance against serious policy mistakes made by the government. But such ‘functionalist’ understanding of corruption may be partial in two important ways.<sup>10</sup> First, its ‘no spreading’ assumption may not be realistic. The functionalist approach focuses on a single case and does not consider its interactive impact. In other words, the functionalist evaluation of corruption neglects its systemic/epidemic potential. Second, and connected with the first reason, the functionalist approach fails to recognise the dynamic nature of corruption and the downward spirals to which it can give rise (Alam, 1989: 441).

Further, Leff presupposes that these markets for bribes function in an ideal way. But in fact they are more often than not very much distorted. A clandestine corruption market is very unlikely to result in actual improvements in allocative efficiency (Alam, 1989; Schleifer and Vishny, 1993).<sup>11</sup> The market for illegal bribes is far from pure competition, where in the ideal situation the most efficient actor prevails in the end. The potential for market failures in this shadow area is manifold and derives from the clandestine nature of the market and

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<sup>10</sup> Many commentators have labelled the interpretative scheme of Leff and similar authors as ‘functionalist’. An inherent part of the functionalist approach was a hypothesis that corruption will inevitably die out in a ‘national maturation process’ in which the pre-industrial societies with widespread corruption will become industrial and modern. We now know that this hypothesis was mistaken. For a more detailed analysis of ‘functionalist’ and critical ‘post-functional’ approaches see Werner (1983). On the foundations of functionalist analysis in general see Merton (1968: 73-138).

<sup>11</sup> Starting from the principal-agent model of corruption (see below) Schleifer and Vishny (1993) also argue that the secret, clandestine nature of corruption makes it a necessarily more distorted activity in comparison to its legal twin - taxation.

from the inherently monopolistic structure of the supply of public services (Alam, 1989: 448-52). It is true that Leff suggested his functionalist conclusions after studying third world countries where governments more or less served themselves and thus had other priorities than economic development or, perhaps, had other ideas of what their policies ought to maximise.<sup>12</sup> Overwhelmingly today corruption scholars, including economists, refuse to draw such radical conclusions. Their view is that evaluations that make sense in specific exceptional circumstances cannot be extended to the phenomenon in general. Tanzi and Davoodi (2001: 89) have described functionalist views of the potential of corruption (seen as a ‘panacea for overcoming red tape and government-imposed rigidities’) as romantic in nature and in fact obsolete in the light of the other harm that it causes.

Nonetheless, I believe that refusing to limit ourselves to the strictly moralistic analysis of corruption enables a more sophisticated debate to take place. In the Kantian framework of purely moral considerations, the economic analogies and questions discussed above would never become part of the discussion.<sup>222</sup> The notion that corruption may, in some specific circumstances turn out to be a good thing even from the public interest point of view, has encouraged the development of some more systematic and precise research questions and thus enriched the analysis.

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<sup>12</sup> The functionalist attitude towards corruption has been accused of Western bias and of having a determinist view of history (Lucchini, 1995: 49). Determinism is shown in the idea of a gradual, evolutionary development of states/societies from pre-modern parochial, to modern industrial (and allegedly corruption free) forms. Interestingly enough the same criticism was – more appropriately I believe – made of certain writers working within the moralist tradition. They consider – implicitly or explicitly – the more corrupt societies of the Third World to be morally inferior to the Western liberal democracies (Williams, 1976: 43). As much as I disagree with the proposition that the determinist understanding of history is a necessary consequence of the functionalist attitude (yes, many have argued in this fashion but this does not make historical determinism a necessary component of functionalist thought), I must agree with Lucchini that certain shared understandings of the social arena have to be present. For example a universalist analysis of corruption is simply impossible in societies that do not share the Western distinction between the public and the private sphere (See, Lucchini, 1998: 53). On these and other cultural factors that complicate universalistic comparative analysis, see Medard (1998: 38-46).

<sup>222</sup> This does not mean that moral considerations ought to be ignored either.

## **New empirical findings . . .**

Within the framework of the traditional, principled, primarily moralist ‘rotten apple’ analysis of corruption, no particular attention was devoted to the issue of concrete harm. The *a priori* moral condemnation of bribery was in principle a completely satisfactory rationale for the activation of the criminal law and other ‘remedies’. There was no need for further discussion of the damage produced by corruption and no need to produce evidence in this respect.

In today’s world those who launch anti-corruption initiatives very much welcome concrete examples and data that can illustrate as much as possible, specific corruption related harm. These data can be used to back their efforts in implementing anti-corruption strategies. In particular, empirical findings can be employed to strengthen/influence the political will that is the vital element in the success or failure of these strategies.

In the case of corruption, demonstrating concrete harm apart from moral outrage might be problematic. Corruption is, as we know, often of a consensual nature (though not, of course, when it evolves into extortion) and usually offers immediate benefits to the actors involved. On the other hand the harm inflicted may be counterintuitive, diffuse and perceived only in abstract terms, and therefore not very obvious at all. Consequently, awareness of the amount and nature of the harm done by corruption may be lacking, unless there are injured parties whose rights have been denied or violated.

In this respect scholars working from an economic perspective were among the first to provide concrete figures. Economists pointed out specific areas where corruption imposes economic and related costs on society as a whole.<sup>15</sup> Some of these findings support intuitive judgements; others are not so intuitively clear.

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<sup>15</sup> For a cursory overview of these areas, see, e.g. Tanzi (1995).

Empirical research demonstrates, for example, that levels of corruption are (not surprisingly) positively correlated with measures of bureaucratic inefficiency (Mauro, 1995), with increased but unproductive public investment in infrastructure, with low maintenance expenditure in the case of past public investment and in general with public infrastructures of poor quality (Tanzi and Davoodi, 1997).

On the macro level, Mauro has shown that corruption levels are negatively correlated with levels of investment as a share of GDP and with levels of government investment in human capital, and positively correlated with the share of the 'black' economy as a proportion of GDP (Mauro, 1995, 1998). Also, high levels of corruption decrease the volume of publicly provided health services and lower their quality. Furthermore, the level of corruption is negatively correlated with the quality of public education (Gupta, Davoodi, Tiongson, 2001).

On the other hand it is interesting to see that the general finding of a negative impact of high corruption on economic growth has exceptions that are repeatedly pointed out in the literature. Countries like Thailand, Indonesia, and northern Italy have always had relatively high levels of corruption, but their economic growth records in the last twenty years have also been exceptional. Some commentators have suggested that the explanation lies in the way corruption is 'organised' in these countries. The argument goes like this: even though in a certain country corruption is endemic, the fact that it is in a sense organised, regular and to that extent predictable, makes it less detrimental to growth than it is in cases where it is chaotic, uncertain and unpredictable (see, for example, Goudie and Stasavage, 1998: 152-53). But, of course, the question remains how much this 'organised and predictable' high corruption equilibrium can resist sudden shocks from outside. It may well happen that sudden distortions at the top significantly disrupt the hierarchically organised corruption networks, and that this, as a consequence, rapidly lowers predictability.<sup>16</sup>

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<sup>16</sup> We can look at the situation in Indonesia, for example. Corruption experts predicted that –due to economic crises, pressures to decentralise political authority after (continued...)

On the micro level, research demonstrates that corruption increases the costs of firms, reduces their rates of return and is more damaging to small than to large enterprises (Tanzi and Davoodi, 2001: 89-110). Other interesting studies connect corruption with the negative (i.e. rent-seeking) allocation of managerial talent as one of the main production factors in a society. Murphy, Shleifer and Vishny (1991), for example, have used international comparative data in order to demonstrate that individuals with above-average managerial skills will try to gain access ('allocate their talent') to those jobs that promise the highest rates of return. However, whether such jobs are so-called 'productive' or simply rent-seeking will not be counted as relevant for their decision; only the rates of return are supposed to decide. As an illustration they provide data that suggest that the number of individuals studying law –arguably a typically unproductive, rent-seeking profession– in any country is positively correlated with the level of corruption (Murphy, Shleifer and Vishny: 1991).<sup>17</sup>

If we are to draw a conclusion on the basis of this by no means exhaustive list of empirical studies produced by economists, we can say that they represent an important empirical input into what have been predominantly theoretical debates about corruption.<sup>18</sup> It is obvious that the types of harm selected and investigated in these studies are still far from complete. It is also obvious that in the case of a clandestine phenomenon like corruption the methodological and

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(...continued)

Suharto, and political instability– this country will experience a shift in the direction of more uncertain, unpredictable and chaotic corruption. Cf., Klitgaard (2001: 4-5). For a formal elaboration of the detrimental impact of such 'disorganised' corruption, see, Wei (1997).

<sup>17</sup> On the other hand, there is bad news for economists too. One recent experiment, which confirmed the results of similar previous studies, found that students of economics tend to be significantly more corrupt than other students. The authors suggest that this has more to do with self-selection than with any 'indoctrinating' effects of their studies. The experiment was conducted among students of economics at the University of Hohenheim, Germany. See Frank and Schulze (1998). Cf. also Carter and Irons (1991).

<sup>18</sup> For an extensive overview of the various economic impacts of corruption –immediate and broader – see, e.g. Goudie and Stasavage (1998).

measurement obstacles in the way of its investigation are serious.<sup>19</sup> Nonetheless, these investigations effectively support intuitive perceptions of harm with concrete figures and point to new correlations with other indicators.

## **The ‘optimum response’ suggestion**

The universe of economics is the universe of trade-offs. As Oliver W. Holmes intuitively described this view: ‘... We learn that for everything we have to give up something else, and we are taught to set the advantage we gain against the advantage we lose, and to know what we are doing when we elect’ (Holmes, 1897: 474). Trade-off therefore implies making a choice, electing, giving priority.

Somehow relating to the previous idea of ‘beneficial corruption’, the trade-off message is reflected in the notion that the optimum amount of corruption may –for a number of practical reasons– not be zero. Not in the sense that it should be positive (as for example, Leff’s arguments could be interpreted to mean, see above), but in the sense that the goal of its total elimination, even if feasible, would not be good or rational from a social welfare point of view.

By this I don’t primarily mean the truism that corruption is an inevitable element of all societies past and future<sup>20</sup> or that the prevalence of corruption is not an either/or notion but rather a matter of degree (Van Duyne, 2002). What I mean by the optimum response idea is that complete eradication of corruption –even if theoretically and practically possible– may be unwise from society’s point of view. The reason for this is that anti-corruption measures are –as economists would say– costly and use scarce resources. The total elimination of corruption (or its elimination in certain specific social areas) is just one among many policy goals that a given society values. In our imperfect world

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<sup>19</sup> See Johnston (2001) for a recent, elaborate and skeptical view concerning the possibility of measurement.

<sup>20</sup> In the latter case this claim is a nice example of fallacious inductive reasoning.

of limited resources trade-offs simply have to be accepted and indeed are accepted on a daily basis whether this fact is acknowledged by policy makers or not. There is no other way. In addition, total righteousness is not only costly in financial terms, it also leads to rigidity with all its accompanying social, cultural and implicitly negative economic impacts.

Here again economic reasoning departs from moral evaluation. The strict moral entrepreneurs want ‘eradication’, i.e., zero corruption, and they would not settle merely for the most cost-effective levels of achievement. The notion of necessary trade-offs in the area of criminal policy has never been part of the traditional discourse of experts or the public (the terms that we use – terms like ‘annihilation’, ‘eradication’, ‘suppression’ – are a demonstration of our attitude of ‘zero tolerance’). To think in terms of trade-offs is difficult to reconcile with the either/or and the condemn-or-condone frame of mind.

Here the criminologists and lawyers might envy economists their very ‘exact’ recipe as to what this mysterious ‘above zero level’ of corruption ought to be. The advice is indeed very admirable in its simplicity and elegance. It goes like this: the fight against corruption should be pursued up to the precise point at which the marginal costs of anti-corruption activities equal their marginal benefits – and no more. If the state and/or society overreacts in its attempts to suppress corruption, then the costs of the anti-corruption campaign in question will exceed its benefits. If that happens, then the society exchanges, so to say, its cow for a sheep, and ends up with a net loss. In this way the medicine turns out to be more damaging than the illness.

In other words, there is such a thing as the optimum amount of corruption and that amount is for all practical considerations most of the time not zero (despite official rhetoric based on the notion of ‘zero tolerance’). To find the optimum amount of anti-corruption effort in practice is, of course, another story. We may agree with those who observe that the people involved in anti-corruption activities in the ‘pursuit of absolute integrity’ tend to underestimate or deliberately downplay the costs of these campaigns (see, Anechiarico and Jacobs, 1996). Without the ability and willingness to compare, in good faith, the

costs and benefits of anti-corruption campaigns, the recipe based on a suggested ‘optimum amount’ becomes a pure thought experiment with no practical relevance.

The last contribution of economics to the analysis of corruption that I want to discuss is the principle-agent model – allegedly the model most suitable for explaining corruption.

## **The transplantation of models . . . .**

Economics has never suffered from a lack of explanatory models. In the case of corruption, the principal model that is utilised is the principal/agent (or the *mandataire/mandant*) model.<sup>21</sup> This is no coincidence. Its application to corruption follows naturally from the basic utilitarian, liberal tenets of the previously described market framework of discussion. What is at stake in this model is a breach of loyalty that takes place as a consequence of the maximisation of self-interest in a situation of agency relations (Cf., Cartiere-Bresson, 1998: 84-5). At stake is the erosion of trust in a principal–agent relation, which consequently lowers mutual expectations and raises monitoring costs of all kinds.

Looking at corruption, economists were quick to recognise the analogy between the typical corruption situation and the agency problem, which they had been studying for a long time as one of the central issues in so-called (neo)-institutional economics.<sup>22</sup> In addition to being a universe of trade-offs every society can also be perceived as a universe of agency relations.

At the centre of the principal-agent controversy is the issue of loyalty and trust. Or, as Banfield (Banfield 1975: 591) presented the problem:

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<sup>21</sup> See, for example: Banfield (1975), Rose-Ackerman (1975), Klitgaard (1988) (1991), Groenendijk (1997). From a criminological perspective Van Duyne (1998, 2001) has shown how this model is derived from a behavioral definition of corruption that is focused on the acts of the individual decision maker.

<sup>22</sup> For a cursory overview see, Groenendijk (1997). On the other hand the same may be said for compliance with the law. Almost by definition entire legal fields like those relating to labour, business, administrative or professional responsibility focus on this problem. Other fields of law deal with it perhaps more indirectly.

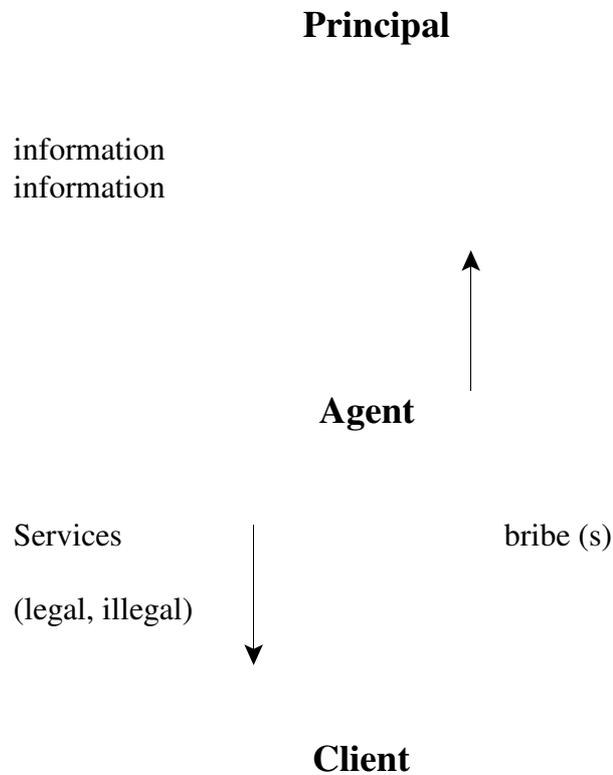
The frame of reference is one in which an agent serves (or fails to serve) the interest of a principal. The agent is a person who has accepted an obligation (as in an employment contract) to act on behalf of his principal in some range of matters and, in doing so, to serve the principal's interest as if it were his own. The principal may be a person or an entity such as an organisation or public... (A)n agent is *personally corrupt* if he knowingly sacrifices his principal's interest to his own, that is, if he betrays his trust.<sup>23</sup>

From the perspective of economics, the *a priori* answer to the question, 'When will the agent commit an act of corruption?', is again simple. Generally, an agent will corruptly betray his trust if and only if the subjectively perceived benefits of accepting the bribe outweigh the totality of the perceived costs of doing so (Becker, 1968). Given this, the problem the principal faces is predicting/forecasting these specific, subjective perceptions of his agent(s). If the principal could adequately predict his agent's subjective estimates, he could, in principle (with the skillful use of appropriate inducements), prevent all corruption. Better still, being rational he could/would prevent the 'optimum amount of corruption' as we saw above.

The very basic relations in a principal/agent model of corruption can be depicted as follows:

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<sup>23</sup> For example, Schleifer and Vishny (1993) depart from the principal-agent model and develop the concepts of 'corruption with theft' and 'corruption without theft' and analyze the consequences of corruption for the allocation of resources within the principal-agent framework.



The principle selects his agent, trains him and regulates his work in order to ensure the observance of his interests in providing services to clients. The principal also rewards his agent for his work and may provide additional bonuses to maintain his loyalty (and at the same time to increase the costs of being disloyal).<sup>24</sup>

At the heart of the principle-agent problem is the fact that the principal –whoever they may be in real life– inevitably possesses only imperfect and limited information about the agent.<sup>25</sup> This informational asymmetry causes problems and the principal must, so far as possible, find ways to overcome it.

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<sup>24</sup> See, in more detail, Klitgaard (1988: 69-74)

<sup>25</sup> Ibid.

The existing literature suggests that for the vast majority of types of corruption the principal-agent model is a good predictor of outcomes, an adequate source of variables and a rich source of hypotheses. Nonetheless, as some critics of the model have suggested, it implies that the one who is corruptly deviant is always the agent, while the one who suffers losses and has a problem is the principal. This exclusive emphasis on the deviant agent shapes the abstract designs of ideal-typical policy interventions aimed at fighting corruption.

However, we all know that principals can also be corrupt. In the mid-1970s, Banfield (1975) had already mentioned the special case of agents who knowingly bypass rules with the purpose of serving their principals' interests. He called this strange type of corruption 'official corruption'. In this case we do not have the essential element of the principal-agent model which is the breach of trust on the part of the agent. Should such a case nevertheless be called a principal-agent model of corruption or is it something else? Perhaps the 'leadership disease' metaphor as described by Van Duyne (2001) is more appropriate.

Still less, to my mind, is the traditional model adequate in modelling political corruption. In this case politicians are typically cast in the role of corrupt agents. The problem is again with the principal, but this time in a different way. The principal here is a vague notion of the interests of the people or a constituency (let us assume we are dealing with a democracy), or something that we usually call the 'public interest'. The problems and the inadequacy of a 'public office'-based principal-agent model in the setting of political corruption is well described by Williams (1999: 509):

While bureaucracy is formally committed to public service, politics is inherently partisan, with winners and losers, supporters and enemies. How can any form of partisanship be reconciled with public duty? The need to reward allies and supporters is at the root of the call 'to the victors the spoils'. The spoils are usually public resources, positions or opportunities, which are allocated on a basis of 'particularistic privilege'. In extreme cases the notions of public office and duty are so remote from the realities of political

life and so alien to the experience of both officials and citizens that it is questionable whether it is sensible to use a term like corruption (Williams, 1999: 509).

Finally, a slightly more complicated example where the principal-agent model does not fit either, is the case of the sole trader. The sole trader by definition does not have anyone above him to play the role of the principal. But let us assume that he, in the course of his business, offers contracts for tender. After that he takes a bribe from one of the tenderers and consequently awards the contract to him. The other tenderers –the losers who do not offer bribes– are in fact deceived that the tender procedure is fair (see Alldridge, 2000: 179-81). In this case corruption clearly occurs, but there is no principal, no principal-agent relation and no breach of trust. Nevertheless both the giver and receiver of bribes do exist.

Most probably one could find other examples of this kind, as exceptions are normally easier to find than examples that follow the general rule. Yet, to my mind the use of the principal-agent model as a tool for analyzing corruption is, for the time being, still the best general solution. This model has been previously applied to other areas of economic and social research and it entered the corruption debate at a relatively advanced stage. By and large, however, the observed anomalies and exceptions ought to form the basis for new, more realistic frameworks of analysis in the future.<sup>26</sup> It may well be that future models of corruption will be enriched by the eclectic, ‘cross fertilisation’ approach (Hutchcroft cited by Williams, 1999: 511). In this way, sensitivity to a variety of conceptual perspectives –each suitable for a particular kind of corruption– ought to prevail.

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<sup>26</sup> See, in this respect the attempts to formulate a coherent so-called ‘distortion of market’ approach in Alldridge (2000, 180-81).

## Conclusion

Corruption research is obviously a growing market of ideas. In the vast literature on the subject one can find many more or less compatible (and sometimes rival) theoretical frameworks that focus on its different aspects and provide clarifications. The aim of my contribution has been to present and comment upon selected contributions from economic analysis of corruption. The examples were chosen from the areas of theory building, empirical testing and policy recommendations. My intention was to show how economic analysis has enriched and increased our opportunities to acquire a more adequate grasp of the elusive subject matter of corruption.

I began by showing how an economic, market-oriented framework evolved from the early functionalist explanations of corruption to mature as the more elaborate and balanced research agenda characteristic of more recent years. One could say today that the contributions of economic analysis make this theoretical framework one of the principal approaches used in analyzing corruption.

Among the novelties introduced by the economic analysis of corruption I would point out its determination to carry out empirical testing of its hypotheses. Here as elsewhere the choice of focus is important. The empirical findings demonstrate the way in which corruption increases the marginalisation of the least advanced members of present-day societies (whether in allegedly less corrupt Western liberal democracies, transitional economies or less developed countries). Empirical findings on the detrimental impact of corruption on such universally important areas of human development and the quality of life as, for example, the quality of public investment, the quality and extent of public education and the quality of public health, are steps in this direction.

These quality-of-life pillars are closely connected with the idea of the proper role of the state in a present day capitalist welfare economy. The proper functioning of these public-sector areas may, if combined with other reforms, reduce structural inequalities and the structural exclusion of significant segments of the population.

In the future, economists should put even more effort into the theoretical analysis and empirical investigation of corrupt processes that contribute to social exclusion, and that subvert the principle of merit and efforts to increase equality of opportunity. Such effects directly obstruct the free development of talent and creativity and ought to be of concern to every society that cares about its future.

Such a research agenda could build upon the findings that already exist. It could also once again demonstrate that techniques of economic analysis are not *per se* biased in favour of alienated power and wealth as has so many times been argued by dismissive *en passant* critics.

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# Anti-corruption policies in Ukraine

Igor Osyka<sup>11</sup>

## Introduction

In 2001, the Ukraine celebrated ten years of independence. This short period has not been long enough to allow it to overcome its legacy, including very high levels of corruption, bequeathed to it by the former Ukrainian Soviet Socialist Republic. Today corruption permeates all spheres of social life, hampering democratic reforms and the development of a market economy. According to international opinion, the Ukraine is one of the most corrupt countries in the world. In terms of Transparency International's Corruption Perceptions Index, in 2000 the Ukraine occupied 88th place among 90 countries.<sup>111</sup>

Corruption in the Ukraine appears to have become a way of life. For many of its citizens it is an ordinary, everyday form of social behaviour. According to a survey conducted in one of the central regions, more than 90 % of those interviewed had paid a bribe at least once in their lives. A considerable number

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<sup>111</sup> Transparency International's Corruption Perception Index can be found at: <http://www.transparency.org/cpi/>

of those interviewed agreed with the statement: 'If you don't pay, you won't go anywhere' (Zeliuk, 2001). The most corrupt institutions are considered to be: the medical institutions; the state's automobile inspection agency; the institutes of higher education; the organs of municipal self-government, and the secondary schools. Other public institutions and spheres of social policy mentioned as being corrupt are: the social security services; customs and tax inspection and administration; education; the health protection services; the agencies of law enforcement and control; municipal executive bodies. According to the results obtained by large numbers of social researchers and in the opinion of many experts, interaction between civil servants and citizens often leads to extortion or bribery (Marunych, 2001).

The majority of the mass media are dependent upon the government or the oligarches, a group of parliamentarians and other leading politicians who have amassed tremendous wealth in the post-Soviet era by using their political offices to gain control of the Ukraine's most lucrative resources and enterprises. In some cases, businessmen with suspected ties to 'organised crime' have purchased media corporations.<sup>1</sup> According to other data most TV channels employ shady capital to stay afloat, because the tax burden is so heavy. 'People's deputies' (members of local, regional and national parliaments), political factions or committees, and local authorities all play some kind of role behind the scenes of at least one third of Ukraine's TV and radio channels.<sup>4</sup> It is highly likely that this state of affairs had a significant impact on the 2002 national election campaign.

Sociological research confirms the seriousness of the problem of corruption. According to a survey conducted by the International Foundation for Election Systems in December 2000, 93 % of Ukrainians feel that corruption is widespread and 75 % that it is *very* widespread. 96 % believe that corruption is a

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<sup>3</sup> Freedom House, 'Media Responses to Corruption in the Emerging Democracies', at <http://freedomhouse.org/reports/mediatxt.html>

<sup>4</sup> 'One-third of Ukrainian TV channels tied to MPs, local authorities', official BBC Monitoring Service - United Kingdom, 9 April 2001 at <http://globalarchive.ft.com/glo-balarchive/article.html>

serious problem and 81 % that it is a *very* serious problem. In both cases awareness of corruption has increased in comparison with previous years (Sikora, 2001).

The number of offences of bribery and criminal abuse of power and position is increasing yearly. In 2000 about 1.500 offences, and during the first 5 months of 2001 1.300 bribery cases, were recorded (*Svoboda*, 2001). During the first 6 months of 2001 alone, the State Service for the Fight Against Economic Crime detected 9.400 offences within this category. Of these, 54 % concerned the misappropriation of public funds, 11 % concerned the process of privatisation and 13 % were related to subsidies in the agricultural sector. 3.000 integrity violations were recorded in the energy sector and 1.100 in international business transactions (Litvinenko, 2001). There was also an increase in the number of people charged with bribery, 4,8 % overall, while for state officials the number increased by 13 % (*Svoboda*, 2001). Since 1996, the Ministry of Internal Affairs has recorded 6.800 cases of bribery, an increase of 20 % compared to the previous 5 years (*Crime Digest*, 2001).

In the years 2000-2001, the Ministry of Interior charged 5.000 people with the administrative offence of corruption. In May 2001 the Ministry launched a special operation, 'Corrupter', throughout the Ukraine. Within 19 days of the operation 1.600 administrative cases had been filed. However, only one quarter was eventually brought to trial, resulting in the conviction of only 265 persons, while only 29 persons were removed from office (*Svoboda*, 2001).

According to the official opinion of the Prosecutor General's Office, the crime statistics do not reflect the true extent of corruption in the country, an opinion that is shared by many scholars. As corruption is a 'consensual' crime, there are hardly any reports to the police by the parties involved, which means that the increase in numbers merely reflects the intensification of law enforcement efforts in this field. The majority of the corruption offences included in the statistics were committed 5-6 years ago. 62 % of them are petty offenses (Zeleneckiy and Kalman, 2001: 13-17).

It is clear that the problem of corruption is widely recognised in the Ukraine. According to the Head of the Parliamentary Committee on the Problems of Organised Crime and Corruption, Yuriy Karamzin, corruption in the Ukraine is rather a social and political than a criminal problem. Because of its wide-spread nature it poses a serious threat to national security (*Svoboda*, 2001).

### **The corruption of high-ranking officials**

Corruption in the Ukraine affects the highest levels of government, including members of the parliament and even the President. According to publicly available sources, the most famous high-ranking criminal in Ukraine is Pavlo Lazarenko, Ukraine's Prime Minister in 1996–97, who is suspected of having embezzled or stolen several hundreds of thousands of US dollars from public funds and of stashing some \$4 million in a Swiss bank during his premiership (Nagle, 2001). But he is not alone. Serious accusations of embezzlement of Western aid funds have been made against the former Speaker of Parliament, Olexander Tkachenko (Shelley, 1998: 658). Legal proceedings have also been started in Belgium against member of Parliament, Volkov, for cheating his Belgian partner out of about \$400.000.<sup>5</sup>

The criminal involvement of members of the national and regional parliaments is also a serious problem. One major motive for pursuing a parliamentary career is to obtain immunity from prosecution. Politicians are very reluctant to vote in favour of lifting their colleagues' immunity, even when confronted with overwhelming evidence of criminal misconduct. More than 20 members of Parliament would have to be indicted on criminal charges if they were to be stripped of their parliamentary immunity, according to Hryhory Omelchenko, a member of the Parliamentary Committee for the Fight Against Organised

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<sup>5</sup> Ukraine: Crime and Safety Report, 2000, provided by the US Embassy in Ukraine, Kiev, available at <http://www.usemb.kiev.ua/>

Crime and Corruption.<sup>6</sup> Forty-four legislators, elected to local political bodies, also have criminal backgrounds.<sup>7</sup> Members of the legislature who have personally benefited from the privatisation of state property are reluctant to pass the laws which are necessary to regulate the economy or to limit money laundering as these provisions might eventually lead to their own prosecution. They are also resisting the passage of conflict-of-interest laws.

The biggest Ukrainian corruption scandal ever, took place in the winter of 2000/2001 when President Kuchma was accused of involvement in serious crimes. Among other things, he was accused of: ordering the kidnapping and murder of journalist Georgiy Gongadze, whose body was found beheaded; threatening local officials with prison if they failed to produce enough votes in the presidential election, and condoning a grenade attack on a political opponent. Incriminating statements by the President were secretly recorded on tape by a former member of his security staff, who planted listening devices in his office. As a result, the opposition joined forces in a 'National Salvation Forum' and thousands of demonstrators protested on the streets of Kiev, demanding the President's resignation, but to no avail. The President admitted that the voice on the tapes was his, but he denied the accusations. At the Parliamentary hearings on corruption, Parliament Deputy Hrygory Omelchenko blamed the President for the disappearance of DM12 million from the State Currency Fund during his term of office as Prime Minister. Omelchenko also accused the President of knowing about the criminal activities of Pavlo Lazarenko before appointing him Prime Minister (*Svoboda*, 2001).

Fighting corruption in the higher ranks of the Government has its particularities. First of all criminal cases filed against high-level officials never go to court. Instead the evidence is used in political power struggles and in the elimination of opposition. For example, shortly after joining the opposition's cam-

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<sup>6</sup> 'Corruption Watch', Ukrainian Center for Independent Political Research, #10, 22 July 1998, cited in Shelley (1998).

<sup>7</sup> 'Ukraine: Security Chief Warns of Local Mafia's Political Ambitions', FBIS-SOV-96-219 Daily Report, 8 November 1996, cited in Shelley (1998).

paign, 'Ukraine without Kuchma', Vice-premier, Yulia Tymoshenko, was arrested and imprisoned on corruption charges. Even though suspicions about her were strong throughout the time she served Kuchma, the indictment was only brought forward after she had changed sides. The judge who released her from prison on legal grounds is now also facing criminal corruption charges.<sup>8</sup>

Sometimes facts about this kind of corruption are just ignored. In the late 1990s, Parliament initiated an investigation into bribery committed by high ranking officials, including some ministers, to the tune of \$100.000. The investigations did not go anywhere. Moreover, one of the suspects is expected to be appointed head of one of the leading government departments (*Svoboda*, 2001).

Another unusual feature of the fight against corruption among the higher ranks of the administration is the distinct passivity of the Ukrainian law enforcement agencies when it comes to initiating investigations. In the majority of well-known cases it is *foreign* law enforcement agencies that have taken legal action against high-ranking Ukrainian officials. For instance, Lazarenko was arrested in the USA and faces criminal charges in Switzerland. Recently a group of Ukrainian MPs had to pass documents on money laundering activities by five suspects from the Ukrainian President's entourage to US law-enforcement agencies. They were compelled to turn to the Americans for help because the Ukrainian Prosecutor General's Office and the President have repeatedly ignored their calls for action (*Ukrayina Moloda*, 2001).

## **Corruption involving public officials**

In the Ukraine, the lower ranks of the civil service are poorly paid but they encounter many opportunities to supplement their meagre incomes by exploit-

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<sup>8</sup> Ukraine: Charges to be brought against judge who freed ex-deputy premier, BBC Monitoring Service - United Kingdom; 5 April 2001 at <http://globalarchive.ft.com/globalarchive/articles.html?print=true&id=010402003508>. In a recent court decision Yulia Tymoshenko was acquitted.

ing their positions. One of the factors facilitating corruption among civil servants is the legislation currently regulating business activities which includes as many as 32 laws, 18 presidential decrees, and over 80 resolutions of the Government. Furthermore, 32 ministries and departments have an authority to issue licenses for various activities and more than 30 government bodies have the power to inspect private enterprises at almost any time and for any reason (Pidluska, 1998). The major problem with such inspections appear to be the fact that clear rules and regulations do not exist. Entrepreneurs are therefore often unaware of what exactly a particular governmental inspection body requires or what its powers are. In short, the current regulatory system allows inspectors to use a great deal of discretion, resulting in a bureaucratic labyrinth and vast opportunities for corruption, if not extortion. For example, according to an International Finance Corporation survey, the average Ukrainian manager spends two days per week on inspection issues. Firms have to respond to an average of 78 inspections and approximately 68 written inquiries annually (Pidluska, 1998).

A survey of managers of private enterprises released by the Ukrainian Market Reform Education Program in June 1998 found that 96 % of the respondents claimed that very high taxes were the reason privatised firms stagnated and failed, and cited current tax policies as reasons for massive tax evasion and the expanding 'black economy'. Other reasons included corruption among officials of the national authorities (59 %), corruption among local civil servants (52 %), and state regulation and interference with business activities (36 % of the responses) (Pidluska, 1998).

Unsurprisingly, this situation has led to an extension of the black economy. The latter's size is estimated to be as much as 40-45 % of GNP. It probably deprives the public purse of 10-12 billion hryvnias (\$2-2,5 billion) per year (Svoboda, 2001). It is estimated that seven out of ten enterprises operate (partly) in the 'black economy'. These companies have no protection from corruption, and are thus open targets for bribery, extortion and other forms of graft. Specialists have calculated that in the energy sector the amount of hidden finance

is about \$1 billion, while in the agricultural sector about \$1.3 billion remain unrecorded (Litvinenko, 2001). According to specialists, investments made in the black economy using the proceeds of corruption, range from \$200 to \$600 millions (*Svoboda*, 2001). Money laundering is a related problem of considerable dimensions, one that causes as well as feeds corruption. Last year the Tax Inspector's Office along with the Militia recorded the names of 20.000 phantom enterprises involved in this type of business (*Ukrainian*, 2001: 4). Specialised firms involved in converting national currency into dollars acquired through the underground economy, including the criminal underworld, and which also specialise in the falsification of documents, are flourishing in the Ukraine. According to the estimates of some specialists, about \$15-20 billion, unofficially exported from Ukraine, are kept abroad, compared with about \$13 billion in loans that the Ukraine has obtained over the last 10 years (Uschapovskiy, 2001: 48).

## **Corruption in law enforcement**

Corruption within law enforcement agencies is another huge problem for the Ukraine. The police are considered to be the most corrupt agency. At the same time they are very transparent in terms of their efforts to fight internal corruption. In 2000, 87 police officers were charged with the 'administrative' offence of corruption (*Svoboda*, 2001). In 2001 more than 200 police officers were similarly charged (*Imenem Zakonu*, 2001). The rise in the figures is strongly connected with the active anti-corruption policy of the recently appointed Minister of Internal Affairs, Yuriy Smirnov. However, even these numbers fail to reflect reality. Unfortunately, the conditions under which police officers have to work, though rarely mentioned, are harsh, to say the least. For example, the average wage of a policeman is about 250 hryvnyas per week (approximately \$50), while he requires approximately 120 hryvnyas (approximately \$23) to pay his utility bills (gas, water and electricity) and his rent. This means that he is left

with 130 hryvnias (approximately \$27) to meet his other daily expenses.<sup>9</sup> Moreover, two years ago policemen were deprived of special social benefits, resulting in a de facto reduction of their income of about 40 %. Little wonder that they supplement their incomes by abusing their positions.

Besides low salaries, insufficient funds are available to provide basic requirements of the job such as vehicles, fuel, computers and communications equipment. Even modest articles like pens and paper are scarce. The lack of funds reflects a negative attitude to law enforcement, which is bound to encourage corruption further.

In spite of all the difficulties, measures have recently been taken to control corruption by and within the Police. New subdivisions responsible for anti-corruption activities within central government agencies were established within the Organised Crime Department of the Ministry of Internal Affairs, and interregional anti-bribery subdivisions have also been organised within the State Service for the Fight Against Economic Crime.

During his third week in office, the new Minister of the Interior issued a Programme to Fight Corruption in the Organs and Divisions of the Ministry of Internal Affairs. The programme aims to reduce corruption within the police force and consists of 17 paragraphs. It includes the following measures: the development of a programme to enhance discipline in the force and detailed recommendations for corruption prevention; the organisation of seminars on anti-corruption legislation for law-enforcement officers; the carrying out of intelligence operations aimed at detecting corrupt officers; the creation of a database on the welfare of Police Chiefs; the implementation of a screening system with an emphasis on the personal characteristics, business interests and business activities of new recruits; facilitation of the development of Charity Funds in support of law enforcement agencies to which business people can

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<sup>9</sup> Ukraine: Retired policemen stage protests, demand social payments, BBC Monitoring Service - United Kingdom; 20 March 2001 <http://globalarchive.ft.com/globalarchive/article.html?id=010320004089&query=ukraine#docAnchor010320004089>

transfer money (instead of giving bribes in cash to individual officers); the facilitation of research, and the issue of a booklet, 'Police corruption and its prevention'; the development of relations with the mass media in order to make the fight against corruption more transparent (*Imenem Zakonu*, 2001). However, the predominance in this programme of repressive measures casts doubt on its likely effectiveness.

### **Action taken by the state to combat corruption**

The State Tax Administration has taken certain steps to address the problem of corruption. For example, it signed agreements with leaders of the business community and the Ukrainian Union of Industrialists and Entrepreneurs to organise joint working groups to devise new tax laws. A public Board of the Authority was established and the vice-president of the Union was appointed a full member of the Board. Another measure taken by the Administration has been to set up a confidential hotline in every city. Any person can make an anonymous call to submit information on persons involved in extortion or bribery. The information will be sent to two independent directorates: one for anti-corruption policy and the other for the inspection of human resources. They will verify the information and act depending on the results of the investigation (*Ukrainian*, 2001).

Since 1998, with the President's 'Decree on the Deregulation of Entrepreneurship', the situation regarding the arbitrariness of the business inspection system has begun to improve. This decree provides a rigid framework for the inspection of private businesses. A firm cannot be inspected more than once a year. The inspections of different control bodies must be conducted simultaneously under the coordination of the Tax Administration. The exception to this provision is criminal investigations. When these are involved, any company can be inspected as many times as necessary. This still leaves room for abuse by law-enforcement officers; for, taxes remain mercilessly high creating incentives for businesses to bribe tax officials rather than pay the taxes themselves.

Despite these actions, the government's efforts to fight corruption are not considered serious or effective by the ordinary citizens. 58,7 % of those surveyed believed that the Government was not doing anything to curb the growth

of corruption or effectively to fight it. Moreover, 77,1 % of the respondents agreed with the statement that some of the activities of government agencies even encourage the spread of bribery (Marunych, 2000). Such ineffectiveness of the government's efforts is often explained by the absence of the necessary legislation and the shortcomings of existing laws. The analysis offered below will reject this explanation. It will show that many laws and provisions are in place, but that the government has failed due to a lack of political will and a failure rigorously to enforce existing laws.

The most important laws in this field are the Law 'On the Fight Against Corruption' (October 5, 1996, no. 356/95) and the corresponding chapter in the Ukrainian Criminal Code. These two pieces of legislation contain definitions of offences of corruption together with sanctions against them. These laws establish two classes of offence of corruption: administrative and criminal.

#### *The law 'On the Fight Against Corruption'*

This law defines three categories of administrative offence:

1. acts of corruption;
2. failure to comply with preventive measures against corruption, and
3. failure to initiate and conduct investigations into suspected act of corruption.

The *act of corruption* is the illegal acquisition of material values, services, privileges or other benefits, including the receiving or accepting of goods or services by purchasing them at a price (or tariff) that is clearly lower than their actual value (Art.1(2)(a)), and the receiving of credits or loans, or the purchase of securities, real estate or other property, by making use of preferences or privileges beyond the ones determined by the legislation in force. (Art.1(2)(b)).

*Corruption prevention* measures include (1) special restrictions on the activities of public officials and other persons authorised to act on behalf of the Government. Such restrictions include a ban on offering special services to individuals or firms by using the powers of one's position, and a ban on involvement in business activities, directly or through mediators; (2) provisions for the compulsory declaration of income; (3) an obligation to notify the authorities when opening a foreign currency bank account in a bank based abroad. Special sanctions are applied to top ranking officials in ministries, state-owned enterprises and other public institutions who fail to control corruption within the organisations for which they are responsible or who fail to report violations of the law to the relevant law enforcement agencies (Art. 10). The withholding

of evidence, or the falsifying of evidence, relating to an alleged act of corruption are also administrative offences (Art. 11).

The law applies to: (a) civil servants; (b) parliamentarians; (c) village, town or city heads and chairmen of district and oblast councils; (d) military personnel (other than those enrolled for fixed terms of active duty); (e) heads of ministries, state-owned enterprises and other public institutions; (f) persons required to draft reports on corruption offenses. Other persons subject to the legislation include: judges; prosecutors; investigators; security service officers; tax administration and tax police officials; customs service officials; members of staff in courts, prosecution agencies and other agencies authorised to exercise the functions of the state.

Those found guilty of offences under the law can be punished by: (a) a fine of fifteen to one hundred times the amount of a gross minimum income followed by dismissal or suspension from employment; (b) removal from office, in the case of elected representatives; (c) withdrawal of the right to vote or to occupy elected positions depending on the kind of offence and official position of the offender.

The complexity of the law makes it difficult to enforce. The present court practice may clarify this. Courts often allow improperly drafted reports to be used as evidence in legal proceedings with the result that innocent persons are sometimes brought to trial. Courts sometimes impose fines that are lower than those prescribed by the Law. Unmotivated discharges of guilty persons sometimes take place. The prescribed length of proceedings is not always observed. Judges sometimes ignore breaches of legal procedures and tolerate delays in verification of the circumstances of offenses, the drafting of reports and the referral of such reports to the courts for review (Supreme Court of Ukraine, 1998).

One in 10 state officials was convicted of the offence of administrative corruption in the first six years after the Law on Corruption came into force. At the same time no charges were pressed for failure to control corruption or for the withholding of evidence relating to corruption (Supreme Court of Ukraine, 1998; *Svoboda*, 2001).

#### *The New Criminal Code.*

Ukraine's new Criminal Code has been in force since September 2001. Like its predecessor, the new Code contains a chapter on crimes in the public service. It introduces some changes. First, it creates certain new offences connected with

the corrupt activities of law enforcement officers. These offences concern the abuse of power or official position and the soliciting of bribes. Such offences are sanctioned more severely than the other offences covered in the chapter, being punishable by terms of imprisonment ranging from 5 to 12, and 3 to 7 years. In general, however, punishment for these kinds of crime is –with the exception of the soliciting of bribes– more lenient in comparison with the old Code. For example, under the old Code, acceptance of a bribe amounting to more than 500 times the value of a gross minimum income, or by a top ranking official, was punishable by ten to fifteen years imprisonment, the confiscation of property and a ban on occupying certain positions or engaging in certain activities for up to five years. Under the new Code the same crime is punished by eight to twelve years imprisonment, the confiscation of property, and a ban on occupying certain positions or engaging in certain activities for up to three years. By contrast, the soliciting of bribes was punishable by up to two years imprisonment under the old Code but is punishable by two to five years imprisonment under the new one. Fines have been explicitly introduced as a new, alternative form of punishment for bribery and related crimes. For example, an alternative punishment for acceptance of a bribe is a fine of 750 to 1500 times gross minimum incomes. The crime of aiding and abetting bribery has been excluded from the Criminal Code because, since 1960 when the old Code came into force, it has been very rarely resorted to.

There are also other measures aimed at curbing corruption. An anti-corruption programme adopted in 1996 encompasses the criminal law, civil education, technical assistance and financial reforms. The Ministry of the Interior assumed responsibility for enforcement of the programme, while the Presidential Administration was assigned a key role in its implementation. Fewer than two thirds of the specified actions have been implemented, though those that have been implemented have failed to produce positive results in terms of eliminating factors conducive to corruption. Although a number of high-profile arrests were made after the programme was enacted, most of those detained have been ‘classical’ bandits rather than the high-level perpetrators whose actions are most damaging to the economy.

In 1998 the President approved the National Programme to fight corruption for 1998-2005. The Programme was accompanied by a statement of principles. Both documents describe the causes of corruption in government and include a number of different measures to be taken to reduce corruption. All of them are of a very general character, however, while there is no control mechanism in place to ensure their implementation.

In November 2000, a Presidential decree entitled, 'On additional measures to fight corruption and other violations in the economic and social spheres and steps to ensure the economical use of state funds', was signed. In accordance with this decree the Cabinet has set a ceiling on the prices of cars, furniture and equipment provided to top state officials and lower-ranking civil servants (*Segodnya*, 2001: 4).

A Cabinet Resolution was recently adopted providing for the publication of corruption statistics. These statistics are intended to include criminal and administrative cases and the numbers of individuals found guilty of corruption.

Other laws regulating different aspects of the anti-corruption effort include:

1. the 'Law on the organisational and legal foundations of the struggle against corruption and organised crime';
2. the Presidential Edicts, 'On the Co-ordinating Committee for the fight against corruption and organised crime', 'On immediate measures to facilitate the fight against criminality' and 'Complex Programme on the Prevention of Crime for 2001-2005';
3. the Cabinet Enactment entitled, 'On the enforcement of the 'Law on the Fight Against Corruption' by central and regional organs of executive power'.

Besides these there are a number of legislative proposals being considered by Parliament. They include:

4. the proposed 'Law on the transparency of information produced by the government and high-level state officials', the aim of which is to give wider public access to official information;
5. the proposed 'Law on the investigative committees of the Verhovna Rada' and the 'Law on special prosecutors', both of which aim to facilitate parliamentary control of corruption in government.

The aforementioned laws have established a system of governmental agencies and given them wide-ranging powers designed to help them combat corruption. These agencies are the Coordinating Committee for the Fight Against Corruption and Organised Crime and special departments with responsibility for combating organised crime and corruption within the Ministry of Internal Affairs, the Tax Militia, the State Security Service of the Ukraine and the offices of the General Prosecutor.

## **Activities in civil society**

One of the Government's achievements in the anti-corruption campaign has been the growth of non-governmental organisations involved in the corruption issue. In 1999, a coalition of NGOs called 'Freedom of choice' was established in the Ukraine. A year later they initiated the National Anti-corruption Programme. The Programme is an independent system of actions by non-governmental organisations with the aim of preventing and reducing corruption in the Ukraine. The main objective is to change attitudes towards corruption and to eliminate its root causes. At present, within the framework of the Anti-corruption Programme, 132 NGOs are working in different regions of the country on about 40 projects aimed at monitoring the Government, providing legal assistance and education to citizens, and promoting the transparency of national and regional governments (Sikora, 2001).

1999 also saw the establishment of Transparency International-Ukraine. The organisation has adopted the name, 'Ukrainian transparency and integrity'. Today, public-private partnerships for integrity have been established in three oblasts. These activities have concentrated on bringing a wide range of organisations together to develop anti-corruption strategies and to strengthen the links between civil society and the Government by providing the tools necessary to interact effectively with government agencies in the fight against corruption.

## **Conclusion**

There is no need to conclude by offering a list of measures that are necessary if corruption is to be reduced in the Ukraine. They are all included in the relevant documents of the Ukrainian Government and they are all listed in accessible literature and publications on the subject.

The situation I have described leads me to the conclusion that at present the legal and organisational framework necessary successfully to reduce corruption

in the country does exist. What is lacking is the political will in the highest levels of the government, where corruption is still rampant, to make this framework effective.

In the Ukraine the tactics are clear but the strategy needs to be altered. Attitudes to anti-corruption activities should be different. First of all it is necessary to reconsider the terminology. The word 'fight' is not the best term in my opinion as it implies victory as the final outcome. But in this field it is not possible to win in the sense of eliminating corruption. In the current situation all anti-corruption activities should be aimed at a *reduction* of corruption. Furthermore, the main focus of anti-corruption efforts should be on its serious manifestations. Petty corruption like gifts to superiors, doctors and teachers are part of national 'customs' or 'folklore' and should (for the time being) be taken into account only if they have serious consequences or involve extortion. The mentality of the people is too important to be brushed aside in an all-or-nothing fight. Third, it is very important to understand that a reduction in corruption can only be achieved gradually. It takes time and, given its 10 years of independence and its legacy of 80 years of 'socialism', the Ukraine is probably in rather good shape in terms of anti-corruption activities, even allowing for the corruption that goes on in higher places. Fourth, cooperation is very important at both national and international levels. Inside the country the government should cooperate closely with civil society. Internationally it is very important to share experience more actively with countries that are close in terms of history and mentality. For the Ukraine these are the states of the former republics of the Soviet Union and the countries of Eastern and Central Europe.

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# Political corruption in Italy

James L. Newell<sup>1</sup>

## Introduction and definitional terms

As Pizzorno (1992) points out, the potential for corruption is inherent in all liberal democracies because in such systems the function of political intermediation between electorate and government is largely carried out by private agents (that is, parties) using private resources and because the activity of intermediation is not separable from activities designed to gather the resources necessary to carry it out. But if corruption can thus arise *in* democracies, it is also subversive *of* democracies (della Porta and Vannucci, 1999a: 9). This is due to its tendency to undermine confidence in the application of universalistic criteria in the exercise of power and therefore, ultimately, its tendency to undermine confidence in democratic institutions themselves.

From the latter point of view, corruption in Italy presents something of a paradox. On the one hand it is perceived as extensive. Thus, at the time the *Tangentopoli* (or 'Bribe City') scandal broke in 1992 (and as the associated *Mani Pulite* (or 'Clean Hands') investigations appeared subsequently to confirm) the phenomenon seemed to have spread to reach a point where Ginsborg (1995: 3) could express the view that Italy was 'one of the most corrupt democ-

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racies in Europe'; and more recently, in 1998, Italy was still achieving the relatively low score of 4.6 points in terms of Transparency International's Corruption Perceptions Index (della Porta and Vannucci, 1999a: 13). On the other hand, notwithstanding its extent, there is plenty of evidence of the sense of public outrage, from time to time provoked by the revelation of individual episodes of the phenomenon, while judicial attempts to combat it continue in all their strenuousness. Paradoxically, therefore, corruption scandals in Italy actually bear witness to the strength of democracy in that country and to the vitality of at least some of its public institutions (della Porta and Vannucci, 1999a: 11).

But what *is* 'corruption', exactly? Broadly speaking, it seems possible to identify three types of approach to this issue. First, there are the approaches (such as the ones taken by Morris (1991) or by Rogow and Laswell (1970)) that see the phenomenon as being tied to acts that in some way violate the 'public interest' or infringe the 'common good'. The obvious problem with these approaches is their dependence on the values of the researcher. Who is to say what the 'common good' is? It is even possible to argue that corruption may sometimes actually *promote* the 'common good', as teleological functionalists have occasionally maintained. They take their point of departure from Durkheim's (1938: 67) argument that deviance 'is a factor in public health, an integral part of all healthy societies' because the emotional reaction against it serves to reinforce the norms it challenges.<sup>2</sup> Given such difficulties, a second group of writers tie the phenomenon to the infringement of legal or non-legal norms. This, however, gives rise to the problem that the term becomes difficult to apply in cross-national comparative analysis for the simple reason that norms vary

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<sup>2</sup> Interestingly, a similarly 'functional' line of defence was not infrequently taken by Italian politicians caught up in the *Tangentopoli* scandal when they sought to defend themselves by arguing that corruption had been essential to the financial viability of political parties and that these, in turn, were essential to the viability of any healthy democracy (della Porta and Vannucci, 1999a: 10). In thus arguing that corrupt party funding had been a necessary and accepted feature of Italian politics (and for what became a famous example of this see Sergio Moroni's suicide note cited in Colaprico 1996: 31-2), these politicians reflected a cultural norm that law and its enforcement is, to a degree at least, to be considered negotiable (LaPalombara, 1987: 48) this being a trait which, in the author's view, as well as that of LaPalombara, speaks positively, not negatively, to democracy and democratic values in Italy (see Newell, 2000a).

between societies. One is forced to conclude that acts that are corrupt in one society may not be so in another. Consequently, a third approach is one that takes its inspiration from principal-agent models. This is the approach we shall adopt here, defining ‘political corruption’ as the secret violation of a contract involving the delegation of responsibility and the exercise of some discretionary power by an agent who, against the interests or preferences of the principal, acts in favour of a third party from whom he receives a reward, and where the principal is the state or the citizenry (della Porta and Vannucci, 1997: 231-2). Admittedly, this definition only apparently solves the comparability problem for it remains for the principal to decide what is to be permitted and what not (Bull and Newell, 1997: 173). However, it is a definition that is adopted in the belief that in the final analysis the researcher must simply choose that conception that most accords with his purposes and disciplinary tastes. For, as Lancaster and Montinola (1997: 191) imply, there is no definition that has been devised so far that is without *some* weakness or another.

### **Newness, scale and varieties of corruption**

Whatever definition one chooses to adopt, a common feature of the kinds of acts most analysts would want to regard as corrupt –at least if the advanced liberal democracies are being examined– is their illegality. In other words, although inadequate as a criterion for defining corruption, illegality does nevertheless tend to be a ‘de facto’ characteristic of the phenomenon. Of course this places huge obstacles in the way of its empirical measurement. One can only get access to known cases, such as those that have come to the attention of the judicial authorities or those that are reported in the press. Yet movements up or down in either of these indicators may reflect, not increases or decreases in the underlying phenomenon, but changes in legal norms; changes in the likelihood that, once discovered by someone, given acts are brought to official notice; changes in the reporting practices of the press - and so forth.

In spite of this, there is consensus among observers of the Italian case concerning both the newness and the scale of corruption, at least in broad terms.

The reason is that while corruption has been a more-or-less salient feature of politics in Italy for many decades, the 1950s and 1960s were a rather quiet time in this respect. There was then a significant acceleration in the spread of political corruption from round about the mid 1970s so that when *Tangentopoli* was at its height two decades later it was possible to say that corruption had become systematic and routine.

Mauro Magatti (1996: 33-4) suggests that there were at least four factors involved in the relative quiescence of the early post-war decades as compared to the later period. First, in the 1950s and 1960s corruption was an elite phenomenon involving small numbers of large firms and the leaders of the political parties. Petty corruption involving public officials and local administrations was still a relatively isolated phenomenon. Second, networks of connivance were initially restricted and lacking in solidity, thus making illicit transactions difficult to undertake and hence correspondingly rare. Third, the Cold War-induced ideological conflict between Christian Democrats and Communists placed heavy restrictions of an ethical-normative nature on corruption and on the ends to which it could be put. And finally, rates of economic growth in the initial post-war period were sufficiently high as to ensure that demands for improvements in the quality of life would be channelled into entrepreneurial activities that involved few contacts with the political parties.

Later, as we shall see in more detail below, these conditions changed. The places of the old politicians and administrators were gradually taken by new arrivals of a lower moral calibre. Networks of entrepreneurs and politicians socialised in the practices of corruption spread and gained in solidity. Ideological conflict declined in intensity. Rates of economic growth slowed down, with demands for improvements in the quality of life as a consequence being increasingly directed at the state and increasingly satisfied by the parties staffing the state through the activities of clientelism and corruption.

While bearing in mind the difficulties of interpretation noted above, we can cite the figures given by Cazzola (1988) which show that from the mid-seventies, reported occurrences of corruption and embezzlement involving the public administration rose significantly: from 412 in 1975 to 1,065 in 1985. Meanwhile, annual averages rose from 514 in 1963-1975; to 681 for 1976-1978; to

808 for 1979-1986. As regards press reports of corruption, the influential national daily, *la Repubblica*, carried reports of 117 separate cases of political corruption between 1976 and 1979; 110 between 1979 and 1983, and 208 between 1983 and 1986 (Cazzola, 1988: 67).

This growth appears to have touched the entire spectrum of relations between the state's politico-administrative apparatus on the one hand, and civil society on the other. Adapting the conceptual framework suggested by Rose-Ackerman (1978), Magatti (1996) deploys a four-fold categorisation to describe the varieties of corruption that contributed to the overall growth in the phenomenon from the mid-seventies. The first three of the categories concern the application of legislation, the fourth, the production of legislation.

First, there is the corruption that arises as a result of the power to take decisions concerning the allocation of public money: what to buy, who to buy it from, according to what criteria and so forth. This category of corruption is typically deployed in the area of public works contracts and that of tendering for the supply of goods and services. These two areas appear to have accounted for about a third and a quarter respectively of the recorded cases of corruption between 1976 and 1992 (Cazzola, 1993; Magatti, 1996: 39).

Second, there is the corruption that arises from the power to supply resources, public services and permits for the carrying on of a range of economic activities. Particularly significant within this category seems to have been that range of activities associated with town planning, building permits and planning permission. These can have a dramatic impact on the value of private land holdings and appear to have accounted for some 16 per cent of the recorded cases of corruption between 1976 and 1992 (Cazzola, 1993; Magatti, 1996: 39).

Third, there is the corruption that arises from the power of public officials to investigate private conduct and impose penalties in case of illegality. Particularly significant in this category seems to have been the area of tax and tax inspection. Here corrupt exchanges were given significant encouragement by the complexity of the relevant legislation (Magatti, 1996: 52). For, by making both inspectors and inspected aware of the near certainty that some irregularity could be found if it were searched for, the laws thereby gave the two sides a

‘built-in’ incentive to deal with the situation by reaching some mutually beneficial accommodation.

Finally, there is the corruption that arises at the level of Parliament and its members when in exchange for items of legislation of benefit to single firms and/or powerful economic groups, individual politicians personally, or their parties, receive payment for their role in securing such legislation. The extent of corruption among parliamentarians that was uncovered by the *Mani Pulite* investigations produced one of the most striking and frequently cited sets of statistics concerning corruption in Italy. It revealed that by the time the scandal broke, the sphere of public policy making had to a large degree degenerated into a market place for mutually profitable exchanges and the construction of alliances between economic and political potentates willing to stop at nothing to achieve their objectives (Magatti, 1996: 55). Hence, by November 1993, requests for the lifting of parliamentary immunity had been issued against over half the members of Parliament, while almost all the members of the government that had held office at the time the 1992 election was called found themselves under investigation – as did the general secretaries of all the governing parties along with significant proportions of the parties’ administrative officials and local-level leaders.

If these data testify to the degree to which corruption had, by the early 1990s, spread to the highest levels and become systemic, then the declarations of politicians seeking to defend themselves by arguing that since everybody was corrupt no-one was corrupt, were revealing of the degree to which, when corrupt practices become routine, they fail any more to arouse any sense of culpability on the part of those who engage in them. Here, for example, is what the Socialist deputy, Sergio Moroni had to say in his 1992 suicide note to the President of the Chamber of Deputies:

An enormous veil of hypocrisy (shared by all) has for many years shrouded the mode of functioning of the parties and the means whereby they have been financed. The establishment of regulations and laws that one knows cannot be respected is a typically Italian way of doing things - one that is inspired by the tacit assumption that at the same time it will be possible to agree upon the

establishment of procedures and behaviours which, however, violate the very same regulations . . . .

I began my political activity in the PSI when I was very young, only 17 years of age. I still remember passionately many political and ideological battles, *but I made a mistake in accepting the 'system', believing that accepting contributions and help for the party was justified in a context in which this was the normal practice ...* (Colaprico, 1996: 31-2; author's translation and emphasis).

## Causes of corruption

The individual moral failings revealed by Moroni's note are, however, inadequate for the purposes of *explaining* corruption and its spread. A key concept here is that of *partitocrazia* (literally 'partyocracy'), referring to the major parties' penetration of vast areas of the state and society. Implied by this is, first, a considerable degree of overlap between the personnel of the parties on the one hand and interest groups and administrative positions on the other. This overlap makes it difficult to draw clear boundaries between these entities and to know, in any given case, in what capacity individuals are acting. Second, it implies recruitment to positions primarily according to the criterion of political party-affiliation and only secondarily, if at all, according to technical competence to perform the job in question. Thirdly, it implies that political power is exercised through the party leaders more than through an executive accountable to Parliament (Partridge, 1998: 69). True, it is reductive (and indeed the sheer variety of types of corruption discussed above of itself suggests that it is reductive) to assume that corruption in post-war Italy can be regarded as nothing more than a manifestation of the positions of power occupied by the political parties (Magatti, 1996: 53). Nevertheless, it remains the case that the concept of *partitocrazia* would have to play a prominent role in answers to most 'Why?' questions about corruption in Italy in recent decades.

The importance of *partitocrazia* lies in its role in sustaining and perpetuating a clientelistic mode of managing power relationships. Clientelism has in turn

fed corruption by virtue of what it has in common with the latter, namely, the fact that it represents an exercise of power that is unrestrained by rules embodying the value of *universalism*. That clientelism has for long been a well-established feature of Italian political culture is to be explained by a large number of historical circumstances. All of these are in one way or another connected to the absence, in the age of state- and nation-building, of an influential bourgeoisie and hence the weakness of the Italian state in the period following Unification. These were circumstances which made it difficult for the authorities rigorously to apply the distinctive bourgeois values of law and order, responsibility and fair competition, and to mediate, in the general interest, the short sighted rapaciousness of the dominant classes' individual components.

The Italy that came to be created in 1861 was socially and culturally highly diverse. Most importantly, industry was largely confined to the north-western Milan-Turin-Genoa triangle, leaving an awesome economic gap between the North generally and an agrarian, largely feudal, South (Allum, 1973a: 20). Public policy aimed at the development of a capitalist economy. It thus favoured the interests of the embryonic northern entrepreneurial class, from whose ranks a large proportion of parliamentarians were drawn, while penalising southern industrialisation, because of '[t]he familiar cumulative effects of every growth process operating through external economies' (Allum, 1973a: 21). At the same time, the privileges of the southern notables and landlords had to be preserved in order to obtain their support for the new regime and its policies. The consequence of this was to ensure that from the outset, the Italian state would enjoy low levels of legitimacy. For on the one hand, the alliance between the northern bourgeoisie and southern gentry, which Unification represented, perpetuated the desperate poverty of the great mass of southern peasants. On the other hand, it perpetuated the oppression of the southern landlord. To make matters worse, the Catholic Church, which lost large chunks of territory as a result of Unification, refused to recognise the new state and forbade Catholics to participate in political life, while suffrage restrictions closed off channels for the legitimate expression of grievances anyway.

Under these circumstances, Unification failed to produce a national, integrative ideology and hence the state had difficulty in asserting its authority against

alternative, unofficial, power centres organised on a clientelistic basis around local elites (and in extreme cases around organisations such as the Mafia). Consequently, once the fascist interlude came to an end, several of the conditions for the development of *clientelismo partitocratico* were already in place. On the one hand, the state's weakness meant that in the power vacuum created by Fascism's fall, colonisation by the parties of numerous sectors of the state would be particularly easy. On the other hand, the same lack of authority of the state had, prior to Fascism, allowed local notables to manipulate state institutions in their own interest, structuring the system around networks of personal relationships based on exchanges of favours. Thus, 'the clientele chains that had sprung up during the pre-Fascist period and stayed alive under Fascism were re-created after World War II with a partisan overlay' (Tarrow, 1977: 69).

Two further factors were important in the development of *partitocrazia* and clientelism after the war. One was the establishment of universal suffrage in the specific economic circumstances of the immediate post-war years. Clearly, possibilities for the development of organised political parties would always be limited until the suffrage extensions immediately prior to, and following, the fascist period. Therefore it was not until after the war that mass-membership parties could develop on a long-term basis. At the same time, these parties found themselves operating in a country significant parts of which were poor. Unemployment was high and traditionally, much economic activity, especially in the South, had been beholden to the state for its implantation and development (Allum, 1973b: 166). In the South in particular, suspicion and mistrust frequently made collective action difficult. The immediate post-war years thus saw the emergence of a new class of party politician who, once elected to public office, found, on the one hand, that he controlled access to the principal source of wealth, and on the other hand, that he was faced with a mass of isolated individuals (electors) each in search of a protector.

In such circumstances, the nature of the post-war party system created a definite incentive for the parties to seek to outdo each other in the supply of the kinds of protection (favour) electors sought. First, the Cold War-induced ideological conflict saw the permanent exclusion from any potential role in government of the second-largest party, the Italian Communist Party (PCI), while the

fascist legacy ensured that the extreme right would likewise be excluded from any role in government. If this ensured the permanence in office of the centre-based Christian Democrats (DC) and the smaller parties in their orbit, it also meant that clientelism became an effective substitute for competing on the basis of policy programmes - which would have undermined that minimum degree of coalition solidarity necessary permanently to exclude left and right extremes in the first place. This in turn facilitated the development and consolidation of *partitocrazia* by stimulating the parties to engage in the *lottizzazione* ('sharing out'), on the basis of relative bargaining power, of ministerial and administrative posts, to be exploited for patronage purposes.

*Partitocrazia* and the clientelism it sustained are central to an understanding of corruption in Italy because of the way in which, in the management of power, clientelism undermines incentives to remain within the confines of what is lawful and because of what it has in common with corruption. As far as the first of these issues is concerned, clientelism allows power to be exercised in an arbitrary fashion because it represents a denial of the value of universalism. In human relationships this is 'the principle that all persons should be evaluated in the same way, regardless of who they might be' (Sharrock, 1977: 507). Because clientelism denies the significance of impersonally applied rules, those whose power depends on it face lower moral costs in resorting to illegality to defend their positions whenever these are threatened. If they do decide to resort to illegality, then the corrupt exchange presents itself as a (more or less feasible) possibility that has much in common with the patron-client relationship. It too is based on an individualistic exchange of interests. It too denies the value of universalism. The positions that allow their incumbents to patronise clients frequently provide access to the resources that can provide the basis for corrupt exchanges. Engaging in clientelism may be considered a crossing of the line towards corruption (Van Duyne, 2002).

While the centrality of clientelism in Italian political culture has traditionally provided fertile terrain for corruption, since the latter is an exchange relationship, explaining its actual incidence in recent years also requires mention of the specific demand and supply factors that have been at work in this time period. For, while cultural factors may create a certain predisposition, or vulnerability,

to corruption, in the final analysis its actual incidence will be a function of its costs and benefits for each of the parties involved.

On the supply side, a major role in the Italian case appears to have been played by the decline of Cold War-ideological conflict, and the growing costs of politics. Since Italy's main party of opposition was a communist party (the largest in the West), the country's principal political division in the early post-war decades more or less directly reflected the global contest between the two world power blocks. In other words, Italy was contested terrain between the blocks (della Porta and Vannucci, 1999b: 14). Under these circumstances, the DC and its governing partners on the one hand and the PCI on the other, received generous funding from the United States and the Soviet Union respectively. This funding allowed the parties to develop strong and costly apparatuses, with a network of local headquarters, publications, paid personnel and so forth (della Porta and Vannucci, 1999b: 14). However, with the declining intensity of the conflict and the emergence of *détente* in the 1970s, funding from the super powers began to dry up.

Meanwhile, the costs of politics, already relatively high in Italy, were increasing. On the one hand, Italy's list system of proportional representation, allowing the voter to express preferences among his chosen party's slate of candidates, raised the costs of campaigning beyond what they would otherwise have been by ensuring that candidates from the same party were just as close, if not closer rivals for the coveted parliamentary or local council seats as candidates from other parties (Newell, 2000b: 49). On the other hand, the media and office revolutions were pushing up information and propaganda costs making necessary large investments in order to provide party offices with the necessary equipment (Rhodes, 1997: 65-6). Of course, funding from abroad was only one source of finance for the parties, but for a variety of reasons it was difficult to compensate for this loss and meet the increased costs by raising the flow of income from other sources. For example, the very decline in ideological conflict that reduced the flow of funds from abroad likewise reduced the flow of less venal donations from private organisations within Italy. The 1974 party finance law, introduced in the wake of the oil scandal of that year, outlawed donations from public-sector companies and thus banned a source of funding that had

previously been legal.<sup>3</sup> So there was a corresponding increase in the propensity of parties and individual politicians to seek funding by offering to sell their services and decisions. Moreover, if the opportunities to do so were already abundant – this by virtue of parties’ and career politicians’ entrenchment in the interstices of Italy’s large public sector through *partitocrazia* – then they were increased by the expansion of the welfare state in the 1970s (Rhodes, 1997: 66).

On the demand side, the most important stimulants to the purchase of favours seem to have been: bureaucracy and administrative inefficiency (Rhodes, 1997: 65); entrepreneurs’ lack of trust in the efficiency and impartiality of public action (della Porta and Vannucci, 1999a: 16); and a situation of legislative uncertainty. In such circumstances, a system of corrupt exchanges offered entrepreneurs a means of re-establishing the degree of certainty and predictability in their dealings with their environment that they needed in order to be able to make rational business decisions (Magatti, 1996: 69). For example, in the construction and transport industries, the formation of cartels that would then seek to establish stable relationships with the world of politics, offered a means whereby the market could be divided among the contracting parties. Outside competitors were excluded, and hence finance and investment managed and planned more rationally (Magatti, 1996: 71-4).

If all this is true, then it raises a question of timing. After all, a lack of confidence in the impartiality and efficiency of the public authorities was long standing. Therefore, if the demand for illegitimate decisions and illicit services really *was* stimulated by this, why was corruption pervasive only from the mid-1970s and not before? Part of the answer to this question has to do with the fact that when corrupt exchanges are marginal phenomena, the search for reliable partners will be difficult, while as networks become established, corruption will then spread in a self-generating way (della Porta and Vannucci, 1999b).

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<sup>3</sup> For details see Rhodes, 1997.

## **Dynamics of corruption**

Corrupt exchanges violate contracts that agents have made with principles. Therefore, they are inevitably deemed to be illegitimate entailing a risk of punishment. This risk will be inversely related to the number of individuals already involved in corrupt exchanges. One of the reasons for this is that in a society where bribery is rare, it will be widely assumed that the behaviour of at least most other people is honest. To the extent that such expectations are met, there will be a more-or-less intensely felt moral aversion to bribery, which is an essential condition for the maintenance of the trust that is itself essential if interactions are to continue without individuals having to worry about the possibility of being cheated. Consequently, attempting to bribe in a society where bribery is rare carries with it a relatively high risk of being reported to the authorities as a consequence of the moral outrage provoked by an overture that threatens the security of everyone. Conversely, in a society in which bribery is widespread, expectations concerning the honesty of others will be correspondingly lower with the result that the moral barriers to bribery will also be lower. For each individual will feel that if others cannot be relied upon to be honest in their dealings with him, then he is under little obligation to be honest in his dealings with them. Consequently, attempting to bribe in a society where bribery is widespread is unlikely to provoke moral outrage and therefore, all other things being equal, to carry a relatively low risk of being reported to the authorities.

It is the inverse relationship between the extent of corruption and the risks associated with it that in turn allows it to feed on itself. The more extensive it is, the lower the likelihood that it will be reported. The lower the likelihood that it will be reported, the fewer the risks it involves. The fewer the risks it involves, the less likely it is that the anticipated costs will outweigh the anticipated benefits for other individuals contemplating corrupt exchanges. As these individuals are as a consequence also drawn into networks of corruption, so do the networks spread and so does it become more difficult to eliminate them as the resources available to investigate corruption are deployed more thinly. This in turn lowers the moral and material costs even more, and so the phenomenon

spreads still further. It was essentially because of this logic and this mechanism that, given the initial conditions described above, ‘the system of bribes’ (della Porta and Vannucci, 1999b: 15) then expanded so dramatically from the mid-1970s onwards, spreading until, by the time the *Mani Pulite* investigations began, it had ‘thoroughly infected every sector of the state, local, and central administrations, public agencies and enterprises, the military apparatus and the bureaucracy, including the judicial power’ (della Porta and Vannucci, 1999b: 15).

Della Porta (1993; 1996; 1998), and della Porta and Vannucci (1997; 1999a; 1999b) have provided detailed descriptions of the actors and resources caught up in these mechanisms in order to provide an analysis of how the logic manifested itself empirically in the Italian case. Their analysis suggests that the processes involved were typified by the gradual transformation that overtook the party most heavily implicated in the early 1990s scandals – the Socialist Party (PSI) – in the period after it first joined the government in 1963. This event led to a major split in the party as a result of which it lost contact with its working class and trade union base. Because of the significance of political affiliation for appointment to so many positions in the public sector, the PSI began gradually to attract less ideologically motivated ‘business politicians’ for whom the party became a source of upward mobility.

Since public positions were distributed as rewards for loyalty to a particular political leader, it was necessary for the business politician to develop *ad personam* electoral and party followings. For these served as resources to be placed at the disposition of political patrons when decisions about the distribution or renewal of positions were being made. And since business politicians had a tendency to view public resources as personal property, their followings would often be constructed in ways that were themselves corrupt. For example, in exchange for public works contracts, licences to trade and so forth, firms could be induced to offer employment to individuals indicated by the politicians. Persons taken on in this way could be relied upon to be faithful to the politician ‘because of their fear of losing their jobs if they [ratted]’ (Allum, 1973b: 162). Even more importantly, they could be relied upon to influence others of their group. Once public-sector positions had been acquired, the acceptance of

bribes, and other abuses of responsibility, offered the means of acquiring even larger clientele followings and thus opportunities to accede to positions of ever-increasing importance. For example, part of the proceeds of corruption could be invested in improving the effectiveness of the politician's political machine. Or, as revealed by Mario Chiesa, the first politician to be caught up in the *Tangentopoli* scandal, proceeds could even be used to pay the subscription fees of party members (della Porta and Vannucci, 1999b: 79).

If processes such as these meant that clientelism and corruption were mutually reinforcing, then the spread of the latter was further reinforced by the two specific needs which the business politician had to fulfil if he was actually to realise the potential for corruption inherent in the office he held. One was the need to ensure that the persons for whom he acted corruptly respected their side of agreements reached; the second, the need to ensure the silence of those who might otherwise report him to the authorities.

The first need arose from the impossibility of using the authorities to force clients to pay if they decided to cheat. As della Porta and Vannucci (1999b: 45-6) explain:

Illegal by definition, there can be no legal recourse for settling disputes within the corruption market. The risk of being 'sold a lemon' in such a situation can become extremely high, also because the transaction is nonsimultaneous in nature and one party must rely on the word of the other. Having secured their payoff, politicians might fail to deliver what they have promised; an entrepreneur, having won the contract, may forget to pay the bribe promised.

In southern Italy, transactions were often underpinned by making use of the services of organised crime which, in effect, substituted for the unavailability of the coercive power of the state by producing and selling protection as a *private* good. In such circumstances, the corrupt politician would receive, from organised crime, the services of the threat of physical violence in exchange for which he would use relationships of connivance with the judicial authorities to provide protection from threats of prosecution. Elsewhere, protection was offered by other politicians or officials. As was explained to an entrepreneur who wanted a piece of land declared buildable:

You have to honour the commitment. If you say, 'I'll give you the six million when I see the building regulation plan' and then you don't pay, you might as well shoot yourself... Afterwards, every time you have to deal with the Commune, the Province, the Region or whatever, they throw it out.... Don't think it's so easy to say, 'So I've managed to cheat them' (*L'Unità*, 4 April 1992, p. 7, quoted by della Porta and Vannucci, 1999b: 60).

The second need was met by two means, one of these being to implicate potential 'squealers' themselves in the process of corruption by offering a share of the bribe money - in effect, exchanging silence for part of the proceeds. As the *Mani Pulite* investigations revealed, the corruption networks to which such agreements gave rise were frequently highly organised. For example, within Milan's municipal transport company, whose board was staffed by political appointees, illegal funds would be deposited in a common pool to await distribution to the parties represented on the board, according to agreed and precise percentages. Silence was also secured by fear, the business politician using an ability to influence things to create a reputation for being powerful. As long as he was successful in this process of 'image management', the business politician *was* powerful, for '[i]f someone possesses a sufficiently robust reputation, few people will dare to challenge the power underlying it' (della Porta and Vannucci, 1999b: 58). And once the spread of corruption had reached a certain point, creating large numbers of such seemingly powerful business politicians, it simply was not rational for the single individual or entrepreneur to risk being cut out of the 'charmed circle' by a refusal to pay bribes – whose payment thus implicated him too in the network of illegal exchanges.

### **Anti-corruption laws, campaigns, remedies and solutions**

On 17 February 1992 Mario Chiesa, then the Socialist head of a Milanese old people's home, the Pio Albergo Trivulzio, was arrested 'in the act of taking a 7m lire (US\$4,000) bribe from the owner of a cleaning company' (Gilbert, 1995: 126). A high-living individual, Chiesa was almost a caricature of the business politicians who had come to dominate the internal life of the governing

parties during the 1980s: a person with little or no sense of civic morality, with an almost exclusively instrumental attitude to politics, with virtually no ideological or programmatic commitments to speak of, and having a semipublic reputation for arrogance as well as a special ability to operate ‘in the shadows’ (della Porta, 1996). As a business politician, Chiesa had built his career through the skilful combination of corruption and the clientele practices described in the previous section. As head of the Pio Albergo Trivulzio, he was also in charge of the large number of properties owned by this institution, a circumstance that had allowed him to establish stable, but corrupt, relations with the firms with which he did business. This enabled him to further his career by collecting bribes and building command of a personal packet of votes among the firms’ employees. His ambition was to consolidate and extend his position such that he might one day lay claim to the position of Mayor of Milan. This required him to ingratiate himself with Bettino Craxi, the PSI leader. Unfortunately for Chiesa, Craxi did not appear to have as high a regard for the health manager as the latter, outwardly at least, had for him. Hence, when Craxi refused to help Chiesa, publicly dismissing him as a *mariuolo* (‘little rascal’), Chiesa decided to empty the sack (Newell, 2000b: 54).

Chiesa’s confession set off a domino effect as his naming of names led others to confess and they in their turn to do likewise. In this way, the investigation quickly brought to light the massive networks of ‘mutually beneficial linkages’ (Waters, 1994: 170) that existed between the political parties and groups of entrepreneurs in the city. Subsequently the investigation spread out to catch in its nets politicians, officials and entrepreneurs in an increasing number of towns and cities in other parts of Italy as well. By the end of 1993, it had reached the highest levels of the state, and by 1995, the annual number of accusations of corruption and extortion had reached 1,065 cases involving 2,731 persons – as compared to an average of 252 cases involving 365 persons per year between 1984 and 1991 (della Porta and Vannucci, 1999b: 3). *Tangentopoli* precipitated the most serious political crisis in the history of the postwar Republic, leading to the complete disintegration of all the parties of government; a restructuring of the party system itself, and attempts at institutional and constitutional reform that led observers to view Italian politics as

having begun an (hitherto incomplete) process of transition from a 'First' to a 'Second Republic'. How, then, can *Tangentopoli* be explained?

In the first place, the exposure of corruption was nothing new in Italy, nor were attempts by the judiciary to use its powers to combat it. Indeed, largely owing to the influx of a new generation of younger magistrates from the early 1970s, a novel interpretation of the judge's role had gained ground within the judiciary. From being a passive *bouche de la loi* (Guarnieri, 1997: 158) the judge was to adopt a far more active stance in many social areas. Through penal initiatives in the areas of workplace safety, environmental pollution, tax evasion, fraud, corruption and so forth, he began to act as a 'problem-solver', attempting to tackle the great social issues of the day (di Federico, 1989: 33). Moreover, judicial independence of other branches of government, the independence of prosecutors' offices of every other office, as well as the specifics of criminal procedure, all created considerable scope for judicial activism. Why, then, did *Tangentopoli* only happen in 1992 and not before?

There were three factors involved in the timing. First, in the past, politicians had usually been able to defend themselves from the threat of judicial investigation using their powers of *insabbiamento*. This is a term meaning, literally, 'covering with sand'. It is used to refer to informal processes whereby, despite the legal powers available to the judiciary, politicians had been able to manipulate proceedings in politically sensitive cases so as to avoid personally undesirable outcomes. Much of the power of *insabbiamento* derived from the informal relations of connivance which politicians had been able to establish with individual members of the judiciary whereby judicial favours could be exchanged for political favours. Given such relations, the hierarchical organisation of the judiciary could be used – via marginalisation, transferral or pressure by superiors more sensitive to 'political needs' (della Porta, 1998: 11) – to curb the activities of excessively zealous junior magistrates. In 1992, on the other hand, the powers of *insabbiamento* were considerably diminished by the great popularity of the investigations.

First of all, the outcome of the 1992 elections, bringing, as they did, defeat for the two largest governing parties, the DC and PSI, made it clear to investigating magistrates that the political class that had ruled Italy since the end of the

war was rapidly losing its authority, and that the investigations were likely to have the solid backing of public opinion. Since the 1940s, support for the traditional parties of government had rested on Catholicism (in the case of the DC), anti-Communism and the distribution of particularistic favours including corruption. Growing secularisation had progressively weakened the first of these pillars, while the second collapsed with the fall of the Berlin Wall in 1989. If this left the third pillar, its effect had long been to undermine the authority of the political class as a whole, even while allowing this or that component to retain support of an instrumental nature as long as they were able to continue to produce the necessary favours. Consequently, when the investigations led to accusations being levelled against formerly powerful political leaders, the effect was to curtail 'their capacity to sanction those breaking the previously all-prevailing conspiracy of silence'. This then set in motion a kind of 'virtuous circle' whereby ever increasing numbers of individuals were willing to collaborate, induced by the decreasing likelihood of effective threats from powerful politicians implicated as a result of revelations (della Porta and Vannucci, 1999b: 267). In this, the judicial investigators were assisted by their own strategy of offering suspects the prospect of being held in custody if they refused to cooperate or immediate release if they did. In addition they also used custody to keep the suspects ignorant of whether, and how much, fellow suspects might have confessed. This made it impossible for suspects to agree to keep silent and created a rush to confess that could be likened to a series of falling dominoes.

The second factor helping to explain why *Tangentopoli* unfolded when it did is the end of the Cold War and the crisis of the PCI. In the immediate aftermath of the collapse of the Berlin Wall it had transformed itself into a non-communist party with a new name – the Democratic Party of the Left – and had undergone a major split leaving it considerably weakened in electoral terms. This made it clear to investigating magistrates that they could now attack the governing class without running the risk that, in so doing, they would thereby enhance the likelihood of the Communists coming to power. It also made it clear to entrepreneurs that, for the first time in 45 years they 'could foster a crisis of the political system without risking [their] own survival' (Calise, 1993: 556).

Finally, the economic effects of corruption also played a part in the timing of the scandal. On the one hand, by perpetuating the maladministration on which it fed, corruption led to a growing fear on the part of entrepreneurs that they would be unable to compete effectively in the increasingly integrated European markets. On the other hand, by bringing ever-increasing levels of public indebtedness (since politicians had to spend if they were to have the contracts on which to collect bribes) corruption raised the prospect of Italy being excluded from the single currency envisaged by the Maastricht Treaty. In a situation, then, in which public spending had drastically to be curtailed, the rising costs of corruption eventually became unsustainable. As one entrepreneur put it:

The enterprises would pay but the politicians were no longer able to help them. All of them, whether large or small, ended up in the same boat and so one would pay more in order to undermine the others: it was an infernal mechanism. It was pointless . . . . Public funds gradually diminished and the number of aspiring firms increased (della Porta, 1993: 236).

## **Impact of political corruption and its exposure**

As mentioned, the impact of *Tangentopoli* was to bring about a complete disintegration of the traditional parties of government and a complete restructuring of the party system. As far as the first of these effects is concerned, the impact of the scandal was financial, organisational and electoral. Financially, it eliminated major sources of funding by disrupting the illegal system of party financing associated with corruption. Organisationally, it fatally undermined the membership bases of the parties while creating divisions and splits among party leaders who sought desperately to find a way out of the crisis. Electorally, the scandal led to unprecedented losses of voting support.

The financial impact was straightforward. During the 1970s and 1980s the parties had become increasingly dependent on corrupt forms of funding while facing mounting accumulated debts. Therefore, by reducing the amounts available from illegal sources of financing to just a trickle, the investigations pushed

all the traditional parties fairly quickly towards bankruptcy. In the spring of 1993, PSI indebtedness was placed by the resigning party secretary Benvenuto at 160 billion lire, while unofficial estimates placed it at 300 billion lire. The historical Via del Corso headquarters in Rome were put up for sale, as were most PSI real estate possessions. By May that year, when leadership of the collapsing party was passed on to Ottaviano del Turco, the day-to-day functioning of the party ground to a halt when, due to unpaid bills, the party's telephones and electricity were cut off. This state of affairs was paralleled in the Social Democratic Party where the resignation of its secretary, Carlo Vizzini, in March was provoked in part by the party's bankruptcy. Vizzini – who soon became caught up himself in the burgeoning investigations – had discovered that the rent on the party's headquarters had not been paid for years and that, with debts amounting to 20 billion lire, public finance had been going straight to the Banco di Napoli, the party's principal creditor (Rhodes, 1997).

The second effect of *Tangentopoli* was to wreak havoc on the parties' organisations thus bringing about their virtual disintegration. The spread of corruption itself had considerably weakened the parties' organisational structures by favouring the recruitment of individuals with all those personal skills necessary in order to create and consolidate networks of relationships based on mutual obligations – discretion, tact, pragmatism, affability – while penalising policy and ideological commitments. If policy and ideology had therefore become less salient features of the internal life of parties, this then affected the motives for joining them in the first place, creating a vicious circle. A gradual decline in the numbers of ideologically committed members tended to reduce the attractiveness of membership for those with similar ideological beliefs while growth in the numbers of members whose motives were venal tended to make membership more attractive for those of like mind. The growth in the extent to which the internal life of parties was based on such instrumental relationships weakened them organisationally by virtue of the concomitant decline in reserves of members' loyalty and commitment. Hence, when *Tangentopoli* destroyed the basis for instrumental relationships by effectively cutting off the resources that sustained them, it left the parties vulnerable to complete collapse. Moreover, even those members who were motivated by shared values rather

than material concerns were likely to resign as a result of the alienation caused by the revelation of matters of which they had been kept ignorant. The sudden collapse of the parties is reflected in the dramatic decline in membership levels which, according to one estimate, went down from 3,804,000 in 1991 to 1.330.000 in 1993 when *Tangentopoli* was at its height (Follini, 1997: 250).

Finally, *Tangentopoli* led to a haemorrhage of electoral support for all the traditional parties of government. Having already in 1992 polled its lowest share of the vote at any general election in the post-war period, by November 1993 DC support, at 11 per cent, stood at less than a third of its post-war average. The PSI's collapse was such as to reduce it to the small change of electoral politics, but none of the traditional governing parties was spared. Facing break-aways of local federations and the desertion of members *en masse*, after June 1993, the five parties from which governments had continuously been drawn since 1945 had largely ceased to exist as credible political forces.

Meanwhile, the wave of popular revolt against the governing class had led to the emergence of a 'referendum movement' spearheaded by dissident Christian Democrat Mario Segni. This sought to dislodge the political class from its positions of power by taking advantage of the constitutional provision allowing for the holding of referenda on proposals to strike down laws and parts of laws when requested by a minimum of 500,000 electors. By this means, Segni and his followers managed to secure the holding of a referendum on a proposal to strike down part of the law governing elections to Italy's second chamber, the Senate. The effect of this would be to bring about a *de facto* change of the electoral system from a proportional to a majoritarian one. In turn, since the two chambers of the Italian parliament have identical legislative powers, this would *per forza* oblige Parliament to change the system for the Chamber of Deputies as well. A majoritarian electoral system would require parties on the left and on the right to reach stand-down arrangements in single-member constituencies in order to avoid the risk of parties on the other side of the left-right divide taking seats at their joint expense. This in turn would encourage the emergence of a bipolar party system, giving voters, for the first time, the power to determine the political composition of governments directly. Thereby, with governing parties seeking to retain office, and opposition parties seeking to dislodge the parties

of government, both coalitions could be expected to abstain from corruption as the price of retaining the confidence of the electorate. The referendum, which was held on 18 April 1993, registered overwhelming support for the proposal and a new electoral law was passed in August 1993. It provided for three-quarters of the seats of both chambers to be distributed according to the single-member simple plurality system, one quarter to be distributed proportionally.

Largely as a consequence of the new electoral law, elections since 1993 have seen the emergence of an essentially bi-polar party system even though the poor cohesion of the competing line-ups indicates that the new system is far from being consolidated. The period has also seen various other reforms, of varying incisiveness, of relevance to corruption. Some of them have been sponsored with the explicit intention of combating corruption. Others have had implications for the phenomenon as a by-product of other ends (della Porta and Vannucci, 1999a). Into the first category can be placed the constitutional amendment of October 1993 relaxing the system of parliamentary immunity which had frequently prevented investigating magistrates from initiating investigations into suspect parliamentarians—as can the establishment, in September 1996, of a Commission of the Chamber of Deputies with the remit of formulating anti-corruption proposals. Into the second category can be placed a series of measures concerned with the privatisation of large public enterprises together with a number of others concerned with the reform of public administration.

The second group of measures has in many instances had a significant impact on those conditions known to favour corruption. Lengthy administrative procedures; an absence of checks on the possibilities of collusion between politicians and public employees, and a lack of accessibility of the public administration are examples of some of the conditions that have been tackled. On the other hand, measures passed with the explicit intention of combating corruption have been few and of an ambiguous character. One of the two proposals of the anti-corruption Commission that had been passed by the end of 1998, for example, actually narrowed the circumstances in which a defendant could be found guilty of abuse of office (della Porta and Vannucci, 1999a: 41).

In a country where the exposure of corruption had been so dramatic as to lead the traditional governing parties to be displaced by completely new parties

in a new, bi-polar system, such legislative inactivity may at first sight seem strange. It is to be explained by three factors. First, there is the incomplete consolidation of bi-polarity in Italy's multi-party system – something that has allowed the lack of inter-party consensus, and the system of interlocking vetoes to which this gives rise, to continue to act as a considerable obstacle in the path of would-be reformers. Second, though reform and political renewal were, when *Tangentopoli* was at its height, central battle cries of many of the parties that now dominate the political stage in Italy, these cries no longer have the political usefulness they once had now that the old parties have been displaced. On the contrary, since a number of the politicians that have stepped into the places of the old ones have not themselves been free of suspicion of corruption, it has in some quarters been asserted (and in others with equal vociferousness denied), that continuing judicial activity against corruption has developed into a kind of witch-hunt against individual members of the political class. This lack of consensus at elite level on the value and significance to be attached to continuing anti-corruption investigations in part accounts for the third factor, namely, that with the passage of time, popular interest and enthusiasm arising from periodic revelations of corruption has gradually given way to a lack of interest, and in some instances even hostility towards judicial investigators. As della Porta and Vannucci (1999a: 188) point out, recounting a telling episode:

If in the early years of *Mani Pulite*, voters were highly sensitive to politicians' involvement in the investigations, today, not even the prosecution and repeated sentences passed against the leader of *Forza Italia* Silvio Berlusconi have damaged the electoral base of his party, or thrown a question mark over his position as leader of the opposition, instead provoking street demonstrations against the judicial investigators.

## Conclusions

The prospects, then, for Italy to move from the category of 'quite corrupt' countries to one or other of the less corrupt categories are, for the moment uncertain. On the one hand, recent years have seen the appearance of several

signs that would augur well for the future. Prior to the early 1990s, the spread of corruption had been encouraged by a political system whose features also fed the popular discontent that would ultimately play a significant role in bringing about corruption's exposure. With the exclusion of left and right extremes and the inability of the governing parties to compete on policy, *clientelismo partitocratico* developed as a significant alternative basis of party competition. This in turn sustained administrative inefficiency and a situation of policy paralysis as the governing parties, in their perpetual squabbles over the distribution of posts to be exploited for patronage purposes, were unable to achieve any kind of governmental stability. It therefore spoke positively to likely future developments when, in the early 1990s, the judicial investigations that brought down a by-then largely corrupt political class were sustained by a wave of popular indignation. This sentiment also fuelled pressure for a significant change in the electoral system. In a situation in which the traditional parties were disintegrating, the new law facilitated the emergence of a restructured party system with strong bi-polar tendencies as a result of which it was reasonable to anticipate significant measures of reform. Some significant changes have been made, particularly in the area of public administration.

On the other hand, hostility towards the political class and its actions is not the same as widespread support for reform of the conditions that facilitate corruption. In this context it is worth noting Ginsborg's remark that the dramatic revelations of the early 1990s have 'not translate[d] into the sort of cultural revolution that had rocked Italy in 1968-69' (1996: 27). While bringing down an entire political class, the *Tangentopoli* investigations failed, beyond intellectual circles, to induce any widespread reflection on those cultural traits of clientelism, nepotism and tax evasion in which the activities of the *Tangentopoli* defendants were ultimately rooted. Since, in a democracy, parties and their leaders are by definition responsive to the wishes and moods of voters, the failure of Parliament to tackle corruption more energetically than it has done in recent years is necessarily tied, to a degree, to these popular attitudes. What is especially worrying is the possibility that popular attitudes and elite-level inactivity come to reinforce each other.

At the elite level, what is now the main party of government, *Forza Italia*, more than any other party symbolises individualism and the persisting absence of a well-developed sense of civic awareness. Because the principal party of the centre-right is a party of the stamp of *Forza Italia*, essentially a vehicle for the political ambitions of its rich leader, effective action against corruption could well continue to elude Italian reformers despite the profundity of the changes in the country's party system. For in continuing to insist that the judicial investigation of the accusations of corruption that have been levelled against him would amount to a political witch-hunt, *Forza Italia*'s leader, Berlusconi, reinforces that deeply-rooted particularistic strain in Italian culture according to which law and its enforcement is ultimately assumed to be negotiable (LaPalombara,1987). This can only perpetuate corruption and other acts of impropriety for, while it is in the interest of citizens collectively that an overall state of legality prevails, if politicians and parties tolerate *illegality*, then individual citizens will begin to find that their own interests are best served by acting illegally themselves. As is true of so many other features of Italian political life at the present time, in relation to the phenomenon of political corruption, the country must be seen as being *in mezzo al guado*. The direction it takes out of the ford is one of most interesting features of Italian politics that awaits to be discovered as the country's history unfolds over the coming years.

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