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The underground economy: a threat to democracy, development and the rule of law

Report¹

Committee on Economic Affairs and Development

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Summary

The underground economy represents a large and growing share of the overall economic activity in Europe and beyond. It accounts for between 10% and over 60% of gross domestic product in different European countries. The “new democracies” of central and eastern Europe – where the rule of law is more fragile and where vested interest groups are firmly rooted – are particularly affected. The evolving structure of the world economy, the geopolitical changes following the fall of the Berlin Wall and the global economic crisis have all fuelled the growth of the informal economy.

The report stresses that the underground economy and its extreme form – economic crime – significantly erode state authority and the capacity for good governance, which are essential for fostering democracy, development and the rule of law. These phenomena also deprive state budgets of much tax revenue, distort competition, flout citizens' socio-economic rights, slow down economic progress, abuse public welfare systems and propagate lawlessness.

The reports considers that the Council of Europe should pay more attention to addressing the problem of undeclared work, study more closely the activities of offshore centres as financial intermediaries and review the situation of organised crime in its member states. It proposes a series of directions for action, ranging from evaluation measures, regulatory adjustments, electronic surveillance of money flows, use of economic intelligence in information exchange, whistle-blowing and witness protection.

1. Reference to committee: [Doc. 11405](#), Reference 3411 of 25 January 2008; [Doc. 11856](#), Reference 3550 of 29 May 2009.



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A. Draft resolution ²

1. There is a growing concern that the underground or informal/shadow/grey economy represents a large and increasing share of the overall economic activity in Europe and the world. For decades policy makers' attention focused on economic development priorities and the immediate grave threats to good governance or national security stemming from economic crime or the black economy. Council of Europe member states have directed their action on the basis of Committee of Ministers Recommendation No. R (81) 12 on economic crime, the relevant conventions and their additional protocols, collaboration with international partners and the work of specialised intergovernmental committees. Yet the consideration of wider problems relating to the shadow economy and its effects on society has been insufficient. This concerns in particular undeclared work and the unregulated use of assets through offshore financial centres.

2. The Parliamentary Assembly notes that the estimates of the size of the underground economy range from under 10% of Gross Domestic Product (GDP) in countries such as Austria and Switzerland, about 25% in Greece, 33% in Turkey, 37% in Bulgaria, around 40% in the Baltic states to over 60% in the South Caucasus countries. The "new democracies" of central and eastern Europe – where the rule of law is still fragile and vested interest groups are firmly rooted – are particularly affected. The evolving structure of the world economy, the geopolitical changes following the fall of the Berlin Wall (globalisation, spread of cyber-technologies, opening of borders, proliferation of free-trade zones, etc.) and, last but not least, the global economic crisis have together fuelled the growth of the informal economy.

3. The Assembly considers that both the underground economy and economic crime significantly erode state authority and the capacity for good governance which are essential for fostering democracy, development and the rule of law. The shadow economy and economic crime deprive state budgets of substantial amounts of tax revenue, distort competition in regular markets, flout citizen's socio-economic rights, slow down economic progress, abuse public welfare systems and propagate lawlessness. At the same time, they draw attention to problems with official laws, rules, regulations and practice, as well as shortcomings in law enforcement. Such problems include loopholes, red tape, excessive regulation or tax burden and a lack of effective oversight and control.

4. Together with its international partners, such as the Organisation for Economic Co-operation and Development (OECD), the World Bank, the European Union, the European Bank for Reconstruction and Development (EBRD), the United Nations, Europol and Eurojust, the Council of Europe has shaped policies, legal instruments, monitoring mechanisms, co-operation programmes and projects for targeting corruption, cybercrime, money laundering, tax evasion, terrorist financing, confiscation of criminal assets, insider trading, environmental crime and trafficking in human beings. However it should strengthen its efforts to address the problem of undeclared work, notably in co-operation with the International Labour Organization (ILO) and the International Organization for Migration (IOM), and to study the activities of the offshore centres as financial intermediaries. Furthermore, considering that the last Council of Europe study on organised crime situation was published in 2005, it seems necessary to prepare a new study.

5. The Assembly appreciates that the priorities for 2012-2013 put forward by the Council of Europe Secretary General lay emphasis on threats to the rule of law, in particular the various kinds of economic crime, including new forms of criminality. It trusts that these priority activities and any new action relating to the underground economy, as suggested in this resolution, will receive adequate budgetary support from the governments of member states.

6. The Assembly also welcomes the proposals by the Council of Europe Secretary General for a critical review of the Organisation's conventions. It is convinced that the Organisation should use this process in order to facilitate accession by the member states, the European Union and non-member countries to relevant conventions which are essential for fostering co-operation in combating the underground economy and economic crime.

7. The Assembly welcomes the recent adoption of the European Convention on Counterfeiting of Medical Products and Similar Crimes involving Threats to Public Health (Medicrime Convention) and the intention of the European Union to become party to this convention. It believes that the convention should be launched without any further delay.

8. In this context, the Assembly recalls its [Recommendation 1793](#) (2007) on the need for a Council of Europe convention on the suppression of counterfeiting and trafficking in counterfeit goods, in which it proposed to consider preparing a legal instrument that would cover a full range of consumer goods which, if

2. . Draft resolution adopted by the committee on 20 May 2011.

counterfeited or adulterated, pose grave risks to the lives and health of Europeans. As the trafficking of counterfeits continues to escalate across Europe and the implementation of the Medicrime Convention will require reliable data, an observatory could be set up under the aegis of the Council of Europe, possibly in co-operation with the European Union, to gather data on cases of fraudulent goods which put public health at risk. This step would facilitate a decision on the need for an additional protocol to the Medicrime Convention in order to widen its coverage to all dangerous goods.

9. The Assembly is convinced that pan-European co-operation on preventing and combating trafficking in human beings can only be effective if the Council of Europe and European Union combine their efforts and means, in particular with a view to strengthening the monitoring mechanism of the Council of Europe Convention on Action against Trafficking in Human Beings (CETS No. 197) and synergies with other institutional actors at national, regional, European and international levels.

10. Enhanced transparency in relations between decision-makers, economic players and citizens is essential for better governance. The Assembly notes a positive first reaction of the Committee of Ministers, on the basis of opinions from the Group of States against Corruption (GRECO) and the Conference of International Non-Governmental Organisations (INGOs), to its [Recommendation 1908 \(2010\)](#) on lobbying in a democratic society (European Code of conduct on lobbying) and trusts that progress will be made rapidly towards the drawing up of such a code.

11. Moreover, the Assembly welcomes the intention of GRECO to use its forthcoming 4th Evaluation Round on “Corruption prevention in parliamentary assemblies, the judiciary and among other actors of the pre-judicial and judicial process” to assess the existing standards of conduct for parliamentarians vis-à-vis lobbyists and lobbying. It believes that it would be appropriate to widen the scope of the evaluation to also cover the executive branch of governance.

12. The Assembly is convinced that curbing shadow economic activities, in particular economic crime, is essential to ensuring the smooth functioning of democracy, the competitiveness and strong performance of the national economy, more adequate protection of citizens' socio-economic rights and the honouring of commitments to foster the rule of law. It therefore calls on member states to:

12.1. carry out national audits of their economic systems with a view to evaluating the extent of shadow economic activities and their interface with the formal economy;

12.2. assess the weight of their regulatory systems related to taxation, licensing, labour, environment, health and safety, consumer protection, and intellectual and industrial property rights, with a view to determining whether these could be streamlined and the cost of compliance lowered;

12.3. work towards the harmonisation of the definition of underground economy and support the Council of Europe efforts in this respect;

12.4. study the impact of migrant labour, in particular the trend of “low-cost” labour, on national welfare systems and corporate compliance with core labour standards;

12.5. put in place specific assistance in favour of better integration of vulnerable groups (including minorities, refugees, asylum seekers, displaced persons and Roma communities) through targeted educational schemes, employability training, self-employment programmes and measures to improve access to public services and decent housing;

12.6. strengthen the electronic monitoring and active surveillance of money flows by banks and financial institutions;

12.7. tighten the rules regarding the use of cash transactions and increase penalties for unrecorded or undeclared cash receipts;

12.8. improve liaison, information exchange, sharing of best practice and co-operation between monitoring, investigating and prosecuting bodies at local, regional, national and international levels;

12.9. facilitate the work of national economic intelligence agencies by strengthening their surveillance and investigative powers, as well as their human and financial resources;

12.10. increase the scrutiny of business transactions involving the use of the services of offshore financial centres;

12.11. support G20 efforts towards improving global rules for the regulation of financial markets, particularly in respect of hedge fund activities, and increased transparency of financial instruments;

12.12. review, clarify and, where necessary, strengthen the national legislative provisions for:

12.12.1. regulating lobbying activities and the work of professional associations;

12.12.2. ensuring transparency in public procurement, administration of state property and privatisation;

12.12.3. enhancing the responsibility of business entities, regulators and control institutions for the disclosure of truthful information;

12.12.4. optimising personal data protection;

12.12.5. improving domestic controls for intercepting counterfeit goods;

12.13. promote whistle-blowing and ensure adequate witness protection.

13. Finally, the Assembly invites national parliaments to ensure continued monitoring of domestic policies and action for tackling the underground economy and economic crime, including as follow-up to measures proposed in this resolution.

B. Draft recommendation ³

1. The Parliamentary Assembly, referring to its Resolution ... (2011) on the underground economy: a threat to democracy, development and the rule of law and to the outline priorities for Council of Europe activities in 2012-2013, invites the Committee of Ministers to draw the attention of the governments of member states to the proposals put forward by the Assembly in this respect and recommends that it:

1.1. instruct the competent intergovernmental committees to prepare studies on the organised crime situation, on undeclared work and on the use by the member states of financial intermediation services through offshore centres;

1.2. put in place a European observatory for gathering data on counterfeit and substandard consumer goods that represent substantial risks to public health, with a view to facilitating the implementation of the European Convention on Counterfeiting of Medical Products and Similar Crimes involving Threats to Public Health (Medicrime Convention) and assessing the need for an additional protocol to this convention;

1.3. urge member states which are not members of the Organisation for Economic Co-operation and Development (OECD) to join the Working Group on Bribery in International Business Transactions and to subsequently adopt the OECD Convention on Combating Bribery of Foreign Public Officials in International Business Transactions;

1.4. ensure that adequate budgetary and human resources are allocated to priority activities targeting the various forms of economic crime and any new action relating to the underground economy;

1.5. develop and strengthen co-operation between the Council of Europe and other international organisations, including the OECD, the World Bank, the European Union, the European Bank for Reconstruction and Development (EBRD), Europol, Eurojust, the United Nations, the International Labour Organization (ILO) and the International Organization for Migration (IOM) in order to facilitate interstate efforts to tackle underground economic activities and economic crime;

1.6. facilitate accession by the member states, the European Union and non-member states to the relevant Council of Europe conventions essential for intensifying co-operation to combat the underground economy and economic crime;

1.7. consider widening the scope of GRECO's forthcoming 4th Evaluation Round evaluation in order to also cover the executive branch of governance vis-à-vis lobbyists and lobbying;

1.8. in the framework of the convention critical review process and in the light of new developments, examine the need to update the following conventions: the Convention on Product Liability in regard to Personal Injury and Death (ETS No. 91), the Convention on Insider Trading (ETS No. 130) and its protocol (ETS No. 133), the Convention on Certain International Aspects of Bankruptcy (ETS No. 136) and the Convention on the Protection of Environment through Criminal Law (ETS No. 172);

1.9. invite the member states that have not yet done so to sign and ratify the following conventions: the Convention on the Legal Status of Migrant Workers (ETS No. 93), the Convention on the Transfer of Proceedings in Criminal Matters (ETS No. 73), the Convention for the Protection of Individuals with regard to Automatic Processing of Personal Data (ETS No. 108) and its additional protocol (ETS No. 181), the Convention on Mutual Administrative Assistance in Tax Matters (ETS No. 127) and its amending protocol (CETS No. 208), the Convention on Cybercrime (ETS No. 185), the Criminal Law Convention on Corruption (ETS No. 173) and its additional protocol (ETS No. 191), the Civil Law Convention on Corruption (ETS No. 174), the Convention on Action against Trafficking in Human Beings (CETS No. 197) and the Convention on Laundering, Search, Seizure and Confiscation of the Proceeds from Crime and on the Financing of Terrorism (CETS No. 198).

3. . Draft recommendation adopted by the committee on 20 May 2011.

C. Explanatory memorandum by Mr Pleskachevskiy, rapporteur

1. Introduction

1. The underground or informal/shadow/grey economy is by its very nature difficult to grasp. It is a parallel, bustling world where jobs, services and goods are created and traded. However, the money flows thus generated escape official accounts and government budgets. There is a growing awareness – and concern – that it represents a large and growing share of the overall economic activity in Europe and the world at large. Moreover, part of the economic activities unaccounted for are illegal transactions that fit more closely our understanding of economic crime or “black” economy. They cover corporate crime (“crime in business”) and organised crime (“crime as business”).

2. The informal economy and economic crime can take many forms, the most common being undeclared work, smuggling, fraud, drug trafficking, trafficking in human beings, counterfeiting, tax evasion, corruption, money laundering, cybercrime and organised crime. They all produce illicit gains, distort competition in regular markets and erode the capacity of states for good governance. From a Council of Europe perspective, this is also a direct threat to democracy, development, respect for economic rights and the rule of law. Whilst this Organisation has devoted considerable attention to the issue of economic crime (notably following the Committee of Ministers Recommendation No. R (81) 12), its consideration of problems stemming from the underground economy has been insufficient.

3. The underground economy and economic crime have long been a problem. They have kept abreast of the times by evolving and taking advantage of the fact that official, state bodies are slow to adapt. This phenomenon, which is now difficult to quantify in economic terms and probably underestimated, varies greatly from one member state to the next: it is thought to range from under 10% of gross domestic product (GDP) in Austria and Switzerland, to about 25% in Greece, 33% in Turkey, 37% in Bulgaria, around 40% in the Baltic states and over 60% in the South Caucasus countries, to mention but a few. The restructuring of the international economy in the last twenty years, the geopolitical changes following the fall of the Berlin Wall (globalisation, spread of cyber-technologies, opening of borders, proliferation of free-trade zones, etc.) and, last but not least, the global economic crisis have fostered the growth of the underground economy.

4. The economic crisis has not only fuelled the underground economy (in particular tax evasion, counterfeiting and money laundering), but has also drawn attention to economic and financial practices which, although legal, are not sufficiently well regulated and have the same “side effects” as the underground economy.⁴ The latter often results in violations of citizens’ socio-economic rights, whereas it is essential that these rights be protected, particularly in times of economic crisis. The flouting of socio-economic rights in turn leads to the violation of human rights in general and undermines democracy and the rule of law in many states, particularly in those referred to as the “new democracies” where the rule of law is still very fragile and vested interest groups are firmly rooted.

5. The Council of Europe works in close collaboration with other international and European organisations in this field, such as the Organisation for Economic Co-operation and Development (OECD), the World Bank, the European Union, the European Bank for Reconstruction and Development (EBRD), the United Nations, Europol and Eurojust. It has a series of legal instruments – conventions and their monitoring mechanisms – that help member states’ efforts to eradicate the underground economy and economic crime. Together with the European Union, the Council of Europe is working on several projects dealing with corruption, cybercrime, money laundering, terrorist financing, criminal asset confiscation, economic crime and human trafficking in eastern Europe, in addition to many long-term programmes for strengthening judicial co-operation of European officials responsible for action against organised crime.

6. The Council of Europe also follows closely the activities of the OECD as regards corruption, tax evasion, counterfeiting and piracy, money laundering and terrorist financing. The two organisations have recently updated their joint Convention on Mutual Administrative Assistance in Tax Matters (ETS No. 127) with an additional protocol (CETS No. 208), which opens the instrument for accession of non-member states. Moreover, the OECD Directorate for Financial and Enterprise Affairs (DAF) has set itself the priority of fighting corruption through its Anti-Bribery Convention⁵ and its working group. The latter, in its conclusions on bribery in international business transactions adopted in June 2009, acknowledged that “the global economic crisis may lead to increased competitive pressures on companies to potentially engage in corruption, notably in public procurement” and reaffirmed that the fight against transnational bribery should remain a priority.

4. . See [Doc. 11856](#), motion for a recommendation on the need to combat economic crime in times of economic crisis.

5. . Convention on Combating Bribery of Foreign Public Officials in International Business Transactions.

7. As it is difficult to be exhaustive on the underground economy and economic crime, the rapporteur chose to focus on the specific areas where the activities of the Council of Europe, in partnership with other international organisations, can have the greatest impact.

2. The different facets of the underground economy, including economic crime

8. The shadow economy springs from human nature, which makes men choose underground activities in search of “better” conditions – bypassing official laws, rules, regulations and practice. The effect is that the underground economy impacts heavily on the official accounts of states by depriving them of tax income and offsetting vital investment; it also penalises law-abiding businesses by subjecting them to unfair competition which, in particular, uses a labour force which is often excluded from social protection in terms of benefits, working conditions and contract enforcement. In times of economic crisis, European governments have an added moral imperative to be vigilant in protecting their resources (human and financial) and curbing losses due to criminal activities.

9. Taking into consideration the gravity of the impact and harm caused, the most severe forms of underground economy have been classified as economic crime. Committee of Ministers Recommendation No. R (81) 12 contains a list of offences. These are: cartel offences; fraud and abuse of economic situation and public funds; computer crime (including personal data related violations); bogus firms; fraudulent bookkeeping; fraud concerning economic situation and corporate capital of companies; violation of security standards; fraud in respect of creditors (including violation of intellectual and industrial property rights); consumer fraud; unfair competition (including bribery of employees and officials) and misleading advertising; fiscal offences and evasion of social costs by enterprises; customs offences; abuse of money and currency regulations; stock exchange and bank offences; and environmental crime.

10. It is presupposed that these offences are knowingly committed by persons with special business knowledge in the exercise of their profession or functions. The boundary between the underground economy and economic crime is blurred, as not only business entities but also more and more individuals engage in off-track activities with wide-reaching negative consequences for the economy and society at large. Minor infringements which go unnoticed and unpunished may lead to more serious offences, gradually increasing the feeling of impunity and *de facto* erosion of the rule of law.

11. In central and eastern Europe, the informal economy thrived under the communist system because it enabled people to remedy the shortage in goods and services that the state-run economy failed to provide. Informal economic activities in those times were associated with economic freedom in the context of planned and ailing economies.⁶ The subsequent transition to market economy and a democratic governance system released a vast labour force accustomed to shadow economy or eager to work informally to “help themselves” as legal frameworks and social systems were undergoing complete transformation.

12. With the current economic crisis, the informal sector has resumed its expansion, thus cushioning the effects of unemployment and poverty for many Europeans as job and income pools have been shrinking. However, this may have attenuated social tensions and prevented them from turning into violent disturbances in many countries. Some experts believe that increased involvement in underground economic activities has also helped avoid a chain of bankruptcies across Europe, especially in smaller businesses.

13. World Bank research has shown that there is a strong correlation between the size of the informal sector and the indicators reflecting the “ease of doing business”: reducing the cost of doing business helps countries improve their competitiveness and also reduce informal economic activities. Moreover, poorer countries tend to have larger shadow economies. The key driving forces of the shadow economy include a heavy tax burden, cumbersome labour market regulations, low quality public services and the state of the formal economy.⁷

2.1. Phantom jobs, undeclared work

14. It is not rare, especially in eastern Europe, that employees receive part of their remuneration informally as “envelopes” or have to work for free even when they are officially on “technical leave”. Unfortunately, this type of practice received a boost with the global economic crisis as a sort of alternative to unemployment. According to the OECD, at least 1.8 billion workers across the globe work without any contract or social

6. . Glovackas S., “The informal economy in central and eastern Europe”, 2007.

7. . “Shadow economies all over the world” (Policy Research Working Paper 5356, the World Bank, July 2010). Friedrich Schneider, Andreas Buehn and Claudio E. Montenegro.

protection, as compared to only 1.2 billion who work in the legal sector. The International Labour Organization (ILO) estimates that the ongoing economic crisis has cost at least 52 million official jobs, pushing workers into poverty, emigration or undeclared employment. This precarious human condition may further breed clandestine activities, such as smuggling, racketeering, trafficking in human beings and even slavery.

15. A large source of undeclared work is migrant labour, especially in the construction sector, agriculture, trade and services. An additional factor is part-time and seasonal employment. Not only does such undeclared labour cause serious friction and security concerns in society in general, but it also distorts the functioning of national welfare systems and erodes corporate compliance with core labour standards. Notably, a trend for "low-cost" labour leads to a race to the bottom, which depresses overall remuneration levels of all workers, diminishes revenue of the social protection system and increases the strain on these systems as welfare benefits are abusively claimed by officially unemployed persons who are in reality undeclared workers.

16. We shall note specific problems that Roma communities and some other vulnerable groups (including minorities, refugees, asylum seekers and displaced persons) are facing in many European countries. These groups suffer from a particularly high level of unemployment (over 70% in some countries) and are at a high risk of sliding into the underground economy where they become locked in by seeking minimum subsistence. In the framework of its country-by-country monitoring reports, the European Commission against Racism and Intolerance (ECRI) has issued a series of recommendations pleading for better socio-economic integration of such communities through targeted educational measures, support for employability training and self-employment schemes, as well as improved access to decent housing and public services.

17. Any effective strategies aiming to diminish the extent of informal labour need to involve employers' and workers' organisations very closely and tackle administrative or regulatory barriers to entry into mainstream economic activity. Moreover, state authorities need to make special efforts to stimulate job creation and to reinforce job inspection systems, including severe and dissuasive sanctions for any infringement of labour or social protection codes. Some economists argue that eliminating cash in labour market transactions would help curb illicit activities. Norway, for instance, decided to ban, as from January 2011, payments in cash for manual labour, and anyone acquiring goods or services in the underground economy is deemed financially liable for the seller's actions.⁸ The rapporteur believes that the Council of Europe should examine trends in undeclared work more closely, together with the IOM (International Organization for Migration) and the ILO (International Labour Organization), in the light of member states' commitments to uphold core labour standards and decent living conditions.

2.2. Invisible networks, organised crime

18. Whilst "Europe without dividing lines" remains a major pan-European political and economic goal, malicious minds have long taken advantage of greater permeability of national borders (not least as an unintended consequence of the Schengen Agreement) for smuggling, fraud, counterfeiting and trafficking purposes. Organised transnational rings operate criminal networks as shadow enterprises with experienced "managers" and cohorts of disciplined "employees" or complicit "intermediaries" – to the detriment of the rule of law, thousands of victims and efforts to build a more unified (politically and economically) greater Europe.

19. Globally, organised crime and trafficking account for about a third of the world's illicit money flows, which are estimated at \$2 trillion per year.⁹ The United Nations Convention against Transnational Organized Crime¹⁰ remains the main international instrument in this field. It helps countries use the mechanism of the convention to adjust domestic provisions on criminal offences; to co-ordinate frameworks for mutual legal assistance, extradition, witness protection and law enforcement co-operation, as well as facilitating cross-border technical assistance and training. A series of Council of Europe conventions on mutual legal assistance, extradition, cybercrime and trafficking in human beings usefully supplement the global action through intra-Europe efforts.

20. Moreover, following the joint Council of Europe–United Nations study and Assembly [Resolution 1782 \(2011\)](#), there is increased public awareness that trafficking of human organs constitutes an extremely serious problem worldwide and that a new Council of Europe convention, open to non-member states, to combat trafficking in organs, tissues and cells of human origin is necessary.¹¹ The rapporteur views this as a timely

8. . Counterpoint by Erik Lahnstein, State Secretary of the Norwegian Ministry of Foreign Affairs, published in the International Herald Tribune on 13 January 2011.

9. . Estimate by Global Financial Integrity, a programme of the Center for International Policy, a US-based research group.

10. . www.unodc.org/unodc/en/treaties/CTOC/index.html.

and highly pertinent initiative that should help enhance Europe's common legal space and trigger action beyond this continent. Furthermore, considering that the last Council of Europe study on organised crime was published in 2005, it seems necessary to prepare a new study.

2.3. Fraud and tax evasion

21. It is a well-known story that the infamous criminal Al Capone was sentenced and jailed not for his most odious crimes (due to lack of proof), but for large-scale tax fraud. Nowadays, the action of public tax services still proves highly useful in helping to identify and dismantle tax evasion schemes as well as much more serious tax fraud cases and criminal enterprises for which the concealment of taxable income is only the "tip of the iceberg". Research also shows that underground economies tend to be larger in countries with weaker institutions for tax compliance.

22. The Tax Justice Network (TJN), promoting transparency in international finance, estimates that "tax is the foundation of good government and a key to the wealth or poverty of nations", yet "assets held offshore, beyond the reach of effective taxation, are equal to about a third of total global assets". Such hidden assets of about \$250 billion result in a loss of tax revenue of about \$11.5 trillion each year (due on the income from these assets); in addition, over a trillion dollars annually in proceeds from crime and corruption from developing and transition countries transits through offshore accounts. Offshore financial centres have in fact become an interface between the illicit and licit economies, according to the TJN experts.

23. Over the last few years, more determined action by states has led to major revelations in the media, a spotlight on offshore tax havens and improved inter-state co-operation in order to avoid "blacklisting" by the OECD or any bilateral sanctions from the major global economic players, such as the United States of America, the United Kingdom, Germany and France. However, much still remains to be done to render offshore financial services more transparent and better regulated in a global context. This committee should subsequently examine the issue in a separate report.

24. The outbreak of the global economic crisis has cast light on some fraudulent actions in financial markets due to insider trading, Ponzi schemes, price manipulation regarding stocks, commodities, real estate and currencies, data manipulation, etc. We have also seen that some enterprises are set up exclusively to conduct fraudulent deals and disappear when such "business" is over. European countries and their major international partners, notably in the G20 group, are working to improve global rules for the regulation of financial markets to prevent future breakdowns and to end abnormal practices.

2.4. Corruption and vested interests

25. Corruption – a misuse of official or decision-making power for private gain – is an endemic problem in Europe. It thrives when bad regulation and red tape abound or where transparency, property rights and law enforcement are weak. Worse still, corruption may be the cause of poor decisions and bad governance. Empirical evidence suggests that corruption can result in, on the one hand, reduced economic growth, productivity and foreign investment, and, on the other hand, an increased shadow economy and dubious public expenditure.

26. Corruption has many country-specific forms, depending on the level of democratic and economic development, and the strength or weakness of domestic institutions responsible for regulating economic activities and enforcing laws. In some countries, for instance the Russian Federation and many CIS countries, much corruption stems from insufficient protection of property rights and vast discretionary powers concentrated in the hands of state officials. The situation is further aggravated by the underdevelopment of civil society institutions, which in some countries may be explained by resistance of corrupt state officials. Strengthening non-governmental organisations to act as whistle-blowers can help to detect and prosecute corruption cases.

27. In the more developed countries, a major problem is insufficient information on the state of affairs in financial markets and the disproportionate influence of vested interests. In other words, the work of regulatory authorities is hampered by the failures of auditors or rating agencies to adequately disclose information on the true position of some companies. The lack of accountability and shortcomings in the regulatory and surveillance systems were clearly revealed during the financial crisis of 2008, which affected the Western

11. . A motion for a recommendation on "Towards a Council of Europe convention to combat trafficking in organs, tissues and cells of human origin" (Doc. 12492 rev) was referred to the Social, Health and Family Affairs Committee in March 2011.

economies more severely than the other economies. These regulators have literally "slept through" the alarming increase of high-risk transactions by the financial institutions. A vivid example of this is that, shortly before the breakout of the financial crisis, the ING Bank, Fortis, Lehman Brothers and several Icelandic banks were considered as financially stable and solvent companies.

28. The Council of Europe, and in particular its Group of States against Corruption (GRECO), takes the problem very seriously. GRECO, which is a partial agreement established in 1999 by the Council of Europe to monitor states' compliance with the Organisation's anti-corruption standards, now has 48 members (47 member states of the Council of Europe plus the United States). Its main aim is to fight corruption in Council of Europe member states and to offer expert assistance in improving national legislation on the basis of the Criminal Law Convention on Corruption (ETS No. 173) and its additional protocol (ETS No. 191), and the Civil Law Convention on Corruption (ETS No. 174).

29. The Parliamentary Assembly has also addressed this issue. Several of its committees have studied the different aspects and effects of corruption. For example, reports have been prepared by our colleagues Alain Cousin and Kimmo Sasi, respectively, on the link between poverty and corruption¹² and on judicial corruption.¹³ The Committee on Economic Affairs and Development has also studied the issue of lobbying,¹⁴ which remains poorly regulated in European countries and which in extreme cases may lead to corruption of political decision makers and public officials (national and European) by vested interest groups, notably from the business sector. The situation is particularly preoccupying in central and eastern European countries, where corruption linked to privatisations or relating to the funding of election campaigns or political parties is a major problem.

30. It is therefore hardly surprising that many central and eastern European countries continue to earn low scores on the Transparency International Corruption Perception Index. The results for 178 countries in 2010 rank these countries between the 26th (Estonia) and 154th (the Russian Federation) place, with Azerbaijan and Ukraine ranking 134th, Armenia 123rd and Moldova 105th.¹⁵ They are in stark contrast to the position of Denmark, Finland, Sweden, the Netherlands, Switzerland and Norway, which are in the top 10 of the best performing countries.

31. The rapporteur has taken note that the reply from the Committee of Ministers ([Doc. 12438](#)) to Assembly [Recommendation 1908 \(2010\)](#) on lobbying in a democratic society (European code of conduct on lobbying) contains positive opinions and comments of GRECO and the Conference of International Non-Governmental Organisations (INGOs) towards the drawing up of such a code. The rapporteur also notes the intention of GRECO to use its forthcoming 4th Evaluation Round on "Corruption prevention in parliamentary assemblies, the judiciary and among other actors of the pre-judicial and judicial process" to also assess existing standards of conduct for parliamentarians vis-à-vis lobbyists and lobbying. Ideally, this evaluation should also cover the executive branch of governance. The Assembly should continue to follow closely developments in these areas.

2.5. Money laundering

32. Economic crime has changed significantly since our committee's last report in 2001.¹⁶ The events of 11 September 2001 and the resurgence of terrorist violence followed by the economic crisis in 2008 have made the problem of money laundering much more central. The understanding that the money laundered through banks and tax havens may be used to finance terrorism has sent a shock wave across the world and compelled strong action. Hence the OECD's different colour lists of tax havens and the debate on the lifting of bank secrecy. The Council of Europe, in turn, adopted¹⁷ the Convention on Laundering, Search, Seizure and Confiscation of the Proceeds from Crime and on the Financing of Terrorism (CETS No. 198), which entered into force in May 2008.

12. . "Poverty and the fight against corruption in the Council of Europe member states", report of the Committee on Social, Health and Family Affairs, [Doc. 10834](#).

13. . "Judicial corruption", report of the Committee on Legal Affairs and Human Rights, [Doc. 12058](#).

14. . "Lobbying in a democratic society (European code of conduct on lobbying)", report of the Committee on Economic Affairs and Development, [Doc. 11937](#) (rapporteur: Mr José Mendes Bota).

15. . See www.transparency.org for a complete report.

16. . "Europe's fight against economic and transnational organised crime: progress or retreat?", [Doc. 9018](#) (rapporteur: Ms Vera Squarzialupi).

17. . In addition to the earlier Convention on the Laundering, Search, Seizure and Confiscation of the Proceeds from Crime (ETS No. 141).

33. Money laundering currently has the Council of Europe's full attention. In addition to its close co-operation with the FATF (Financial Action Task Force), an intergovernmental body whose purpose is to frame and promote policies to combat money laundering and the financing of terrorism at both national and international level, the Council of Europe also has a very effective tool, MONEYVAL, the Committee of Experts on the Evaluation of Anti-Money Laundering Measures and the Financing of Terrorism, which regularly monitors the efforts made by member states to combat money laundering. On the basis of MONEYVAL recommendations, the Council of Europe also conducts technical co-operation projects (for example, the MOLI/MOLICO projects) in countries such as the Russian Federation, Ukraine and Moldova.

2.6. Cybercrime

34. The sprawl of new means of communication and new technologies over the last decade, in particular the Internet, has had far-reaching implications for society and the economy. The Internet is used not only as a tool to spread ideas and transmit information, but also for economic transactions and flows of capital (about 90% of the world economy depends on digital networks and services). At the same time, economic crime on the Internet has also increased, adapting to the new situation very quickly, while policies for ensuring privacy, security (of networks and data) and consumer protection have lagged behind at both state and enterprise levels.

35. The Internet is now part of a critical infrastructure that requires adequate protection and regulation. The Council of Europe is trying to fill the existing security gaps through its legal instruments, such as the Convention on Cybercrime (ETS No.185), the only international legally binding instrument dealing with this issue. It has been signed not only by numerous member states but also by non-member states such as the United States, Canada, Japan and South Africa. Co-operation has also been established with Morocco, Nigeria and the Dominican Republic.

36. The Council of Europe also adopted, in December 2010, a new open convention – a binding international instrument criminalising the counterfeiting of medical products and similar crimes that threaten public health (Convention on the Counterfeiting of Medical Products and Similar Crimes involving Threats to Public Health, "Medicrime Convention", ETS No. 211), including through the use of the Internet. We trust that this convention will soon be opened for signature. This is truly urgent as there is a big surge in this criminal activity, with seizures of fake medicines up by 400% since 2005 in European distribution networks. In a separate move, the Organisation is updating its Convention for the Protection of Individuals with regard to Automatic Processing of Personal Data (ETS No. 108) in order to take into account the need for better management of data flows over the Internet, including for the purpose of enhanced transparency (in the light of overriding public interest) to tackle tax evasion, copyright violations and other crime. On 28 January 2011, the Council of Europe and the European Union announced their intention to work together on optimising their personal data protection rules.

2.7. "Rotten" assets

37. Illicit money flows (that is, money earned, transferred or used illegally) continue to pose a real problem. Such funds – including trade and asset mispricing¹⁸ and sham transactions – are often channelled through tax havens and this has a major impact on national economies, which invest in public services (infrastructure, education, judicial system, etc.) but are deprived of substantial dues from private capital movements and might even be obliged to borrow to cover the revenue gaps. This is a vicious cycle that leads to a rise in public deficits, which in turn lead to economic crises, monetary problems and lower investment levels with disastrous social consequences and a growing public mistrust in the state's ability to govern. There needs to be greater public scrutiny of cross-border capital flows and more pragmatic international co-operation in this matter, not least as a means of protecting the national interest, sovereignty and security.

38. Alongside illegal activities relating to the underground economy, some perfectly legal financial practices have led to the same results, in other words, heavy economic and financial losses in terms of national wealth, economic activities and households' financial resources. Here, one should highlight the fault of financial institutions and credit rating agencies. The latter gave high ratings to derivative financial products which have since caused so many bankruptcies in chain, whilst the former traded risky assets repackaged as top-grade without any due check. This failure in due diligence can be assimilated to stock exchange manipulation, misinformation and wide-scale customer abuse – all liable for prosecution as economic crime.

18. . According to the Tax Justice Network, more than half of the world trade passes through offshore centres, allowing value manipulations, market distortions and capital flight.

39. The fall of Enron in 2001 was only a premonition of the future problems that escalated from 2007 onwards: the oversight of critical financial sectors was largely relaxed (“liberalised”) over the last decade, instead of being strengthened, and shadow banking practices became commonplace rather than the exception. Yet the rating agencies – notably the oligopoly of the “Big Three”, all based in the United States but operating across the globe – are still paid by the companies which commission their evaluations and many European banks have not yet completely cleared their accounts of the toxic assets which were responsible for the economic crisis. These toxic assets continue to be a major problem. One perhaps should not be surprised by this international collision: “[w]hat else could one expect on a highway where there were neither speed limits nor neatly painted lines?”.¹⁹

40. One of the aims of the Council of Europe, as indicated in its Statute, is to protect human rights and to facilitate economic and social progress in member states. Moreover, provisions of the European Convention on Human Rights (notably Article 1 of Protocol No. 1 on the protection of property, including savings) and the revised European Social Charter cover a wide range of economic rights. Therefore, in considering the real options to better protect the basic economic rights of citizens, we should ensure that all member states subscribe to these legal tools and that citizens are adequately informed in order to take the right decisions on the use of their possessions. In the wake of the global financial crisis, we see a strong need to enhance transparency of financial information on market players and to strengthen obligations for persons and institutions to disclose information. A comprehensive mechanism of criminal and civil liability, including sanctions, needs to be introduced with respect to the reliability of information provided.

41. Finally, mention should also be made of the damage caused by hedge funds which speculate on new crises. International financial speculators, who bear a major responsibility for the 2008 financial meltdown, are at work again just as some European countries such as Greece, Ireland, Portugal and Spain are experiencing serious financing difficulties. This type of activity therefore needs to be strictly regulated on stock markets to avoid further economic disasters. The European Union attempts to regulate hedge funds finally yielded some results in November 2010 when the Alternative Investment Fund Managers Directive was agreed. Although criticised as imperfect and diluted, this directive will impose minimum capital requirements, market licensing procedure and an obligation for such funds to disclose their investment strategies and accounting practices to investors and regulators in the European Union as from 2013. This directive could give inspiration to non-EU legislators to take similar steps across greater Europe.

3. Responsibility of states, businesses and citizens

42. The shadow economy has a tendency to thrive when taxpayers – individuals and companies – consider that the government demands are exorbitant and unfair. In harsh economic times, economic players’ tolerance towards rising unemployment, taxes, regulations and/or inflation is even lower, thus weakening their respect for the law and fuelling their propensity for underground activities in order to augment their income, unless strong state institutions can ensure compliance. Moreover, underground enterprises might stimulate economic life wherever government has failed to regulate adequately.

43. Quality state institutions, policies and frameworks are therefore key vaccines against the underground economy. They need to be constantly adapted to a changing economic and social context. Continued dialogue with employers’ and employees’ organisations plays a vital role in strategies to trim informal activities and to improve the overall economic climate for regular economic activities. The state – as a key regulator and the guarantor of the rule of law – must seek maximum transparency in its own affairs and request more transparency from the other players of the economic system, in particular with regard to ownership and income of economic entities. As the Assembly’s debate on “Human rights and business” has shown,²⁰ the rise of enterprises as highly influential actors on the global scene should be accompanied by more clearly defined corporate responsibilities towards society.

44. The expansion of multinational enterprises and financial markets, accompanied by the liberalisation of the world economy, has diminished the power of individual states. As political and economic spheres are increasingly interrelated, both the state authorities and the corporate sector increasingly share concerns and responsibilities. It is particularly important to protect sensitive personal data from abuse by ill-intentioned entities and to raise public awareness of the need to be vigilant about releasing personal data, especially over

19. . “The financial crisis inquiry report: final report of the National Commission on the Causes of the Financial and Economic Crisis in the United States”, January 2011.

20. . On the basis of a report by the Committee on Legal Affairs and Human Rights (rapporteur: Mr Holger Haibach), [Doc. 12361](#), and an opinion presented by the Committee on Economic Affairs and Development (rapporteur: Mr Tuur Elzinga), [Doc. 12384](#).

the Internet. We should also bear in mind that for all the shadowy ventures there is a demand side and a supply side: states, businesses and citizens should therefore act on both fronts by spotting, signalling, sanctioning and correcting deviations as far as possible – including in their own ranks.

4. Concluding remarks: the need for improved regulation, co-operation and law enforcement

45. As we see from this report, the underground economy is not an abstract phenomenon. It not only severely cripples legitimate businesses, violates economic rights and undermines living standards, but is also a real threat to democracy and the rule of law. We therefore need to promote a common, inter-state approach to fighting the shadow economy. To this end, we have to harmonise the notions and clarify the terms we use. Because there is no uniform definition of underground economy, even the interpretation of terms such as cybercrime, corruption or drug trafficking varies from country to country. This is explained by the specificities of different economic and political systems and countries. However, the lack of uniform terms is a significant challenge for developing a common or similar toolbox for use by national jurisdictions.

46. Moreover, recognising national specificities with regard to the various forms of shadow economy and economic crime, the practical recommendations and measures on how to address these problems may also differ. For some economies, it may be useful to carry out privatisation, to adjust the functioning of public services, to implement administrative reforms and to strengthen the systems of checks and balances, notably through professional associations. In the more open and more advanced economies, the creation of independent supervision mechanisms for ensuring the truthful (accurate, complete and timely) disclosure of financial information and the strengthening of regulatory functions may be necessary.

47. Such measures would reflect a modern approach to protecting civil freedoms and the principles of democracy. We need to accommodate these mechanisms promptly, since the era of electronic money and new technologies brings both new opportunities for market players and new risks of abuse, as capital travels in less than a second from one bank to another across the globe. With life getting more sophisticated, European legislators and governments have to stay vigilant and continuously adapt their policies in seeking pragmatic ways to address modern challenges.

48. Sound economic governance entails a strong commitment to the values of democracy, development and the rule of law. It requires effectiveness of governing structures based on accountability and transparency that leave no space for shadow dealings. However, this state of affairs remains an ideal that the Council of Europe countries should strive for. To start with, they must refine their data collection methods so as to be able to measure the true extent of the underground economy and economic crime in individual countries, to allow cross-country comparisons and to evaluate progress made further to targeted action measures introduced to combat the phenomenon. It is also necessary to analyse the interface of the shadow economy with the formal economy at national and European levels.

49. There is much scope for improvement in all European countries in terms of regulation, taxation, state administration and law enforcement. Moreover, the global economic crisis has clearly pointed to the serious shortcomings in the existing economic and financial regulations, above all where the public and international authorities' supervision of the activities of financial institutions is concerned. The Basel Committee on Banking Supervision issued new regulations (Basel III) in September 2010, aimed at strengthening the security and reliability of the international financial system by establishing stricter standards in banking oversight (notably as regards liquidity and prudential ratios). The EU countries have recently moved to regulate hedge fund operations on their territory, and other European countries should follow suit. Moreover, the rapporteur is convinced of the need for increased scrutiny of business transactions involving the use of the services of offshore financial centres.

50. At the same time, member states should be careful not to increase the overall regulatory burden which has been shown to negatively affect competitiveness, economic climate and growth prospects whilst also stimulating informal economic activities. They should therefore assess the weight of their regulatory systems related to taxation, licensing, labour, environment, health and safety, consumer protection, and intellectual and industrial property rights, with a view to determining whether these could be streamlined and the cost of compliance lowered. The rapporteur further suggests studying the impact of migrant labour, in particular the trend of "low-cost" labour, on national welfare systems and on corporate compliance with core labour standards. Specific assistance could be put in place to help better integrate vulnerable groups (including minorities, refugees, asylum seekers, displaced persons and Roma communities) through targeted educational schemes, employability training, self-employment programmes and measures to improve access to public services and decent housing.

51. The Parliamentary Assembly must help establish a healthier financial system and propose further improvements in international co-operation, such as for the supranational monitoring of money flows (relating to both electronic and cash transactions), sharing of best practices in surveillance, investigation and prosecution techniques, and co-ordination of national policies for combating the underground economy and economic crime. Some of its proposals could concern the promotion of whistle-blowing and witness protection, tougher sanctions for offering bribes (tackling the “supply side” of corruption), stronger rules on the use of cash transactions and increased penalties for unrecorded or undeclared cash receipts, the enhanced use of economic intelligence, and the accelerated implementation and updating of relevant Council of Europe treaties,²¹ etc.

52. Using its existing links with the OECD, the Council of Europe could explore the possibilities for joint action in order to promote the participation of those of its member states which are not members of the OECD in the Working Group on Bribery in International Business Transactions and their subsequent accession to the OECD’s Anti-Bribery Convention, which in addition to 34 OECD countries has so far been adopted by Argentina, Brazil, Bulgaria and South Africa. This would usefully complement these two organisations’ co-operation on anti-money-laundering activities and joint instruments for mutual administrative assistance in tackling tax evasion (Convention ETS No. 127 and an amending protocol, CETS No. 208).

53. Whilst welcoming the recent adoption of the Medicrime Convention, we should recall this Assembly’s request, contained in [Recommendation 1793](#) (2007), that a legal instrument be drawn up that would cover not only medical products but also a full range of consumer goods which, if counterfeited or adulterated, pose grave risks to the lives and health of Europeans. As the implementation of the Medicrime Convention will require relevant data, the rapporteur believes that some form of European observatory could be set up under the aegis of the Council of Europe, possibly in co-operation with the European Union, to gather data on cases of fraudulent goods that put public health at risk. This would help to collate the information necessary to shape further action, such as considering the need for an additional protocol to the Medicrime Convention so as to widen the latter’s coverage to all consumer goods. The task is challenging, but inevitable if this Organisation wishes to remain relevant in Europe in the context of globalisation by being responsive to Europeans’ needs and by duly protecting their rights.

21. . These include: European Convention on Mutual Assistance in Criminal Matters (ETS No. 30) and its additional protocols (ETS Nos. 99 and 182); European Convention on the Legal Status of Migrant Workers (ETS No. 93); Convention for the Protection of Individuals with regard to Automatic Processing of Personal Data (ETS No. 108) and an amending protocol (ETS No. 181); Convention on Mutual Administrative Assistance in Tax Matters (ETS No. 127) and an amending protocol (CETS No. 208); Convention on Insider Trading (ETS No. 130) and an amending protocol (ETS No. 133); European Convention on Certain International Aspects of Bankruptcy (ETS No. 136); Convention on the Protection of Environment through Criminal Law (ETS No. 172); Criminal Law Convention on Corruption (ETS Nos. 173) and an additional protocol (ETS No. 191); Civil Law Convention on Corruption (ETS No. 174); Convention on Cybercrime (ETS No. 185); Convention on Action against Trafficking in Human Beings (CETS No. 197); Convention on Laundering, Search, Seizure and Confiscation of the Proceeds of Crime and on the Financing of Terrorism (CETS No 198).