

VAT Fraud and the Policy of Global Ignorance

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A. Plato's Cave

Fraud is in many ways the craft of deceit and therefore seemingly difficult to perceive correctly. Strangely enough this statement does not apply to the deceived victims. As a rule they find out sooner or later, that they have been defrauded: the Cartier watch turns out to be counterfeited, the document appears to be false and the cheque happens to bounce. The difficulty to perceive the phenomenon of fraud correctly is rather an issue of the authorities. In this regard the authorities, the national policymakers, the public prosecution services as well as the European Commission resemble the prisoners in Plato's famous cave. In one of his dialogues he describes the human observer, chained in a cave with a big fire, who is unable to see the reality itself; he is only able to perceive some shadows of hidden statutes, projected from the fire on a wall. Translate this old philosophical metaphor into the daily reality of the policymakers, who are engaged in the areas of fraud, organized crime or money laundering: their office is the cave and the shadows are the reports from outside, and one can see quite a fitting resemblance. Though most policymakers do not seem to be hampered in their daily policy affairs by this shadowy state of their knowledge, they do sometimes make attempts to overcome this impediment by hiring other statute carriers in the form of expensive consultants. These consultants duly stoke up the fire, polish the statutes, but do not change the cognitive situation of the policymaker in the cave. The only thing which is not shadowy are the fees raked in for this act.

In this article the above metaphor will be expanded upon, aiming at finding a way out of the 'cave'.

B. Problems and Tentative Solutions

The state of affairs sketched above is not a parody. The issue of fraud is repeatedly placed on the political agenda, though the policymakers are actually very poorly

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informed indeed. Though everybody agrees on the seriousness of the problem of fraud, it appears to be impossible to say anything precise, because of the difficulties one encounters if one wants to capture this phenomenon in concrete facts and figures. If one knew how bureaucracies and policymakers function, one would be amazed indeed. Who would take any private enterprise seriously, if elementary quantitative questions could not be answered? No one would and the enterprise would be terminated if not investigated for negligence or fraud. Nevertheless, the European Commission succeeds in putting this issue regularly on the political agenda, without any tangible success in providing any quantitative clarity, which is the responsibility of the national authorities. Of course, the Commission is only one of the public bodies which operate in an information twilight zone. That is no consolation for this lack of elementary data. There are several causes for this impediment.

The first cause is the *lack of precise definitions*. Fraud manifests itself in various forms of economic conduct, which are covered by very different legal concepts: false documents, counterfeiting, deceit, false pretences, and various special laws like fiscal fraud, environmental fraud etc. The diversity of the empirical reality and legal definitions do not always fit. Though *deceit* may be considered a good common denominator, any quantitative assessment needs a more precise delineation by means of an unambiguous definition.¹ Simply stated: if there is no proper definition, there is no suitable instrument to discern the single occurrences of fraud. Hence, there are no counting units. Consequently there is nothing to count and every quantitative assessment is doomed to become a debate about educated guesses. A way to solve these problems is to enumerate the codes which cover various forms of fraud, which creates new problems: many occurrences are covered by more than one code.

The second cause is a *human one*: despite a never ending debate about the seriousness of fraud, policymakers themselves have never made a really serious attempt to establish a permanent body of experts to measure the extent and scale of this 'threatening' phenomenon. As a matter of fact it is rather a technical problem, albeit a bit complicated one. Nevertheless to a large extent the problem can be solved. However, its solution requires long term investment in such humble efforts like statistics, which require a proper database with precisely defined variables and (in a European context) a harmonization of national databases. In addition, it also requires a less humble investment in *strategic* analysis and *knowledge* development of the phenomenon. The 'humble', technical side is expensive, but can be budgeted. However, the 'strategic knowledge' approach requires more brain capacity on the side of the users. This is an intellectual bottleneck, which few are willing to recognize, let alone invest in its solution.

¹ R. Bosworth-Davies and G. Saltmarsh, 'Definitions and Classifications of Economic Crime' in *The Regulation and Prevention of Economic Crime Internationally* (J. Reuvid (ed.)) (London, Kogan Page 1995), provide a useful phenomenological typology of the various kinds of economic crime. However these are too broad and too little operationalized for precise quantitative assessments.

The various attempts to shed some light on the issue of fraud have to be projected against this context. These attempts can be divided into several categories. Roughly we have the 'scholar expert approach', the commercial 'fact finding' approach and the 'statistical inventory' approach.

In the scholar expert approach academic experts are invited to deliver their judgements about the size of the problem. What do these experts do? They consult other experts who work in various branches of law enforcement, regulatory agencies or in the trade and industry. These experts, usually high ranking officials and managers, will again rely on the reports of executives who provide some 'field experience' and in the best cases are able to produce some rough statistics. The author has seen many of these statistics and can say that they have been designed for basic *managerial* purposes, and never for any strategic analysis or a 'knowledge base'.

In the commercial fact finding approach, consultancy firms will act as researchers. They send out questionnaires and have interviews with experts, who are the same experts mentioned above, consulting the same rough statistics and field impressions. It does not look much different from the first approach, the difference being (apart from the fees) that the scholars are used to accounting for their methodology.²

Now we come to the statistical inventory approach: a proper set of statistics, based on a well-determined and 'well-groomed' database which is fit for in depth analysis. However, this third approach does not exist. Despite all the high sounding rhetoric in the information age, we do not have reliable data which tells us anything about the parameters of fraud: the totals, the mean or the median of the financial damage per category, the number of suspects involved, the prosecution or the sentencing outcomes, let alone a cross comparison of such variables.

Briefly, we have to face an utter poverty of basic knowledge. It is not the author's purpose to blame particular policymakers for this defect, as it is a matter of collective lack of interest, which is veiled by regular half-hearted ritual attempts to do something. Woe betide those who do not comply with this ritual dance.

One example may illustrate the strange obstacles one runs into, when one mistakenly takes the ritual rhetoric seriously. Five years ago, the European Heads of State convening in Essen, wondered whether anything was known about the prosecution and sentencing of all the cases of EU fraud which had been uncovered

² A recent example of such an investigation is the survey carried out by Deloitte & Touche, *Fraud Without Frontiers. A Study for the European Commission of International Fraud within the European Union* (London 1997). The tender procedure reveals the irresponsible way in which the Commission addresses the quest for knowledge: there was no independent scientific committee to judge the quality of the tenders or any transparent decision procedure; there was no independent evaluation of the product and there was a budget of only ECU100,000 for which proper research could never have been carried out. The yield was commensurate: confusing results based on a questionable methodology presented in a glossy report.

and reported to the Commission. As could be expected, nothing was known about this penal follow-up. The well-known Unité pour la Coordination de la Lutte Anti Fraude (UCLAF) of the European Commission (the EC) showed some interest and suggested to an EU funded research organization of independent scholars, to design a research project on the penal follow-up of registered EU fraud cases. The scholars carried out some preparatory reconnaissance, which revealed that no ministry of justice or interior in the Member States could produce any court statistics on EU fraud. After having reported this bleak state of affairs, the UCLAF, itself vehemently opposed to any kind of independent scientific knowledge, found some flimsy arguments to stop the work of these researchers. There was no longer any interest and the whole enterprise petered out, due to the well-known praxis of bureaucratic stalling, like taking some six months to write a letter of six lines. If the UCLAF,³ established to fight fraud, takes fraud that seriously, no wonder that some national authorities have other priorities too.

Though the poverty of our knowledge is embarrassing indeed, we are not faced with a *tabula rasa* in this field. Even if quantitative research is lacking, there is a steady flow of qualitative research which contains sufficient data to tell us something about the *market* of fraud. The outcome of many forms of deceit are cheap products and services, which are in high demand, for example goods derived from 'long firm fraud'.⁴ After all, the only real competitive mechanism in a capitalist society is price and quality comparison, not honesty, which has to be enforced continuously. This market perspective is, of course, selective. Many fraudsters are expert financial illusionists, or experts in discovering procedural flaws in the banking security system. Other fraudsters do not compete with low prices. They just cheat by offering nothing but 'dream gold': expectations of getting rich easily and quickly.⁵ Though the impact of fraudsters operating on this virtual 'dream gold market' should not be underestimated, inflicting yearly multi-billion damage to greedy but uninformed

³ The well-informed reader is correct in comparing this to the UCLAF's role in the Perry Lux fraud affair, concerning the alleged abuse of humanitarian aid funds and Commissioner Cresson having demonstrated a shameless clientilism in relation to this temporary office. It took the UCLAF again 13 months to report this fraud to the responsible Commissioner, the same timespan the UCLAF used to eliminate the work of these independent scientists.

⁴ For a 'classic' research on this topic, see M. Levi, *The Phantom Capitalists. The Organization and Control of Long Firm Fraud* (London, Heinemann 1981).

⁵ This is the craft of the investment fraudsters, selling worthless stocks which are inflated by repetitive selling and reselling. See D. Francis, *Contrepreneurs* (Toronto, Macmillan 1988); P.C. van Duyne, 'Organized Crime and Business Crime-Enterprises in the Netherlands' in (1993a) 19 *Crime, Law and Social Change*, at pp. 103-142; P.C. van Duyne, 'Implications of Cross-Border Crime Risks in an Open Europe' in (1993b) 20 *Crime, Law and Social Change*, at pp. 99-111; P.C. van Duyne, *Het spook en de dreiging van de georganiseerde misdaad* (Den Haag, SDU-uitgeverij 1995); R. Bosworth-Davies and G. Saltmarsh, 'Definitions and Classifications of Economic Crime' in *The Regulation and Prevention of Economic Crime Internationally* (J. Reuvid (ed.)) (London, Kogan Page 1995).

investors, the author will concentrate on those fraudsters who are *real* traders: selling cheap products and services to 'legitimate' firms or the consumer market, because of their fraudulent conduct. How do we approach and analyse this real, but fraudulent, market and what can we learn from a systematic analysis?

C. Fraud and the Information Constraints of the Market

Restricting our focus to the category of fraud in which normal, tangible goods and services are involved, we enter the legitimate visible market of the upperworld. From the perspective of the fraudster there is something paradoxical in his way of doing business. On the one hand he has much to conceal, but on the other hand he must come into the open in some way to make connections with sellers and buyers in order to do business. By doing so he generates information. Not only because he handles real goods, but particularly because he produces victims, who sooner or later start to complain: either they are the defrauded authorities or they are private persons or companies who address themselves to the authorities. In both cases information, that is legal evidence, is released which should lead to the end of the fraud scheme. Usually this is not the intention of the fraudster. If he wants to continue his scam and to retain his place in the market, he will need skills to reduce these information risks while remaining attractive for the market. In this regard the fraudster has to handle two important factors:

- (1) the *victimization alert rate* which determines the detection time span and law enforcement reaction; and
- (2) the *price wedge* between the cost price and the selling price caused by the system of taxes, excises, subsidies and licences.

These will be considered more closely, in turn.

I. *The Victimization Alert Rate*

Unless fraudsters sell counterfeited products they create direct deficits: the creditors do not get paid, the tax authorities learn that a firm has gone bankrupt without paying the due taxes etc.⁶ These deficits, the profits for the fraudster, and the legal actions they ensue, bring the enterprise technically to an end. The professional fraudster, who will be called a *business crime entrepreneur* intends to continue his business if he is not arrested and incarcerated. How to cope with these problems? The first thing he has to do is to reduce the victimization alert rate or its effects. There is no general formula to accomplish this as the techniques depend very much on the nature of the victim, though there are some broad strategies.

⁶ Trafficking in counterfeited goods also creates victims by lost market opportunities and low qualitative goods bought in the expectation of the real brand.

1. Cross-Border Operation

A common way to reduce the victimization alert rate is to produce victims or commit the offence in jurisdictions other than where the crime enterprise has its seat. For example, the products of brand piracy of music, software, computer components etc., are frequently produced in countries other than where they are being marketed. Another example given by a meat trader is transport insurance fraud, which in essence is organized pretended theft in a country in which investigators know they will meet little co-operation from the local agencies, and, therefore, will mainly lose time and money. Trucks transporting meat or other merchandise are reported to have been regularly hijacked in Italy. The problem for the police and insurance firms alike is: was the robbery real or a mere pretence and has the cargo been sold on the black market on behalf of the 'victim'? To the author's knowledge no hijacking of trucks in Italy has ever been considered as a form of cross-border insurance fraud, though there are persistent rumours about this. After the fall of the Iron Curtain fraudsters strove to take similar advantage of the ensuing chaotic law enforcement situation in Eastern and Central Europe by reporting a regular flow of stolen vehicles. Many vehicles had genuinely been stolen, but a number of cases had been cleared in Poland as an insurance fraud, some of them on an enterprise base.⁷

The investigation of such crimes is hampered by the fact that the police in the jurisdictions of the perpetrators have little interest in investing efforts in a crime which has been committed elsewhere against foreign victims, while the police in the jurisdictions of the victims are dependent on the zeal of the foreign police forces. Despite all the complaints about flaws in the international legislation, co-operation is rather hemmed in by this lack of human interest, which is the grist to the fraudster's mill.

2. Bust Firm Juggling

Another broadly used strategy is to create a jungle of phoney companies shielding the identity of the fraudster. The technique is known: one establishes a chain of companies which are destined to go bankrupt. In Dutch fiscal vernacular these firms are called 'busters' or 'bust firms'. These bust firms are mere 'debt collectors'. Apart from legal technical skills in managing such bust firms, the hamstring for the fraudster is a *social* one: to find sufficient strawmen to staff these front firms, taking the heat when the (fiscal) police or the terminator moves in. The ideal strawman is willing to sign any document for a few bucks. Perhaps he is also sufficiently representative to answer the phone. Otherwise he should not know or do anything but just sign the papers. An extensive fraud scheme requires a small platoon of such strawmen and a well-developed strategic feeling and

⁷ See also U. Sieber and M. Bögel, *Logistik der Organisierten Kriminalität* (Wiesbaden, BKA-Forschungsreihe 1993) chapter 3 II.

timing on the side of the crime entrepreneur. As a matter of fact he has to think in two overlapping time spans: on the one hand he must estimate when his bust firm will draw police attention. Long before that event the firm must be stripped of its assets and a reliable strawman must be installed as responsible manager if it has not started with such a strawman.⁸ Meanwhile the crime entrepreneur has to take a new bust firm 'from the shelf' (frequently established or bought beforehand and 'put on the shelf' as a reserve) with which to enter the market. As a matter of fact he has to juggle with a number of bust firms at the same time, knowing some will eventually 'fall', i.e., go bust.

The reader will appreciate that this technique is most effective when the 'front firm juggling' is carried out internationally. The deceit with the bust firms is combined with the bottlenecks inherent with international police co-operation, because of the constraints on the exchange of information.

As a matter of fact, it is not only the victim alert rate which is reduced, but in addition the effects of the victims alerting the authorities. Because of under-reporting the information comes too slowly to the police to stop the crime entrepreneur (assuming the police respond with due diligence): while the fraud squads are unravelling fraud scheme A, the crime entrepreneur is already operating scheme C.⁹

Crime entrepreneurs operating along these lines have one social and economic impediment: they remain marginal, because they are only tolerated by those 'legitimate' entrepreneurs who profit from the low prices of their offers. In addition their 'trail of victimization' prevents them from becoming settled businessmen: most of them have a long history of civil and criminal law suits. Though they are less mobile than the fraudsters deceiving directly and personally by selling worthless articles or mere promises, they are likely to run out of time and luck after all. For example, they have used all their 'clean' strawmen, forcing them to use false names for their invoices.¹⁰ Consequently, their information risks

⁸ See for a description of this phenomenon P.C. van Duyne, 'Organized Crime, Corruption and Power' in (1997) 26 *Crime, Law and Social Change*, at pp. 201–238. In that article this type of crime entrepreneur is called 'front firm runner' but performs the same act. In the Netherlands this performance has become more difficult. Nowadays one has to *start* with a strawman as the law on civil liability for managers has a retrospective effect of three years in case of reprehensible mismanagement and abuse.

⁹ The bottlenecks in policing fraud depend on the organization of the police. In large cities there are Fraud Squads specialized in complicated scams (see also M. Levi, *Regulating Fraud. White Collar Crime and the Criminal Process* (London, Tavistock Publication 1987)). Still the public priorities in interest as well as funding are public order and at present 'organized crime', by which is meant drug trafficking and other forms of 'underworld crime'.

¹⁰ In some organized fraud cases studied by the author this bottleneck could sometimes be observed: being short of strawmen the invoices had been made in the name of arbitrary persons from the telephone book, unknowing neighbours and even deceased people received invoices. (P.C. van Duyne, *Het spook en de dreiging van de georganiseerde misdaad* (Den Haag, SDU-uitgeverij 1995)).

increase: they become known and if not apprehended they will have to move to another area or go into hiding. The information constraints of the market forces them to such a degree of mobility that it is difficult for them to take roots and become integrated.

3. *Mixed Business: The Comminglers*

The most effective way of reducing the victim alert rate is to prevent victims becoming *aware* of being defrauded at all. This requires a real legitimate business, selling real goods and services, while paying for the purchases, because private persons and companies are usually alert victims. However, often the authorities prove to be less alert, as long as one handles the paperwork with care, avoiding, for example, quickly rising debts to the tax authorities or social security agencies. One would call this the 'normal' tax evasion. For the non-systematic or incidental tax fraud cases, like inserting a few false receipts for expenses not incurred, this may be a correct qualification. But when one wants to compete fraudulently in the market during a longer time span such incidental frauds (even if they are substantial) carry too little weight. The fraudulent reduction of the cost price has to be mixed systematically within the paperwork of the company. This requires a careful balancing of the invoices: a well-planned system of deceit and concealment, commingling and blending the 'white' and 'black' flows of goods and moneys, while keeping the whole operation very low profile.

The market environment which suits such fraudulent competition is usually characterized by many marginalized entrepreneurs, who are each willing to defraud 'just to survive'. Most of the fraud cases are considered 'irregularities' and are relatively small as they have to fit into the volume of the turnover of the company: black payments for overtime, under-the-counter-sales, inflated expenses. In such a 'democratic fraudulent landscape' (meat, mineral oil in the shadow of the majors, alcohol, catering) the more systematic fraudster can succeed when he manages to mix a criminal cost reducing 'column' of only ten per cent with the other paperwork, cashing an after tax extra profit of 2.5 to 5 per cent. Such a system requires an elaborate system of internal tampering with the paperwork, carried out by the professionals of the staff. Such a company may develop into a 'major' of his branch, obtaining any credit from banks (black money creates white money). Investigating such a systematic fraud scheme is very costly and hampered by complex civil and fiscal technical subtleties. Against such wily 'comminglers', who are frequently respected and may have a considerable clout, the (fiscal) police only hesitantly takes action. They face less information constraints of the market, even if they operate large scale.¹¹

¹¹ In the Netherlands the catering firm of the Van der Valk family operated according to this formula (R. Bogaarts and H. van Gelder, *Het teken van de toekan. Op het spoor van de familie van der Valk* (Amsterdam, Meulenhoff/Kritak 1996)), generating an estimated fiscal damage of NLG200 million. International comminglers in the cigarette industry were *adroit* to shift the fiscal liability from the Netherlands to Swiss, where the offence was

II. The Price Wedge

Crime entrepreneurs, whether they operate as front firm jugglers or as mixers, often succeed in conquering their contested market place by abusing the regulatory system of taxes, excises, levies and subsidies. These are the 'price wedges' put between the cost price and the sales price. This age old way of making profit is no revelation. What is new at present is the growing scale of this abuse. This has resulted in organized networks of crime entrepreneurs operating simultaneously in the various jurisdictions of the EU.¹² Two simple determinants can be observed.

The first is the above-described victimization alert rate, which is in the international context is slow and low. This may have important socio-economic consequences. In the first place it allows the usually small inner circle of business crime enterprises to consolidate their social connections. Around these networks the better skilled aids, errand boys and strawmen develop into reliable auxiliaries. In addition, there develops a symbiosis with the 'legitimate' market as outlet for the cheap goods. One may say that the lines of criminal co-operation become gradually engraved in the copperplate of the upperworld. In previous studies the author has described these engraved networks as a cross-border 'crime community' of professional fraudsters evolving around the bigger 'pivot' organizers.¹³ A second consequence is the spreading of the network. Lower placed executives appear to have learned enough to start a crime business of their own. Not only has the author observed the veterans returning from prison and starting as if nothing of importance had happened (or to earn their confiscated money back), but also the 'rising stars' of newcomers, sometimes previous strawmen, a few also coming from other criminal branches, like drug trafficking.

The second determinant is simple too: the largest price wedge is created by the fiscal regulations of cross-border trade. Today, a real mega bonanza can be observed in the abuse of VAT, although the VAT scams are sometimes combined with fraud concerning excises of alcohol, tobacco and mineral oil, as well as EU levies. This adds legal flexibility to the already flexible European crime connections. In the next section some aspects of the booming Value Added Tax business: the VAT crime 'market' will be described.

cont.

considered tax evasion, for which the Swiss authorities do not have to co-operate (P.C. van Duyne *supra* note 10).

¹² P.C. van Duyne, 'Implications of Cross-Border Crime Risks in an Open Europe' in (1993b) 20 *Crime, Law and Social Change*, at pp. 99–111; P.C. van Duyne *supra* note 10.

¹³ P.C. van Duyne, 'Implications of Cross-Border Crime Risks in an Open Europe' in (1993b) 20 *Crime, Law and Social Change*, at pp. 99–111.

D. VAT: A Booming Euro Business

The brilliant British historian, A.J.P. Taylor once observed ironically that policy-makers used to repeat old mistakes in new forms. That is quite a compliment compared to the policymaking in the area of cross-border VAT fraud. As remarked in the previous section, research carried out in the field of organized business crime in the late 1980s and early 1990s stressed that this form of crime was about to establish itself in the form of crime networks, stabilizing itself as virtual cross-border crime communities. Discussing this problem with the erstwhile Director-General of DG 20, this high-ranking official remarked indifferently that this form of organized cross-border crime was not the Commission's problem, as the Commission got its share of the VAT anyhow. Apparently he did not realize that this indifference was quite similar to the lack of interest for which he blamed the Member States, who do not care (enough) about the defrauded EU funds. Not only in the author's research, but also customs and fiscal officers in the field warned about the post-1993 increase of VAT fraud when the border controls were to be lifted. What happened?

According to the field experts the author worked with, both perpetrators and fiscal investigators had to adapt to the new open border situation in which the VAT is due in the country of purchase. In the first two years after 1 January 1993 the feared flow of mega frauds did not emerge immediately. Crime entrepreneurs and law enforcement were grasping their opposite opportunities: committing and preventing crime, a kind of antipodal quest for criminal information. After 18 to 24 months the objective of prevention proved more difficult to attain than the commission of VAT fraud. At first the well-tested veterans found out how easy it was to cash the VAT by making a few loops over the open border. Then they were followed by some legitimate traders, for example one of the biggest meat trader in the Netherlands.¹⁴ And finally the 'legitimate' and 'criminal' entrepreneurs found out that they could learn much and earn even more by a well-tuned, but veiled co-operation.¹⁵ Apparently they were quicker learners than the law enforcement policymakers. How did this all come about?

First a few words about the *system* of VAT in cross-border trade in Europe. The basic rule is that the VAT has to be paid in the country of purchase and consumption of the goods and services. When goods are bought in the Netherlands the merchant N pays X per cent VAT to his seller. The latter has to hand this over to the inland revenue (or rather will settle this with other paid VAT he can reclaim). The merchant N then exports the goods to Germany. These goods have to pass the border *without*

¹⁴ P.C. van Duyne, 'Organized Crime, Corruption and Power' in (1997) 26 *Crime, Law and Social Change*, at pp. 201–238.

¹⁵ See for an extensive research into the VAT fraud after 1993/94 A.A. Aronowitz, D.C.G. Laagland and G. Paulides, *Value-Added Tax Fraud in the European Union* (Amsterdam/New York, Kugler Publications 1996); pointing also at the symbiotic relationship between organized and 'legitimate' entrepreneurs.

VAT, the so-called zero tariff. So the merchant reclaims the VAT he paid previously. When the German trader G sells the goods he charges VAT, which he has to hand over to the inland revenue or has to settle with the VAT he can reclaim. Exports to firms in other Member States of the EU have to be reported monthly, so the Dutch trader will report this export. The German merchant has to report his intra-communitary acquisitions in his monthly tax form too. The German tax authorities can compare these declarations with the quarterly listings they have obtained from abroad, summarizing the deliveries by foreign EU firms to German enterprises in order to have some measure of control. If the intra-communitary deliveries and acquisitions do not match, there is a problem: there may be a phoney export, or the importer does not pay VAT or does not exist at all. For the Netherlands the rule is that when a merchant imports goods for transition to another country he does not have to pay VAT at the moment of import: the VAT will be settled at the end of the term.

Predictably, the system is full of cross-border fraud opportunities.¹⁶ The simplest form is the ABC construction, consisting of three companies. The Dutch firm A exports to Italy to B. B sells to C, also in Italy. A and C are companies which are actually handling the goods for the market, but B is placed in between by A and C to pocket the VAT, while that firm will not declare anything to the inland revenue. B only handles the invoices. B is headed by the well-known marginal strawman and when addressed by the tax inspector pretends to know nothing, while there are no assets for recovery left. A and C (who can both reclaim the previously paid VAT) share the spoils, while the investigators are left empty handed with only strong suspicions, but no evidence.

This is still simple, but now the well-known carousel fraud can become operative: C *re-exports* the merchandise to Spain and reclaims the VAT he paid to B (but this strawman hands him the money back, minus his share): that is two times the VAT. The importer in Spain repeats the trick, because on paper the merchandise goes to an intermediary front firm with another strawman. And he does not know or does not do anything either. The Spanish importer re-exports to the Netherlands, to a

¹⁶ Despite these forebodings the European policymakers chose this system as a temporary device. A system based on VAT levied in the country of origin with a clearing house mechanism for settling the differences between countries with an export surplus and import excess proved politically impossible at that time. The present system was supposed to last until 1996, but nothing is so lasting as provisional arrangements (C.M. Ettema, 'Harmonisatie van het Europese BTW-systeem' in *Strijd tegen BTW-fraude in de Europese Unie. Handhaving in België en Nederland* (J.A.E. Vervaele (ed.)) (Antwerpen, Maklu Uitgevers 1995)). For typologies of VAT fraud, see A.F. van Abbeele, 'Typologie van BTW-fraudes' in *Strijd tegen BTW-fraude in de Europese Unie. Handhaving in België en Nederland* (J.A.E. Vervaele (ed.)) (Maklu Uitgevers, Antwerpen 1995); R.T.K.M. Faber, 'Fraude en fraudebestrijding bij ICT's' in (1993) *Intracommunautaire transacties*. Belastingdienst, 's-Gravenhage, and A.A. Aronowitz, D.C.G. Laagland and G. Paulides, *Value-Added Tax Fraud in the European Union* (Amsterdam/New York, Kugler Publications 1996).

colleague of A, who finally sells to the latter. If the combination is clever enough they see to it that the last two links in the chain duly pay their taxes to prevent suspicions growing into their direction.

This simple carousel knows many variations. Once abroad, shipments can be split into parts, which follow the same trails along the intermediary front firms. A clear sign of fraud is selling at a loss: the goods are gradually made cheaper, the loss being compensated by the non-paid VAT.

This carousel system is typically a specimen of 'organized business crime' if measured according to the definition of the *Bundeskriminalamt*.¹⁷ But who are these organized business criminals? Some are well-known veterans with a criminal record, but they are accompanied by a mixed company of financial adventurers and 'respectable' entrepreneurs, who fulfil the role of commercial amplifiers while remaining technically out of the reach of the fiscal authorities. The phase in which the established entrepreneurs enter the criminal landscape is an important one, because that provides the outlets for the unfolding of a real criminal economy of scale. The 'legitimate' entrepreneurs may play two roles: that of the provider of the goods and that of the purchaser. Some manage to perform both roles, cashing in twice.

The following estimate may clarify the staggering extent of financial losses caused by carousel schemes. If a company produces computer parts, for a total of NLG200 million per year and these are imported by a legitimate firm for a fixed price, which is paid everywhere in Europe, each sale under this price must have a dubious (VAT) cause. In this trade each processor (or rather each sealed box) is individualized by means of a bar code, such that its routing can be followed from the beginning to the end. In this particular case the importing firm found out that its NLG200 million worth of imports which had been sold to traders, returned time and again as purchases from other firms. Concretely this means that every time the *same individualized* boxes are returned for a lower price than its original purchase price to the same firm. The firm calculated that the volume of NLG200 million boxes generated a *fivefold* turnover of NLG1 billion. A miraculous multiplication indeed.

It is interesting to approach organized business crime from the perspective of criminal information risk management: the craft of manipulating the information

¹⁷ The definition of the German *Bundeskriminalamt* (D. Küster, 'Das Lagebild der organisierten Kriminalität in der Bundesrepublik Deutschland, illustriert anhand typischer Ermittlungsverfahren' in *Organisierte Kriminalität in einem Europa durchlässiger Grenzen*, (Bundeskriminalamt, Wiesbaden 1991)) is:

'Organized crime is the planned violation of the law for profit or to acquire power, which offences are each, or together, of a major significance, and are carried out by more than two participants who co-operate within a division of labour for a long or undetermined timespan using:

- (1) commercial or commercial like structures; or
- (2) violence or other means of intimidation; or
- (3) influence on politics, media, public administration, justice and legitimate economy.'

constraints of the market. In the first place the victimization alert rate is low (though in the Netherlands it is increasing), while, if it has been aroused, the effects are deliberately blunted by inserting a series of bust firms. In the interaction with the Dutch fiscal police (the *Fiscale Inlichtingen en Opsporingsdienst* or FIOD), the crime entrepreneurs judged that this protection has become too thin and transparent. Therefore, other small intermediary firms (who do pay VAT) have been inserted, acting as an extra 'wedge' to veil the relationships and to disconnect the links in the chain of evidence. The alert rate is further lowered by meticulous paperwork in regard to the incoming and outgoing goods and payments: real goods are being transported by hired transport firms and delivered to a real address abroad (where the bust firm may disappear overnight, though), which makes it technically difficult for the tax inspector to refuse the deduction of VAT. Bank transfers are preferred to cash payments to maintain the impression of legality.¹⁸ The game is further complicated (for the investigation) by spreading the information risks cross-border over numerous law enforcement agencies, which entails a slow and frequently confused alertness in addition to an accompanying slow information exchange. For, even if numerous law enforcement agencies in the various jurisdictions have been alerted, this state of arousal does not lead to increased efforts.

As can be deduced from the previous section, the kingpins of the carousels go out of their way to clothe their price wedge abuse in a legitimate appearance while still making use of the bust firm jugglers, but by means of the protective layer of intermediary firms. The computer firm mentioned above, complaining (and making profit) of the fivefold recycling of its own articles, never bought from or sold to bust firms. Other firms, which were closer to the black VAT hole of the bust firm, could always prove that they checked all credentials: VAT and chamber of commerce number, reception of delivery signed etc. With so much display of legality one is inclined to think of Antony's funeral oration to the people of Rome at Caesar's bier: 'so they are all, all honourable men'. The FIOD has become wary of these honourable men.

It is difficult to make a precise estimate of the total of the VAT damage. There are several methods of VAT fraud, based on either the inland sales of bust firms, exports to foreign EU bust firms, invalid VAT numbers in the Member States and 'negative declarations' (claiming back of VAT) and the 'end links' (last selling firms) of the intra-communitary deliveries. The official estimate for 1997 mentions damage of NLG96 million. If estimates are based on the bust firms, involved in intra-communitary deliveries, the damage for the computer branch alone range between

¹⁸ Analysing the 'suspicious transaction' of the Dutch FINPOL in the period of 1994–1995 the author found out that VAT fraud was accompanied by a sudden increase in electronic payments, in one case amounting to NLG 192 million in nine months (more than 50 per cent of the reported suspicious inland electronic transfers). Though there is some tendency to add such sums implicitly to the alleged amount of money laundering, only at most seventeen and a half per cent of that sum constitutes 'crime money' to be laundered.

NLG100 and NLG200 million in the Netherlands. As the carousels are cross-border phenomena, an estimate of the damage in other countries should be added, amounting to some NLG350 million, *only related to VAT carousels unveiled in the Netherlands*.

This is of course not the whole picture. VAT fraud carousels, combined with excise fraud are a recurring phenomenon in the car trade and the mineral oil market.¹⁹ How can such an omnipresent phenomenon be addressed?

E. Knowledge Management and Victimization Alert Rate

As can be deduced from the previous sections the concept of the 'victimization alert rate' is not meant to stand for the frequently heard sullen lamentations that 'criminals are always smarter' (smarter than the police, which is quite a consolation) or 'the problems have become unmanageable' (so we need more staff and powers). It implies an awareness leading to a problem-solving attitude. The heart of the problem to be solved is twofold. On the one hand, the law enforcement has to increase the information risks of the crime entrepreneurs and on the other hand the infringements on the state imposed price wedge has to be contained and subsequently reduced. The approach to reach these two aims is to invest in the development of an information system which is tailored to the problem at hand.

In the second section of this article the *human* factor was mentioned contributing to our poor state of knowledge. How can this criticism be changed into a positive outcome? Let us look at the truism that information is knowledge and let us not only force this open door, but enter the room behind it. The first basic question to be asked is about the *basic components of knowledge* on which organized business crime in a (fraud affected) market turns. These are the *acting persons*, natural and corporations. The kingpins in fraud carousels depend for the success of their operations on networks of personal connections: relationships between legitimate wholesalers, knowledge of marginal firms willing to act as intermediaries in order to survive and the relationships of these marginal firms with social fringe figures to head a bust firm. This is the 'personnel toolbox' without which the technical knowledge of the kingpin in elaborating a fraud scheme will remain ineffective. Only with a well-filled personnel toolbox will a fraudster be able to lower or to reduce the effects of the victimization alertness as soon as it is aroused. Moreover, in EU carousel schemes this personnel toolbox has to be an international one: the fraudster has to have relationships with foreign counterparts and has to know the return rooting of the cargo to his company

¹⁹ Or they rather continued unabated: P.C. van Duyne and A. Block, 'Cross-Atlantic Organized Crime. Racketeering in Fuels' in (1995) 22 *Crime, Law and Social Change*, at pp. 127-147.

or to one or more new bust firms associated with his supply line. What does that imply for our quest for the components of knowledge?

F. The Outline of a Knowledge System

The answer is to resort to the roots of the basic and classic police work: the establishment of a suspect's database, which for this kind of financial investigation is made fit for an in-depth 'relational analysis'. The basic principle is that each person:

- (1) is a carrier of characteristics or traits;
- (2) has a fiscal and/or criminal history; and
- (3) has links to other persons.

This implies that to each person (legal and natural) a set of standardized variables (the traits, historical backgrounds and connections) have to be linked. These bits of information together form the basic components of a knowledge system or database. Such a system is already being used in many high risk financial organizations. For example the Dutch banks use such a system to prevent being abused or defrauded by financial illusionists, allowing them to analyse the (inter) personal backgrounds of customers who have a certain 'risk profile'.

As mentioned before, this requires an investment in hardware and software information capacity, but only after the human knowledge question has been answered. What do we want to know about these persons? The technical requirements will not be elaborated upon in this short paper, but the minimal variables for natural persons will concern:

- (1) the standard personal items;
- (2) the personal fiscal history;
- (3) the criminal history;
- (4) the history of business relationships: in what companies has he been active; from whom did he purchase and to whom did he deliver?

The last bundle of variables entails two kinds of search entries: a *person's* entry and an entry for individual *corporations* to establish the connections between these two kinds of actors. For the legal person a similar bundle of variables can be designed, but more adapted to the business history and patterns, for example:

- (1) the fiscal history in terms of revenue and turnover; and
- (2) the trading connections and patterns.

This looks simple, but technically such a database will be quite extensive and complicated. Take the item 'directorship of a firm'. When a normal legitimate firm has to be turned into a bust firm, *adroit* fraudsters will change the directorship

several times in order to fool the investigators about the real responsible background figure and to evade civil and criminal liability. This means that a number of names (plus all their variables), dates of changes in directors etc. have to be inserted (and subsequently analysed). It will imply a gradually growing system, which requires a well-trained staff to maintain highly educated analysts for, the searches through the system as well as scientific personnel for the evaluation and strategic analysis.

G. A Knowledge Centre in Action

Is such an investigatory relational database sufficient? For a 'get the villain' as well as a preventive approach such a system has proven its worth. Realizing that the carousel phenomenon cannot be solved by diligently handling case by case when they happen to surface after the staggering deficits became apparent, the FIOD established a Co-ordination Point Carousel Fraud as a kind of 'knowledge centre'. This Carousel centre started to unravel the patterns to eliminate the mechanisms which were created by the known fraudsters as well as (supposedly) by some 'legitimate' entrepreneurs. For the time being the most important mechanism proved to be the availability of bundles of bust firms, as can be deduced from the previous sections. So the Carousel knowledge centre initiated a bust firm directed analysis project. Pattern analyses were carried out on the flow of goods and the enterprises involved. Inspectors were informed about 'legitimate' firms like the ones described above, if the analysis cast doubt on their *bona fide* position in the market (more recycling patterns than selling to consumers, unlikely high turnovers), operating behind rows of marginal intermediary firms before one got to the level of the bust firms. This enabled the inspectors to carry out meticulous controls. The FIOD then began to root out these firms. Subsequently the 'legitimate' firms against which there was too little criminal evidence, lost those price reducing fraudulent links in the chain. No longer able to purchase or to sell cheap products, they were deprived of the price wedge advantage. Their turnovers shrunk to the level where the volume of the consumer market or the 'legitimate' firm simply vanished altogether.

Was a solution to the problem achieved through this approach? The answer is partly 'yes' and partly 'no'. Yes, because this application of the 'villains register' proved its worth by reducing the VAT damage in the computer branch considerably. No, because within the framework of the law the system has to be designed on a *national* basis while the problem remains international. The leading fraudsters proved to be quick learners and moved the bust firms to other countries, where law enforcement officials revealed an inadequate knowledge of the fraudsters' techniques and their use of social patterns, while their organizations were not geared to the

requirement of quick responding (low victim alert rate), which hampered a smooth and flexible co-operation, despite individual diligence.²⁰

At first sight this approach looks very good, but its vulnerability lies in its very short term success relative to cycles of policy developments, which frequently leaps from crisis to crisis. As soon as a crisis seems to diminish, policymakers move to the next problem and lose interest in the backbone on which the success of the approach depends: the establishment of systematized and enduring knowledge. Knowledge is a difficult plant: if not cared for, it soon pines away as may be learned from the following example.

In the mid 1980s the Dutch Ministry of Justice developed a system of national 'fraud statistics' on behalf of the policymakers of the public prosecution service and the ministry. After a very difficult start the system began to work with much groaning and moaning.²¹ After some time and some successes however it appeared very difficult to feed quantitative information to those who decide on the continuation of the system: officials with a law school education who simply did not grasp the quantitative feedback! The end of the investment was simply de-investment and the only fraud statistics which were left were about social security fraud of those who inflict the least damage! Though from time to time some senior civil service groups ritually declare fraud a top priority, no one starts with the obvious: amassing knowledge while filling an organizational memory with basic data.

It is the author's experience that purely action oriented get-the-villain-knowledge in which knowledge is equated with a well filled case database has no real future. The basis of knowledge does not consist of data (the basic components) but an ordered memory: the learning results from past events. This simple truism applies to individuals as well as organizations. Organizations which claim to develop strategic policy plans (with the intention of actual execution, which is not a truism), need such a memory not only for a proper preparation, but especially to look back, learn and improve. Few organizations look back.

²⁰ It is not meant as irony, but as an outright sarcasm to observe, that if these fraudsters had hidden only one ounce of cannabis in their cargoes, all law enforcement agencies would have been put on top alert to clamp down on 'organized crime'.

²¹ P.C. van Duyne, *Eindrapport Experiment frauderegistratie*. (Staatsuitgeverij, 's-Gravenhage 1986) describes the *via dolorosa* of establishing a statistical instrument for what was then a political top priority. Psychologically the bottleneck is a mismatch between the short-term attitude of the case workers and the long-term interest of strategic knowledge collection. Law enforcement and policymaking is basically a case by case work routine even for the higher management who may be swayed by the issues of the day.

H. The European Dimension

It is not the intention to dwell in all sorts of utopias, though it is never wrong to express how things should be carried out in improved settings. The proposal of a knowledge system outlined above and the initiation of the FIOD knowledge centre approach should actually be made at the EU level. With regard to the present day reality, in which there are not only 15 Member States in the EU but also 15 federal states in Germany, between which co-operation is sometimes as strenuous as between different EU Member States, we have to be modest and realistic. However, to those Member States which are capable and willing to co-operate, it may be a challenge to develop tools, or rather apply existing tools to the present problem. How can common tools be applied in a framework with national legal constraints?

If we accept the political reality that a common European VAT task force is not likely to be realized and that many Member States guard their data like the Holy Grail, the present state of technique is such that it is not difficult to cope with these impediments. What is required is a strictly identical data format and processing programme. In brief, the same entries (persons and corporations) and a kernel of the same variables. Taking advantage of the fiscal social security numbers, one can anonymize, if privacy regulations require it, and still exchange information. Without needing a common database, a common computer or any tangible common, established physically in a Member State (which immediately creates the bickering about who will host it), the national fiscal agencies can work with an identical make-up of the basic information components. Administrative assistance can then be provided in a computerized and standardized way, which allows a cross-border analysis, *without having to cross borders of competence and privacy*, simply by exchanging fiscal social security numbers (+ variables). In addition, by developing and expanding such a system one creates the common national and European memory which allows *strategic* and methodologically well-founded cross comparisons between Member States, going beyond the level of the present questionable 'guesstimates'. Is this the way out of the cave of Plato? That may be too ambitious, but if it leads to the entrance and provides us with more insight into the reality of cross-border fraud and deceit, we have gained much.

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