

Financing of Organised Crime

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Almost on the same day there were two different events related to organised crime. On 7 April 2015 at the Bajakovo border crossing between Serbia and Croatia more than 140 kilograms of heroin was seized by the Croatian police. The drugs were hidden in the double bottom of a car driven by a 46-year-old citizen of Turkey, while in the passenger seat was a 26-year-old German citizen of Turkish origin. The market value of the seized drugs is estimated at more than HRK 42 million or 5.5 million euros.

A few days earlier, the Centre for the Study of Democracy from Sofia published a comprehensive and interesting book entitled *Financing of Organised Crime*¹. Its editors are Michael Levi, Ognian Shentov and Boyko Todorov. Organised criminals need significant financial resources to start their business, to launch new products or cover new areas; to meet periodic financial needs, to cover any incidental or regular expenses and/or to support the potential vertical or horizontal expansion of their enterprise.

Various researches have shown that financiers are often behind the funding of large-scale trafficking of commodities like cigarettes or drugs. Although they have an important role in the whole business, financiers mostly remain outside the interest of analysis of organised crime at EU level and such information is largely omitted. Usually, legal enterprises secure external capital through borrowing, equity financing, or reinvestment of past internal profits. This raises the question about whether such possibilities also exist in illegal markets. Are there black market banks and investors? And, if this is the case, how do they differ from their legal counterparts?

The many authors in the book analyse three forms of organised crime: the illegal market of cocaine, the illegal market of a tobacco products and VAT fraud. The aim of the study is to examine the sources, mechanisms and approaches behind the financing of organised crime, through collecting and analysing empirical data in order to enable more effective investigations of organised crime and money laundering. Furthermore, the report also tries to scrutinise the possible interlocking relations between criminal structures and businesses and legitimate financial institutions; to examine cash flows in criminal enterprises and the costs and profits of doing illegal business.

The methodological approach of the study presented in the report includes a broad collection and use of a multiple set of both secondary and primary data. The data collection for the study was based on four key elements: published literature (different reports by academics, institutes, governments, law enforcement reports by EUROPOL, INTERPOL, National Crime; media sources in many EU member states; survey and follow-up interviews with law-enforcement, judicial, and other government officials; and case studies were performed for Belgium, Bulgaria,

¹ The book is available on: <<http://www.csd.bg/artShow.php?id=17317>>.

Czech Republic, Estonia, France, Greece, Italy, Spain, Sweden and the United Kingdom. Each research partner – University of Trento, Italy; Teesside University, UK; and the Centre for the Study of Democracy, Bulgaria – was responsible for covering 9 EU member states and identifying potential respondents through their informal networks and official communications with the relevant governmental and law enforcement institutions.

From the various authority bodies in each EU member state, 8-10 persons were asked to take part in written interviews. They were officers in the police, financial police, border control, tax and customs authorities and officials from public prosecutors or organisations responsible for the fight against organised crime. Around one third of the persons invited returned their completed interviews. The second step of the data collection was to make further telephone interviews the goal of which was to enhance and broaden the information collected via the survey. The respondents were asked to explain and elaborate on the details provided and to illustrate the evidence with experiences from their practice. Of the 83 participants who returned the questionnaire, approximately 23% agreed to give fuller accounts in a more detail interview.

In 10 countries (Belgium, Bulgaria, Czech Republic, Estonia, France, Greece, Italy, Spain, Sweden and the United Kingdom) more detailed researches were carried out in at least one of the selected markets. These countries and the specific markets were determined by the initial stages of the research according to evidence from the literature review, statistical data and the availability of locally-based researchers. In-depth interviews were accomplished with country officials and other knowledgeable actors such as investigative journalists and business people, as well as criminal entrepreneurs. In-depth interviews with 225 participants were conducted in all 10 countries. Active criminal entrepreneurs were often identified from previous work in the field of organised crime and on some occasions these criminal entrepreneurs introduced acquaintances or collaborators to the researchers.

As the cocaine market is central to the global drug problem, after these introductory remarks and explanation of the methodology, the first chapter is dedicated to cocaine trafficking in Europe. Most data show that on a whole, this market is on the decline. Cocaine entering Europe is smuggled often by sea using container shipments, or through transport by air or postal services, as well as by using drug couriers (i.e. swallowers). Besides the more traditional entry points of cocaine into Western and Central Europe (primarily Portugal, Spain, the Netherlands and Belgium, which are countries for the further distribution of cocaine), the Black Sea area and the Balkans are more and more involved in the diversification of cocaine trafficking routes. A key entry point for cocaine directed to South-Eastern Europe is Greece, which has recorded some of the largest port seizures among all the countries. Studies conducted and data collected confirm the presence of fluid,

horizontal and loose criminal networks within the European cocaine market that have replaced the traditional hierarchical organisations. The first model has high levels of flexibility and adaptability regarding business opportunities and contingencies. It is structured into independent units – connected by key individuals (brokers) – with clearly defined roles and duties along the trafficking chain: managers coordinating group activities, persons organising logistics (like recovery and purchase of vehicles and equipment) or dealing with the recovery of drugs and/or money. Brokers are essential because they are responsible for the charges for connecting potential partners, buyers and suppliers, employees and employers and they need networking skills specifically adjusted to the cocaine business.

The Report explains the routes of trafficking operations and sources of capital for their financing and settlement of payments including advanced payments, revolving credits and multistep payment arrangements. Very interesting is the structure of the total costs, consisting of transshipment services (€10,000 to set up an import-export company) and payments to complicit legal entrepreneurs owning import-export companies at 30% of the value of the load; compensations to drug brokers, who earn from 3-4% up to 10% of the value of the load at the EU price; drug couriers are paid per trip with cash or with a percentage on the value of the transported loads, the prices of which range from €600-€6,000 per kilo transported within the EU; drug mules – swallows that are paid per trip with travel and accommodation expenses covered from €2,000 to €3,000; money counters and collectors receiving €400 to €550 per day; money couriers earning around €1,000 (salary and expenses) per trip; bribes to officials in the range of from €1,000 to €10,000 per container; fees for protection: in order to ensure the security of the trafficking operations and the recovery of cocaine in the destination countries and other costs and fees in the form of a share of profits of the deal at around 10%.

Regardless of these costs, organised crime makes huge profits due to significant differences in the cocaine purchasing and selling price found in South America and EU countries. For instance, the cocaine retail price in the UK is €70,000 per kilo but it can be bought for around €2,700 in South America. Profits margins depend on several factors – availability of cocaine in an observed market, the retail prices (which differ in various EU markets), the quantity acquired, quality of the drug (level of purity), and risks taken/encountered (primarily seizures and arrests).

A very important factor is access to capital in critical moments because criminal entrepreneurs need to ensure the safety of trafficking (fees to competitive organisations, bribes to officials), and need to ensure consistent funding to continue the cocaine business. Financial resources are often invested in legal businesses entities that may serve for money laundering and/or facilitation of criminal activities. Despite critical moments, criminal entrepreneurs at all levels of the cocaine mar-

ket seem to be able to continue with their criminal activity without facing any particular problems.

The second section of the book analyses the illegal trade in tobacco products. This is a manifestation of organised crime with a long history, one that has only relatively recently acquired academic and law enforcement attention. Four schemes characterise the illegal tobacco trade: *bootlegging* – buying an amount of cigarettes and tobacco that exceeds customs regulations; *large-scale smuggling* of untaxed tobacco products diverted from the licit international market; *counterfeiting* – the manufacturing of fake tobacco products; and selling legally manufactured cigarettes which are stolen. According to the available evidence, inflows from non-EU countries accounted for the bulk of illegally traded cigarettes in Mediterranean and Eastern border European Union member states. The worst situation is in Latvia where almost one third of all tobacco products are illegally traded. In Croatia the share mentioned is around 3.7%.

In the illegal trade in tobacco products the most critical issue is the financing of start-up capital. This is because once a smuggling operation is developed it can generate sufficient profit to allow further investment in schemes in a number of self-financing cycles. There is a wide range of financial sources used to initiate tobacco smuggling operations including funds from legitimate work and savings and/or funds from legal businesses that belong to, or are managed by, illicit tobacco entrepreneurs, but very often there are also a financing consortia. Interestingly, financing the illicit tobacco business from other illegal activities and businesses, is a rather uncommon source. Costs of the illegal trade in tobacco products consist, among other things, of expenditures for transporting and storing the merchandise, payment to actors and other costs for bribes, corruption, political protection, security and insurance.

For the readers of our Journal, the most interesting part is section 3 dedicated to organised VAT fraud. The EU has worked towards a common VAT anti-fraud strategy and recently strengthened anti-fraud measures. Two new directives were adopted by the Council in 2013: one introduced a quick reaction mechanism allowing member states to respond immediately to a sudden and massive VAT fraud; the other initiated the application of the reverse charge mechanism in relation to supplies of certain goods and services susceptible to fraud. Under this directive, member states have the possibility to apply this mechanism on a temporary basis and for a pre-agreed list of sectors and goods. The reverse charge mechanism requires that the liability for the payment of VAT is shifted from the supplier (as normally required by EU rules) to the customer.

Numbers of goods and services are affected by organised VAT fraud schemes. Because of their combination of small size and high price – which makes them convenient for simulating high value – mobile phones, computer and electronic

components have often been used for VAT export frauds. Also used for the same purpose are railway vehicle components, scrap and precious metals, metal allocations and cars. Evasion of VAT is present in many forms, like fictitious exports, undervaluation of inputs and overvaluation of outputs to reduce tax liability, false classification of goods to take advantage of lower rates, declaration of false quantities and smuggling. One of the major organised crime threats present in EU member states is the missing trader intra-community (MTIC) fraud. Other models of fraud are *acquisition fraud* – the missing trader supplies the imported goods at the final consumption market and then disappears, embezzling all the due VAT debited; *carousel fraud* – the goods imported by the missing trader are sold through a chain of domestic companies (“buffers”) and finally re-exported to another country with zero VAT rate; and *fictitious export* – a trader realises an export transaction on paper, levying zero VAT tax and claiming VAT refund to the tax authorities, while at the same time selling the goods on the domestic market without sales invoices. It is almost impossible to assess exactly the overall VAT gap, but according to the CPB Netherlands Bureau for Economic Policy Analysis from The Hague, for 2012 for the EU-27 it was estimated at 16% of the overall tax liability. The countries with the largest gap were Romania (44% of theoretical liability), followed by Slovakia (39%) and Lithuania (36%), while it is relatively low in Finland, the Netherlands and Luxembourg where the gap was around 5-6% of the VAT due.

The organisers of VAT frauds use different sources to acquire capital for starting and running their operations. The required capital comes from both legitimate and illegal sources. Professional crooks specialised in swindles, tax and customs duty frauds may work as ringleaders. The most common source of capital for initiating new VAT fraud schemes is achieved through re-investing the proceeds from previous fraudulent schemes. It is quite common for a legitimate entrepreneur to invest part of his or her legitimate revenues and/or personal savings to initiate a VAT fraud scheme. Various cases demonstrate that criminal entrepreneurs invest financial sources from other criminal activities. Apparently, well-established entrepreneurs with legitimate businesses may acquire financing through licit channels such as obtaining a bank loan. In Bulgaria, a ringleader of a big VAT fraud ring received €23 million in the form of bank guarantees and loans from a Bulgarian bank through two companies under his control. In Belgium and Spain actors asked for the help of illegal financiers or investors.

Operational costs usually consist of expenses such as the incorporation of fictitious companies, payments to straw men, proxy men, accountants, supervisors and facilitators, corruption fees. Since these costs are relatively low, many law enforcement experts believe that a VAT fraud project does not require substantial initial investments, while others state that this is true only in part. The profitability of VAT fraud depends on a number of factors such as the rate of VAT tax, the type of goods, the type of the fraudulent model and the scale of the fraud scheme and

the number of actors involved. The gross profit is usually equal to the amount of the VAT tax embezzled and after the deduction of the business costs there remains a significant net profit.

Other parts of this interesting book present case studies of the criminal activities mentioned in the observed countries. The current report has provided a different perspective on criminal finances and an alternative approach for researching the subject. It also suggests possible steps toward the introduction of novel approaches to tackle organised crime. Building on the key findings from the study, the authors propose a set of recommendations at EU and national levels. Despite the inevitable caveats about a very under-researched component of criminal activity, the authors believe that their report provides sufficient information and analysis to stimulate more academic and practitioner research on these important topics.