

# U4 Expert Answer



## Literature review on the linkages between illicit economy and corruption

### Query

**Can you please provide a review of the literature on the linkages between illicit economic activity (specifically: people trafficking, narcotics, illicit financial flows, and illicit trade in minerals and manufactured goods) and corruption/institutional weakness?**

### Purpose

This answer will be used in an OECD meeting on the topic.

### Content

1. Shadow economy and corruption
2. Illicit financial flows and corruption
3. Organised crime, trafficking and corruption
4. Illegal natural resource exploitation and corruption

### Summary

There is consensus in the literature on the reciprocal causality of illicit economic activities and corruption. The prevalence of an underground economy and illicit financial flows and the intrinsic opacity of such activities create a fertile ground for corruption to thrive. Corruption is in turn an enabling factor for illicit economic activities. This becomes a vicious cycle, with illicit trade damaging the state structure and legitimate economy, then using these conditions to facilitate more trafficking and laundering of dirty money.

This helpdesk answer presents a selection of recent publications examining the linkages between corruption and the shadow economy, illicit financial flows, organised crime and trafficking as well as illicit exploitation of natural resources.

### 1 Shadow economy and corruption

A "shadow economy" is defined by the Oxford Dictionary as the "illicit economic activities existing alongside a country's official economy." It is the market in which goods and services are traded illegally, to avoid government regulation or taxation. Not all services and goods traded in the shadow economy are illegal per se, such as cigarettes or manufactured goods for example. Similarly, some segments of the shadow economy often described as the informal sector assume a vital role in providing jobs, livelihoods and vital services particularly to the poor and marginalised communities in developing countries, where formal institutions fail to reach or function. This means that informal economic activities should not automatically be equated with corrupt transactions to be stamped out. See for example TI Global Corruption Report 2009 for a

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discussion on how to address informality). This review focusses, however, on the less benign and criminal dimensions of the shadow economy.

There is only limited research and literature on the impact of the existence of shadow economies on levels of corruption, but expert opinions tend to see shadow economies as an important driver of corruption. In the shadow or underground economy, corruption can be perceived as an alternative “tax” being paid to avoid detection, official taxation or prosecution. In this way the shadow economy becomes a driver of corruption and weakens public institutions.

### **Global Corruption: Money, Power and Ethics in the Modern World**

Cockcroft Laurence, 2012, I.B. Tauris

This volume, by Laurence Cockcroft, aims to consolidate the lessons learned from the fight against corruption over the 20 last years. In addition to identifying organised crime as one of the main drivers of corruption, the author points to the prevalence of shadow economies as one of the most significant obstacle to any effective anti-corruption effort.

### **Corruption and the Shadow Economy: A Structural Equation Model Approach**

Buehn Andreas, Schneider Friedrich, 2009, The Institute for the Study of Labor (IZA)

<http://www.econstor.eu/bitstream/10419/35501/1/602112672.pdf>

This paper presents empirical evidence of a positive relationship between the shadow economy and corruption. The authors initiate their argument by stating that theoretically the relationship between corruption and the shadow economy is not clear. They apply advanced econometric methods to explore the relationship between the two concepts. The results of their model suggest that the shadow economy influences corruption more than corruption influences the shadow economy.

The findings show that a large shadow economy is linked to high levels of corruption. In order to avoid detection, taxation, and punishment, they bribe bureaucrats. Moreover, low tax revenues reduce the quality of public services and infrastructure. This in turn reduces the incentives to remain in the official economy. Weaker legal systems and unstable conditions for economic activity increase corruption.

Acting like an extra tax corruption drives individuals into the shadow economy.

## **2 Illicit financial flows and corruption**

The existing literature offers a couple of complementary definitions of illicit financial flows. Dev Kar, from Global Financial Integrity, defines “illicit financial flows” as “money that is illegally earned, transferred, or utilised. Somewhere at its origin, movement, or use, the money broke laws and hence it is considered illicit.” For the United Nations Development Programme (UNDP), “illicit [financial] flows include, but are not limited to, cross-border transfers of the proceeds of tax evasion, corruption, trade in contraband goods, and criminal activities such as drug trafficking and counterfeiting.” (Le Billon 2011).

There is a close relation between illicit financial flows and corruption since the former is often the result of the latter. Research featured in this section tends to show that there is a reciprocal causality between illicit financial flows and corruption, in which money-laundering plays a central role; corruption being a source of illicit funds and an enabler of money-laundering and money-laundering allowing for the proceeds of corruption to be hidden away and used. Moreover, illicit flows disproportionately damages state institutions in developing countries, by limiting the provision of public goods and undermining the stability and legitimacy of the institutions.

Financial profits are one of the main drivers of corruption and the contributions featured in this section demonstrate how different money laundering techniques enable the corrupt to conceal illicit funds.

### **Corruption and illicit financial flows. The limits and possibilities of current approaches**

Reed Quentin, Fontana Alessandra, 2011, U4 Anti-corruption Resource Centre

<http://www.u4.no/assets/publications/3935-corruption-and-illicit-financial-flows.pdf>

This paper attempts to clarify the links between illicit financial flows and corruption, and how corruption may be tackled by stemming such flows. For this purpose, it clarifies the terminology surrounding illicit flows, describes the impact of such flows, outlines the techniques used to launder them (with a particular focus on laundering of the proceeds of corruption), and

critically analyses existing policies designed to tackle illicit flows.

This paper argues that corruption and illicit financial flows have a reciprocal causal relationship: corruption facilitates money laundering, and money laundering enables corruption to reap large profits. Corruption is linked to money-laundering as the source of proceeds (e.g. bribes) that constitute illicit funds to be laundered; as a means to facilitating the creation of illicit funds, through bribery of tax administrations for instance; as a means for enabling an illicit flow itself by the corruption of institutions with anti-money laundering obligations.

### **The Puppet Masters How the Corrupt Use Legal Structures to Hide Stolen Assets and What to Do About It**

World Bank, 2011

<http://star.worldbank.org/star/sites/star/files/puppetmastersv1.pdf>

This report shows how corporate vehicles are used to hide the proceeds of bribery, embezzlement of public funds, or other forms of corruption. In the past, people hid their involvement with funds through anonymous bank accounts or accounts in fictitious names. This option, however, is becoming increasingly less available. By offering new more refined and ingenious ways of concealing ill-gotten gains, the misuse of corporate vehicles, among other techniques, drives corruption and fuels impunity.

In addition to examining the ways in which corrupt officials misuse corporate vehicles to conceal their interests, this report takes a closer look at the chain reaction that spurs both the corrupt officials and those seeking to track them down to continuous improvement of their methods.

### **Undue Diligence How banks do business with corrupt regimes**

Global Witness, 2009

[http://www.globalwitness.org/sites/default/files/pdfs/undue\\_diligence\\_lowres\\_0.pdf](http://www.globalwitness.org/sites/default/files/pdfs/undue_diligence_lowres_0.pdf)

This report presents a series of case studies about bank customers in Equatorial Guinea, Republic of Congo, Gabon, Liberia, Angola and Turkmenistan. In these countries, the national resource wealth has or had been captured by an unaccountable few, whether for personal enrichment, to maintain an autocratic personality cult that violated human rights, or to fund devastating wars. The report names some of the major

banks who have done business with corrupt regimes. It shows how, by accepting these customers, banks are assisting those who are using state assets to enrich themselves or brutalise their own people.

Despite the existence of anti-money laundering laws and due diligence requirements, financial institutions often fail to identify the real person behind a series of front companies and trusts. These laws and norms fail to be explicit about how banks should handle natural resource revenues when they may be fuelling corruption. A shadow state's kleptocratic elite generates much of its illicit wealth via the expropriation of national assets, particularly the natural resources which should belong to the public and be utilised for the common good. The amounts involved are often catastrophic for the country's economy.

The authors show that when running such a shadow state system it is helpful to keep funds well away from the national budget and the national treasury, by whatever means. A parallel financial system, held offshore or operated through a state-owned enterprise allows rulers to keep funds to pay people off when necessary, maintain control of favours, and in many cases to set aside funds for their own luxurious lifestyles. In addition, the calculated institutional dysfunctions created by shadow state leaders in order to maintain their own rule also makes their own countries highly unsuitable venues for the safekeeping of their stolen wealth, which is why they prefer to keep these gains offshore.

### **Africa's Bane: Tax Havens, Capital Flight and the Corruption Interface**

John Christensen, 2009

<http://www.u4.no/recommended-reading/africa-s-bane-tax-havens-capital-flight-and-the-corruption-interface/>

This paper outlines how secrecy jurisdictions (also known as tax havens) and the bankers, lawyers and accountants who operate from these jurisdictions, actively encourage and support corrupt practices by facilitating illicit financial flows through an 'offshore interface' between the illicit and lawful economies. Financial market liberalisation has contributed to this problem by not addressing the 'secrecy space' comprised by banking secrecy, non-disclosure of ownership of corporations and other legal entities, lack of accounting transparency for multinational companies, and the lack of provisions for effective exchange of information between national authorities.

### 3 Organised crime, trafficking and corruption

As presented by the [UNODC](#), organised crime manifests itself in various forms including trafficking in drugs, arms and human beings, among others. Organised criminal groups are at the heart of international trafficking schemes and are key actors at the illicit economy/corruption nexus.

There is a causal relationship between organised crime, especially through trafficking operations, and corruption. The large sums involved represent a form of power that can compromise legitimate economies and undermine public and political processes. Corruption linked to organised criminal activities takes many forms, from petty corruption of customs officers to complete infiltration of society and state capture. Corruption is an enabling activity of organised criminal groups.

#### International Drivers of Corruption. A Tool for Analysis.

OECD, 2012

<http://www.oecd.org/development/governance-development/49263997.pdf>

This analytical tool addresses the essential issue of how the international drivers affect country-level governance, focussing on those forms of corruption and governance failure most damaging to economic growth and development. Corruption and governance failures here also extend to other behaviours that may not always be considered illicit, but that are driven by the narrow and self-serving interests of powerful groups. This includes attempts by such groups to create and capture economic rents, and to direct public spending to private goods benefitting themselves or narrow bands of supporters.

The report looks at major changes in the global economy, in particular since 1970, which have fundamentally affected the incentives facing political and economic elites. International drivers are defined as “the global or regional factors that influence the domestic political economy”. They primarily include economic processes operating at the global or regional level, but also include trends in international relations and security, such as the increasing demand for natural resources or the growing influence of criminal groups.

The high level of international demand for raw materials generates massive rents that can greatly influence the

economy and governance of producer countries. Impacts in relation to governance include the struggle among and within elites to control the resulting rents and the negative effect of non-tax incomes on accountability.

Powerful groups emerging from criminal backgrounds are often well connected across international borders, as are those empowered by military links. Illegal narcotics trading and smuggling into rich country markets also generate high profits and rents, with particularly corrupting effects on police and politicians in transshipment areas. The incentive to take advantage of all these opportunities for personal enrichment is intensified by some features of financial liberalisation which both facilitates large transnational capital movements and provides scope for hiding financial assets overseas.

#### Transnational Crime in the Developing World

Haken Jeremy, 2011, Global Financial Integrity

[http://www.gfintegrity.org/storage/gfip/documents/reports/transcrime/gfi\\_transnational\\_crime\\_web.pdf](http://www.gfintegrity.org/storage/gfip/documents/reports/transcrime/gfi_transnational_crime_web.pdf)

This report analyses the scale, flow, profit distribution, and impact of 12 different types of illicit trade: drugs, humans, wildlife, counterfeit goods and currency, human organs, small arms, diamonds and gemstones, oil, timber, fish, art and cultural property, and gold. It finds that the profits of global illicit trade amounts to billions of dollars, and that profits from illicit markets are funnelled mainly to the transnational crime syndicates which establish and maintain vast trade networks involving everyone associated with the production, transport, and sale of an illicit good; from the labourer, to the corrupt customs official, to the migrant worker.

Those involved in illicit trade use corruption and bribery to enable their activities and the transfer of goods, and to avoid prosecution. The profits of illicit trade are used to criminalise the state itself. In the long run it is the trust that citizens have in their institutions and government that is destroyed. This becomes a vicious cycle, with traffickers damaging the state structure and economy, then using these poor conditions to facilitate more trafficking.

#### Examining the links between organised crime and corruption

Centre for the Study of Democracy, 2010

[http://ec.europa.eu/dgs/home-affairs/doc\\_centre/crime/docs/study\\_on\\_links\\_between\\_organised\\_crime\\_and\\_corruption\\_en.pdf](http://ec.europa.eu/dgs/home-affairs/doc_centre/crime/docs/study_on_links_between_organised_crime_and_corruption_en.pdf)

This report was commissioned by the European Commission (EC) to analyse the links between organised crime and corruption with the main objectives to identify the causes and factors that engender corruption by organised crime within the public and private sectors, the scope and the impact of that corruption on society and institutions, and the best practices in prevention and countering corruption linked to organised crime.

The report presents two different analytical views of organised crime's use of corruption: (i) it examines how politicians/ government administration, police, customs, the judiciary, and private companies are targeted; and (ii) depicts how corruption facilitates the operation of illegal markets (illegal cigarettes, drugs, prostitution, car-theft and extortion). The study concludes that prostitution and illegal drugs markets exert the most corruptive effect in the EU. It shows how some illegal markets, like the illegal cigarette trade, target primarily customs or local governments and law enforcement in border areas. In other illegal activities, such as motor vehicle theft and protection rackets, corruption is needed much less because of the nature of the criminal operations.

In some countries, "political patronage" creates a vertical system of corruption that functions from top to bottom in all public institutions (administration, judiciary and law enforcement, customs). In other countries politicians, magistrates, and white-collar criminals form closed corruption networks that are not systematic in nature. Mid- and low level government bureaucrats are primary targets of organised criminal groups. In addition to public institutions, criminal networks have a special interest in the private sector. By targeting company employees they have great opportunities to extract significant revenues, avoid anti-money-laundering regulations, or facilitate the operation of illegal markets.

The research shows that political corruption is organised crime's most powerful tool, both at the national and local levels. Police corruption, judicial corruption, customs corruption, as well as private sector corruption are all very common consequences of the operations of organised criminal groups.

### **Squeezing a Balloon? Challenging the nexus between organised crime and corruption**

Reed Quentin, 2009, U4 Anti-corruption Resource Centre

<http://www.u4.no/publications/squeezing-a-balloon-challenging-the-nexus-between-organised-crime-and-corruption-2/>

This U4 Issue examines the links between corruption and organised crime, using both analytical frameworks and real-world examples primarily from Afghanistan, Latin America and West Africa.

The activities or sectors in which organised crime engages are many, ranging from traditional protection rackets to the organisation of production in the grey economy of ordinary consumer goods. The author divides these activities into "primary activities" (those generating profit) and "enabling activities" (those that make the primary activities possible). Corruption is one of the primary enabling activities and may take many different forms – varying from petty bribery of customs officials to ignore drug shipments to the integration of high-level border officials or even national politicians into the illegal trafficking networks.

In the context of organised crime, the author characterises corruption as the ways in which organised crime infiltrates or penetrates the state (public sector). The paper lists five ways of infiltration: (i) sporadic bribery; (ii) having low-ranking state officials on the organised criminal payroll; (iii) hiring of state personnel in managerial positions in order to favour the operations of criminal groups; (iv) corruption of the heads of agencies responsible directly or indirectly for fighting organised crime-related activities; and (v) state capture by criminal groups who are then able to manipulate law making, law enforcement and judicial decisions themselves.

### **Analysing the business model of trafficking in human beings to better prevent the crime**

OSCE, UN.GIFT, 2010

<http://www.osce.org/cthb/69028?download=true>

This study was produced to identify theoretical underpinnings which may explain the business and socio-economic factors contributing to human trafficking. Numerous crimes are committed when human trafficking occurs. These may be instrumental criminal activities which are perpetrated in direct furtherance of the trafficking activity (falsification of documents, forced prostitution or other forms of sexual or labour exploitation, violence associated with maintaining control over victims, and corruption of government officials). In addition the crimes may be



indirect and occur as a result of the trafficking activity (money laundering and tax evasion).

To be able to subsist, criminal networks need the complicity and/or corruption of the legal economy and the state. Trafficking may be facilitated by legitimate businesses or individuals working for or with trafficking enterprises. Businesses may knowingly or unknowingly purchase the products produced or harvested by trafficked victims; customers may use the services of women and children forced into prostitution. Corrupt border guards, police or embassy personnel may facilitate trafficking practices.

#### Human Trafficking & Corruption: Triple Victimisation?

Holmes Leslie, 2009, in Friesendorf (ed.) *Strategies against Human Trafficking: The Role of the Security Sector*

[www.dcaf.ch/content/download/36920/529057/file/Chapter%202.pdf](http://www.dcaf.ch/content/download/36920/529057/file/Chapter%202.pdf)

This chapter provides evidence of involvement of corrupt officials in trafficking from various parts of the world. It identifies the types of officials involved and how they operate. This includes consideration of the ways in which corrupt officials can impact upon trafficking indirectly as well as directly. The resulting scale of trafficking-related corruption is larger than is commonly assumed.

The author provides examples of how human trafficking can lead to public officials' corrupt involvement:

- Directly through running or consciously participating in trafficking operations or related activities;
- Indirectly through using persons known or suspected to be victims of trafficking, refusing to investigate allegations of trafficking, through the supportive involvement in passing legislation that is conducive to trafficking or refusing to pass legislation designed to curb trafficking.

The author stresses that human trafficking and corruption create a vicious circle of blackmailing by which public officials are coerced to continue their corrupt involvement and even to deepen their collaboration with criminal groups, for security or reputational purposes.

He concludes that although organised crime and corruption are interactive, the latter drives the former more than the reverse. If trafficking is to be reduced,

states and international organisations will have to acknowledge far more than most currently do that it could not occur on the scale and with the ease it does without the collusion of their own officers.

## 4 Illegal natural resource exploitation and corruption

Similarly to drug or human trafficking, the exploitation of natural resources, be it oil, gas or minerals, generates enormous revenues, making it an attractive sector for the criminal and corrupt. Academic literature has shed some light on what is commonly referred to as the "resource curse" as a means to demonstrate how corruption deprives the populations of resource-rich countries of benefits from the generated wealth.

The exploitation of natural resources often lacks transparency and accountability. The high levels of discretionary political control of a few, coupled with the large sums of money involved and the concentration of power, create a fertile ground for corruption to thrive.

#### Rigged: The scramble for Africa's oil, gas and minerals

Global Witness, 2012

<http://www.globalwitness.org/library/rigged-scramble-africas-oil-gas-and-minerals>

Using case studies from Angola, Nigeria and the Democratic Republic of the Congo, this report demonstrates how intensifying competition for commercial access to the world's remaining deposits of oil, gas and minerals brings with it a serious risk of exacerbating corruption and violent conflict. Such corruption can prop up autocratic governments that keep their people in poverty while enriching elites and the international companies that are willing to do business with them.

The risk of corruption lies not only in the flow of revenues from contracts and licences, but also right at the start, when extractive companies are granted access to these licences and contracts. Too often private shell companies with opaque ownership structures are awarded lucrative concessions, with little information available as to who the beneficial owners of the company are, how much (if anything) the company has paid for the licence, and what the country has gained in return.

#### Extractive sectors and illicit financial flows: What role for revenue governance initiatives?

Le Billon Philippe, 2011, U4 Anti-corruption Resource Centre

<http://www.cmi.no/publications/file/4248-extractive-sectors-and-illicit-financial-flows.pdf>

The author attempts to demonstrate why most countries do not reap the full benefits from their wealth in natural resources, regretting that existing initiatives to address governance issues in extractive sectors have not been designed with the problem of illicit financial flows in mind. According to him, one of the major causes of his loss is illicit financial flows, that is, money that ends up benefiting local and foreign elites rather than the general population. Much of this money is generated by corruption, illegal resource exploitation, and tax evasion.

The author stresses that many factors make resource-rich countries and the extractives sector prone to illicit financial flows: underperformance in revenue collection; high-level discretionary political control; high concentration of power and limited competition; frequent blurring of public, shareholder, and personal interests with regard to extractive sectors; and complexity of the technical and financial processes that require high-level expertise.

This paper identifies three sources of illicit financial flows derived from extractive sector revenues: (i) corruption; (ii) illegal exploitation; and (iii) tax evasion. Large resource revenues facilitate rent-seeking and patronage, resulting in higher levels of corruption, diversion of time and talent from productive activities, inefficient public spending, and low political

accountability. Corruption can take place at all levels of the value chain, beginning with the initial bidding and contractual process.

### **Shining a Light on the Resource Curse: An Empirical Analysis of the Relationship between Natural Resources, Transparency, and Economic Growth**

Williams Andrew, 2010, *World Development* Vol. 39

This paper demonstrates linkages between being a resource-rich country and a lack of transparency. Using a relatively new index of transparency that has extensive coverage, both across countries and time, the results suggest a strong and robust negative causal association running from resource export revenues to transparency. Furthermore, there is also some evidence that this lack of transparency is associated with a subsequent decrease in economic growth.

The author argues that this lack of transparency can: (i) make corruption more attractive, in that it can reduce the probability of discovery; (ii) make it easier to capture rents; (iii) create monitoring and control problems (between governments and its citizens, but also between elected officials and the bureaucracy); and (iv) can undermine democracy via these resource rents by reducing the need for domestic taxation (and hence reducing demands for accountability), increasing spending on patronage, and/or increasing spending on the direct oppression of dissenting voices.