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9. INTERDEPENDENCE BETWEEN MONEY LAUNDERING AND CIGARETTE SMUGGLING: EMPIRICAL EVIDENCE FROM UKRAINE

Abstract: Money laundering is one of the EU Policy Cycle priorities, Europol's priority crime area, under 2018-2021 EU Policy Cycle. Money laundering is an offence in its own right - but it is also closely related to other forms of serious and organised crime as well as the financing of terrorism. Smuggling of money laundering cigarettes is a strategically important area for any country seeking to reduce the risk of these phenomena occurring. The main aim of the article is to determine how money laundering is related to cigarette smuggling in Ukraine. Ukraine is one of the biggest official exporters of cigarettes among former Soviet Union countries. Smuggling of cigarettes is the basis of the shadow economy flow because, according to studies, the proportion of counterfeit tobacco products in circulation is only 0.1%. That is, the illegal turnover increases almost exclusively due to the smuggling of cigarettes. Ukraine is included in the US INCSR list of major money laundering countries. Money is often laundered through real estate, insurance, financial and non-financial institutions, shell companies and bulk cash smuggling schemes. The focus group survey has revealed that cigarette smuggling is linked to money laundering, although the links are not apparent. The results are in line with findings of previous studies: the money earned from cigarette smuggling in Ukraine is often used for personal needs, tourism clusters, acquisition of real estate, development of legitimate business and/or funding of corruption schemes.

Keywords: cigarette smuggling, money laundering, Ukraine.

JEL Classification: F19, K42

1. Introduction

Money laundering, or the process of hiding or disguising the unlawful origin of property and/or ownership of the money derived from particular criminal acts or transactions, has a number of detrimental macroeconomic, political and social effects, the most devastating of which are distortions in the demand for money, risks caused to the stability of financial systems, contamination of legal financial transactions, inexplicability of cross-border capital flows and exchange rates, infiltration of organized crime into strategically important economic sectors (commonly through investment which is made in an attempt to return dirty money back to the legitimate economy) and society, corruption in public institutions, and the threat to the rule of law (Poormazahaeri et. al, 2013; Hendriyetty, Grewal, 2017; FATF, 2019, etc.).

Being related to layered criminal proceeds and transactions, money laundering is recognized as one of the critical factors feeding transnational organized crime (McDowell, Novis, 2001; Billingslea, 2004; Rose-Ackerman, Palifka, 2018, etc.), including tobacco smuggling activities. Tobacco smuggling has already ceased being only the contraband of world-famous international tobacco brands (FAFT, 2012; TRACIT, 2019). Nowadays it leans on such three closely interrelated pillars as smuggling, counterfeiting and sales of tax-evaded products. Substantial profits and insufficiently

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strict penalties imposed on the agents involved make tobacco smuggling an attractive business for criminal organizations from Asia, the Middle East, the former Soviet Union (e.g. Armenia, Georgia, Moldova, Ukraine) and less developed European states (e.g. Albania, Serbia).

As money laundering is considered to be one of the major funding sources for almost all profit generating types of crime (FATF, 2019), it is purposeful to research how close the links between money laundering and tobacco smuggling are, and to determine whether money laundering is the main funding source for tobacco smuggling in some former Soviet Union and developing European states.

The main purpose of this article is to determine how money laundering is related to cigarette smuggling in Ukraine. The defined purpose was detailed into the following *objectives*: 1) to present the concept and basic stages of money laundering; 2) to review the results of previous studies on the links between money laundering and illicit tobacco trade; 3) to select and substantiate the methodology of the research; 4) to introduce the results of the empirical research on the links between money laundering and tobacco smuggling in Ukraine. *The methods* of the research include systematic and comparative literature analysis and Focus group methodology.

2. Money Laundering and its Basic Stages

When interpreting money laundering as a process, it is defined as processing a number of criminal proceeds that are undertaken to hide, obstruct or disguise the real origin and ownership of the money derived from particular criminal acts or transactions (FATF, 2012). In this respect, the process of money laundering is invoked in order to change the legal status of a property or property rights, to disguise existing property rights, to transfer a property that has been acquired through criminal activities, or to assist a criminal to escape the legal penalty for his/her offences.

Considering the rationale of this phenomenon, it can be defined as illegitimate activities enabling individuals or groups to earn undeclared and/or illegitimate profits (FATF, 2019) and/or gain a cover for their income and wealth (Gilmour, 2016; Hopton, 2016). In this case, money laundering is treated as a complex of illegitimate activities that are undertaken for gaining substantial material benefits.

Finally, the modern definition of money laundering, provided by Hopton (2016, p. 2), specifies that “money laundering occurs every time any transaction takes place or relationship is formed which involves any form of property or benefit, whether it is tangible or intangible, which is derived from criminal activity”. Such definition, in its turn, proposes that apart from the processing actions undertaken by agents, money laundering covers transactional and/or personal relationship that makes preconditions to generating material or non-material gains from illegitimate activities.

Literature (Hopton, 2016; Qureshi, 2017; Colladon, Remondi, 2017) distinguishes placement, layering and integration as three main stages of the money laundering process (Figure 1).

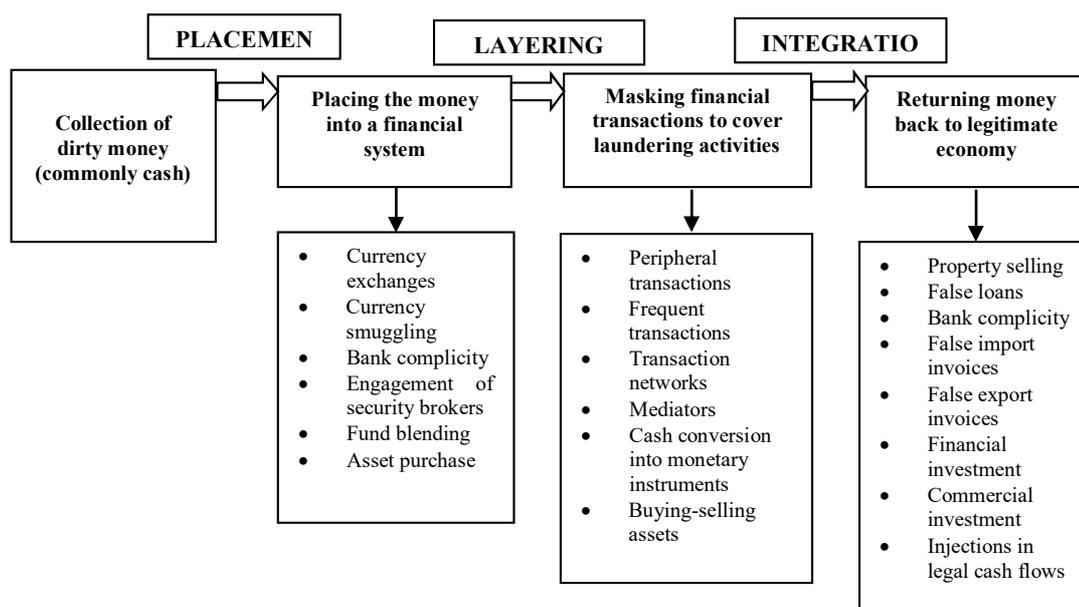


Figure 1. The scheme of a typical money laundering process

Source: compiled by the authors on the basis of literature analysis

Placement refers to direct or indirect placing of the financial funds possessed by an individual or a group into a particular financial system (for instance, placement of cash into a foreign bank, casinos, *bureau de change*, etc.). In other words, placement is putting the dirty money collected into the circulation through local or foreign banks, shops, casinos and other businesses. Placement stage commonly involves such methods as currency exchange and smuggling, bank complicity (involvement of bank representatives), engagement of security brokers, fund blending and asset purchase. For instance, Teichmann (2017) found that purchase of such valuables as gold, jewellery, raw diamonds, antiques, art, real estate as well as engagement of consulting firms, mergers, acquisitions, complicity banks, deposit boxes, private cash deals and currency exchange offices are extremely suitable tools for money laundering.

Layering means the process in the course of which criminal proceeds are separated from their source by engaging several masking layers of financial transactions (peripheral, more frequent financial operations, engagement of transaction networks, mediators, transactions in different economic sectors, banker's drafts, money orders, asset purchase and reselling, etc.) (Colladon, Remondi, 2017) to conceal the real origin of money and cover laundering activities by providing anonymity.

The ultimate - integration stage - signifies withdrawal of cash and returning it back into the legitimate economy so that it could represent regular business funds, earnings, legitimate investment, etc. In this stage, money is laundered by selling properties, taking out false loans (deposits), engaging fake international trade operations (issuing false import/export invoices, under-invoicing of goods, multiple invoicing of goods, over- and under-shipment of goods, falsely described goods), making fake financial, commercial or industrial investment, injecting illicit funds into the legal cash flows of high-turnover enterprises, establishing fictitious companies to declare the money as earned in a legal business, etc. (Thanasegaran, Shanmugam, 2007; Mohamed, Ahmad, 2012).

Apart from the above-mentioned ones, some other money laundering methods can cover legal or illegal cash exchange for checks, decomposition of deposits so that they would not exceed the amounts specified in legal regulations, giving bribes to bank clerks or other authorised persons for confirmation of customer identity, purchase of different valuables by specifying the price that is not subject for declaration, cash transfers to the accounts of bogus companies and relatives and many others, depending on the intended use of the money. Bjelajac (2011) also notes that traditional money laundering methods nowadays are increasingly being replaced by e-money transfers, abuse of money deposit cards, use of Internet banking, abuse of electronic cash, Internet gambling, WAP technologies and e-insurance transfer cards since contemporary IT systems "provide anonymity, international transfer, discretion and safety, quick transaction services, dematerialization, and most importantly, unlimited transaction size." (Bjelajac, 2011, p. 13).

To summarise, as it was noted by van Duyne (2003), some money laundering processes may be composed of more than three basic above-mentioned stages, but such classification makes it easier to understand money laundering as a complex process. Money laundering covers such a great variety of methods that it is hardly possible to discuss all of them, especially minding the fact that more and more money laundering options and schemes are becoming publically available due to the IT advancement.

3. Interconnections between Money Laundering and Tobacco Smuggling: Theoretical Background

First of all, it should be noted that the concept of illicit tobacco trade is not the same as the concept of tobacco smuggling: the former is much wider since it incorporates not only tobacco smuggling, but also illicit tobacco manufacturing and counterfeiting (Maftai, 2012), while the latter, according to Merriman (2002), refers to the action of contraband aimed at evading excise taxes by circumventing customs control and is a structural part of the former.

According to the Federation of American Scientists (FAS) (2000), tobacco smuggling is attributable to the category of nondrug contraband smuggling which also covers illegitimate export and import of alcohol, textiles and manufactured products. Previous findings indicate that the key reasons for tobacco smuggling include tax evasion (Antonopoulos, Hall, 2016; Antonopoulos, von Lampe, 2016; Prieger, Kulick, 2018), ease of illicit operating facilitated by weakness in governance and corruptive authorities (Ross, 2015; World Bank Group, 2019), poor prevention of organized crime

and inadequate punishments for illicit operation (Joossens, Raw, 2012; Alderman, 2012), bordering on the states with weak regulatory framework (Joossens, Raw, 2012; Calderoni, Rotondi, Favarin, 2013), social acceptance of illicit trade (World Bank Group, 2019), and availability of various transportation forms (ships, trucks, airplanes, goods trains, mules, border pedestrian crossings, etc.) and concealment methods (single passenger perspective, involvement of airline and ship crew members, gangs) as a part of distribution network (FATF, 2012).

Although it is the case that tobacco smuggling can generate sizable profits for criminal organizations, individuals and illicit manufacturers, it should not be overlooked that formation of a tobacco smuggling network as well as building and maintenance of smuggled tobacco delivery systems needs particular monetary funding. Some sources (FAS, 2000; von Lampe, 2011; FATF, 2012; Alderman, 2012; Maftai, 2012, Haysom, 2019, etc.) indicate that a substantial share of funds come from criminal organizations or corrupt authorities that are involved in various money laundering schemes. This brings up the question of to which extent money laundering is related to tobacco smuggling and whether money laundering is the main source of funding for tobacco smuggling.

Previous literature mainly focused on the relationship between money laundering and illicit tobacco trade (i.e. a wider approach was followed), while the studies addressing the relationship between money laundering and tobacco smuggling cross borders (i.e. a narrower approach) are scarce. However, minding the fact that tobacco smuggling is a structural part of illicit tobacco trade in general, we treat previous findings on the relationship between money laundering and illicit tobacco trade as the theoretical background for this research. The results of some previous studies addressing the interrelationship between money laundering and illicit tobacco trade are reviewed in Table 1.

Table 1. Review of some previous findings on the interrelationship between money laundering and illicit tobacco trade

Author(s), year	Research method(s)	Results
FATF, 2012	Questionnaire survey, critical assessment	Given its cash intensive and profitable nature, it is plausible that the illicit tobacco trade is also a vector for money laundering; nevertheless, only 6 from 18 respondents indicate that they could relate money laundering cases to the illicit trade in tobacco
Antonopoulos & Hall, 2016	Empirical data analysis, interviews with active criminal entrepreneurs, UK case study	Money laundering is a part of the financial management of the illicit tobacco business in the UK
World Health Organisation, 2003	Statistical data analysis, critical review	Illicit tobacco trade in Middle East is facilitated by money laundering schemes
Joossens, Gilmore, Stoklosa, & Ross, 2016	Statistical data analysis, critical assessment	The EU's illicit trade agreements with major transnational tobacco companies (TTCs) on annual and supplementary seizure payments promote involvement of TTCs in illicit tobacco trade
Boister, 2010	Law synopsis, critical assessment	The judicial measures taken against a complex of money laundering offences should also be effective fighting against the proceeds of the illicit trade in tobacco
Billingslea, 2004	Statistical data analysis, report analysis, critical assessment	The illicit sale of cigarettes has become a crucial part of terrorist funding activities.
Alderman, 2012	Law synopsis	Tobacco smuggling operations have been linked to numerous terrorist organizations globally, and evidence shows that cigarette smuggling profits have financed terrorism around the world
von Lampe, 2011	Literature analysis, statistical data analysis, critical assessment	The source funding for terrorist groups is one of the major aspects that describe the nature of illegal tobacco trade

Source: compiled by the authors

As it can be seen from table 1, most previous studies confirm the existence of the interrelationship between money laundering and illicit tobacco trade. Nevertheless, it should be noted that the relationship is not one-sided, but can go both directions, i.e. money laundering may constitute

a substantial part of the financial management of illicit tobacco trade (World Health Organisation, 2003; Antonopoulos, Hall, 2016), while illicit tobacco trade may serve as a vector for money laundering (FATF, 2012) and funding of the activities of terrorist and criminal organisations (Billingslea, 2004; von Lampe, 2011; Alderman, 2012). Boister (2010), who analysed the relationship between the Draft Illicit Tobacco Trade Protocol and the UN Convention against Transnational Organised Crime, proposes that the judicial measures taken against a complex of money laundering offences should also be effective fighting against the proceeds the illicit trade in tobacco, which proves the existence of the interrelation between money laundering and tobacco smuggling. Moreover, different money laundering schemes are linked to large-scale rather than small-scale illicit tobacco trade (tobacco smuggling) (von Lampe, 2011).

Finally, whatever striking it may sound, illicit tobacco trade can, in some cases, be funded by authorized institutions that pursue the initial goals to prevent, detect and control the scopes of this phenomenon. For instance, Joossens et al. (2016) introduce the study in which they assess the EU's illicit trade agreements with four major transnational tobacco companies (TTCs) - "Philip Morris International", "Japan Tobacco International", "British American Tobacco" and "Imperial Tobacco Limited". The authors note that annual and supplementary seizure payments, equivalent to 100% of the evaded taxes in the case tobacco products are seized, are foreseen in the above-mentioned agreements. However, they conclude that due to the lack of transparency in the area under consideration, the agreements of such type hardly help to alleviate the problem of the illicit trade in tobacco products; on the contrary, they mainly serve to the benefits of TTCs, promote their involvement in illicit tobacco trade, and thus impede an effective control of tobacco trade.

On balance, the majority of previous findings confirm the interrelationship between money laundering and illicit tobacco trade, which gives a presumption to believe that money laundering can be as well closely linked to tobacco smuggling. On the other hand, because some of the studies indicate that only a small part of the cases of illicit tobacco trade under prosecution are at the same time related to accusation of the perpetrators of the involvement in money laundering schemes, and that illicit tobacco trade can even be funded by authorized public institutions making payment agreements with major transnational tobacco companies whose products are the main object of smuggling, the issue of whether namely money laundering is the main funding source for tobacco smuggling still requires a deeper analysis.

4. Research Methodology

Focus group discussion is frequently used as a qualitative approach to gain an in-depth understanding of social issues. The method aims to obtain data from a purposely selected group of individuals rather than from a statistically representative sample of a broader population. Even though the application of this method in conservation research has been extensive, there is no critical assessment of the application of the technique. In addition, there are no readily available guidelines for conservation researchers. The focus group developed for this research involved five experts with at least 20 years of professional experience, working in the Institute of International Relations, Taras Shevchenko National University of Kyiv, Ukraine. The experts' main areas of interest cover smuggling, corruption, money laundering and organized crime. The participants of the focus group were asked the following questions: "How money laundering is related to cigarette smuggling in Ukraine?"; "What measures do you think would be most effective in reducing cigarette smuggling in your country?"; "What measures do you think would be most effective in reducing money laundering in your country?".

5. Empirical Results from the Research

The empirical research is aimed at identification of the links (if any) between money laundering and cigarette smuggling in Ukraine. Further in this section, the experts' answers and insights are provided.

How money laundering is related to cigarette smuggling in Ukraine??

According to the first expert, money obtained from cigarette smuggling is legalized and used to meet personal needs (to purchase cars, houses, summer houses, or other property) and they are very interconnected. According to second expert, smuggling operations are closely connected with development of the tourist clusters, especially in the western part of Ukraine. Third expert added that money obtained from smuggling is invested in property: in the first place, connected to tourist services, tourist infrastructure in Ukraine and close neighbouring areas. Fourth expert pointed out that

money obtained from cigarette smuggling is legalized and used to develop legal business, to finance corruption schemes, and stressed that cigarette smuggling and money laundering are different spheres, the major context of money laundering is not paying taxes properly. Fifth expert summed up the outcomes of the discussion and concluded that volume of the money laundering connected to cigarette smuggling is not extremely high. *The link between cigarette smuggling and money laundering exists, but it is not so evident.*

“What measures do you think would be most effective in reducing cigarette smuggling in Ukraine?”

The first expert pointed out that the approximation of Ukrainian legislation to the provisions of the EU Directive 2014/40/EU of 3 April 2014 on approximation of laws, regulations and administrative provisions of the Member States concerning the manufacture, presentation and sale of tobacco and related products will increase the price of cigarettes to the level similar to the EU and will also adjust standards for cigarettes produced in Ukraine to the EU standards. (On the other hand, it might encourage cigarette smuggling to Ukraine from Russia and Belarus). The second expert emphasized that the most effective means to reduce smuggling is to introduce centralized combined customs and tax service system aimed to make it impossible to circulate/sell any goods or commodities including cigarettes on the internal market without proper legal processing by Ukrainian customs. Third expert reminded that in the EU Directive adopted in 2014 produces most of the provisions regarding packaging and content of the cigarettes.

The fourth expert proposed to discuss drafting laws in the Parliament and the question of raising the excise duty rates. He said that higher prices will lead to smuggling from Russia, Belarus and other countries. If we have the higher prices than in other countries and that smuggling from Russia, Belarus and other countries is similar to the situation of the early 2000s, reminding that there were huge smuggling volumes (approximately 30% of the market volume in 2000) from Russia and almost all this market, especially for low price segment, was supplied from Russia.

It was also noted by the fifth expert that now Ukraine is one of the biggest official exporters of cigarettes among former Soviet Union countries. As of 2018, in the world ranking of cigarettes exporting countries, Ukraine ranks 16th with an export volume of \$ 340.3 million, Russia - 17 (\$ 301.3 million), Armenia - 18 (\$ 265.8 million) (Workman, 2019). He also pointed out that the question of jobs and social security is rather sensitive, and the criminal liability would not stop people from smuggling. He mentioned that the cigarette market is being divided and e-cigarettes, vapers and new types of e-cigarettes are the challenges for classic cigarettes market in general, and that the popularity of a healthy lifestyle among all age groups is growing in Ukraine. Such issues as raising excise duty rates and criminal liability were also discussed.

“What measures do you think would be most effective in reducing money laundering in your country?”

It was mentioned by the first expert that the National Bank of Ukraine and Ministry of Finance are very active now and that internal compliances of private banks and state-owned banks are working quite effectively. The expert pointed out that now Ukraine has problems with liquidity, but not with money laundering, although this partly complicated it.

The second expert discussed such issues as Ukraine and FATF cooperation, tougher regulation in the use of offshore jurisdictions, the functioning of so-called shell companies, the conduct of commodity-free operations; laws designed to abolish this problem and transfer pricing and all this excessive legal for tracing the links between the owner of the enterprise and its true beneficiary; amendments to Ukrainian legislation.

The third expert emphasized that Ukraine is much more open now than other countries. She reminded that in Ukraine you do not need even to pay for some business intelligence or business insight to look through the whole holding system, you could find the final beneficiary, the information is open to public.

The fourth expert continued the discussion, pointing out that Ukraine is more open in the context of public access to data on ultimate beneficiaries, affiliated companies, ownership structure than other countries in Europe in some way; measures implemented are successful in that area e.g. electronic declarations, financial control of the operations of all public servants, generally effective operation of the financial monitoring system, including its automatic mode. According to the fifth expert Ukraine has a list of measure to fight money laundering: a) application for FATF Membership

and approximation of Ukrainian legislation and implementing practices to FATF standards including CRS standard (standard of automatic exchange of financial information), which makes it mandatory for banking institutions, insurance companies and brokers to disclose information on their clients; b) adoption of criminal charges for money laundering as a result of serious crimes, which may depend on the amount of “laundered” money, the duration of criminal activity, etc.; c) introduction of special procedure for financial institutions in order to identify their customers and proper record keeping; d) appropriate procedures for controlling and supervising the activities of financial institutions.

6. Conclusion

Literature analysis has revealed that the links between money laundering and illicit tobacco trade can be of different character in different states. In the case of Ukraine, the links between cigarette smuggling and money laundering also exist, but they are not so evident because cigarette smuggling and money laundering are different spheres. The money earned from cigarette smuggling in Ukraine is often used for personal needs, tourism clusters, acquisition of real estate, development of legitimate business and/or funding of corruption schemes. The main expert recommendation in the fight against cigarette smuggling is development of the centralized customs and tax service system. Raising excise duties is considered a risky alternative because it can promote cigarette smuggling into the country from Russia and Belarus. It is thought that stricter reinforcement of criminal liability would not deter agents from smuggling, while promotion of healthy lifestyles may have a greater impact on reduction of the scopes of cigarette smuggling. The efficient implementation of the National Bank regulation rules, the development of an effective system of financial monitoring, and introduction of a simple and transparent tax system may serve as effective measures against money laundering. The practical applicability of the study is obvious, revealing areas where anti-money laundering and cigarette smuggling would be most effective.

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