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ILLEGAL ACTIVITIES IN THE 1993 SNA¹

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EXECUTIVE SUMMARY

1. Since the publication of the 1993 SNA, the recording of the illegal activities has been considered in detail in the *Handbook, Measuring the Non-Observed Economy*² (hereinafter referred to as the *NOE Handbook*). The *NOE Handbook* has proposed some guidance to

¹ This paper has been prepared by Ivo Havinga, Gulab Singh, Herman Smith and Viet Vu for the Fourth Meeting of the Advisory Expert Group on National Accounts, 30 January-8 February 2006, Frankfurt and is subject to possible changes following the discussion at the meeting. The views expressed in this paper are those of the authors and should not be attributed to the United Nations.

² *Handbook, Measuring the Non-Observed Economy*, (2002), Organisation for Economic Co-operation and Development, International Monetary Fund, International Labour Organisation, Interstate Statistical Committee of the Commonwealth of Independent States.

countries for recording illegal activities pertaining to theft and fencing, bribery, extortion and money laundering.

2. Accordingly, it is proposed to include clarifications on the following topics in the updated SNA:

- the scope of illegal activities included in the production boundary should be further clarified by examples;
- recurrent thefts of significant value should be treated as transactions;
- sales of stolen goods (fencing) should be recorded similar to the recording of second-hand goods;
- bribery should be treated as a transaction as it can be assumed that individuals have a freedom of choice to enter into bribery;
- extortion payment should be recorded as other change in the volume of assets; and
- for money laundering, the difference between the value of the illegal cash and the value of the legalized cash should be looked upon as a provision of services.

Specific recommendations on these topics are made in the text that follows.

BACKGROUND

3. The 1993 SNA provides more guidance on the treatment of illegal activities than did the 1968 SNA. In the 1993 SNA, illegal activities that have the characteristics of transactions - notably that there is mutual agreement between the parties - are treated the same way as legal actions. Consequently, those illegal activities are included in production boundary. Moreover, the 1993 SNA makes it explicit that the accounts could be considerably distorted if significant redistribution of assets through actions without mutual agreement is not recorded as other flows in the other changes in volume account.

PROPOSED CLARIFICATIONS OF THE 1993 SNA

4. Since the publication of the 1993 SNA, the *NOE Handbook* has provided more examples of illegal activities and proposed further guidelines on theft and fencing, bribery, extortion and money laundering (relevant portion of Chapter 9 of the *NOE Handbook* is annexed for reference). This paper presents those elaborations for the considerations of the AEG.

EXAMPLES OF ILLEGAL ACTIVITIES

5. The *NOE Handbook* discusses illegal activities in some detail and identifies the following illegal activities:

- a) production and distribution of illegal goods, such as banned drugs or pornographic material;
- b) production of illegal services, such as prostitution (in countries where this is illegal);
- c) production activities which are usually legal but which become illegal when carried out by unauthorized producers, such as unlicensed medical practices, unlicensed gambling

- activities, unlicensed production of alcohol and poaching, e.g. illegal fishing, hunting, tree cutting;
- d) production and sale of counterfeited products, such as watches and other products with false trade-marks and unauthorized copies of artistic originals, e.g. software, CDs and videos;
 - e) smuggling, in particular of tobacco, weapons, alcohol, food, people, both wholesale and retail;
 - f) theft and fencing (resale) of stolen goods;
 - g) bribery;
 - h) money laundering; and
 - i) forgery of banknotes, contract murders, espionage, etc. For national accounts purposes, these are generally of minor importance.

Recommendation 1: The explanation of illegal activities in the 1993 SNA should be further clarified by providing examples based on those in the NOE Handbook. These include production and distribution of illegal goods and counterfeit products, production of illegal services, production activities which are usually legal but which become illegal when carried out by unauthorized producers, theft and resale of stolen goods, bribery, extortion, money laundering, and forgery.

THEFT AND FENCING

6. The 1993 SNA discussion relating to the recording of normal rate of theft does not warrant any further clarification.

7. In case of theft of significant value, the SNA recommends that output should not be reduced. To do this, the stolen goods are not to be removed from inventory as is done in the case of insignificant theft so as to lower the total value of changes in inventory but to make an adjustment in the accumulation account as other changes in volume: "If thefts, or acts of violence (including war), involve significant redistributions, or destructions, of assets, it is necessary to take them into account. they are treated as other flows, not as transactions. Less significant redistributions, such as shoplifting, may be included in change of inventories and therefore need not be recorded separately" (SNA para 3.56).

8. The SNA treatment of theft of significant value ignores the fact that it may occur on a regular basis as accepted standard practice and increase substantially the income of households and their final consumption.

9. An example is given in the *NOE Handbook* of the existence of widespread practices of illegal appropriation of the output of agricultural co-operatives (collective farms) by their members. This kind of theft occurs on a large scale and is used to supplement the low compensation of the workers or members of co-operatives. Stolen goods may be sold or used for intermediate or final consumption. The *NOE Handbook* (para. 9.18) recommends that theft in this case should be recorded as additional compensation of employees in kind. Such a recording of theft of significant value would require an imputation of theft as a transaction (instead of recording it as other flows in the current SNA).

Recommendation 2: Recurrent theft of significant value by employees should be recorded as compensation in kind of employees.

10. Another case of significant theft occurs through illegal tapping of water and electricity by households. In some situations, this has become an accepted practice. Such theft is widespread in shanty towns in developing countries where the payments of utility bills can not be legally enforced by the producers of those utilities. In such cases, recording of the theft of water and electricity as final household consumption expenditure would depict the reality. To balance this increased household final consumption expenditure, a current transfer-in-kind needs to be imputed from the producer to the households.

Recommendation 3: Recurrent theft of water and electricity of significant value by households should be recorded as final household consumption expenditure. This treatment requires an imputation of a current transfer-in-kind from the producer (non-financial corporation sector) to the consumer (household sector).

FENCING OR (RE)SALE OF STOLEN GOODS

11. Sale of stolen goods (fencing) involves interaction between two units by mutual agreement. If the units are involved in these activities on a regular scale, value added and trade margin are generated as part of the distribution of the illegal goods. It should be treated in a similar way to the sales of second-hand goods.

Recommendation 4: Sale of stolen goods (fencing) should be recorded in a similar way to the recording of sales of second-hand goods – that is, recording the value added and trade margins of distribution activities.

BRIBERY

12. The 1993 SNA does not provide guidance on whether bribery is an interaction between institutional units by mutual agreement, or in other words a transaction, or not. The *NOE Handbook* argues that bribery, in general, is an interaction between institutional units by mutual agreement. In this case, recording as a transaction rather than as another flow is to be preferred (para. 9.21).

13. The *NOE Handbook* examines the question whether bribery should be recorded as part of output and value added, or as an income transfer, in several scenarios. It concludes that if the bribe is linked to the provision of market goods/services, recording as part of output seems to be preferable. The “official” prices plus the bribes should be considered as the genuine market prices and from an income point of view, the bribe adds to compensation of employees or mixed income (para. 9.22).

Recommendation 5: In the provision of market goods and services, bribes taken by employees as an additional margin on the “official” price should be recorded as an increase in the value of output of market production matched by an identical increase in the compensation of employees.

14. In the case of non-market services, two scenarios can be distinguished depending upon whether the payment to the civil servants is allowed by the government or not. If bribery to government employees is generally accepted as standard practice, for instance to compensate low salaries, then a bribe should be registered as additional compensation of employees. As such, it adds to total output of government. Because sales of government services are affected by the same amount, the final consumption expenditure of government remains unaffected.

Recommendation 6: If the bribery is accepted as standard practice in provision of non-market services, then the bribe should be recorded as additional compensation of employees and an increase in output of government.

15. In case the payments linked to non-market services are not allowed or are not publicly accepted or expected, the bribe should be recorded as a current transfer. The same would be true for the payments to persons in privileged positions to obtain a contract. (*NOE Handbook*, para. 9.24).

Recommendation 7: Bribes linked to the provision of non-market services that are not allowed or not publicly accepted should be recorded as current transfers. The same holds for payments to persons in privileged positions to obtain a contract.

Extortion

16. Extortion payments are enforced by violence or blackmail. There is no mutual agreement and therefore such payments are clearly not a transaction in line with the 1993 SNA. The paper is in agreement with the *NOE Handbook* (par. 9.25) that extortion should be recorded as another changes in the volume of assets.

Recommendation 8: Extortion payment should be recorded as another change in the volume of assets account.

Money laundering

17. Money laundering comprises the transfer of money through different bank accounts to conceal its original source from taxation authorities or other regulatory agencies. The *NOE Handbook* (para. 9.26) argues that “in so far as there is a difference between the value of the illegal cash and the value of the legalized cash, this should be looked upon as a provision of services.” This recommendation assumes that an illegal service is provided that is not captured elsewhere in the system.

Recommendation 9: The difference between the value of the illegal cash and the value of the legalized (laundered) cash should be looked upon as a provision of services.

Fraud and swindle

18. Fraud often relates to false claims for social benefits or subsidies. The relevant transactions are registered in the system. The *NOE Handbook* (para. 9.27) recommends that a breakdown into a legal and an illegal part is needed only for a complete picture of the illegal activities within a certain country. It is not a problem of recording of transactions. The paper agrees with this point of view and no clarification is needed in the 1993 SNA Rev. 1 on this issue.

Points for consideration:

19. Do you agree that the following nine clarifications relating to illegal activities should be incorporated in the updated SNA?

- (i) *The explanation of illegal activities in the 1993 SNA should be further clarified by providing examples based on those in the NOE Handbook. These include production and distribution of illegal goods and counterfeit products, production of illegal services, production activities which are usually legal but which become illegal when carried out by unauthorized producers, theft and resale of stolen goods, bribery, extortion, money laundering, and forgery.*
- (ii) *Recurrent theft of significant value by employees should be recorded as compensation in kind of employees.*
- (iii) *Recurrent theft of water and electricity of significant value by households should be recorded as final household consumption expenditure. This treatment requires an imputation of a current transfer-in-kind from the producer (non-financial corporation sector) to the consumer (household sector).*
- (iv) *Sale of stolen goods (fencing) should be recorded in a similar way to the recording of sales of second-hand goods – that is, recording the value added and trade margins of distribution activities.*
- (v) *In the provision of market goods and services, bribes taken by employees as an additional margin on the “official” price should be recorded as an increase in the value of output of market production matched by an identical increase in the compensation of employees.*
- (vi) *If the bribery is accepted as standard practice in provision of non-market services, then the bribe should be recorded as additional compensation of employees and an increase in output of government.*
- (vii) *Bribes linked to the provision of non-market services that are not allowed or not publicly accepted should be recorded as current transfers. The same holds for payments to persons in privileged positions to obtain a contract.*
- (viii) *Extortion payment should be recorded as another change in the volume of assets account.*
- (ix) *The difference between the value of the illegal cash and the value of the legalised (laundered) cash should be looked upon as a provision of services.*

(Extract from the *NOE Handbook*)

“9. ILLEGAL PRODUCTION

9.1. Introduction

9.1. As previously noted, the 1993 SNA explicitly states that productive illegal activities should be included in national accounts. There are several reasons for this. The 1993 SNA emphasises the need for overall consistency. “Clearly, the accounts as a whole are liable to be seriously distorted if monetary transactions that in fact take place are excluded.” (SNA 1993: 3.54.) Not taking illegal activities fully into account gives rise to discrepancies in the accounts. The incomes earned from illegal production are largely spent on the purchase of legal goods and services, on the acquisition of legal fixed or financial assets or other legal transactions. Since all these transactions are recorded in the accounts along with those that are financed by incomes from legal activities, there is inevitably a discrepancy between supply and uses for the economy as a whole if the production and imports of illegal goods and services are omitted.

9.2. For the same reasons the ESA 1995 includes illegal production. “All such activities are included even if they are illegal or non-registered at tax, social security, statistical and other public authorities.” (ESA 1995: 3.08). Thus, both the 1993 SNA and ESA 1995 depart from a “moral” point of view in which illegal activities should not be included in GDP, because “representatives of the people have determined such products to be ‘bads’ rather than ‘goods’ with sufficient conviction to outlaw them” (Dennison, 1982).

9.3. In addition to the consistency of the overall system, comparability of national accounts figures between countries and over time is another major reason for the inclusion of illegal activities. Some activities, for example the production and distribution of alcohol, or prostitution, may be illegal in one country and legal in another. Exclusion of illegal production may thus distort international comparisons. Likewise, it will give rise to distortions over time if some activities switch from being illegal to be legal, or conversely. Production and distribution of alcohol during the prohibition period in the USA is an example.

9.4. Production and distribution of illegal drugs is a relatively major economic activity in some countries of Latin America and Asia. Excluding drugs production and distribution from the accounts seriously understates value added in agriculture, manufacturing and domestic and international trade and results in GDP estimates that are grossly understated.

9.5. Another consideration is that much of the value of illegal products – over 90% in the case of some narcotics – exists only because their illegality makes their prices high. According to Dennison (1982) “the value of the quantities of drugs now produced would be of trivial importance in the economy if they were legalised”. This is sometimes used as an argument for excluding drug production and trade from the national accounts. However, following the 1993 SNA, the national accounts should describe the economic environment as it actually is. The economic behaviour of households and enterprises is based on the relative prices and costs actually existing in society. It is not based on a hypothetical situation that would exist without illegal production. Suppose that drugs were legalised and prices subsequently dropped to a third of current prices. This certainly would affect the behaviour of economic actors. The consumption patterns of drugs dealers would (have to) change dramatically due to the decrease in income. On

the other hand there might be an increase of the volume of drugs consumed. Simply disregarding illegal production overlooks this reality.

9.6. In countries where the output and value added of illegal productive activities is quantitatively insignificant, it is almost certainly a poor use of resources to try to cover them in the national accounts. Efforts are better directed to reducing the amount of underground, informal sector or own final use household production that are omitted from the GDP. In addition, the methods available to measure illegal activities are still experimental. Indeed, although there seems to be more or less agreement on the correctness, in principle, of including illegal activities, very few countries explicitly include estimates of illegal production in their national accounts figures at the present time. However, this is slowly changing. Measurement obstacles should not stop efforts to move towards the conceptually correct system, and research on finding appropriate estimation methods continues.

9.7. In summary, the intention of this chapter is to provide a starting point for an experimental theoretical and practical investigation of illegal activities. It aims at interpreting and clarifying the SNA 1993 and ESA 1995. It builds on the previous discussion of illegal activities in Section 3.3. Section 9.2 lists and categorises the most significant types of illegal activities; Section 9.3 discusses the conceptual issues concerning the recording of illegal activities within the national accounts; Section 9.4 outlines the data sources and methods for compiling estimates for selected illegal activities; and Section 9.5 explores the issue of double counting.

9.2. Types of Illegal Activities

9.8. Based on Blades (1983), the following general types of illegal production are identified:

- production and distribution of illegal goods, such as banned drugs or pornographic material;
- production of illegal services, such as prostitution (in countries where this is illegal);
- production activities which are usually legal but which become illegal when carried out by unauthorised producers, such as unlicensed medical practices, unlicensed gambling activities, unlicensed production of alcohol; poaching, *e.g.* illegal fishing, hunting, tree cutting;
- production and sale of counterfeited products, such as watches and other products with false trade marks and unauthorised copies of artistic originals, *e.g.* software, CDs and videos;
- smuggling, in particular of tobacco, weapons, alcohol, food, people, both wholesale and retail;
- fencing (resale) of stolen goods;
- bribery; and
- money laundering.

9.9. The scale and distribution of such activities varies across countries. For example, in the Commonwealth of Independent States, the following illegal activities are of significant size:

- bribery;
- poaching, including fishing, illegal production of caviar and similar sea products, hunting, and logging;
- illegal production of alcoholic beverages which do not meet certain standards;
- provision of medical services by the persons who do not have qualification;

- production of goods whose quality does not meet established standards;
- illegal production of copies of audio and video materials, and software programmes;
- production and distribution of pornographic materials.

9.10. In addition to the activities included in the above lists, there are many other types of illegal production, for example forgery of banknotes, contract murders, espionage, etc. For national accounts purposes, these are generally of minor importance.

9.11. As previously noted in Chapter 3, some illegal activities do not involve mutual agreement, thus are not transactions by definition and are not productive. Examples are theft and robbery, kidnapping, and extortion. However, although not productive, they may cause underestimation of the GDP. For example, theft by employees results in less output or increased intermediate consumption and thus lower GDP estimated by the production approach.

9.3. Issues in Recording Illegal Activities

9.12. From a conceptual point of view, recording illegal production within the national accounts framework does not pose special problems if the production process resembles the production process for legal activities. This is the case for the production and distribution of illegal goods, services and counterfeit products, for productive activities carried out by unauthorised producers, and for smuggling. For other illegal activities such as theft and fencing, bribery, extortion, and money laundering, there are some difficult conceptual issues, as discussed in the following paragraphs. The 1993 SNA does not give much specific guidance in these cases. However the recording procedures that are proposed follow the general guidelines of the 1993 SNA as closely as possible.

Theft and fencing

9.13. In relation to theft, a distinction can be made between *i)* theft of capital goods, consumer durables, money or other financial assets, and *ii)* theft from the inventories of producers. Both are discussed below, together with fencing, an activity related to theft.

9.14. The 1993 SNA (Para. 3.56) states “If thefts...involve significant redistributions... of assets, it is necessary to take them into account... they are treated as *other flows* not as *transactions*”. They cannot be treated as transactions because a transaction is defined as “an economic flow that is an interaction between institutional units by mutual agreement” (1993 SNA: 3.12). Theft of capital goods, consumer durables, money or other financial assets often involves significant amounts and in these cases, recording of these activities as another change in the volume of assets (*i.e.*, as a change in the value of assets (or liabilities) that does **not** take place as a result of a transaction) is appropriate.

9.15. Theft from the inventories of producers includes theft from stocks of materials, supplies and finished goods on the one hand, and theft from stocks of goods for resale on the other. In the 1993 SNA, output and intermediate consumption are defined as sales/purchases of goods and services plus/minus the value of changes in inventories. Recurrent losses due to normal rates of wastage, theft and accidental damage are considered as (negative) changes in inventories (1993 SNA: 6.62). As a consequence, normal rates of theft from the stock of finished goods lead to a decrease of output, whereas normal rates of theft from the stock of materials and supplies lead to an increase of intermediate consumption. In both cases, value added decreases accordingly. The

same holds for normal rates of theft from stocks of goods for resale. Output and value added of wholesalers and retailers are influenced negatively by theft.

9.16. From the above, it can be concluded that normal rates of theft from inventories of producers are registered neither as a transaction nor as an other flow. Implicitly, they are completely removed from the system of national accounts. Only theft from inventories which exceeds the “normal rates” is included in the 1993 SNA as an other change in the volume of assets (1993 SNA: 12.41). Thus, leaving aside the (negative) consequences of theft from producers’ inventories, value added is not affected by theft. No value added is generated; all that is happening is that assets are redistributed.

9.17. This statement does not apply to an activity related to theft, namely trade in stolen goods, which is not explicitly addressed in the 1993 SNA. Trade in stolen goods involves action by two units in mutual agreement, namely the purchase and the subsequent sale of stolen goods by the receiver. Clearly, these actions constitute monetary transactions and should be recorded accordingly. Furthermore, if the units are involved in these activities on a regular scale, value added (trade margin) is generated, as part of distribution of the illegal goods.

9.18. The treatment of theft recommended in the 1993 SNA requires clarification, if not elaboration, in order to take into account the special circumstances in some countries. For example, in some members of the Commonwealth of Independent States there is a widespread practice of illegal appropriation of the output of agricultural co-operatives (collective farms) by their members. This theft occurs on a large scale and is used to supplement the low compensation of the workers or members of co-operatives. The stolen goods may be sold or used for intermediate or final consumption. In many cases this supplement is an important source of income without which the collective farmers could hardly survive. In these circumstances, consideration must be given to recording the value of the theft as income in kind of employees. If the theft is of materials and supplies, its value should be moved from intermediate consumption to compensation of employees. If the theft is of final products, both output and compensation of employees have to be adjusted upwards.

9.19. In some cases it is difficult to draw a clear distinction between theft and underreporting. For example, in the Russian Federation, the crews of the fishing ships often sell a part of the output abroad (sometimes from ship to ship) and do not show these sales in their records. The income obtained from the sale of this output may be used for a variety of purposes and the expenditure may be measured in the context of estimation of GDP by summing up expenditures on final use. It appears that this type of underreporting is actually very similar to that described in connection with collective farms. The missing production should be estimated and included in the GDP according to the 1993 SNA. Again this suggests recording such theft as income in kind.

Bribery

9.20. Two different kinds of bribery can be distinguished, first, payments linked to the provision of services, and second, payments to persons in privileged positions. In the first case, the payments may be linked to market goods and services or to non-market services. For market goods or services, the bribe usually consists of a supplementary payment above “official” prices. For example, hotel clients are required to bribe the hotel receptionists to confirm their reservations. Examples related to non-market services are payments of (additional) amounts that

are required to obtain medical services from publicly financed health care, or to get passports from civil servants. Examples of payments to persons in privileged positions are those made to officials who award contracts to the highest bribing supplier, to politicians to obtain a privileged position as a producer, or to policemen or other government officials who accept bribes in return for not prosecuting the offender.

9.21. An important question, on which the 1993 SNA does not give guidance, is whether or not bribery should be considered as a transaction, or, to put it differently, whether bribery is an interaction between institutional units by mutual agreement. In general, it can be supposed that individuals have a freedom of choice to enter into bribery. The person paying the bribe agrees to pay the (additional) sum of money. In this case, recording as a transaction rather than as another flow is to be preferred.

9.22. A more difficult question is whether bribery should be recorded as part of output and value added, or as an income transfer. If the bribe is linked to the provision of services, recording as part of output seems to be preferable. This is especially true for market goods/services. The official prices plus the bribes should be considered as the genuine market prices, and, from an income point of view, the bribe adds to compensation of employees or mixed income.

9.23. In the case of non-market services, an additional criterion may be needed. If the payment to the civil servant is (implicitly) allowed by government, for example in the case of doctors or other people employed by government who receive only a small official income, or if the bribery is generally accepted as standard practice, then a bribe should be registered as additional compensation of employees. As such, it adds to total output of government. Because sales of government services are affected by the same amount, the final consumption expenditure of government remains unaffected.

9.24. If payments linked to non-market services are not allowed or not publicly accepted or expected, then recording as an income transfer seems to be preferable. The same holds for payments to persons in privileged positions to obtain a contract.

Extortion

9.25. Extortion consists of obligatory payments enforced by violence or blackmail. There is no mutual agreement, and, in line with the 1993 SNA, extortion should not be registered as a transaction. In this respect, it resembles theft of money (or goods or services) and it should be registered as an other change in the volume of assets.

Money laundering

9.26. Money laundering is here defined as the transfer of money through different bank accounts so that its original source is concealed from the taxation authorities or other regulatory services. There is mutual agreement, at least implicitly, that the transactions should be registered in the system of national accounts. In so far as there is a difference between the value of the illegal cash and the value of the legalised cash, this should be looked upon as a provision of services. Often, the actors such as banks will be unaware of their involvement in money laundering, and the fees that banks charge for transferring money between different accounts should be included in the system of national accounts together with the fees from legal transactions.

Fraud and swindle

9.27. Fraud and swindle are quite different from the other activities mentioned above. Fraud often relates to false claims for social benefits or subsidies by giving incorrect information. The relevant transactions, however, are registered in the system. Here, a breakdown into a legal and an illegal part is needed only for a complete picture of the illegal activities within a certain country. It is not a problem of exhaustiveness of GDP.”

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