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Cross Border Crime

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Introduction

There have been dramatic changes in the political, social, and economic foundations of many countries. The transition from the former communist political and economic systems into developing market-oriented economies have greatly contributed to the rise of criminal or illegal activities. These economies include a varying mix of old and new institutions that are not mutually compatible. Large parts of the economy share many of the features of what Feige (1990) identified as characteristics of an underground economy, where economic activities are illegal, unreported, unrecorded and informal. To some observers the transition towards a market economy appears to look like a process of the criminalization of the economy.

The transition has allowed a large amount of abuse to take place against the system by both criminals and ordinary citizens. There has also been a growing relationship and affinity among government authorities, the business sector and organized crime. Lapses in public safety, border control and internal security have also occurred. The governments of these countries have recognized and publicly acknowledged these deficiencies, but have lacked the general material and financial resources to make the necessary adjustments.

In this paper, we examine one aspect of this new development -- illegal cross-border activity in the Greater China area embracing China, Hong Kong and Taiwan. Trade and investment flows between these three areas have grown by leaps and bounds following China's decision to open her economy in 1979. The growing economic integration of these three areas has also fueled criminal activity. Today a significant volume of the trade and investment flows within the three areas are illegal in nature. We attempt to describe the nature and scope of illegal cross border activities in the Greater China area and to draw out the broader implications of such activities for the future development of this region. Our analysis complements a growing body of literature on the development of the Greater China economic area that are mostly silent about the implications of illegal transactions and the underground economy.

We define illegal activities to include all forms of activities that violate the laws of a country or jurisdiction. Illegal activities do not necessarily generate an external diseconomy as is commonly presumed in most discussions of crime. Indeed some illegal activities may enhance economic efficiency because they correct some of the inefficiencies caused by arbitrary government regulations and controls. One should not, however, conclude that such crime have no social cost. In principle, all criminal activity generate some external diseconomy because it erodes legal authority, promotes corruption, and may provide financing for the activities of organized criminal groups. The net benefit to society need not be positive.

Economic Reform and Crime in China

Since 1978, China began to liberalize her economy incrementally and achieved extraordinarily rapid output growth. Real GNP expanded at an average annual rate of 9.5% during 1978-1994. Reported crime rates almost doubled in the same period. A casual comparison of GDP and crime figures in Table 1 suggests that crime rates appear to be countercyclical in this period. Crime statistics, however, do not reveal the full extent of illegal activities in a transition economy like China. The problem is not simply a matter of under-reporting and unreliable statistics. Crime in China and especially cross-border crime is a result of the pattern of economic reform in China.

Table 1

The reforms started in agriculture with the replacement of the communes by a system of household farming with land leased from the state. By 1984, the engine of rapid economic growth had shifted to rural light industry, which began to absorb the labor force released by productivity gains in agriculture. Small scale private traders flourished alongside numerous new manufacturing enterprises owned largely by townships and villages. These became the backbone of the new market driven non-state sector. Most of the enterprises in the non-state sector are collectively owned and operated by local governments.

Foreign trade was liberalized gradually by setting up special economic zones that had some autonomy and were allowed to operate outside the control of the traditional state trading monopolies. The first and most important ones were in the Pearl River Delta area in connection with the Hong Kong export oriented outward processing investments from (see Sung etal., 1995). In time a trade boom became China's new engine of economic growth. Exports as a share of GNP rose from 5.31% in 1979 to 18.76% in 1993. In 1995, about 45% of China’s total trade was with Hong Kong. Most of China’s exports to Hong Kong were re-exported.

The Chinese economic reforms were only partial in nature. The system continues to operate under a dual track system, where the old system co-existed with the new. This dualism reflects the lack of consensus within the political leadership. The debates over price reforms, foreign exchange reforms, enterprise reforms, and the piecemeal nature of the reforms mirrored the on-going conflicts within the top leadership.

The market economy expanded largely through a process of growing out of the state plan by diverting resources away from the state sector. This evolutionary approach explains why reform has been incremental. One can discern a pattern of starting with the easy tasks and gradually progressing to more difficult tasks. This was not, however, a conscious strategy as is sometimes implied by those who claim that the Chinese reform strategy is gradualist. A more appropriate characterization would be as a series of breakthroughs in the old system at points that offered the least political resistance from the establishment.

Regional differences were substantial and reinforced by the policy of creating special economic areas with greater freedom to experiment with and implement more liberal reform measures. It also created a vast underground or informal economy. In China, the body of law is in a state of permanent change because of on-going reforms. New legislation and regulations are constantly being drafted and institutions are being created to implement and enforce them. As power is gradually devolved from the center, numerous enterprises and local authorities often engage in practices that have not been approved by the central government. If they had asked for approval in advance it is likely that permission might not be granted or they will have to spend long periods of time waiting for a decision. As a consequence, there is an unavoidable element of ambiguity about the legitimacy of many local reform measures at the time they are introduced.

Regional and local variations imply that reform measures that are considered acceptable and legitimate in one area may not be so in another area. Provincial and local authorities have frequently approved or condoned practices that contravene policy regulations stipulated by the central government or the legislature. The best example is that large amounts of Hong Kong currency circulate in Guangdong province with almost no restriction in direct violation of central government regulations. Greenwood (1992) conservatively estimated that 21% of the currency issued in Hong Kong amounting to HK$10.5 billion circulates in China at the end of 1991.

Some features of China's underground economy are illegal because they violates legal statutes. The growth of crime in many areas, including organized crime, is evident in many cities. Some of the activities are unreported because they violate fiscal statutes. Tax evasion is pervasive as a consequence of the introduction of the fiscal contract responsibility system, whereby the central government engages in annual bargaining exercises to determine the level of taxes that local governments and state owned enterprises have to pay the government. Perhaps the most important form of underground economic activity is the unrecorded informal economy. Individuals and enterprises in China engage in widespread violation of legal and administrative rules. As in many developing countries, full compliance with the rules would make economic activity impossible to pursue (see De Soto, 1990)).

Private property rights are ill defined in China’s transitional economy. Regulations are pervasive but enforcement is often ineffective. The co-existence of the state and the non-state sector under such conditions creates enormous opportunities for rent seeking, corruption and the pursuit of illegal gains. These activities take many forms, but an important characteristic is the diversion of resources from the state to the non-state sector. The act is illegal as well as the methods that are employed. Liberalization has given bureaucrats and managers greater freedom to capture the profits that should have accrued to the state and to divert funds and resources of state owned enterprises and banks into non-state enterprises that they themselves control or own. Some of the enterprises may even be incorporated overseas, for example, in Hong Kong.

Economic liberalization has shifted decision making authority and the residual claimant role from the central government bureaucrats to numerous managers, entrepreneurs, and local officials. One consequence of this change is to make corruption easier because it has become more difficult to monitor the behavior of so many agents.

Economic crimes have also grown rapidly in recent years. China's first anti-embezzlement and bribery bureau was established in South China's Guangdong Province in 1989 where market reforms was first initiated. To date, 26 of the 30 municipalities, provinces and autonomous regions have set up such bureaus, with a total of more than 40,000 working staff. The Central Bureau of anti-embezzlement and Bribery, China's legal arm specializing in fighting corruption was established in 1991.

A limited amount of corruption can improve incentives for bureaucrats and managers to improve the performance of their enterprises. Corruption may also improve the overall efficiency of the allocation of resources in the economy by diverting resources from the state sector to the non-state sector. Unfortunately, given that most state owned enterprises are losing money and have to be financed by the state banking system, the advent of growing corruption in the financial sector will complicate the problem of maintaining macroeconomic stability.

Pervasive corruption is, however, socially disruptive and breeds discontent. As law enforcement agencies themselves become corrupted it becomes increasingly difficult to maintain law and order in society. As corruption becomes institutionalized it may be increasingly difficult to maintain open and competitive markets and will threaten the reform momentum. Presently, corruption is already a pervasive feature of the Chinese economy.

Cross-Border Crime in the Greater China Area

Cross-border crime in the Greater China area is believed to be rampant. There are many reasons why this is the case. Trade and investment flows within the Greater China have grown enormously as a result of the opening of China. The volume of foreign merchandise trade between China and the rest of the world grew by leaps and bounds after China adopted an open door policy in 1979. The value of total trade was US$20.7 billion in 1978 and grew to US$280.5 billion in 1995.

A considerable part of China's trade activities are driven by manufacturing investments from Hong Kong. Since China's opening, Hong Kong has consistently accounted for about two-thirds of the foreign investment in China and about half of China's total trade. At the end of 1995, the value of cumulative actual direct foreign investment was in excess of US$80 billion. Most of these were in export oriented manufacturing investments concentrated in Guangdong province.

However, the three areas remain separate jurisdictions with different economic and legal systems and policies. Since China and Hong Kong have very different economic regulations and policies, it is not surprising why Hong Kong is the major staging ground for smuggling goods into China and a trafficking center for drugs and illegal immigrants. Many Chinese enterprises deposit their funds in Hong Kong and use Hong Kong as a conduit for capital flight and money laundering to take advantage of the more secure system of property rights in Hong Kong.

For political reasons, Taiwan continues to ban direct trade and investment relations with China, although the regulations have become more relaxed over time. Official trade and investment flows between China and Taiwan substantially understate the extent of economic interaction between the two areas. Often the economic relations between the two use Hong Kong and also other territories as an intermediary.

These legal and policy barriers impede the development of open and transparent economic relations and provide enormous incentives for the growth of illegal activities.

Illegal Trade

(1) Smuggling between Hong Kong and China

Smuggling across the China-Hong Kong border is rampant. China remains a regulation ridden economy despite her open door policy. Imports are highly regulated through tariffs and other non-tariff barriers, including access to foreign exchange.

Smuggling takes place both by land and sea. In 1995, some 59.5 million person crossed the border between Hong Kong and China; a figure that is almost ten times the size of the population of 6.3 million in Hong Kong. In the same year, some 8.0 million goods vehicles and 466,000 passenger vehicles cross the border by land and 218,000 cargo vessels and 46,000 passenger ferries travel between ports in the Pearl River Delta (in China) and Hong Kong.

Serious smuggling began to occur in 1986 and 1987. These also happen to be the years when there was a rapid acceleration of trade and investment flows between China and Hong Kong. Lai (1994) estimated that the amount of goods smuggled into China from Hong Kong to be about 10% of China's imports in each of the years between 1988 and 1991.

Geographically, smuggling as a form of illegal trade is now a national rather than regional phenomenon. In the past, smuggling was mainly confined to southern coastal areas. In recent years, it has spread all the way up to the coast of Shandong and Dalian. However, it is unclear whether the increase of reported smuggling reflects the fact that enforcement has improved or that there are more incidences of smuggling.

In 1993, Hong Kong customs seized some US$26 million worth of goods destined for China. In the same year, China's customs seized a record of US$410 million in smuggled products, an almost 80% increase over 1992. If we assume that all of the smuggled products seized originated from Hong Kong (obviously an overestimate), and make use of Lai's figure that smuggled goods across the Hong Kong-China border are estimated to be 10% of Chinese imports from Hong Kong, then at most 10% of the goods so smuggled are seized by the Chinese and Hong Kong customs. The year 1993 was not a typical year and it is quite likely that in other years the amount of smuggled goods that were seized would be less than 5%. Effective tariff rates on popular smuggled items like 170% on television sets, 180% on cigarettes, and 230% on automobiles. Given the low rates of detection the expected gains from smuggling are very high.

The gains will be even larger if the smuggled product are stolen goods. Automobile theft of luxury German cars reached crisis proportions in 1993. The number of private cars stolen in all categories was in excess of 7,000 amounting to some 3% of the total number of registered private cars in Hong Kong. It is reported that about 10% of all luxury cars in Hong Kong are stolen and smuggled into China. According to an industry source, the amount of cigarettes smuggled into China is twice the amount that is officially imported. It has been estimated on the basis of import and consumption figure in Hong Kong, that half the television sets imported into Hong Kong are subsequently smuggled into China. Smuggling between Hong Kong and China had become so serious that the Hong Kong government was compelled to outlaw the licensing of high powered speed boats that could out run the patrol boats of the customs and marine police in a bid to stem the flow of smuggled goods.

(2) "Illegal" Trade Between Taiwan and China

An important part of trade between Taiwan and China is "illegal". The Taiwan government has an official policy that bans direct trade with China. Indirect trade is permitted and occurs mainly via Hong Kong in the form of re-exports. In recent years, re-exports via other areas have also grown, notably Singapore, Japan, Guam, etc.

Re-exports are considered as indirect trade because the merchandise clears customs in Hong Kong before it is re-exported and it involves an intermediary who buys the good for resale. In principle, the intermediary has the right to resell it to whoever he wants. This allows the Taiwan authorities to officially regard it as not being in violation of the ban on direct trade. Indirect trade is more expensive than direct trade because it involves a re-export margin that includes the profit of middleman as well as costs of uploading and downloading, storage, insurance, financing, marketing, perhaps packaging and sorting, and maybe even minor manufacturing processes that are not significant enough to confer country of origin. This re-export margin for Chinese goods has been estimated to be at least 25% according to Sung (1992).

Import controls on China's products had been gradually liberalized. By the end of 1990, indirect imports of 92 items were permitted, including all agricultural and industrial raw materials (Kao 1993). Tables 2 and 3 present figures of Taiwan exports to China and imports from China. As is evident a significant share of trade between

China and Taiwan is illegal direct trade. This may take the form of transshipment, transit shipment, illegal direct shipment and smuggling.

Table 2

Table 3

Transshipment means that goods are consigned directly from the exporting country to a buyer in the importing country, though the goods are transported via Hong Kong and are usually loaded into another vessel for further journey. Since transshipment is a form of direct trade, it is illegal from Taiwan's standpoint. Transshipment is not a part of Hong Kong trade because nobody has legal possession of the goods in Hong Kong. The goods do not clear customs. Taiwan's customs allow exporters to leave the final destinations open and specify Hong Kong as the port where goods will be discharged to be further shipped elsewhere. In Taiwan's trade statistics, such exports are put under exports to Hong Kong. When the cargo arrives in Hong Kong, the shipping company can simply fill in a Chinese port as the final destination and Hong Kong customs allows these goods to pass as transshipment.

Such cases are known as "switch bill" because another bill of lading, a bill consigning the goods from Hong Kong to a Chinese port, replaces the original bill consigning the goods from Taiwan to Hong Kong. In December 1993, a spokesman of the Taiwan government in Hong Kong asserted that "switch bill" is legal. Such an interpretation is quite farfetched since no third party assumes legal ownership of the goods in Hong Kong. The cost savings from transshipment is quite negligible compared with re-exports and is also almost risk-free since the Taiwan government apparently sanctions the practice. Indeed “switch bill” has the advantage of confidentiality and anonymity because Hong Kong customs has no records of the trade. It is very difficult for the Taiwan or Chinese government to trace who has sold what to whom. The Hong Kong government has data on transshipments by weight. The value of transshipments is not known because transshipped goods do not go through customs. The tonnage figures suggest that this form of trade has grown enormously since 1988.

Transshipment is different from transit shipment. The latter means that the goods do not change vessels and they just pass through Hong Kong on their way to the final destination. Since there is no uploading and downloading of cargo considerable savings can be realized. Exporters from Taiwan claim that their goods are going to Hong Kong when they leave Taiwan, and then claim in Hong Kong that they are going to China. Unlike transshipment, this method of direct trade is risky since it involves lying to the Taiwan government. The Hong Kong government does not keep records of transit shipment, which are cargo in transit. Transit shipment entails some risks: if an accident occurs while the ship is on the Hong Kong-China leg of the voyage, the insurance company could refuse compensation as misreporting was involved and the insurance did not cover the Hong Kong-China leg of the voyage. In a court case where a ship carrying Taiwan goods to China sank on its voyage, the court ruled that the insurance company was not liable. The ruling made it difficult for Taiwan exporters to get insurance for transit shipment from Taiwan companies, but some Hong Kong insurance companies are willing to insure transit shipment if the exporter is willing to disclose the true destination to the insurance company.

From press reports and knowledgeable sources illegal direct shipment between Taiwan and China is not uncommon. Taiwan exporters claim their goods are destined for Hong Kong when their goods left Taiwan, but the ship sails directly to a Chinese port without passing through Hong Kong. Illegal direct shipment obviously saves transportation cost, but is more risky than transit shipment. Shipping records are public information and the Taiwan government can check if a ship has passed through Hong Kong. In 1993, a Panamanian vessel was fined for sailing directly from Taiwan to a Chinese port, but the Taiwan owner refused to pay the fine on the grounds that the Taiwan government has no right to fine a Panamanian vessel.

In analogous fashion, Taiwan imports both indirectly and directly from China. Taiwan policy towards imports from China was liberalized in 1988 and immediately there was a huge jump in both indirect and direct trade. Since then growth of legal indirect trade has slowed down, but illegal direct trade has continued to soar.

The Taiwan policy has created an elaborate trading system involving, Taiwan, Hong Kong and China. The value of both legal indirect trade and illegal direct trade between China and Taiwan has been estimated by Kao (1993)), Sung (1994) and is reported in Fung (1996). Table 2 reports Taiwan legal re-exports to China via Hong Kong, via other places, and illegal direct exports. Total Taiwan exports to China are significantly higher than "legal" trade alone. In 1991 and 1992, the percentage of illegal trade is 31.3% and 36.5% respectively. In 1992, illegal direct exports were between 52% to 60% of legal exports. The corresponding figures for imports were between 44% and 76%.

Taiwan fishermen routinely conduct barter trade with Chinese fishermen in the open seas. In a bid to regulate such trade activities, the authorities in Fujian province have legalized them as "minor trade" in 1985 and stipulated that they take place in designated coastal mainland ports managed by customs officers. But from Taiwan's point of view this is still smuggling because Taiwan authorities bans direct trade with China. One estimate showed that in the late 1980s, such smuggling of Chinese goods to Taiwan was about one-third of Hong Kong re-exports of Chinese goods to Taiwan (Kao 1993). For 1989, this estimate puts the value of such illegal trade at US $195 million.

With the exception of smuggling, goods shipped in all forms of direct trade -- transshipment, transit shipment, and illegal direct shipment -- have to be financed twice, usually by banks in Hong Kong, as it is not possible to settle payments directly between a Chinese bank and a Taiwan bank. Regardless of the form of shipment, the financing and trade documentation are usually handled under two sets of documents as if there is a middlemen in between. In the exceptional circumstance where a Taiwan exporter is trading with its subsidiary in China can bank financing we exempted. The cost of financing is appreciable and is part of the cost of banning direct trade with China by Taiwan authorities.

Large scale illegal trade between China and Taiwan has also spawned the growth of piracy along the China coast. The cost of committing piracy is lower when illegally shipped merchandise is seized. Press reports indicate that in most incidents ships are not damaged and crew are unharmed. It has been reported that sometimes Chinese law enforcement and military vessels are also involved under the cover of investigating smuggling activities.

Evasion of Foreign Exchange and Investment Controls

China is a significant exporter of capital for a developing country. Among developed countries China is the largest exporter of foreign capital. But a large volume of capital exports leave China clandestinely. There are a number of reasons why there is large scale capital flight from China. A combination of high domestic financial transactions costs, inappropriate exchange rates, and political and economic uncertainty.

(1) Illegal Capital Exports to Hong Kong

Hong Kong is the number one destination of Chinese outward investment. Presently, Chinese investment in Hong Kong is well over US$20 billion according to Sung (1976). Hong Kong has also been the number one investor in China since the inauguration of China's open door policy with cumulative investments in excess of US$80 billion.

The number of Chinese companies that have received official approval to operate in Hong Kong was slightly over 1000 according to Liu (1994) and the number has been quite stable from 1989 onwards. However, a large number of Chinese enterprises and provincial and local authorities in China have established unofficial companies in Hong Kong by evading foreign exchange and investment controls.

The total number of Chinese companies in Hong Kong was estimated by Ni (1994) to be around 14,000 at the end of 1993). One popular form of unofficial representation is joint venture with Hong Kong traders. Since such firms are nominally operated by Hong Kong traders, China has no formal control over them. Counties and villages in Guangdong province have been encouraging people who have relatives in Hong Kong to emigrate and to promote exports, and some of them become one-person operations after their arrival in Hong Kong. Some of these unofficial companies can be quite large with market capitalizations of US$10 million or more.

Since these companies are incorporated in Hong Kong they are treated as foreign companies by China. In reality these are Chinese capital and not foreign capital. The Chinese call these companies "fake foreign investors". When these companies invest in China they enjoy preferential tax benefits accorded to foreign investors. The tax rate on profits for foreign and joint venture companies is 15%, but can be as high as 50% for domestic companies. This simple mechanism provides a way for diverting and transforming Chinese government funds into foreign private funds controlled by Chinese officials and entrepreneurs. The proportion of foreign investments in China that is really domestic investments is unknown.

To take advantage of Hong Kong's position as a gateway to China and the rest of the world, Chinese trading corporations representing various ministries, provinces, cities, counties, and villages have swarmed into Hong Kong in the open-door era. Another reason for Chinese enterprises and investors to move their capital into Hong Kong is because the laws in Hong Kong provide stricter protection of property rights than those in China. As long as property rights and freedom of capital movement in Hong Kong remain protected, the influx of Chinese capital will continue even after China assumes sovereignty after 1997. The funds parked in Hong Kong can be used very flexibly, and can be redeployed into China or anywhere overseas. In other words, Hong Kong is the staging ground and laundry center for China's capital outflow.

Since China maintains control over foreign exchange and capital outflows, unapproved investments into Hong Kong must effectively evade such controls. The most important means is through underinvoicing of Chinese exports. Given that total trade between Hong Kong and China was about US$126 billion in 1995, transfer pricing has served as a major conduit for capital flight from China. Profits that accrue to Chinese entities are therefore deposited in companies in Hong Kong controlled by Chinese officials and entrepreneurs. Table 4 presents some estimates of the extent of under-invoicing of Chinese exports to Hong Kong. In 1992 it amounted to US$4.57 billion.

Table 4

It is estimated that at least 15% of the currency issue in Hong Kong amounting to US$1.5 billion circulates within China. They can be deposited in Chinese banks as foreign currency deposits. Since Chinese banks are not allowed to make foreign currency loans these deposits are recycled into Hong Kong. It is reported that Chinese enterprises who make deposits in China have loan facilities extended to them in Hong Kong indirectly, thereby facilitating their financial transactions in Hong Kong and elsewhere.

(2) Capital Flight from China

Since 1985, the foreign debt of China has increased at a greater rate then can be explained by changes in the her current account, foreign direct investment and reserve holdings. This pattern is consistent with the large scale outflow of financial capital, commonly known as capital flight. Two commonly used methods for estimating capital flight are (1) the balance of payments method and (2) the residual method. An important characteristic of flight capital is that it is “hot” money.

The balance of payments method equates this feature of flight capital to the sum of reported short-term capital exports by the non-bank sector and, the balancing entry, errors and omissions. The assumption used is that errors and omissions reflect unrecorded short-term capital flows. Table 5 gives estimates of capital flight from

China using this measure for the period 1984 to 1994. The figures show that capital flight has been rising over time from US$1.7 billion in 1984 to US$19 billion in 1994.

Table 5

The more widely accepted residual method estimates capital flight as a residual measure. The current account balance, change in reserves and the amount of net foreign direct investment determine the amount of necessary international borrowing for a nation. If actual foreign borrowing exceeds this necessary amount then it is assumed that the difference or residual represents additional borrowing necessary to offset capital flight. Figures in Table 5 shows that the amount of capital flight according to this measure has been rising from US$4.2 billion in 1984 to US$22 billion in 1994.

These two methods rely on fundamentally different approaches to measure capital flight. Both approaches are flawed in different ways, but they provide a rough guide to the direction and volume of capital flight from China.

A common practice found in many developing countries is the deliberate mis-invoicing of exports and imports in order to circumvent trade controls, avoid import tariffs and facilitate capital flight. Accompanying the growth of China trade has been a growing discrepancy in the statistics reported for bilateral trade. Analyzing bilateral trade between the China and Hong Kong reveals an interesting pattern. The China data on trade with 22 industrial nations reveals an over-invoicing of imports by US$11.1 billion in 1994 and under-invoicing of exports by US$32.9 billion in 1994. Does this apparent mis-invoicing of China trade in the amount of US$44.0 billion imply capital flight?

The answer to this question is complicated by the importance of Hong Kong as an entrepot for China. Hong Kong is China’s largest trading partner and a large proportion of Hong Kong’s international merchandise transactions take the form of re-exports. In its trade with the industrial nations, Hong Kong tends to under-invoice both exports and imports resulting in a net discrepancy of approximately US$11.7 billion. With respect to their bilateral trade, the gap between the China’s reported imports from Hong Kong and Hong Kong’s reported exports to China has been growing at an increasing rate over time. This growth in the discrepancy between China and Hong Kong trade statistics is opposite in direction to the growing gap between China and its major industrial nations trading partners. These results lend support to the view that the discrepancy in China trade statistics may be more related to problems of determining provenance and destination of merchandise trade with respect to China and Hong Kong rather than deliberate mis-invoicing to facilitate capital flight.

Another way of viewing this result would be to sum the exports and imports reported by both China and Hong Kong, subtract out double counting of trade between China and Hong Kong, and compare this figure to the counter-part data for both countries reported by their trading partners among the industrial nations. The results of these calculations are given in Table 5. The effect on the discrepancies of the trade statistics with the industrial nations are dramatic. When the trade with Hong Kong is added to that of the China (this sum will be referred to as China plus HK), the discrepancy in the trade data goes from a positive US$44.0 billion in 1994 for China to a negative US$10.5 billion for China plus HK.

If one accepts that transshipment of Chinese exports through Hong Kong as the primary source of the discrepancy in the China's bilateral trade statistics then one is still left with the question of determining the destination of the earnings from this mis-reported trade. A straight forward explanation is that these earnings from China exports are repatriated to China but not reported as such. The failure to report may be a result of defective data collection or an attempt to capture certain subsidies intended for foreign investors.

The former explanation is consistent with the increasing importance of the Special Economic Zones (SEZ). The success of these SEZ in speeding China's industrial development and trade has been attributed, at least in part, to a reduction in regulation and bureaucratic reporting requirements. While leading to increased efficiency, these changes tend to lead to a deterioration in the quality of data concerning the volume and value of trade.

The other possibility is that Hong Kong is being used as a laundry center to disguise the origin of China funds in order to facilitate the return of these funds to the China as "fake foreign investments" or round tripping. There are at least two motivations for this round tripping. First, like many developing nations, China provides various tax, regulatory and other benefits to foreign investors that are not available to domestic investors. Round tripping through Hong Kong may allow a "false foreigner" such as a China portfolio holder to claim these benefits. A second motivation for round tripping is concern that the government may impose restrictions on the use of foreign exchange in the China such as those of July 1993. By routing investments through Hong Kong, it is easier to circumvent restrictions on the foreign exchange transactions. In 1994, investment commitments from Hong Kong were almost twice as large as those from the rest of the world combined.

One way of estimating how much round tripping actually occurs is to look at the growth of foreign assets held by Chinese residents. For a given amount of capital flight, the greater these foreign assets, the lower the amount of round tripping.

Table 5 gives both "Low" estimates (column D.3) and "High" estimates (column E.3) of Chinese capital flight. The "Low" estimates point to an annual capital flight of about US$2.2 billion in 1984 and rising to US$9.9 billion in 1994. There is much year to year variation in the sample period. The "High" estimates show a steady rise in capital flight from US$5.5 billion in 1984 and rising to US$64.5 billion in 1994. The "High" estimates are due to the adjustment for mis-invoicing. While it seems plausible that actual China capital flight is somewhere between the "Low" and "High" estimates, improving the accuracy of these estimates will require more detailed information on the destination of the earnings from the transshipped exports.

Much of the additional evidence on China capital flight is either anecdotal in nature or subject to multiple interpretations. One source is the statistics on deposits by China entities in foreign banks which is provided in Table 6. Over the sample period these deposits have increased by approximately 252% to reach about US$60.0 billion at the end of 1994. The growth of these foreign financial assets of entities in the China reflects a large net outflow of capital of approximately US$4 billion a year with very large outflows in 1990 and 1994. While an increasing amount of this outflow found its way to U.S. banks, these banks still only accounted for about 17% of the total in 1994.

Table 6

Direct or portfolio foreign investment by China corporations, individuals and, in some cases, municipalities is another possible destination for flight capital. It has been estimated that while government approved foreign investment is less than $0.5 billion annually, recent unsanctioned foreign investments may total US$2-3 billion a year.

While government approved foreign investment has gone primarily to Australia (38.5%) and North America (33.6%), the recent expansion of un-official investment has at least initially been directed to Hong Kong (Leung and Smith, 1994; Wu, 1993:14-15). It is believed that only a portion of these outward flows remain in Hong Kong.

The data on capital flight presented in Table 5 might be divided into three periods. From 1984 through 1988, the average of the "High" and "Low" estimates of capital flight was about US$5.9 billion a year. During the second period, 1989 through 1991, capital flight almost doubled to an annual average of US$16.3 billion. Finally, in the third period of 1992 through 1994, capital flight doubled again to an average of over US$33.2 billion.

However, because of the importance of Hong Kong as a station for financial round tripping, it is likely that the "High" estimates exaggerate the true volume of China capital flight. Probably the best guess is that actual capital flight from the China is near the upper end of the lower half between the "High" and "Low" estimates, i.e., in 1994, China capital flight amounted to US$20-35 billion. If this belief is correct then over the eleven years of the sample period, the total accumulated China capital flight would be somewhere between US$50 billion and US$175 billion (the sum of the average estimates). The large scale and upward trend of China capital flight point to the importance of understanding the role of Hong Kong as a laundering center for Chinese flight capital.

Hong Kong fills three roles with respect to Chinese flight capital. Some of this capital simply passes through Hong Kong on its way to another foreign haven. A second portion is actually invested in the Hong Kong economy, while, as was discussed above, a third portion of Chinese capital flight is eventually re-invested in the China. The difficulty is in determining the relative importance of the three.

An optimistic view for Hong Kong is that the latter two roles are dominant, hence, Hong Kong is viewed by Chinese portfolio holders as a good place to invest as well as a center for financial intermediation within China. However, a more pessimistic view is that Hong Kong has been a popular destination or way station for Chinese capital flight because it is viewed as a safe haven. While the Chinese government has provided assurances that there will be minimal interferences with international financial activities in Hong Kong after 1997, these assurances may not be credible to Chinese portfolio holders. It is likely that most of the Chinese capital funds in Hong Kong are not controlled by Beijing and their own individual assessment of what is their government's credibility will determine whether the Chinese portfolio holders will seek other foreign havens for their flight capital either permanently or temporarily.

Growth of Organized Crime and Cross Border Activities

While there was widespread speculation among sensationalist authors and reporter that 1997 would trigger a mass exodus of organized criminal groups in Hong Kong to the industrial nations (see Booth, 1990). Today law enforcement organization believe that the initial fear was greatly exaggerated as there is little sign at present of any significant exodus of organized criminal groups out of Hong Kong. The triad members' poor education, lack of professional qualifications and expertise, lack of a foreign language, their criminal records and lack of contact in destination countries do not make them strong immigration applicants. Moreover, given the wealth of opportunities for criminal enterprise offered by China's rapidly expanding economy, there seem to be little incentive for exodus, at least for the time being.

Indeed, criminal groups from Hong Kong and Taiwan have expanded very aggressively both their legal and illegal activities into China after the open door policy came into being in 1979. At the same time, local criminal organizations are emerging in China. Some of them are entirely indigenous groups, but others are offshoots of Hong Kong and Taiwan groups. A third type like the Big Circle Boys were the uneducated veterans of China's Cultural Revolution (see DeVoss and Gluckman, 1995),. They came to Hong Kong in the late 1970s, but were rejected by the locals. These young criminals found solace in solidarity. Bound by language and a love of military weaponry, the Big Circle Boys is not a conventional triad. Today many of its members have immigrated to different parts of world and are still able to maintain their network of ties. Their members resemble avuncular commodity traders whose products -- heroin, prostitution, fake credit cards and counterfeit money -- just happen to be illegal.

The growth of organized criminal activity has become international in nature; local and foreign criminal groups use the Greater China area as both an operating and transiting zone. Their activities have rapidly expanded across existing national frontiers as both commerce and travel have increased between these countries and the rest of the world. For example, countries in Western Europe have seen criminal groups from the East operate either independently or jointly with local groups. Criminal activities have included smuggling, drug trafficking and distribution, alien-smuggling, money laundering, the illegal transfer of capital, prostitution, and the illegal trade in stolen vehicles, arms, goods, antiques and strategic metals. There has also been an upturn in the degree of violence associated with many crimes.

Nevertheless contrary to popular myth, triad societies are not monolithic organizations controlled by a "Big Brother" whose influence extends across the oceans to countries like the U.S., Canada, Australia and the UK. Most triad societies are a collection of loose-knit groups or gangs rather than a centralized criminal organization. The vast majority of international criminal groups operate as a loose confederation, frequently supplying goods and services to large more organized groups. Leading law enforcement agencies in the U.S. and U.K. have come to similar conclusions when they assess the triad situations in their own countries (Hopton, 1995 and FBI, 1995). These observations are consistent with recent theories of organized criminal groups reported in Fiorentini and Peltzman (1995).

The ability of these groups to operate with impunity throughout the world is staggering, and the availability of false documents, counterfeit credit cards and money, coupled with an intricate communications network make detection and enforcement difficult.

The scale of their activities are also quite staggering. According to a *Newsweek Magazine* (1993) report, alien-smuggling by Chinese gangs have involved corrupt officials in China, criminal groups in Hong Kong, Taiwan, Central and South America and the U.S. It is believed that as many as 100,000 undocumented Chinese enter the U.S. in a year. According to Chinese official statistics the number of illegal emigrants apprehended at the border while attempting to leave varied between 10,000 to 25,000 in the early 1990s. Given that the effort to prevent illegal emigrants from leaving is not vigorous, the estimate of 100,000 Chinese illegal aliens entering the U.S. appears to be believable. Illegal immigration alone is responsible for about US$2.5 billion yearly in revenue for the gangs (*World Press Review*, 1994). In these reports it is claimed that these illegal aliens are often forced into involuntary servitude by Chinese gangs. Illegal immigration into Hong Kong from China has always been a problem ever since China opened up. Few illegal aliens entering Hong Kong today sneak across border without the assistance of organized criminal groups. The number of illegal immigrants apprehended in Hong Kong and returned to China numbered 27,826 in 1990, 25,422 in 1991, 35,646 in 1992, and 37,517 in 1993; approximately equal to half a percent of the local population.

The smuggling of illegal migrant labor is becoming a thriving industry in Asia, but the participation of workers in the Greater China area appears to be quite peripheral according to a report by the *Far Eastern Economic Review* (1996). The trafficking of migrant prostitutes from China to Hong Kong, Taiwan, Macao and other Asian nations appear to be on the rise. Indeed criminal organizations in Taiwan and Hong Kong operate bars, nightclubs, and massage parlors in throughout the Greater China area and in other Asia cities (*Far Eastern Economic Review*, 1995). A survey reported in Guo etal. (1995) found that 60% of the karaoke bars in the Special Economic Zone of Shenzhen across the border from Hong Kong were operated by overseas organized criminal groups.

Counterfeit bills and credit card fraud has also grown rapidly with manufacturing technology and distribution skills supplied from Hong Kong and production based in China. Credit card fraud in Hong Kong in 1991 nearly accounted for 12% of the world's total losses, but has declined to 3.5% in 1993 due to the adoption of tougher penalties and enforcement measures (Gluckman, 1995). It is believed that the Hong Kong gangs have merely exported their activities overseas.

Money from all sources of organized criminal activity pales in comparison with drug manufacturing and trafficking. According to Chinese sources cited by Guo etal (1995), half of the drug in the U.S. originate from the Golden Triangle in Southeast Asia. About 10% of the drugs in the Golden Triangle enter China of which half would go to Hong Kong. The growth of drug manufacturing, trafficking, and abuse have increased enormously in China. Table 7 provide figures that indicate close to an annual doubling of reported drug offenses in recent years. The number of offenders that are apprehended have also changed predominantly from overseas in the 1980s to predominantly locals in the 1990s. A recently issued report by the World Customs Organization (1996) stated "with Hong Kong returning to Chinese rule in 1997, a new threat will exist, when the Triad marketing expertise is re-united with a vast cultivation and production potential".

Table 7

Last Section

This study is preliminary report of an on-going research project on economic interaction in the Greater China area. When the project was first conceived it did not include the investigation of illegal activities. As the study progressed we became convinced that the inclusion of illegal transactions in view of the importance of the underground economy.

It is too early to provide any firm conclusions as our understanding of the vast web of underground economic interactions remains limited. I end by quoting from an article in the Time Magazine (1996) that cited a speech I gave on "three visions of how the city [Hong Kong] could evolve. With luck and deft management from Beijing, it could remain the Manhattan of the Orient, free and open to the world's businessmen and financiers. With heavier interference from the north, Hong Kong could degenerate into a Chinese Bombay, used mainly as a base for businessmen interested in the China market. It could be another kind of prosperity,.....but it would still prosper. Least promising of all, Hong Kong could become the Miami of China, dominated by the underworld, awash in dirty and laundered money and swamped with migrants from China....".

On August 6, 1996, Michael Leung, Commissioner of Hong Kong's Independent Commission Against Corruption went out of his way to point out to a press conference that corruption had become more prevalent across the China-Hong Kong border. He said it was particularly worrying that there had been collusion between China and Hong Kong law enforcement officers in such crimes as smuggling and trafficking in drugs, workers and migrants, and prostitutes (Ming Pao Daily, 1996).

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