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Terrorist Financing and Money Laundering

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Abstract:

Terrorism causes enormous costs to society. Since the 9/11 attacks, the “war on terror” has therefore been an important challenge to all civilized countries. In the present contribution we analyze the root causes and costs of terrorist activity, thereby setting the stage for discussing the need for measures against terrorist financing. We argue that running a terrorist organization requires substantial financial resources which are transferred to the groups through clandestine and often illegal channels. Anti-money laundering policies may appear useful measures to stop transfers to terrorist groups; however, they are not sufficient means to deal with all facets of terrorist financing. Compared to similar activities of organized crime, terrorist financing involves “reverse” money laundering. This is a consequence of some fundamental differences between terrorism and organized crime, which also lead to different implications in terms of choosing appropriate counter-measures.

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Keywords: terrorist financing, causes and costs of terrorism, money laundering, organized crime vs. terrorism, anti-terrorist financing policies

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1. Introduction

Terrorism has long threatened nation states. However, especially since the attacks on the World Trade Center in New York on September 11, 2001, terrorism has become a major challenge for all countries in the international arena. While domestic terrorism still accounts for the majority of terrorist incidents, transnational terrorism has become more relevant and is now considered as particularly dangerous.¹ The direct and indirect costs of terrorism, ranging from the loss of human lives and assets to reduced growth and life satisfaction, are substantial, making it advisable to fight terrorism with a variety of means at the same time.

While eliminating the root causes of terrorism, e.g., through an improvement of unfavorable socio-economic and political conditions which otherwise make individuals turn to terrorism, appears to be the most promising strategy against this threat, it is also the strategy which takes the longest time to prove successful. In the short run, therefore, other more direct means are needed to tackle the problem. Since running a terrorist organization involves some non-negligible costs (e.g., meaning that funds must be raised to maintain the organization), the issue of terrorist financing has moved into focus. Drying out the financial flows from terrorism sponsors to terrorist organizations or from organization headquarters to terrorist cells around the world might severely impede the capacities of terrorist groups to attack.

Not surprisingly, in the aftermath of the 9/11 attacks national and international legislation was introduced to intercept financial flows towards or from terrorist organizations, the most prominent example being the *Financial Action Task Force's* "FATF Special Recommendations on Terrorist Financing" which extend the international framework for fighting money laundering by organized crime. In an immediate sense, this appears reasonable because there is a direct link between organized crime and terrorism: most terrorist acts are themselves crimes (Dandurand and Chin 2004). However, although the extended FATF framework includes recommendations dealing with some issues which are specific to terrorist financing, the analogy drawn between money laundering and terrorist financing is still open to debate. On the one hand, it is argued that organized crime and terrorist groups are sufficiently similar (or even converging) to treat them alike and to use a similar set of instruments to disrupt their financial activities. On the other hand, there is a fundamental difference with respect to the "direction" of financial flows: money laundering by organized crime aims at disguising the criminal identity of funds so that they appear legitimate, while terrorist financing has been called "almost money laundering in reverse" (J. Sloan, FinCEN director, cited in: Gouvin 2003: 973) because it is the use of funds that is criminal, whereas its sources and their transfer are often legitimate. This fundamental difference has important practical consequences because money-laundering prosecutors have to correctly predict a dangerous future use of funds, which turns out to be a difficult challenge and may require close cooperation with counter-terrorism intelligence.

This difference is aggravated by the fact that the main goals of both types of organizations differ: organized crime is mainly interested in maintaining a stable, but secret "business", while terrorists want to achieve the biggest possible (political) effect in terms of media attention and destabilization. This, however, can be achieved at rather low cost, so that most terrorist attacks are rather inexpensive. This imposes further challenges for prosecutors as the financial flows they need to detect are usually small. Especially since terrorists are increasingly organized in networks of the *Al-Qaeda* type nowadays, anti-money laundering instruments may fail to yield the desired success, while at the same time interfering with fundamental civil rights in a problematic way.

¹ *Transnational terrorism* means that at least two countries are involved in terrorism (e.g., because foreign targets are attacked or because a group crosses borders to attack). *Domestic terrorism* refers to terrorism that only involves one country. Usually, domestic terrorism is estimated to account for 80-90% of all terrorist activity (e.g., Abadie 2006).

The present contribution starts by giving a thorough discussion of the causes and costs of terrorist activity in Section 2. We show that the root causes of terrorism are unlikely to be “healed” in the short run, while at the same time the costs of terrorism are substantial, which justifies the prosecution of terrorist financing (as one among several instruments against terrorism). In Section 3 we consider the connections between terrorist activities and terrorist financing. First, we turn to the financial needs of terrorist organizations, arguing that while a single attack is usually inexpensive, running and maintaining a terrorist organization requires substantial financial means. We then show that typically there are three forms of terrorist financing: state sponsorship, legitimate financial support through legal channels by private persons and private financing by unlawful means, with the latter case being closest to money laundering activity by organized crime. Finally, we take account of some empirical estimates of financial flows involving terrorist organizations. Section 4 explores the connection between terrorist financing and money laundering. We start by discussing the main analogies and differences between these two concepts. Here, the central issue is whether terrorist groups and organized crime are sufficiently similar to lay the basis for potentially identical financial behavior. In a next step, we discuss whether similar organizational structures indeed imply an analogous behavior, i.e., we evaluate the importance of money laundering for terrorist financing. We conclude by taking an economist’s perspective on the existing anti-terrorist financing framework and its potential practical challenges which follow from the specificities of terrorism. Section 5 summarizes our main findings.

2. Terrorism: Causes and Consequences

2.1 *The Causes of Terrorism*

Eliminating the root causes of terrorism seems to be the most promising and sustainable strategy, as it ought to reduce the incentives and support for terrorist activity most effectively. However, as Krieger and Meierrieks (2011) show, while a plethora of empirical studies has surfaced especially after the 9/11 attacks, the academic debate regarding the roots of terrorism is still inconclusive.

Existing empirical studies usually rely on (economic) rational-choice theory to motivate statistical efforts. Here, it is argued that terrorists are rational actors that choose their level of terrorist violence considering its benefits and (opportunity) costs, subject to certain economic constraints (e.g., Sandler and Enders 2004). Following such a perspective, it is plausible to argue that a variety of country-specific factors (i.e., macro variables) may matter to the terrorists’ calculus. For instance, poor socio-economic conditions (e.g., slow growth, poverty) may mean that the opportunity costs of terrorism (e.g., foregone earnings) are comparatively low, while its benefits (e.g., a redistribution of wealth) are comparatively high (e.g., Blomberg et al. 2004b). In such an environment, terrorism ought to be more likely than in an environment where conditions are more favorable. In the empirical literature the influence of a variety of country-specific factors on the emergence of terrorism has been assessed.

In general, we may distinguish between analyses of the role of direct and permissive factors in terrorism. The former refers to the *root causes* of terrorism, i.e., socio-economic and political conditions that incite terrorism. The latter refers to factors that do not incite terrorism on their own but influence the *opportunity* to rebel. In this subsection we focus on large- N studies that try to unveil the root causes only (rather than the opportunity factors).² Most of these studies have focused

² Among the factors potentially providing an opportune environment for terrorism once it has erupted due to the aforementioned factors (i.e., root causes) are (i) an inaccessible terrain (e.g., Abadie 2006), (ii) spatial and temporal proximity to terrorism (e.g., Braithwaite and Li 2007; Krieger and Meierrieks 2011), and (iii) low state

on transnational terrorism due to data constraints (cf. Sanchez-Cuenca and de la Calle 2009). Here, studies may analyze whether countries produce international terrorism (*origin perspective*) or whether they are targeted by it (*target perspective*). We pay primary attention to those (macro) factors that are argued to be related to the emergence (production) of terrorism when comparing socio-economic and political conditions in cross-sections of (origin) countries and assess how these conditions matter to terrorism.

One strand of the empirical literature argues that poor socio-economic development matters to terrorism (while controlling for political and demographic conditions). That is, e.g., poverty and inequality are believed to be among the root causes of terrorism, meaning that they decrease the opportunity costs of terrorism (e.g., in terms of economic participation). Indeed, some empirical analyses support this hypothesis (e.g., Blomberg et al. 2004b; Blomberg and Hess 2008a,b; Krieger and Meierrieks 2010b). For instance, Blomberg and Hess (2008a,b) find that economic progress is negatively related to the generation of transnational and domestic terrorism. Further studies construct indirect linkages between a country's level of socio-economic development and terrorism. For example, Li and Schaub (2004) show that higher levels of economic integration (e.g., trade openness) are negatively related to terrorism through their beneficial effect on economic development. Similarly, Burgoon (2006) and Krieger and Meierrieks (2010a) argue that social welfare policies reduce terrorist activity by ameliorating socio-economic grievances (e.g., through redistribution).

However, the idea that terrorism is an economic creature is not supported by the empirical mainstream (cf. Krieger and Meierrieks 2011). In fact, a bulk of empirical studies find that political and institutional variables trump economic ones in statistical analyses (e.g., Abadie 2006; Basuchoudhary and Shughart 2010; Krueger and Maleckova 2003; Krueger and Laitin 2008; Kurrild-Klitgaard et al. 2006; Lai 2007; Li 2005, 2008; Piazza 2008; Sanchez-Cuenca 2009; Tavares 2004). That is, even though these studies control for the effect of the economy on terrorism, they do not find that it matters to it once politico-institutional factors are also considered. On the one hand, some of these studies argue that certain unfavorable politico-institutional conditions (e.g., political instability and transformation, low state capacity) offer opportunities for terrorist groups to conduct attacks, e.g., by lowering operating costs. For instance, Piazza (2008) finds that state failure and political instability (e.g., incidences of civil war) are conducive to the emergence of terrorism, given that such instability makes it less likely that a government reacts effectively in the face of terrorism. On the other hand, it is also argued that a lack of political participation and poor institutional quality constitute root causes of terrorism (e.g., Abadie 2006; Basuchoudhary and Shughart 2010; Li 2005). For instance, Li (2005) finds that democratic participation is detrimental to terrorism. Basuchoudhary and Shughart (2010) find that high levels of economic freedom (e.g., property rights protection) also reduce terrorist activity.

A handful of studies also point to the role of international political factors in terrorism (e.g., foreign policy), again suggesting that such factors matter more to it than socio-economic ones (e.g., Dreher and Gassebner 2008; Pape 2003; Savun and Phillips 2010). For instance, the findings of Dreher and Gassebner (2008) suggest that political proximity to the US makes countries likelier targets of transnational terrorism. The latter finding indicates that in particular international terrorism (e.g., *Al-Qaeda* activity) is strongly motivated by foreign policy behavior (and not so much by poverty, inequality etc.), so that such policy behavior may yet be another root cause of terrorism.³

capacity (e.g., during times of political instability or state failure) that makes it difficult for affected countries to efficiently counter terrorism.

³ Interestingly, the recent trend toward self-radicalization and "home-grown" terrorism (which should reasonably be labeled "domestic terrorism") also seems to be frequently motivated by international political developments.

Besides socio-economic and politico-institutional factors, demographic conditions have also been argued to matter to terrorism. In fact, a very robust finding in the analysis of terrorism is that larger countries are more prone to terrorism (cf. Krieger and Meierrieks 2011). This finding may provide first evidence that demographic stress (signaled by large populations) creates (terrorist) conflicts over rents and scarce resources. Also, Basuchoudhary and Shughart (2010) find that ethnic tensions are conducive to the emergence of transnational terrorist activity. However, while such findings may imply that demographic stress results in terrorism, the context of ethnically or religiously motivated conflict should not be disregarded. Usually, such conflict is interconnected with poor socio-economic and politico-institutional conditions (e.g., poverty, inequality, discrimination, lack of representation). As noted by Sen (2008), such poor conditions may exacerbate ethno-religious conflict, which in turn may lead to a further deterioration of these very conditions. Such a view implies that terrorism is not rooted in one but many causes, where these causes may be interrelated and form vicious circles of violence.

While governments are advised to consider an amelioration of the aforementioned root causes of terrorism (e.g., by increasing economic and political participation) as the most promising strategy against terrorism, more in-depth research regarding the role of direct and permissive factors in terrorism seems necessary, given the lack of empirical consensus to this date. As we shall discuss in the next subsection, terrorism may be associated with a variety of economic, political and social costs, making it even more important to identify its determinants to develop sound counter-terrorism strategies.

2.2 The Costs of Terrorism

Terrorism is argued to produce costs for affected countries. In this subsection we want to focus on its negative economic consequences.⁴ Schelling (1991) argues that terrorist actions (e.g., assassinations or bombings) are means to achieve economic and political destabilization and media attention. These actions aim at enforcing the terrorists' long-run political objectives (e.g., redistributing wealth and power, gaining independence). Economic destabilization is among the terrorists' short-run goals because such damage weakens their enemy (i.e., the government). A government that is attacked by terrorists ought to weigh the cost of giving in to (at least some) terrorist demands (i.e., political or social goals that are not enforceable in the ordinary political process) against the cost of a prolonged terrorist campaign that results from continued resistance by the government (e.g., Sandler and Enders 2008). When terrorists are successful at destabilizing an economy, the (opportunity) costs of continued resistance increase, so that accommodating terrorists' demands becomes comparatively less costly (i.e., more likely) from the government's perspective.

Terrorism may harm the economy directly and indirectly, where the latter effect refers to the reaction of economic agents (e.g., consumers, foreign investors, government) to terrorism. Similar to the negative economic consequences of civil war (e.g., Collier 1999), there exist several channels of transmission from terrorism to the economy, namely destruction, disruption, diversion, dissaving and portfolio substitution. *Destruction* refers to the direct costs of terrorism. Human and physical capital is destroyed through terrorist attacks, resulting in a reduced economic output. The other effects refer to the indirect consequences of terrorism on the economy that emerge from the response of economic agents. The *disruption* effect may become manifest in higher transaction costs, as the effectiveness of public institutions is challenged and manipulated by terrorism, or as insecurity in general increases. For instance, given that terrorism creates uncertainty, it may consequently lead to the postponement of long-term investments and thus reduced economic activity (e.g., Bird et al. 2008). *Diversion* occurs when public resources are shifted from output-enhancing to non-productive

⁴ Other studies that review the economic consequences of terrorism are Bird et al. (2008) and Sandler and Enders (2008).

expenditures. For instance, a government may increase spending on security at the expense of (more productive) spending on education and infrastructure, which may impede future economic development. *Dissaving* refers to a decline in savings that affects an economy's capital stock. *Portfolio substitution* means the flight of human, physical and financial capital from a country in the face of conflict. For instance, Abadie and Gardeazabal (2008) argue that terrorism negatively affects an economy's foreign direct investment position since it poses a costly risk and reduces the returns to investment. The resulting withdrawal of international capital may hurt economic development, particularly when foreign finance is an important engine of economic growth (e.g., in developing economies). That is, terrorism may distort the allocation of resources through the disruption, diversion and portfolio substitution channel. It may also negatively influence resource accumulation, mainly via the destruction and dissaving channel. Through all these effects economic performance suffers, particularly because the effects are expected to reinforce each other.

Several empirical studies indeed suggest that terrorism is detrimental to economic growth and development on sub-national, national and global levels. On a sub-national level, e.g., Abadie and Gardeazabal (2003) analyze the negative effects of the terrorist conflict in the Basque Country. They find that due to *ETA (Euskadi Ta Askatasuna)* terrorism the Basque Country suffered a per capita GDP decline of about 10 percent relative to a "synthetic" Basque region without terrorism that the authors constructed; in addition, they show that the level of violence and political actions (e.g., cease-fires) influence economic dynamics in anticipated ways. On a national level, e.g., Eckstein and Tsiddon (2004) focus on the effect of terrorism on the Israeli economy and find that terrorism reduced per capita output by 10-15 percent, potentially due to the detrimental effects of terrorism on consumption, investments and exports. Finally, on a global (i.e., cross-country) level, several studies also find that terrorism is a negative determinant of economic activity (e.g., Blomberg et al. 2004a; Gaibullov and Sandler 2008, 2009; Gupta et al. 2004). As one example, Crain and Crain (2006) assess the macroeconomic consequences of terrorism for 147 countries between 1968 and 2002 and suggest that in the absence of terrorism global GDP could have increased by \$3.6 trillion in 2002. Evidently, this finding indicates that the economic costs of terrorism can be very substantial.

Due to these (potentially enormous) costs, some empirical studies have analyzed the channels of transaction through which the negative repercussions may occur. Given that the direct effects of terrorism through destruction are unquestioned, these studies have centered on terrorism's indirect effects. Here, the disruption effect emerges through, e.g., higher transaction costs in international trade. Using bilateral trade flow data, Nitsch and Schumacher (2004) report that a doubling in the number of terrorist incidents in a single year is associated with a decrease in bilateral trade by about 4 percent. Further evidence hints at the effect of terrorism on macroeconomic variables such as consumption, investment and public spending (e.g., Blomberg et al. 2004a; Crain and Crain 2006; Eckstein and Tsiddon 2004; Gaibullov and Sandler 2008; Gupta et al. 2004), indicating that disruption, diversion and dissaving induced by terrorism also play a role. Finally, there is also evidence that portfolio substitution takes place. For instance, Abadie and Gardeazabal (2008) show that terrorism may harm economic activity by weakening a country's investment position. They estimate that a one standard deviation increase in the intensity of terrorism leads to a reduction of the economy's net FDI position by five percent. As another example, Enders and Sandler (1996) also document the negative effects of terrorism on foreign direct investment, which is withdrawn in the face of terrorism.

However, some qualifications regarding the effect of terrorism on the economy have to be made, particularly given that some studies do not attribute a strong role to terrorism in economic development (e.g., Enders et al. 2006; Gries et al. forthcoming; Tavares 2004). Some factors seem to govern this role. First, terrorism is anticipated to have only localized effects. That is, while it may clearly damage certain sectors of an economy (e.g., the tourism industry; see Drakos and Kutan 2003) or regions (e.g., the Basque Country), substitution of economic activity away from vulnerable to robust sectors/regions within an attacked economy is likely to take place (accompanied by quick

adjustments in price and capital allocation). A higher intensity of terrorism ought to make such adjustments more difficult. Second, this adjustment is likely to depend on a country's degree of diversification and macroeconomic resiliency. When countries are well-diversified and robust, terrorism is less likely to produce notable economic damage. Third, a country's economic size also matters. Even the high costs of the 9/11 attacks (in absolute terms) can be considered small when seen in relation to the economic size of the US (cf., e.g., Sandler and Enders 2008). Smaller countries are more likely to suffer the economic consequences of terrorism. Overall, as Sandler and Enders (2008) note, small and less diversified countries (i.e., less developed economies) that are characterized by low macroeconomic robustness and which face significant terrorist activity ought to experience the most severe macroeconomic consequences.

Finally, we also want to briefly highlight the non-economic costs of terrorism. As for its political effects, some studies point at the dangers of terrorism for open and democratic societies, where they argue that government reactions to the threat of terrorism (e.g., using torture, constraining civil liberties) predominantly produce these political costs (e.g., Dreher et al. 2010; Piazza and Walsh 2010). Other studies (e.g., Gassebner et al. 2007) suggest that terrorism also affects government stability, where governments are more likely to be replaced in times of terror. As concerns terrorism's social costs, some authors stress that looking at economic aggregates (e.g., income, GDP growth) is not enough. For instance, Frey et al. (2009) find that terrorism is accompanied by a robust decline in life satisfaction, particularly when regions are strongly affected by terrorism (e.g., Northern Ireland). The evidence provided by these studies indicates that even though the economic repercussions of terrorism may be low (e.g., because a country is economically robust as in, e.g., the developed world), its political and social consequences may still matter. Therefore, we can conclude that the costs of terrorism in sum, i.e., economic and non-economic costs, appear sufficiently high to call for a broad range of counter-measures to reduce it, possibly also including instruments against terrorist financing

3. The Financing of Terrorist Groups

3.1 Financial Needs of Terrorist Organizations

Terrorism is a costly venture. We have already hinted at the fact that terrorists are (in theory) considered rational actors that maximize their utility from violence, subject to certain costs, benefits and budget constraints (all of which are usually governed by socio-economic, politico-institutional and other social conditions). That is, financial means (as they manifest themselves in a group's budget constraint) also influence the patterns of terrorist activity. Basically, financial means can be channeled into two activities: (i) aggressive actions (terrorist attacks) and (ii) other operative (also defensive) actions (e.g., secret communication). Limiting the availability of financial resources through appropriate counter-terrorism policies may be an effective means to restrain terrorist activity at least in the short run.

Terrorist attacks serve as a prime instrument of "communication" of terrorists with the general public, intended to win support, demoralize enemies, and to raise public awareness and the terrorists' own morale (e.g., Sirseloudi 2004). They are the terrorists' main instrument to make their political objectives known and to inflict costs on the government to make government concessions more likely. Due to their central role in terrorist activity, some authors have tried to estimate the costs directly associated with conducting major terrorist attacks. Table 1 gives an overview of such estimations that focus on the cost of recent attacks by radical Islamic organizations (e.g., *Al-Qaeda*).

Table 1: Direct Costs of Assorted Islamic Terrorist Attacks

Terrorist Attack (Year)	Estimated Direct Cost (in US-\$)
US embassy bombings in Kenya and Tanzania (1998)	30,000-70,000
Attack on <i>USS Cole</i> (2000)	5,000-10,000
9/11 attacks in New York and Washington (2001)	400,000-600,000
Ghriba synagoge bombing (2002)	20,000
Attack on oil tanker <i>Limbourg</i> in the Gulf of Aden (2002)	127,000
Bali bombings (2002)	60,000-74,000
11/3 attacks in Madrid (2004)	15,000-80,000
7/7 attacks in London (2005)	15,000-17,000

Sources: Brisard (2002), Whitlock (2008), Brzoska (2009).

From these estimates it becomes clear that the financial needs to conduct even major attacks are comparatively small in absolute terms. The estimates show that terrorism can be a highly cost-efficient way of making one's cause known and winning support, while simultaneously hurting one's enemy very severely, as indicated in the previous section.

Besides the (supposedly) small cost of conducting attacks, however, running and maintaining a terrorist organization in the medium and long run requires a significant amount of financial resources. Associated (operative) costs may include, e.g., the operation of secret communication systems and training facilities, the process of recruiting, "wages" for active members of the group and the families of martyrs or the support of sleeper cells. Clearly, it is difficult to estimate these operative (fixed) costs for terrorist groups. Schneider (2009, 2010) estimates the financial flows of Islamic terrorist groups to amount to \$5-50 million per year. For instance, he estimates that the annual budget of *Al-Qaeda* between 2001 and 2004 was approximately \$20-50 million (cf. also Comras 2005). From these estimates and the comparatively low estimates regarding the costs of offensive actions (i.e., actual terrorist strikes) we may hypothesize that it is especially the "fixed costs" of terrorism that matter, even net of the possibility that terrorist groups use some of their financial resources to build up a "war chest" to increase financial independence.

Clearly, there is an interaction between the financial needs of a terrorist group, its organizational structure and its effectiveness in terms of inflicting damage. On the one hand, larger and/or more aggressive groups ought to be more effective in generating socio-economic and political destabilization. On the other hand, larger and/or more aggressive groups are also expected to need more financial resources. In contrast to this, the trend toward loose network structures in terrorism with a stronger reliance on self-organized home-grown terrorism tends to reduce the need for funds. Given that utility maximization of terrorist groups (partially) depends upon their budget constraints (i.e., financial resources), understanding the forms and mechanisms of terrorism financing (also with respect to the role of money laundering) is important for mitigating the socio-economic and political repercussions of terrorism. In the next subsection, we shall discuss the issue of terrorist financing in more detail.

3.2 Forms of Terrorist Financing and Interaction with the Level and Type of Terrorist Activity

The various forms of terrorist financing are discussed in, e.g., Bantekas (2003), Ward (2004) and Napoleoni (2004). The authors conclude that terrorist groups gain financial resources primarily from (i) *state-financing* (i.e., state sponsorship of terrorism), (ii) *financing by legitimate means* (e.g., from

legitimate business, charities, diaspora support etc.), and (iii) *private financing by unlawful means* that usually includes outright *criminal activities* (e.g., bank robberies, drug trafficking, kidnapping, extortion).

State-financed terrorism. One option for terrorist organizations to obtain financial resources is to resort to state support. State sponsorship of terrorism means that a state enlists terrorist groups to attack other states that are the sponsor's enemy (e.g., O'Brien 1996). That is, states that sponsor terrorism use it as a foreign policy tool to weaken their enemies by means of economic and/or political destabilization. For instance, during the Cold War the Soviet Union was argued to support Palestinian terrorist organizations (e.g., *PLO*, *PFLP*) so as to weaken the position of Israel and the US in the Middle East (e.g., O'Brien 1996). Terrorism thus seems to be most likely state-financed when the (tactical and strategic) goals of the sponsoring state and the sponsored group coincide. For instance, terrorism sponsorship of Western European terrorist groups and Third World liberation movements by the USSR and its allies during the Cold War was likely driven by common interests and ideological beliefs of the sponsors and sponsored (e.g., anti-Americanism, Socialism, anti-colonialism). Due to international political repercussions, states are usually expected to mask their financial support for terrorism, also relying on reverse money laundering, where money from legal sources (i.e., state money) is used to serve a terrorist purpose (e.g., Casella 2003). Here, the difficulties of proving a link running from an alleged state sponsor to the terrorist organization has surely contributed to the attractiveness of state sponsorship of terrorism as a means of foreign policy in the past (cf. O'Brien 1996).

Financing through legitimate activities. Financing through state sponsorship is available to a small number of terror groups (and state support has been decreasing over time, as we will argue below), so alternative private financing sources – some of them being legitimate – are exploited by several groups. Here, on the one hand, income may result from legitimate business activities. For instance, Napoleoni (2004) notes that some terrorist groups in the Middle East own shops to self-finance. On the other hand, financing through legitimate activities often refers to the voluntary sponsorship of terrorism by private persons (e.g., through donations to charities). Here, financial support may come from the country in which the terrorist group operates (domestic support) or from individuals living abroad (diaspora). Siqueira and Sandler (2006) offer some game-theoretical considerations as to why private persons may voluntarily support terrorism. They argue that (potential) grass root supporters of terrorism weigh off the attractiveness of the terrorists' agenda against the offers by the government (e.g., in terms of public good provision), consequently throwing their (financial) support behind the player who offers the most. That is, terrorist groups are likely to gain financial grass root support when they are able to attract a sufficiently high level of popular support by building on a compelling ideology (e.g., national liberation, religious fundamentalism) and/or by referring to poor social conditions (e.g., ethnic/religious discrimination, foreign occupation). Groups that have resorted to financing terrorism through legitimate activities are, e.g., several *Sikh terrorist groups* (e.g., by receiving financial support from their American diaspora), *Al-Qaeda* and other radical Islamic groups (e.g., *Hamas*) and terrorist groups fighting for the unification of Northern Ireland with the Irish Republic (e.g., *PIRA*). Usually, these forms of financial support for terrorism by private persons are masked in order to avoid legal repercussions. For instance, terrorist groups in Northern Ireland received financial support from the US-Irish diaspora, where this support was collected legally by front institutions (e.g., *Noraid*) and then supposedly channeled to terrorist organizations so as to support their activity in the UK (Napoleoni 2004).

Private financing by unlawful means. Not all terror groups can rely on state or private sponsorship to finance their activities or are able to run their own legitimate businesses (which could, in fact, severely undermine their secrecy). Therefore, many groups rely on criminal means to gain financial resources. Related criminal activities usually include, inter alia, bank robberies, kidnapping, the production and trafficking of drugs, weapons, diamonds etc., extortion and smuggling (e.g., Dishman

2001; Bovenkerk and Chakra 2004; Ward 2004; and Napoleoni 2004). Terrorist groups are, on the one hand, likely to resort to criminal activity to obtain financial resources when they are not successful in attracting (or when they lose) domestic and/or international support for their cause.⁵ Such isolated groups are expected to rely on limited criminal activity to obtain financial resources (e.g., robberies). For instance, a lack of popular support (and the loss of support from the Soviet bloc with the end of the Cold War) may explain why Western European groups (e.g., the *RAF* in Germany) often resorted to ordinary crimes to obtain financial resources (e.g., “revolutionary” bank robberies). On the other hand, terrorist groups may resort to private financing by unlawful means when they are able to exert some territorial control (e.g., Bantekas 2003). That is, not only small and isolated but also large, organized groups with some degree of public support may rely on criminal activity. However, the latter groups are expected to rely on means of large-scale (organized) crime to self-finance. For instance, territorial control allows for the production of drugs, drug trafficking and other forms of smuggling. Here, social-revolutionary and national liberation movements such as the Colombian *FARC* (*Fuerzas Armadas Revolucionarias de Colombia*), the Turkish *PKK* (*Partiya Karkerên Kurdistan*) or the Afghan Taliban have been argued to use money from drug production and trafficking to finance their armed struggle. As we shall discuss below in more detail, the potentially close links between (political) terrorism and criminal activity may result in the transformation of terrorist groups, where groups increasingly give up their politico-military causes in favor of purely criminal behavior. For instance, the *PIRA* (*Provisional Republican Army*) is argued to be on the verge of becoming a group where criminal activities (drug trafficking) are its main focus, whereas the *FARC* seems to have already reached this stage (cf. Bovenkerk and Chakra 2004).

3.3 Estimating Financial Flows to Terrorist Groups

By now, we discussed that terrorism is costly, as terrorist groups need to finance attacks and the day-to-day operations of their organization. The financial capacity of a terrorist group is usually expected to correlate with its longevity and effectiveness in pushing its socio-political and military agenda. This capacity crucially depends on the various pillars of terrorist financing which we discussed above (state-financed terrorism, financing through legitimate activities and private financing by unlawful/criminal means). Below, we present some (rough) estimates of the financial flows to terrorist groups, so as to evaluate which forms of financing matter the most to terrorist organizations. Clearly, the clandestine nature of terrorism (and its financing) makes such a task difficult: usually, there is considerable anecdotal information about illegal activities and financial flows (cf. Comras 2005), but little “hard” evidence. Hence, “numbers” floating in the international discourse on terrorism have to be treated very cautiously. Nevertheless, the presented estimations may give a first indication where terrorism may be effectively fought by constraining its “income” streams (e.g., by combating money laundering activities). Curtailing the financial capacity of terrorist groups is expected to affect an organization’s budget constraint, thus lowering the possibility to launch an attack (offensive actions) or to sustain a terrorist insurgency (“operative costs” of terrorism).

State-finance terrorism. During the Cold War sponsorship of terrorism by states (used as a foreign policy tool) was wide-spread. The role of state sponsorship in the financing of terrorist groups has been on the decline since the end of the Cold War. That is, many terrorist groups have substituted state assistance with other means of finance. However, some groups still receive financial assistance from foreign states. For instance, the Lebanon-based *Hezbollah* has been estimated to receive \$100-200 million per year from Iran (e.g., Wilson 2004).

⁵ While a loss of international support from states is usually related to changes in the international political system (e.g., end of the Cold war), a loss of domestic popular support (or support from diasporas) may result from improvements in social conditions (e.g., economic development, political reforms). In turn, a lack of support and mobilization also reduces the effectiveness of terrorist groups in pushing their political agenda, potentially resulting in the political isolation of these groups and the end of their armed campaigns.

Financing through legitimate activities. Financial support also comes from legal sources, where this money is then used to finance terrorist activity. Here, donations and support from diasporas and other private persons is believed to account for most of this money. For instance, the National Commission (2004) assumes that – at least until the 9/11 attacks – the *Al-Qaeda* network was mainly financed from donations of private persons and religious communities (plus some state support from the Taliban regime in Afghanistan). Comras (2005) provides information that after the 9/11 attacks some 100 charities in the Gulf countries were either shut down or have come under official surveillance due to their unclear connection to *Al-Qaeda*. Other terrorist groups (in particular with comparatively strong diaspora support) have also relied strongly on financial support coming from legitimate sources (e.g., donations, charities), e.g., *PIRA*, Sri Lanka's *LTTE (Liberation Tigers of Tamil Eelam)* or the *PKK* (Byman et al. 2001). These estimates point to the importance of legitimate activities (particularly in the form of transnational support) in financing terrorism and calls for the identification of those legitimate systems also used for terrorist fundraising.

Private financing by unlawful means. The decline in state support has led to changes in terrorism financing. In particular, many large-scale terrorist organizations (e.g., *PIRA*, *Al-Qaeda*, *FARC*), some of them with little private support, have increasingly resorted to criminal activities to self-finance and to compensate for declining state assistance. For instance, Schneider (2009, 2010), using the MIMIC (i.e., Multiple Indicators, Multiple Causes) approach, estimates that 10-15% of *Al-Qaeda's* annual budget comes from “classical” criminal activity and 30-35% from drug business.⁶ As another example, Dishman (2001) finds that the *FARC* was able to earn \$100-500 million from drug-related criminal activity (e.g., drug production, drug trafficking) in the 1990s and early 2000s. These estimates highlight the importance of financing by criminal means in terrorism and hints at the links between (transnational) terrorism and (transnational) organized crime, which we will discuss in detail in the following section.

4. Terrorist Financing and Money Laundering

The previous discussion has shown that terrorist organizations need financial resources. Especially in the case of transnational terrorism they also need to find ways of transferring funds from terrorist sponsors via group leaders/headquarters to terrorist cells in the target countries. The sources of funds may have a legitimate or illegitimate origin. Particularly when they are illegitimate it appears natural to assume that terrorists resort to money laundering activities (similar to those employed by organized crime) to finance their activities. This is one of the reasons why the international legal framework for fighting money laundering was extended to incorporate terrorist financing since the late 1990s.

A first major achievement in this respect was the *UN Convention for the Suppression of the Financing of Terrorism* (1999). Before this convention, the issue of tracing, freezing and confiscation of terrorist funds played only a minor role in international treaties dealing with the fight of terrorist activity (Gilmore 2004). The UN Convention established for the first time a distinct and internationally recognized notion of an “offense of terrorist financing”, which comes about whenever an offense, as described in the – at that time – existing international counter-terrorism treaties, or any other violent intimidating act is committed (Bantekas 2003; IMF 2003). Terrorist financing is defined in broad terms, including all direct or indirect financial flows, including those of groups claiming to have charitable, social or cultural goals or which also engage in illicit activities such as drug trafficking or gun running (UN 1999). States are required to hold those who finance terrorism liable, while at the

⁶ Differences to the National Commission's (2004) finding that *Al-Qaeda* is mainly financed from legal private sources can be explained by the fact that estimates of clandestine activities are naturally very difficult.

same time international cooperation is called for, including a reduced level of bank secrecy when partner countries ask for assistance against terrorist groups.

Under the impression of the 9/11 attacks, the UN Security Council adopted *Resolution 1373* on September 28, 2001. The resolution imposes very similar obligations as the 1999 UN Convention (Bantekas 2003); in fact, it even called for ratifying the UN Convention, which only few states had done at that point in time. According to Bantekas (2003), it was the strategy of the US to use the momentum to impose measures that would not have been adopted under “normal” circumstances. These measures also include, next to the general criminalization of any form of terrorist financing, the obligation to freeze any terrorist funds and the imposition of substantive legal measures at the domestic level.

A third important international agreement against terrorist financing is the *FATF Special Recommendations on Terrorist Financing* (FATF 2001/2010). While being closely related to the previous agreements (and again calling for ratification of the previous resolutions), these nine recommendations have to be seen as practical implementation guidelines by clarifying terms, suggesting policy measures and pointing at specific forms of terrorist financing marking the difference to criminal money laundering (which is dealt with in the *FATF-40 Recommendations*, cf. FATF 2003/2010). For instance, it includes recommendations for dealing with non-profit organizations (such as charities) or cash couriers, both of which were identified as financing channels specific to terror groups.

These cornerstones of international legislation against terrorist financing, which are complemented by several further measures at the international level (e.g., at the IMF, the EU or Interpol), are closely related to anti-money laundering legislation at the national and international level. In this chapter, we turn therefore to the question whether there is a sufficient level of similarities between organized crime (and its money laundering activities) and terrorism (and its financing) to justify fighting both with a very similar set of instruments. We start our discussion by investigating some analogies and differences between money laundering and terrorist financing, asking whether organized crime and terrorist groups are sufficiently similar to lay the basis for a potentially identical financial behavior. Then we investigate whether similar organizational structures imply an analogous financial behavior and explain why this is not self-evident. Finally, we evaluate the existing legislation against terrorist financing from an economist’s point of view.

4.1 Analogies and Differences

Money laundering usually refers to a process through which criminals attempt to conceal the true origin and ownership of the proceeds of criminal activities. Successful money laundering implies that the ill-gotten money loses its criminal identity and appears legitimate. Money laundering activities are typically associated with organized crime and tackled through anti-money laundering legislation, such as national laws inspired by, e.g., the FATF-40 Recommendations (cf. FATF 2003/2010).

Terrorism financing, on the other hand, includes the financing of terrorist acts and of terrorists and terrorist organizations (FATF 2001/2010). Consequently, *terrorist financing offences* relate to any person who willfully provides or collects funds with the unlawful intention (or in the knowledge) that they are to be used by terrorist organizations to carry out an attack. Obviously, most terrorist acts are themselves crimes (Dandurand and Chin 2004), so that there is some proximity between organized crime and terrorism by definition. In fact, if terrorist organizations (sufficiently) mirror criminal organizations, there would be little doubt that approaching terrorist financing by a standard anti-money laundering framework is promising. It appears reasonable to assume that similar organizational structures, tactics and actors’ characteristics in organized crime and terrorist organizations also imply similar financing structures.

The similarities, or the “blurring of the line” (Lacqueur 1999),⁷ between organized crime and terrorist organizations can be best understood by considering the crime–terrorism continuum suggested by Makarenko (2004). Following her argument, the crime–terror nexus is to be placed on a continuum within which every single group can slide up and down the scale depending on the environment in which it operates. In fact, Makarenko (2004) argues that some convergence (possibly even *full* convergence) between organized crime and terrorism can be observed. Figure 1 shows the relevant continuum ranging from “traditional” organized crime to “traditional” terrorism. In the middle of this spectrum, organized crime and terrorism become difficult to distinguish: some criminal groups display political motivations (“political crime”) and some terrorist groups are rather interested in criminal profits and end up using their political rhetoric only as a façade (“commercial terrorism”).⁸

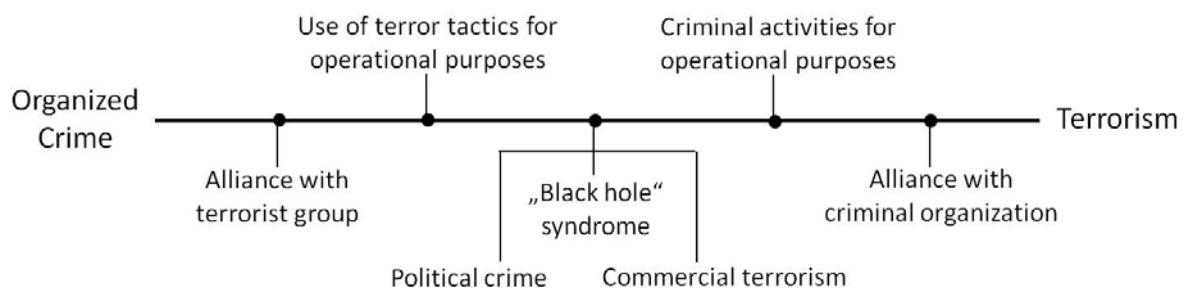


Figure 1: The Crime–Terrorism Continuum (Makarenko 2004).

The view that similarities already exist or some convergence between organized crime and terrorism (will) take place is supported in several respects. However, it should be clear from Figure 1 that this applies mostly to organizations which are already placed around the center of the crime–terrorism continuum. First important aspects are *structural* similarities (e.g., Schneider 2009, 2010). Criminals and terrorists have a common enemy, namely the state and its law enforcement agencies. They act secretly and use similar infrastructures, weapons and tactics for their activities. At the *organizational* level, however, analogies are restricted to certain types of criminal groups which also use network structures that have been shown to have tactical and strategic advantages to terrorist organizations (e.g., Arquilla and Ronfeldt 2001; Asal et al. 2007; Galeotti 2002; Jones et al. 2003; Tucker 2001; Zanini 1999). While some modern criminal organizations, especially when acting internationally, may indeed resort to this organizational structure, it is neither typical nor beneficial for “traditional” large-scale, hierarchically organized criminal organizations, such as the Mafia or Yakuza. Furthermore, the goals of organized crime and terrorism differ the more the further they diverge from the center of the crime–terrorism continuum. For instance, “traditional” criminal organizations, which are usually interested in setting up stable criminal “business” activities for longer time periods, do hardly match which fanatic terror groups aiming at causing – through their attacks – destabilization in the short-run.

When congruence in the above dimensions is high and neither criminals nor terrorists initially plan to leave their position in the crime–terrorism spectrum, collaboration may be advantageous to both sides.⁹ Later, this could lead to convergence, or at least to the adoption of behaviors of the other

⁷ According to Thompson and Turlej (2003) there exists even a “natural” partnership between organized crime and terrorism, which at the same time may be an evolutionary process.

⁸ These components are particularly likely to meet in failed states (“black hole syndrome”). These states tend to be safe havens for terrorist organizations, while groups engaged in civil war activities (and with aims similar to those of terrorist groups) more and more focus on criminal aims.

⁹ From an economic perspective it is not obvious why extending the scope of a terrorist (criminal) group’s operations into crime (terrorism) should be a superior strategy compared to labor division and specialization.

type of organization, including, e.g., terrorists “learning” how to obscure illegitimate money flows. Bovenkerk and Chakra (2004) hypothesize that terrorist groups ought to be mainly interested in collaborating with criminal production, smuggling and sales organizations, while organized crime prefers collaboration with terrorist organizations that exert substantial political influence. This leads to the conclusion that between organized crime and terrorist organizations – given that criminals and terrorists meet in the underground (or in prison, cf. Shelley 2006) at some point in time – associations, alliances, cooperation, confluence, convergence or even symbiosis may arise (Schmid 1996, 2004). More precisely, Williams and Savona (1995), Williams and Godson (2002) and Schweitzer and Dorsch (2002) suggest that – at least for a nucleus of groups (which is, again, most likely placed in the center of the crime–terrorism spectrum) – terrorism can change into organized crime and vice versa due to their highly similar interests and structures.¹⁰

Structural and organizational similarities between organized crime and terror organizations are only sufficient conditions for collaboration, potential convergence and the emergence of similar financial behavior. Individual characteristics of group members and ideological similarities/differences may also play a role. There is little controversy that at least among group leaders of both types of organizations a consistent rational behavior can be observed (e.g., Bovenkerk and Chakra 2004; Sanderson 2004; Schneider 2010). Furthermore, the rank and file members typically exhibit certain character traits (e.g., risk-taking and few moral concerns) that enable them to conduct criminal or terrorist actions (Bovenkerk and Chakra 2004; Victoroff 2005; Schneider 2010; Krieger and Meierrieks 2011).¹¹ This does not, however, imply that recruitment necessarily takes place from the same reservoir of socio-economically deprived segments of the population (Bovenkerk and Chakra 2004).¹²

The most relevant difference between terrorism and crime relates to ideology. Terrorists operate often in the name of “higher ideals” (Ignatieff 2002; Bovenkerk and Chakra 2004) which may not be beneficial to straightforward criminal activity or may lead to conflicts with criminal groups (Dishman 2001). Since terrorist activity is born out of political motives or socio-economic grievances, from which – usually in open confrontation with the government – political, social and economic demands arise, it follows that terrorists seek public attention to communicate their interests or, at least, to convince the world of the justness of their causes (Bovenkerk and Chakra 2004). Political credibility is in fact highly valued by terrorists, and groups run into danger of losing credibility when they act as normal criminals or when cooperating with organized crime. In addition, some terrorist groups have a revolutionary impetus in the sense of being progressive on societal issues. Compared to this, organized crime is usually considered as “conservative” (Bovenkerk and Chakra 2004) with a strong interest in abusing the imperfections of private and public institutions. Conserving the existing structures and institutions is therefore beneficial to organized crime, which ought to run counter to

Criminals could engage terrorist groups to run attacks, and vice versa, if it is in their specific interest. The main argument against labor division can be seen in potentially arising principal-agent problems.

¹⁰ The empirical basis for a *full convergence* of organized crime and terrorism is rather limited. According to Bovenkerk and Chakra (2004) the examples provided by the various proponents of the hypothesis (e.g., Makarenko 2004) include only very few groups, particularly the *FARC* in Colombia, *Sendero Luminoso* in Peru, guerrilla fighters in Chechnya, the *Abu Sayyaf Group* in the Philippines, the *IMU* in Uzbekistan and a few others. In most cases, reference is made to so-called “narco-terrorism” activities (Bantekas 2003). Schmid (2004) and Naylor (2002) share the view that the presumed links are still too little investigated to conclude that a problematic convergence will become a major issue in the future.

¹¹ However, in times of the globalization of crime and terrorism differences between group members may increase. For instance, members of Islamist terror groups have rather specific motivations based on their cultural-religious background (Kruglanski et al. 2009) which hardly align with the individualistic behavior of members of, e.g., western criminal organizations.

¹² In fact, a number of studies show that members of terrorist groups are carefully selected among the highly skilled to guarantee the success of attacks (e.g., Hassan 2001; Krueger and Maleckova 2003; Berrebi 2007; Benmelech and Berrebi 2007; Krueger 2008; Brockhoff et al. 2010), while – except for *white-collar* crime – the need for skilled members at the operational level of (hierarchical) criminal organizations is far less pronounced.

the terrorists' interest in solving a country's socio-economic and political problems. This difference can also be expected to have consequences for financing modes of both types of organizations, as terror groups that care about their "image" will prefer legitimate ways of financing, such as donations and diaspora support.

Collaboration, potential convergence and the emergence of similar financial behavior are fostered by exogenous political and economic developments which create similar opportunities and obstacles for both types of organizations. In Section 3, we already argued in the context of state-financed terrorism that with the fall of the Iron Curtain state sponsorship ended for many terrorist groups. While some terrorist groups stopped their activities in response, others sought other sources of material support (Bantekas 2003; Bovenkerk and Chakra 2004; Brandt and Sandler 2010; Byman 2005; Dishman 2001; Makarenko 2004, 2005; O'Brien 1996; Thompson and Turlej 2003), which ultimately resulted in a process of *transformation* of terrorist groups (Sanderson 2004). Similar to organized crime, these terrorist groups needed to build up and maintain an effective financial infrastructure to run their operations successfully (Hutchison and O'Malley 2007). Therefore, they started to engage in similar types of criminal activities as organized crime groups (Dandurand and Chin 2004), including a movement toward similar financing structures. Several further factors may contribute to this development. Increasingly global markets provide profitable opportunities for organized crime to act transnational, while global interactions may increase grievances (global injustice, socio-economic setbacks etc.) potentially leading to violent dissent in the form of (transnational) terrorist activity. They also allow for world-wide flows of ideas, cultural products and people, so that ideas of terrorist ideology, new criminal techniques as well as terrorists and criminals themselves easily spread across borderlines, undermining (national) state control policies.¹³

Summing up our discussion, we can conclude that – at least for a nucleus of criminal and terrorist organizations – relevant and sufficiently large similarities exist which may potentially lay the basis for an identical financial behavior. In particular, we see that several structural and enabling factors facilitate the movement of some terror groups toward organized crime. These groups, which may be labeled as "commercial terrorists", are the most likely candidates to apply anti-money laundering legislation to. At the same time, some terrorist groups, especially those with highly ideological goals, are so far from organized crime that they are rather unlikely to resort to traditional criminal activities. In the following subsection we shall have a closer look at the actual importance of money laundering for terrorist financing.

4.2 Evaluating the Importance of Money Laundering for Terrorist Financing

Compared to anti-money laundering legislation targeting organized crime, analogous measures against terrorist financing are a more recent development, as argued above. Next to the fact that at least some organizational convergence can be assumed, this helps to explain why fighting money laundering and terrorism financing are treated alike in terms of prosecution.¹⁴ Thony (2005) argues that the main concern of prosecutors should be the funds themselves (and the organizations behind them), not the illegal *processing* of the funds. Therefore, he claims that the rationale of the anti-money laundering strategy can be applied *mutatis mutandis* to terrorist groups. Hence, after the 9/11 attacks it appeared reasonable from the prosecutors' perspective to simply extend the existing

¹³ With an increasingly global reach of transnational terrorist activity the need for financial resources also rises (although globalization has also led to falling costs of transport and communication, cf. Makarenko 2005) and might be satisfied again only by more traditional criminality.

¹⁴ Dandurand and Chin (2004) point out that the list of behaviors related to terrorism that are criminalized is constantly extended, so that the same instruments used against organized crime are easily applicable nowadays (in fact, in some respects anti-terrorist financing rules go even beyond those for fighting organized crime).

anti-money laundering legislation by adding some rules tailored to the specific case of terrorist financing.

Our previous discussion has already shown, however, that this argument is likely to apply only to some terrorist groups which have some inherent proximity to organized crime. In addition, turning to the genesis of the funds provides an even more complex picture. In general, money laundering involves committing two criminal acts: the crime itself and the laundering of the proceeds of crime (Ferwerda 2009). Criminals may be caught at both stages, and law enforcement at the second stage works back from the crime itself. Compared to this, in cases of terrorist financing prosecutors are supposed to intercept the funds before a – potentially catastrophic – terrorist act takes place (Malkin and Elizur 2002).

With respect to the direction of money flows differences between organized crime and terrorism are very obvious. From the definitions of money laundering and terrorism financing, as stated above, we can see that money laundering aims at disguising the criminal identity of funds such that they appear legitimate. Contrary to this, as Section 3.2 shows, substantial financial means of terrorist organizations stem from state or private sponsorship implying a legitimate origin. This means that legitimate funds are obviously used for illegitimate activities. Because of this, terrorism financing has been called “money laundering in reverse”.¹⁵ This fact exacerbates the prosecutors’ problem because money flows which are perfectly legitimate have to be recognized as leading to dangerous terrorist activities. This requires knowledge of the ultimate intentions of the remittee of the funds. From a practical point of view this calls for close cooperation between money laundering prosecutors and counter-terrorism intelligence. This argument does not, however, imply that the instruments of anti-money laundering policies should be disregarded in fighting terrorist financing. But they show that an even broader and more sophisticated approach is needed to detect financial flows especially towards the operative units of terror organizations, i.e., towards terrorist cells all around the world.

Despite this structural difference, our previous discussion has shown that at least some terror groups engage in criminal activity to finance their organizations. Especially if these groups have a legal front institution, money laundering of illegitimate funds becomes necessary.¹⁶ This link matters particularly when illegitimate funds have to be relocated from an illegal venture (possibly located abroad) toward the terrorist groups’ headquarters or leaders, as this volume of financial flows is usually much more significant compared to the far less important flows from the group leaders to small cells. Recall that the 9/11 attack required funds of about half a million dollars, while running the *Al-Qaeda* main organization amounts to estimated 20-50 million dollars annually (see Section 3.1).

Even if we abstract from “commercial terrorist” groups and consider “traditional” terrorism only (i.e., the extreme position in the crime–terrorism continuum), we have to acknowledge that terrorist organizations tend to obscure or disguise the links to their sponsors (Gilmore 2004) for reasons of sustaining the terrorist organization in the long run. It is clearly not in the interest of the group leaders to disclose these sponsors or the channels of transferring funds to the operative units, as these links could be used for future terrorist activities. In this sense, terrorist financing – at least in terms of illegal processing of funds – might in fact be seen as some close variant of traditional money laundering conducted by organized crime (implying the use of the same anti-money laundering instruments).

¹⁵ Closely related to this is the difficulty of measuring the effectiveness of legislation criminalizing terrorism financing partly because the presumed preventive effect is by definition not measurable (CTITF 2009).

¹⁶ Without any “legal” activities at the surface, there is not necessarily a reason to launder funds because illegitimate funds could simply remain clandestine, unless the funds have to be transferred through the legal banking system. However, when using, e.g., the *Hawala* banking system the funds may remain completely disguised.

This does not, however, consider other legitimate financing options available to terror groups. National intelligence of (e.g., rogue) states has usually sufficiently sophisticated means of transferring funds to terrorist cells and/or groups around the world without leaving significant traces (cf. Section 3.2). Even more fundamental, however, is the problem that state sponsors play a significant role in providing non-financial support to terrorist groups, e.g., by offering training facilities or providing retreat areas (e.g., Byman et al. 2001). In both cases, anti-money laundering instruments are unlikely to be helpful. In the case of private financing of terrorist activities, these instruments appear to be more promising as some funds need to be transferred through legal channels, such as the banking system. The problem here is that alternative transfer systems, such as *Hawala* banking,¹⁷ may be used by terrorist groups, which are far less under the control of prosecutors. In addition, specific organizational forms of raising funds may be applied, which are again hardly controllable by the state. Funds collected, e.g., through contributions to charities (or by levying revolutionary taxes) are difficult to detect. Finally, given the rather low cost of a single terrorist attack, a “decentralization” of fund raising may be a reasonable strategy for terror cells: for instance, the (low) costs of buying explosives may easily be covered through a single criminal act, such as a bank robbery.

4.3 Evaluating the Legal Anti-Terrorist Financing Framework from an Economic Perspective

With the 1999 *UN Convention for the Suppression of the Financing of Terrorism* terrorist financing has entered the international stage. An important advantage of the international agreements is that they allow for a coordinated response to the increasingly global reach of terrorism. Unilateral policy measures face the problem of potentially producing undesired spillover effects. Krieger and Meierrieks (2011) point out that terrorism is contagious in space, i.e., terrorist activity can easily spill over to neighboring countries. Then, uncoordinated counter-terrorism policies may give rise to an underprovision of these measures, as free-riding on neighbor countries’ efforts to reduce terrorism may be a rational strategy for some countries (Lee 1988).¹⁸

In general, international agreements face the problem of implementation at the national level. For instance, although 167 countries ratified the 1999 UN Convention (Klein 2009), it cannot be ruled out that some (rogue) states could have used the ratification as a façade. Verdugo-Yepes (2008) points out that implementation of the FATF Special Recommendations is insufficient in many countries, possibly indicating intentional government decisions.¹⁹ But even if the intentions to fight terrorism financing are sincere (and ignoring the fact that possible substitution between financing channels renders it almost impossible to have a “perfect” monitoring), some – especially failed – states may simply be unable to enforce the rules effectively. From an institutionalist perspective, the difficulties are twofold. On the one hand, poor institutions foster terrorism (cf. Krieger and Meierrieks 2011), and, on the other hand, they impede the efforts to monitor financial transactions effectively (e.g., Verdugo-Yepes 2009), implying a positive correlation between *terror hotspots* and what might be called *terrorist financing havens*. Improving institutions in a country could therefore allow reaping a “double dividend” by reducing both terrorism genesis and terrorist financing.

¹⁷ According to van de Bunt (2008), *Hawala* bankers are financial service providers who carry out financial transactions without a license and therefore without government control. They accept cash, cheques or other valuable goods (diamonds, gold) at one location and pay a corresponding sum in cash or other remuneration at another location. Unlike comparable services by firms like Western Union, *Hawala* bankers usually disregard important legal obligations relevant to the regular banking sector.

¹⁸ A related argument has been made by Unger and Rawlings (2008) who argue that low standards in suppressing money laundering and terrorist financing might be intentional by some countries.

¹⁹ Verdugo-Yepes (2008, 2009) recognizes implementation problems in three dimensions: (i) tensions between financial regulation and political will; (ii) the difficult interaction between international standards and the implementation at a domestic level; and (iii) (domestic) tensions between governments and financial and non-financial institutions.

Another problem is related to a recent development in terrorist activity, namely the increasing importance of “home-grown” terrorism, i.e., the phenomenon that terrorists self-organize in diasporas with only very loose contact (e.g., through the internet) to an overarching terror network such as *Al-Qaeda* (e.g., Sageman 2008; Crone and Harrow 2010). In a process of self-radicalization young people turn into terrorists (“lone wolf terrorists”) and conduct severe terror attacks, although no financial flows have taken place (e.g., Homeland Security Institute 2009). Financial flows might take place in the case of “sleeper cells”; however, given that these cells are often inactive over a long time span, they can be supported with steady, but small bank transfers which do not appear suspicious. Again, this is related to the problem that terrorist financing is “reverse money laundering”, i.e., prosecutors have to recognize legitimate funds to be transferred for future illegitimate uses.

A related problem refers to the increasing secrecy of terrorist financing. Some authors model the trade-off between group security and intragroup communication faced by terrorists (e.g., Enders and Su 2007), an argument which can analogously be extended to intragroup financial flows. In this context, network analysis (e.g., Lindelauf et al. 2009) indicates that (global) terrorist organizations appear to be rather stable even when prominent figures of the network are captured or isolated, or when interconnections between cells are reduced. By analogy, the latter also matters to successful interceptions of financial flows within the network. Then, in order to “survive”, these networks tend to become more decentralized, more global and more secret in their information and financial flows. This could mean, for instance, to rely more on home-grown terrorist activity or sleeper cells which will make prosecution more difficult not only for prosecutors of illegitimate funds but for all types of counter-terrorism agencies.²⁰

In a final step, we conclude this section by providing – based on economic theory – a broader picture and evaluation of anti-terrorist financing policies to determine an optimal level of control measures. Consider Figure 2, in which the optimum level of control measures of financial transactions for fighting terrorist financing, i.e., the “strictness” of control (S^*), is determined from the (marginal) costs and benefits of control measures. The marginal-benefit curve (MB) is positive, but falling, thus indicating decreasing marginal returns to control measures. While introducing stricter measures of controlling financial transactions will always help to detect potential terrorist plots (which is beneficial to society), the probability of being successful gets smaller. In the beginning, hardly disguised transactions are easily uncovered within a highly regulated financial system. More sophisticated groups, however, use alternative, far less regulated money transfer systems (such as *Hawala* banking) which make detection increasingly difficult. At the same time, the marginal costs (MC) of controlling financial transactions increase because, e.g., the direct costs of implementing the necessary measures rise. Regulators and intelligence units need additional equipment and personnel when transactions get more sophisticated; also, detecting illegal activity becomes more time-consuming. In addition, civil liberties may get violated and the danger of misuse of the information collected increases.²¹ At the intersection of marginal-benefit and marginal-cost curve, the optimal level of control strictness is determined.

²⁰ In fact, on the practical side CTITF (2009) recommends not to outlaw alternative remittance systems because it would drive operators further underground, but rather to introduce an effective licensing system.

²¹ Accordingly, CTITF (2009: 3) states: “Authorities should exercise caution not to introduce laws or regulations burdening private and public sector stakeholders in the name of countering the financing of terrorism without sufficient evidence or typologies that the burden is proportionate to the risk.” A practical example of this aspect is related to the problem that some countries resorted to “ethnic profiling” to identify potential terrorists. However, the categorization in the profiling process is often cursory (young, male, Muslim) and may lead to problematic prejudgments. A point in case is students from Arabic countries who receive transfers for covering their livelihood and tuition fees from their home countries. Another practical problem involves transliterating Arabic names of potential suspects correctly into English (or other languages) in order to avoid unjustified freezing of the funds of innocent citizens with a similar name (Gouvin 2003).

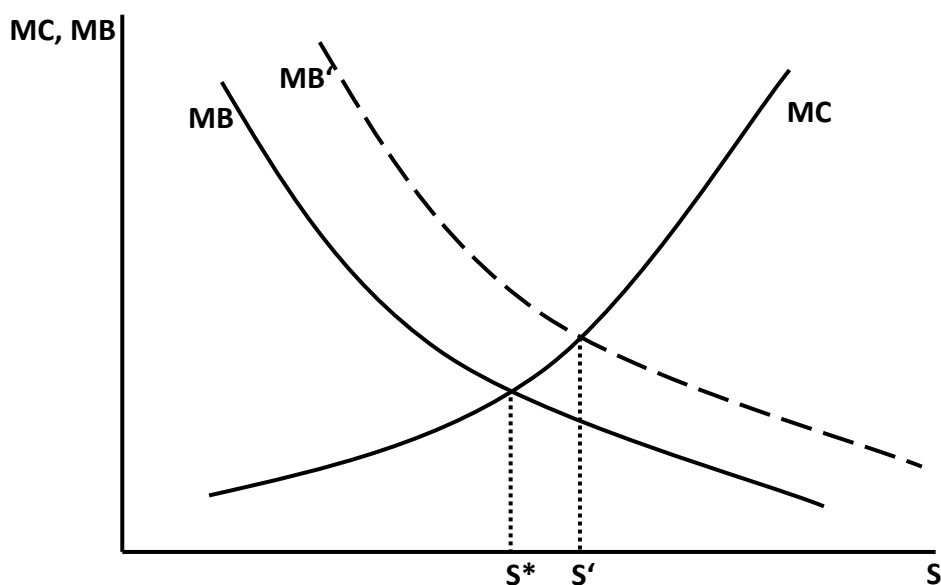


Figure 2: The optimal level of control strictness

Consider now a sudden terrorist attack such as 9/11. This attack changes the perception of terrorist threat and renders measures promising a reduction in terrorist activity more beneficial. This is even the case when the probability of terrorist events hardly changes at all, given that individuals – under the impression of a recent terror attack – tend to substantially overestimate the danger of terrorism (e.g., Viscusi 1993; Becker and Rubinstein 2011). Hence, for a given level of control costs the marginal benefit of monitoring financial transactions seems to increase and the marginal-benefit curve shifts rightwards to a new level MB' , implying a higher optimal control level S' . Given that after some time the evaluation of the terrorist threat returns to “normal” levels and thus the marginal-benefit curve returns to MB , there exists for some time a “window of opportunity” for legislators to introduce new, stricter levels of monitoring transactions. Since this legislation is usually not revoked after the reevaluation of the terrorist threat, this process may lead to a sub-optimally high level of control in the long run, thus imposing additional transaction costs to financial transactions, potentially also impeding economic development (e.g., Bekaert et al. 2005).

A comparison of policies on fighting terrorism financing and money laundering of organized crime highlights this problem. In many countries, neither was terrorism considered a relevant threat for long periods in the past, nor showed fighting organized crime up on top of the political agenda at the same time. With regard to the latter, the public and politicians seemed particularly reluctant to grant additional funds and (legal) instruments to prosecutors of these illegal activities, although organized crime has been considered by the police as a major problem. After a severe terrorist attack like 9/11, however, terrorism is likely to become a major topic and substantial new legislation is introduced. If this legislation aims at fighting terrorist financing, it also ought to help fighting organized crime and its money laundering activities. In fact, it appears that some of the measures introduced in the face of the 9/11 attacks are much better suited for fighting organized crime than (in particular) Islamist transnational terrorist activity. It proved helpful for politicians' interest in stricter money laundering

legislation to argue for a seemingly strong *money laundering-terrorist financing nexus* to make the public become more willing to accept the same measures which they rejected before.²²

5. Conclusions

Terrorism is a costly challenge to modern societies. Terrorists aim at economic destabilization to push their agenda and to force the governments to give in. Terrorism may produce direct costs (destruction) and (more importantly) indirect costs, where the latter stem from the reaction of economic agents to the threat of terrorism (by means of capital flight, diversion of investment, adjustments in government budgets etc). While the exact macroeconomic consequences of terrorism depend on country-specific conditions (e.g., macroeconomic size and robustness, intensity of terrorism), in particular developing economies seem to be vulnerable to terrorism, given that they are often less-diversified and thus economically weak. At the same time, the political and social costs of terrorism (e.g., in terms of reduced political openness and life satisfaction) should not be disregarded, which may very well also matter to more developed economies. In general, the costs of terrorism appear sufficiently high to call for a broad range of counter-measures.

We argued that eliminating terrorism's root causes appears to be the most viable policy option in the long run. We have shown that terrorism is likely to be rooted in a set of unfavorable social conditions (e.g., poor socio-economic development, foreign policy behavior that creates grievances, demographic stress), although a true academic consensus on this issue has yet to emerge. It seems that terrorism is a complex phenomenon rooted in a variety of conditions that are usually coupled and which potentially reinforce each other. Among the factors possibly inciting terrorism are (i) poor socio-economic conditions, in particular when they are not counter-acted (e.g., by means of redistributive policies), (ii) poor politico-institutional frameworks (e.g., lack of economic and political participation), (iii) foreign policy activities that create grievances and possibly lead to the internationalization of domestic conflict and self-radicalization, and (iv) demographic stress.

In the short run, however, it also seems necessary to pursue policies that do not eliminate the underlying motivations for terrorism, but aim at interrupting the planning and execution of terrorist attacks. In a sense, such strategies resemble the "stick" in the "stick-versus-carrot" approach to fighting terrorism (Frey 2004). Their main goal is to raise the material costs of terrorism instead of raising its opportunity costs (the "carrot" that removes the root causes of terrorism). Here, tackling the issue of terrorist financing (and considering the role of money laundering in this process) and disrupting the financial flows towards terrorist organizations is one policy that is clearly expected to make terrorism more difficult and expensive and thus less likely, at least in the short run.

This basic reasoning provides the rationale for creating an extensive set of instruments to prosecute financial flows from terror sponsors via terrorist group leaders towards cells around the world. Especially in the aftermath of the 9/11 attacks several measures were introduced which extended the existing anti-money laundering legislation so to also face the new challenges of terrorist financing. Our analysis shows, however, that drawing a simple analogy between money laundering of organized crime and terrorist financing takes too narrow a view. Money laundering aims at disguising the criminal identity of funds such that they appear legitimate. Contrary to this, terrorist groups are often financed from legitimate sources, while it is the use of funds that is criminal. Because of this, terrorist financing has been called "money laundering in reverse" and presents a particular challenge

²² A striking example for this development is the US case, as documented by Gouvin (2003). In 1999, the so called "Know Your Customer" (KYC) joint proposal of the federal banking agencies was withdrawn due to strong opposition of the financial institutions against these far-reaching anti-money laundering measures. Only two years later, after the 9/11 attacks, a new version of the KYC standards easily passed Congress although the problems of the older proposal were hardly corrected.

to prosecutors who have to anticipate the future misuse of today's legitimate funds. At the same time, there exist financial sources of terror organizations, e.g., when it comes to "narco-terrorism", which are clearly illegitimate and where more traditional forms of money laundering do take place. Nevertheless, in order to tackle terrorist financing a close cooperation of money-laundering prosecutors and counter-terrorism intelligence appears to be a particularly promising strategy which is able to deal with both "directions" of financial flows.

An important finding of our analysis is that new organizational forms of terrorism (such as the trend toward network structures and home-grown terrorism) may render the anti-money laundering framework less important as a tool against terrorism. Self-radicalization, sleeper cells and "lone wolf" terrorist activity, which are only loosely connected to the over-arching structure of a terror network, require fewer and smaller financial transfers (if at all) which can be less easily detected by money laundering prosecutors. If these trends continue, the question has to be raised whether the rather strict rules introduced in the aftermath of 9/11 should be sustained. There were good reasons why some of the anti-money laundering regulations adopted in the face of the terrorist threat in 2001 were rejected in the decades before (when legislation against organized crime and money laundering was proposed without connecting it to terrorism). These regulations were argued to severely interfere with civil rights and to cause substantial transaction costs which could ultimately harm economic growth. The 9/11 attacks for a certain time opened up the possibility to adopt far-reaching legislation (also beyond the issue at stake), which proved to be rather a success to the terrorists, given that fundamental civil rights were called into question in the practical implementation of this legislation.²³ One decade later, new developments may lead to a political reevaluation of these rules, thereby possibly re-strengthening civil rights while at the same time improving counter-terrorism intelligence and the fight against the root causes of terrorism.

A shortcoming of most studies on terrorist financing, including the present one, is clearly the lack of reliable data and thus sound empirical investigations. The few existing studies show an enormous mismatch between the costs of a single attack and supposed costs of running and maintaining a terror organization today (also in comparison to former terrorist organizations like the RAF). At the same time, estimates of actual financial flows between parties involved in terrorist activities appear rather preliminary. However, this information is urgently needed to provide a sound cost-benefit analysis of anti-terrorist measures associated with terrorist financing. This calls for more dedication to empirical work in this field, e.g., to field studies which might help to get a clearer (and unbiased) picture of the financial needs of terrorist organizations. On the basis of convincing empirical findings, the open spots or ambiguous conclusions in our theoretical discussion could more easily be resolved and sound policy recommendations be provided.

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²³ The "Report of the Special Rapporteur on the promotion and protection of human rights and fundamental freedoms while countering terrorism" (UN 2007) explicitly criticizes the impact of several countries' measures against the financing of terrorism as violating fundamental human rights.

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