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## **Impact of Organized Crime on Shadow Economy: Social Impact Assessment**

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### **ABSTRACT**

This study examines the issues of the organized crime social consequences assessment and its impact on the shadow economy of Kazakhstan. The study is based on the results of studies of a number of scientists who had used an economic approach to the organize crime and considere it as an institution of the criminal enterprise. However, the Kazakhstan evaluation system of the shadow economy size does not consider the impact of the criminal factors in general and organized crime in particular. At the same time, such American scientists as Levitt and Venkatesh, who had conducted a detailed financial analysis of a separate drug gang, have proposed a possible algorithm of such calculation in 1998. Based on their scheme, the authors propose a set of measures for evaluating the real impact of organized crime on the shadow economy of Kazakhstan.

**Key words:** Organized crime, shadow (unobserved) economy, criminal enterprise, economic analysis of organized crime, social consequences (price) of organized crim

### **INTRODUCTION**

Economic sovereignty and development of the country as an independent state is determined by the national security. It is provided with protection and elimination of the emerging threats. The threats to national security are the shadow economic relations, having a destabilizing effect on the national economy. Their expansion leads to distortions and destruction of the bonds between the state and an individual. Undermining the moral and ethical foundations of society, erodes the criteria for the choice of means to achieve the objectives and the boundaries between permitted and prohibited activities (<http://kisi.kz/img/docs/982.pdf>).

Meanwhile, the shadow economy is not something introduced from outside and accompanies the life of any state, regardless of the current socio-economic system. Accordingly, the roots of this modern phenomenon lie in the recent Soviet past.

Analyzing the characteristics of the socialist economy, more than a quarter century ago (Sampson, 1988), it was emphasized that the shadow economy is not “an island of capitalism” but remains its integral part (Sampson, 1988). Many western economists have noted the main features of the Soviet shadow economy-production and distribution of goods and services for mercenary ends in violation of legal norms. This phenomenon was known as “counter-economy”, “unofficial economy” (Grossman, 1977), “parallel market” (Simes, 1975) or “second economy” (Karol, 1971).

For example, in the conditions of shortage, the enterprises have often created unrecorded surplus goods in order to exchange them for other goods intended for employees or executives (Berliner, 1952).

Thereby, the main identification feature of the shadow economy is “unaccounted value creation” (nichterfabte Wertschopfung), it refers to any economic activity that contributes to creation of the economic values of the country but is not included in its gross domestic product. That is, any activity of producing goods and services, associated with tax evasion or tax-exempt but not including the purely financial transactions or property transfers, various illegal or criminal activity without creating valuables (Cassel, 1986).

According to Marrese (1981), the shadow economy also includes all unregulated (legal and illegal) elements of economic activity in the state and cooperative organizations that plus all the unrecorded activities plus all forms of private (legal, semi-legal and illegal) economic activity (Marrese, 1981).

Feige (1990), while developing the above approaches, identified four types of underground economic activities:

- **Illegal economy:** When illicit goods and services (drugs, speculative currency exchange, etc.) are produced and distributed
- **Unreported economy:** It Include violations of tax rules and generating the difference between the estimated and actually collected tax revenues
- **Unregistered economy:** It is not covered by the statistical authorities and reproduces the unreported income
- **Informal economy:** It include private expenses and revenues obtained by informally operating economic structures (Feige, 1990)

This far from exhaustive review of the scholars’ opinions, fully supports the conclusion that a well-known economist had made almost half a century ago, crimes occur when there is a benefit from it (Becker, 1968). Likewise, Ehrlich (1987) had said about the positive or negative incentives to committing crimes so, the aim of this study was to evaluate the impact of organized crime on the shadow economy.

## CASE STUDY

It is obvious that the shadow economy promises the organized crime as sufficiently high incentive. With respect to Kazakhstan, its annual scale could be more than 40 billion U.S. dollars in 2013 (<http://www.ereport.ru/stat.php?razdel=country&count=kazakhstan> and [table=grecia](http://www.ereport.ru/stat.php?razdel=country&count=kazakhstan)), or about 20% of gross domestic product, as shown in Fig. 1 (in the official documents the term “unobserved economy” equal to the “shadow economy” is used) (<http://adilet.zan.kz/rus/docs/P1300000190>).

Such a “tidbit” never fails to arouse interest of the criminal structures, especially taking into account the views of experts talking about organized crime as entrepreneurship (“business enterprise”), aimed at maximizing the income (Kelly *et al.*, 1994; Albanese, 1995).

The concentration of the “organized criminal entrepreneurship” is largely explained by the fact that the profit potential in this activity is relatively high (Buchanan, 1973).

The studies on the organized crime have been based on the theory of organizations-the section of the economic theory, which studies the firms and their market behavior (Schelling, 1967). Like

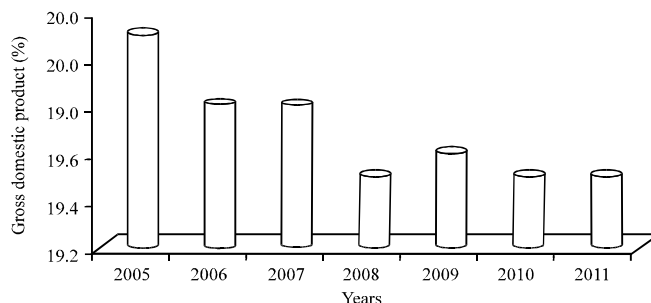


Fig. 1: Amount of shadow economy in Kazakhstan (%)

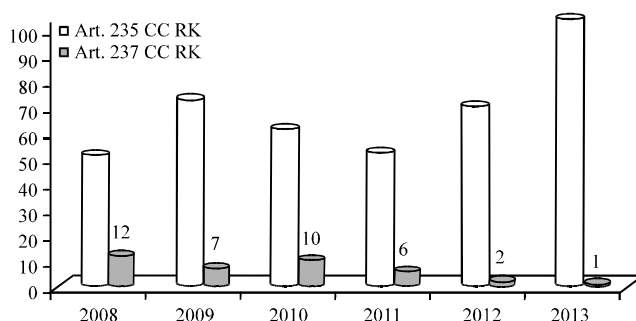


Fig. 2: Criminal cases of criminal code of republic of Kazakhstan

any labor collective, the criminal organization has more or less complex structure, work rules, cares about the personnel selection, training and placement, supports labor discipline, provides operating safety and strives to the highest income (profit). The manuals on mafia management are described by Johnson (1996).

Rubin (1978) has noted that “one way of considering organized crime is its study as a network of firms producing goods and services. Most of those criminal activities, which are considered organized-heroin drug trafficking, gambling, financial fraud, perhaps, prostitution-are actually parts of the trade of goods and services that individuals want to buy. In the criminal market, the organized criminal firms communicate with each other and with consumers who buy goods and services” (Rubin, 1978).

Other authors have mentioned similar criminological features of the interaction between the organized structures (Abadinsky, 2012; Albin, 1971; Arlacchi, 1986; Smith, 1990).

However, despite the obvious facts of organized crime impact on the shadow economy, the problem is almost unexplored. Similarly, the questions of damages (whether direct or indirect) to state and society caused by criminal organizations remain uninvestigated, although the presence of organized crime in Kazakhstan is obvious. Figure 2 shows the number of criminal cases under article 235 (creation of an organized criminal group) and 237 (banditry) of the Criminal Code of the Republic of Kazakhstan (<http://service.pravstat.kz/portal/page/portal/POPageGroup/Services/Pravstat>).

The existing situation is largely caused by woefully inadequate legislative control of the financial aspects of organized criminal groups activities. Prior to 2011, one of the few such

provisions of the Criminal Code of the Republic of Kazakhstan was Article 193, which establishes liability for legalization of money or other property acquired by illegal means ([http://online.zakon.kz/Document/?doc\\_id=1008032](http://online.zakon.kz/Document/?doc_id=1008032)).

According to the current legislation of Kazakhstan in order to bring the members of organized crime to justice, it is necessary to prove that any specific crime is the source of such funds ([http://online.zakon.kz/Document/?doc\\_id=1023817](http://online.zakon.kz/Document/?doc_id=1023817)). However, law enforcement experience shows that in most cases, it is not possible to establish such connection. Thereafter, it is impossible to bring someone to responsible for it.

Some progress was achieved in 2011, when with the direct participation of the authors of this study into the criminal legislation of Kazakhstan were introduced regulations that criminalize the creation and functioning of the common monetary fund's of the organized crime, including in the shadow economy. In particular, a new Article 235-4 of the Criminal Code has established the liability for such funds raisers and for those who knowingly finance the organized criminal groups. In this case, it is not required to prove their involvement in a specific offense (Government of Republic of Kazakhstan, 2011).

The legal statistics show that the new rule has already begun to be used by law enforcement agencies. Thus, in 2013, there was 11 crimes registered and in the 1st quarter of 2014-3 (<http://service.pravstat.kz/portal/page/portal/POPageGroup/Services/Pravstat>).

However, it should be noted that the financing of organized crime is only a small part of its extensive influence on the scope of the shadow economy. There are many areas that are potentially attractive to criminals, the northern region of Kazakhstan; grain products, smuggling of Russian goods, production of alcohol, the central and eastern regions-nonferrous and rare metals, arms sales; the southern region-drug trafficking, illicit manufacturing of pharmaceutical products and alcohol, smuggling of Chinese goods, the western region-caviar fish products, oil business, arms sales (Spanov, 2001).

## **METHODOLOGY**

Methodological basis of this study formed the dialectical method of knowledge of socio-legal phenomena, as well as systematic structural, comparative legal, logical-theoretical and private scientific methods of study. In addition, the research used such sociological techniques as surveys of law enforcement officials and the analysis of specific criminal cases. To achieve objectivity of the study results, these methods have been applied comprehensively.

## **RESULTS AND DISCUSSION**

As noted above, the problem of formation and functioning of the shadow economy at the present stage of development of Kazakhstan plays an increasingly crucial role in the economic life of the state. For a better understanding of its origins, it seems appropriate to examine the experience of those countries that have much earlier encountered this phenomenon.

First, the ideas of a famous Peruvian economist De Soto (1989), published in 1987, deserve close attention; they made a genuine revolution in the conceptions about the role and importance of the shadow economy.

Previously, the legal sector was thought to be the carrier of modern economic culture, while the shadow sector-an ugly relic of the traditional economy. The Peruvian economist argues that the legal economy of the developing countries is enmeshed in mercantilist bonds, while the shadow businesses establish a truly democratic economic order, organizing their private enterprises on the

principles of free competition. The main cause of the shadow economic activity, he considers the irrational legal regime when “the prosperity of the company is less dependent on how well it works and more on the costs imposed on it by law. An entrepreneur, who manipulated these costs or ties with officials, is more successful than the one who is concerned with production only” (De Soto, 1989).

Complementing the ideas of De Soto (1989) to some extent and relying on the modern development of the organized crime, it is safe to say that the scope of the shadow economy is under its specific impact.

More than ten years ago in Kazakhstan, there was a trend of a dynamic and qualitative change in the organized crime, which has acquired a completely new form. Besides the traditional crimes, the organized crime groups actively explored the scope of economic crimes, related to creation of the front companies that were used to obtain “irrecoverable” commodity and cash loans, smuggling of goods, tax evasion, cashing and “laundering” of the money obtained from criminal activities. They actively penetrated in the legal economy, investing already legalized funds in businesses and banks (<http://www.nomad.su/?a=13-200206240048>).

This picture leaves no doubt that the organized crime in its various manifestations largely affects the formation and functioning of the shadow economy.

It is possible to distinguish several types of such effects depending on the subjects of criminal acts. Firstly, when the main participants are the representatives of the traditional criminal environment and various government officials play a supportive role. For example, this year in Kyzylorda, there was suppressed the activity of an organized criminal group involved in the illegal acquisition and sale of crude oil in the Kyzylorda and Aktobe regions. In two years period, it had transported and sold 54 wagons of oil and petroleum products worth over 356 million tenge (about U.S. \$ 2 million) without proper documents. More than half of that money was legalized through a network of sham companies (Praliev, 2014).

Secondly, when criminals and public officials act on a relatively equal footing; an example of such may be the so-called “Khorogos case” trial. It is known that the corruption scandal at the Kazakh-Chinese customs “Khorogos” erupted in 2011. The criminal community had organized smuggling across the border on a large scale. The criminals acted under the protection of special services officials, who, among other things, eliminated competitors in criminal activities by detaining smugglers, on a tip from the criminal community leaders (<http://tengrinews.kz/crime/horgosskoe-delo-podsudimyim-vyinesli-prigovor-253495>). During the three-year investigation, it was found that of 45 defendants, there were 3 national security employees and 15 customs officers. Only in 2011, the cost of the smuggled goods imported and detained from China reached 1,5 billion (or approximately U.S. \$ 10 million) ([http://forbes.kz/process/probing/horgosskoe\\_delo\\_obvinyayutsya\\_45\\_chelovek](http://forbes.kz/process/probing/horgosskoe_delo_obvinyayutsya_45_chelovek)).

Finally (third type), when a key role in the criminal activity is performed by representatives of the government. For several years in the Atyrau region, there functioned a criminal organization headed by the former akim B. Ryskaliyev and his brother-former Member of Parliament A. Ryskali, that engaged in plundering the budgetary funds and abuse of power. In total, harm to the state and the citizens amounted more than 71 billion tenge (about U.S. \$ 500 million) ([http://forbes.kz/process/opg\\_eks-akima\\_ryiskalieva\\_naneslo\\_uscherb\\_v\\_71\\_mlrd\\_tenge/?mark](http://forbes.kz/process/opg_eks-akima_ryiskalieva_naneslo_uscherb_v_71_mlrd_tenge/?mark)). Such development of the organized crime completely fits into a framework outlined by It seeks to maximize the expected utility and normal investment decisions under risk and uncertainty (Becker, 1968).

De Soto (1989) confirms that in all kinds of illegal activities (housing construction, trade, transport, etc.), there are strong organizations that coordinate the contacts of shadow businesses with each other and with the legitimate state institutions. In 2014 in Kazakhstan, there was revealed a group of 18 employees of the Tax Committee of the Republic who worked for a large organized crime group and through front organizations helped to evade taxes by bogus inspections of sham enterprises belonging to criminals. As a result of their actions, the treasury of the republic has missed 2,3 billion tenge (over U.S. \$ 15 million) (<http://www.news-asia.ru/view/kz/6101>).

However, despite the above evidence of presence of the organized crime in the shadow economy, the state policy of Kazakhstan still ignores these realities. Accordingly, the problem of even approximate damage assessment from such presence is not considered even in production terms.

According to the traditional approach, in our country, the assessment methods of the shadow (or unobservable) economy are divided into three groups; direct, indirect and combined methods, representing the combination of the first and the second. The direct methods include, indicators of households and businesses, unorganized retail outlet, as well as the results of tax, financial and other inspections. The indirect methods include the analysis of national accounts statistics, the activity of the working population in the formal economy, the demand for cash in the money supply, the analysis of the shadow economy on the basis of consumption of production factors (for instance, electricity, because electricity consumption is the only physical indicator of economic activity) (<http://adilet.zan.kz/rus/docs/P1300000190>).

Obviously, these methods are dominated by purely statistical approach that does not consider the impact of criminal factors (especially organized crime) on the formation of the shadow economy. There are two possible reasons: (1) These problems have not been studied in the domestic science; (2) Development of the methods that take into account the criminal component of the shadow economy is deemed impossible because of the difficulty of measuring the financial elements of crime.

However, in the foreign practice, there are interesting examples of direct estimates of these factors. Thus, in 1998, American scientists and economists (Levitt and Venkatesh, 1998) published a scientific study on the financial analysis of the drug gangs (Levitt and Venkatesh, 1998).

At the same time, they have integrated similar studies conducted by other authors. Different gangs are an integral part of many American cities. For a long time, their criminal activity was dominant over any business projects. However, over the past few decades, there has happened the cardinal dynamic changing of the street gangs' nature that (Taylor, 1990) designated as "corporatization" they turned out of the ordinary criminal structures into the criminal "firms". The catalyst for this process was drug trafficking when a powerful stream of cocaine, heroin and especially cheap crack had flooded the trafficking, which turned yesterday's thugs into the drug dealers (Taylor, 1990). Rising unemployment and falling of living standards ensured growth in the number of bands. For example, in California alone, the number of those working for organized crime (not including the basic structure of groups) could be 250 thousand people in 2000 (Landre *et al.*, 1997).

A lot is known about the street gangs of American cities but the financial side of their activities remains a scantily explored area. The main reason is the difficulty of collecting statistical data on the operation of such criminal "firms". Studies of Levitt and Venkatesh (1998) became possible after they accidentally obtained records of a drug dealing group's executives; those records were kept for a long time-more than four years and included various items of income and expenses.

In other words, Levitt and Venkatesh (1998) have done the work of the appropriate law enforcement bodies, fighting against drug trafficking. Moreover, the authors showed the possibility and necessity of exploring the financial aspects of organized crime.

Based on this methodology, there is a real opportunity to carry out a similar economic analysis for each of the most important activities of organized crime in Kazakhstan.

## **CONCLUSION**

The aim of this study is the creation of the state monitoring system of the criminal factors impact, especially organized crime, on the shadow economy; building of an adequate counteraction mechanism on this basis and minimization of their social consequences (price).

To achieve this connection, the gradual resolving of the following problems is necessary:

- To establish an interagency working group with representatives of law enforcement bodies and special services, as well as scientists and experts studying the problems of organized crime and the shadow economy
- To summarize and organize the information on this subject, available in both the scientific literature and databases of relevant government authorities. The sources of information may become the materials of numerous criminal cases against the members of organized crime groups in recent years. In addition, significant materials are contained in the abovementioned cases of the Customs “Korgos”, ex-officials of Atyrau region and many others. Additional information can be received from law enforcement agencies in the course of their work
- To develop different methodologies to assess the damage from criminal factors and organized crime in the most important areas of the shadow economy on the basis of the data obtained
- To develop guidelines for government agencies and financial institutions to minimize the impact of crime on the shadow economy

The methodology for assessing the size of the shadow economy existing in Kazakhstan does not take into account the degree of influence of the organized crime and other criminal factors and this may be the biggest cause of error and failure to reduce its volume in the long-term period.

The proposed measures, at the initial stage of the great work, could eventually lead to development of the additional methods for assessing the size of the shadow economy, to the possible significant adjustment of the existing indicators and improving the national economy managing.

Furthermore, the establishment of such methods would be a new step in understanding the social consequences (price) of crime (especially organized) and this, in turn, will allow to more specifically approach its prevention in general.

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