

Helpdesk Research Report

Relationship between illicit economic activity and illicit financial flows

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29.10.2013

Question

Identify literature which discusses the relationship between illicit economic activities (specifically people trafficking, narcotics, illicit trade in minerals and manufactured goods or arms) and illicit financial flows. Look to identify evidence which proves (or disproves) a causal relationship between the two.

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1. Overview

Econometric evidence finds a mutually reinforcing relationship between illicit economic activities and illicit financial flows. Qualitative research identifies impacts of illicit economic activities and financial flows. These may provide potential ways of explaining the causal link.

It is important to note that data on illicit economic activities and illicit financial flows is very difficult to obtain, with quantitative analysis based on often complex estimation techniques which are limited by the strength of these (arguably strong) models. Many analyses group illegal economic activities together, and

illegal financial flows are not always disaggregated by origin. It has therefore not been possible to identify to what extent individual types of illicit economic activities are drivers and driven by illicit financial flows¹.

People trafficking, narcotics, illicit trade in minerals and manufactured goods or arms, are a type of criminal activity which make up one form or grouping of illicit financial flows. The other forms are from government corruption and from commercial transactions. Within financial flows from criminal activity, illicit drugs are the most valuable market, and therefore the largest contributor to illicit flows.

Econometric analysis of data from Russia, India and Mexico find a significant link between illicit flows and the illicit or underground economy with the two driving each other (Kar, 2010, 2012; Kar & Freitas, 2013). The underground economy is made up of criminal activities, such as illicit drugs and human trafficking, but also includes money earned legitimately which has been transferred through illegal channels. From this quantitative research the causal pathway between illicit economy activities and illicit financial flows is not clear.

Illicit economic activity and illicit financial flows have a number of impacts. These impacts may help explain the causal link, specifically how illicit economic activity and illicit financial flows mutually reinforce and drive each other. They:

- **Undermine governance and development:** Illicit flows are not spent or taxed domestically which means less public and private expenditure and investment. Illicit activities and flows can undermine the quality and reputation of state and financial institutions. Criminals are also strongly incentivised to undermine governance so as to continue criminality.
- **Undermine financial systems:** Illicit flows can damage the reputation of (and weaken) financial firms, financial centres, and the wider financial system. Rather than banks being passive players, they may play an active role in illicit flows though further research is needed to identify how exactly banks play a part.
- **Cause economic distortions:** Illicit funds can distort resource allocations and crowd out legitimate firms and sectors. In Africa, for example, some estimates find that economic growth would have been notably higher had the illicit outflows not taken place.
- **Support reinvestment into crime:** Illicit flows can be used to invest into further criminal activities. Drug traffickers – the largest source of illicit criminal flows – are more likely to reinvest into their business sector than other criminals.
- **Can develop unique symbiotic relationships:** Certain illicit economic activities can develop symbiotic relationships with types of flows. Corruption, which primarily takes place in developing countries, seems to have a symbiotic relationship with money laundering, which takes place in more developed countries. They seem to reciprocally reinforce each other.

¹ Additional literature relating to issues such as drug trafficking funding terrorism, tax havens, and the methodological debate about how best to assess capital flows was examined, but excluded as it was not felt to be directly relevant to the question.

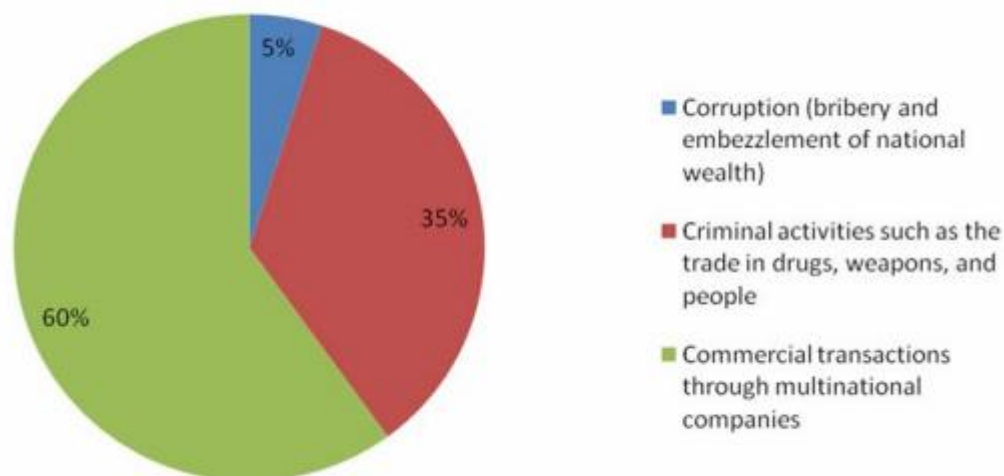
2. Breakdown of illicit financial flows from illicit economic activities

Illicit financial flows can be broken down into three main forms (UNECA 2013):

- The proceeds of theft, bribery and other forms of corruption by government officials;
- The proceeds of criminal activities including drug trading, racketeering, counterfeiting, contraband, and terrorist financing; and
- The proceeds of tax evasion and laundered commercial transactions.

Estimates of this breakdown globally (see figure 1), suggest that commercial transactions through multinational companies make up most of the illicit flows with criminal activities including people trafficking, narcotics, illicit trade in minerals and manufactured goods or arms, making up approximately 35 per cent (UNECA 2013).

Figure 1: Relative composition of global illicit financial outflows



Source: Baker, in UNECA, 2013, p. 3.

An analysis was undertaken through a literature review on the scale, flow, profit distribution, and impact of 12 different types of illicit trade (Haken, 2011). These types of trade were drugs, humans, wildlife, counterfeit goods and currency, human organs, small arms, diamonds and coloured gemstones, oil, timber, fish, art and cultural property, and gold. In 2010, the global illicit flow of goods, guns, people, and natural resources is estimated at approximately US\$ 650 billion, with **illicit drugs** (worth roughly US\$ 320 billion) and **counterfeiting of goods and currency** (worth roughly US\$ 250 billion) generally accepted as the two most valuable markets (Haken, 2011).

Financial flows from **people trafficking** are estimated to be substantially lower than illicit drug trafficking, with estimates of people trafficking at US\$ 32 billion for 2010 – roughly 10 times lower than drugs trafficking (UNODC, 2011). The global market for **counterfeit medicines** is estimated at US\$ 75 billion in 2010, twice as large as the income generated from trafficking in persons (ibid).

3. Econometric analysis of causal links

Global financial integrity has undertaken a number of case studies on illicit financial flows (e.g. Kar 2010, 2012; Kar and Freitas, 2013). Illicit flows involve the cross-border transfer of money mainly earned through illegal (or underground) economic activities such as corruption, transactions in contraband goods including drugs, criminal activities, human trafficking, and the sex trade (Kar, 2012). Illicit flows may also include money that has been earned legitimately, such as business profits or individual income that has been transferred to avoid tax.

The following case studies use econometric analysis to identify a relationship between illicit flows and the underground economy in Russia, India and Mexico.

3.1 Russia

Kar and Freitas (2013) find that total illicit flows both drive and are driven by underground (i.e. illicit) economic activities. Their study quantified and evaluated the volume and significance of illicit financial flows from Russia since 1994. The authors introduce the concept of total illicit flows (i.e. illicit inflows plus outflows) to examine the link between the total volume of such flows and underground economic activities in Russia, using macroeconomic, structural, and governance-related variables.

Testing the link in the context of a simultaneous equation framework, the authors find a significant link between illicit flows and the growth of the underground economy with the two driving each other. That said, the authors note the limited robustness of their conclusions, given comprehensive data has only been available since 1994. A longer time series is needed to attain more confidence in tests of significance and the results should be seen as being preliminary or indicative in nature rather than conclusive.

The authors argue that unlike licit flows, illicit flows in both directions are harmful to the economy. They conclude that governance seems to be the most important driver of both illicit flows and the underground economy. The large illicit flows and how they both drive, and are driven by, the underground economy, is symptomatic of weak overall governance (Kar and Freitas, 2013).

3.2 India

Kar (2010) finds that India has lost a total of US\$ 213 billion dollars due to illicit flows since 1947. Regression analysis shows a statistically significant relationship between illicit flows and the size of the underground economy. Kar (2010) concludes that the underground economy is an important driver of illicit financial flows, and the growth of the underground economy is indicative of the state of overall governance in the country. He argues that shrinking the underground economy can will curtail illicit flows while expand the underground economy would increase such flows.

Kar (2010) proposes that illicit flows from India are driven by a complex interplay of structural factors and governance issues rather than by poor macroeconomic policies. He suggests that India should enact tax and customs, reform, redistributive policies to ensure more inclusive growth, and other regulatory oversight changes to improve governance. At the same time developed countries should ensure greater transparency in banks and offshore financial centres so as not to facilitate the absorption of illicit funds.

3.3 Mexico

Between 1970 and 2010 cumulative illicit financial flows from Mexico are estimated at US\$ 872 billion, with the volume of illicit outflows rising during the onset and aftermath periods of Mexico's macroeconomic crises (Kar, 2012). Using econometric analysis, Kar (2012) finds clear evidence that the underground economy in Mexico is mainly driven by illicit outflows and is related to the size of the underground economy in the previous time period. Model simulations demonstrated a dynamic interaction between illicit flows and the underground economy with each driving the other.

Kar (2012) finds that macroeconomic instability such as high fiscal deficits, inflation, and external debt can lead to loss of confidence in the economy triggering depreciation of the exchange rate which in turn can drive illegal capital flight. Though prudent macroeconomic policies can curtail illicit flows, Kar (2012) argues that structural and governance-related issues also need to be addressed to stem the outflows.

4. Impact of illicit economic activities and illicit financial flows

There is little comprehensive literature that explains the causal pathway between illicit economic activities and illicit financial flows, and how they actively drive each other. However, an important way to analyse their relationship is to examine their impacts they have. There are a number of political, social, and economic impacts of illicit economic activities and illicit financial flows. This section looks to identify those impacts that may help understand the causal link between them.

4.1 Undermining governance and development

The most immediate impact of such illicit flows is a reduction in domestic public and private expenditure and investment, which results in fewer jobs, hospitals, schools; less infrastructure; and ultimately less development (OECD, 2013). Illicit financial flows undermine the state, through bribery and public theft, and undermine various institutions, such as banks, financial intelligence units, and legal systems, that are responsible for detecting and prosecuting these illicit flows (UNECA, 2013).

Profits from illicit economic activities benefit transnational crime syndicates and the criminal networks they establish and maintain. These criminal networks have very little incentive to bolster the legitimate economies in the countries where they operate as any improvements in economic development and governance would hinder their illegal activities (Haken, 2011).

Dar (expert comments) argues that the size of the underground economy serves as an excellent proxy for the state of overall governance: in well-governed countries the underground economy is small (and perhaps declining) as a share of the official economy while in poorly governed countries, the underground economy is large and increasing (Dar, expert comments).

4.2 Undermining financial systems

Receiving illicit funds can damage the reputation of the firms and financial centres that receive them, or the financial sector as a whole (UNODC, 2011). UNODC (2011) argues that a reputation for integrity is one of the most valued assets by investors and receiving illicit fund can undermine investors' trust in them, and, therefore, weaken the financial system.

Heggstad and Fjeldstad (2010) argue that banks should not be regarded as passive players when analysing capital flight, which includes illicit flows, as they play an active role in facilitating this. The authors conclude that that more knowledge is needed on how banks assist political elites and their close associates, companies, individuals and organised crime to channel capital out of countries.

Baker (in Haken, 2011) notes that cross-border passage of criminal money is facilitated by the global shadow financial system which also enables the movement of the other illicit proceeds from corruption and commercial tax evasion. He argues that is not possible to curtail the cross-border passage of criminal money without also curtailing other illicit flows.

4.3 Economic distortions

Even when criminal funds are invested in the legal economy, this may create a number of problems, from distortions of the resource allocation, to 'crowding out' licit or legitimate sectors and undermining the reputation of local institutions (UNODC, 2011). This can also hamper investment and economic growth.

In 2001, Collier et al. estimated that if illicit outflow of funds not taken place, GDP per capita in Africa would have been roughly 16 per cent higher (Collier et al. 2001).

4.4 Reinvestment into crime

Criminal funds further perpetuate and promote criminal activities (UNODC, 2011). An analysis in the Netherlands, found that illicit drug traffickers, who produce the largest proportion of illicit flows. (see section 2) were most likely to reinvest their money (UNODC, 2011). Compared to other criminal activities, the overall proportion of money used by drug traffickers for reinvestment into their 'business sector' is higher: income from drug trafficking seems to promote drug trafficking more than income from other crimes fosters other crimes.

4.5 Unique symbiotic relationships

There are likely to be symbiotic relationships between different types of illicit economic activities and flows. Chaikin and Sharman (2009) argue that corruption and money laundering are symbiotic. Not only do they tend to occur together but 'the presence of one tends to create and reciprocally reinforce the incidence of the other' (Chaikin and Shareman, 2009, p. 1). The authors highlight the relationship between corruption in developing countries and money laundering which often takes place in the developed world, arguing dealing with both requires an integrated approach.

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Suggested citation

Rao, S. (2013). *Relationship between illicit economic activity and illicit financial flows*. GSDRC Helpdesk Research Report 1019. Birmingham, UK: GSDRC, University of Birmingham.
<http://www.gsdrc.org/go/display&type=Helpdesk&id=1019>

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