cooperation, might depend on factors other than a precise attitude of the country towards money laundering. For example, the country might lack the necessary resources in technical, financial, and human capital necessary to actively and effectively cooperate at the international level. Second, and most importantly for our analysis, the Fatf has focused attention on *all* non cooperative countries. The list might thus include two very different types of countries: On the one hand, countries for which non cooperation is part of a wider strategy aimed at attracting foreign illegal capitals; (the ones with which we are concerned) on the other hand, countries for which non cooperation is more usefully thought of as a means through which the country aims at protecting domestic illegal capital from investigations undertaken abroad.

Furthermore, although we just depicted the extreme cases, there is the obvious possibility that non cooperation might be the result of a mixed set of factors, like inadequacies in the bureaucratic structure, strengthened by pressure from criminal organizations aimed at protecting their business. Consider Russia. Although we did not conduct any specific research on Russia,[10] it appears fair to say that the lack of cooperation is not rooted into a strategic decision not to cooperate, but is rather the result of a situation of huge institutional problems connected with the transition to a market economy. Moreover, organized crime in Russia, if anything, appears to be a buyer rather than a supplier of money laundering services in the international market, as some well known scandals appear to suggest.

3. A SUPPLY AND A DEMAND SCHEDULE FOR MONEY LAUNDERING REGULATION

As already noted, we treat regulation that can affect money laundering as a product, with a demand and supply schedule. But whose demand schedule is driving the system?

Assume that the policy maker in a given country has not yet decided the direction that it will impose on its financial regulation, with specific regard to money laundering. The policy maker may thus decide to implement a regulation that creates serious obstacles to money laundering, or it can decide to make the opposite choice, devising a regulation that facilitates money laundering.

Money laundering generates costs as well as benefits for the parties involved. The costs for society, as underscored above, depend on the circumstance that more predicate offences will be committed if money laundering is possible and on the possible negative impact that money laundering will have on the financial system. The benefits of money laundering accrue, first of all, to criminal organizations, that can employ the proceeds of crime avoiding the threat of being prosecuted for predicate offences. On the other side of the transaction, money laundering offers to the launderer the possibility to earn a commission in exchange for its services. Four different categories of actors potentially interested in the regulation can be identified: a) the policy maker; b) criminal organizations; c) those who bear the costs of money laundering; d) the financial community. Starting with the latter, it does not appear easy to predict which side will the financial community take. For the sake of simplicity, we can think that the utility function of financial intermediaries does not appear to be affected by whether profits stem from legal or illegal financial activities, thus probably making them disinterested in the choice taken by the policy maker. The interests of b) and c) are obviously incompatible, as the gains of the former depend on the loss of the latter; a) is in the middle, having to decide which demand schedule to follow.

Note that we are not assuming that b) and c) are necessarily based *outside* the country where the policy maker we are concerned with is based. This is not an assumption, but rather the consequence of our line of argument. As with all policy issues, as long as the costs and benefits of a decision fall within the boundaries of the area of influence of the policy maker, we expect to have an efficient decision. Policy makers in countries where crime is pervasive will tend to bear at least some of the costs associated with a decision to favor money laundering.

[10] Or, for what matters, on any other country. This is not an empirical paper, and the references to characteristics of countries included in the list should be taken as little more than anecdotical evidence.

This is the first explanation of the apparently paradoxical incongruence among intuition and real world experience with regard to the two hypothetical countries described above. Countries where organized crime is pervasive appear to play a minor role in the offer of financial services at the international level. This might be so because the widespread presence of organized crime in the country increases for the policy maker the costs of a regulation that favors money laundering.[11]

Citizens will bear the costs of the decision and will hold the policy maker responsible. Entering the international market for money laundering services has a greater potential for countries that are immune from criminal activities. Such countries will almost by definition be able to externalize the costs associated with the increase of predicate offences.[12] A negative correlation between crime rate in the country and the role played in the offer of money laundering services appears likely. At the same time, as Masciandaro and Castelli have argued,[13] states that have fewer resources are potentially less attractive to criminals and will therefore be less vulnerable to the threats posed by money laundering. Such countries will thus be more likely to offer financial services to organized crime.

As a result of this process, some countries which do not bear the costs associated with money laundering become predisposed to adopt a regulation that facilitates money laundering. The other side of the coin is that both criminal organizations and those who bear the costs stemming from money laundering will "naturally" tend to be situated in countries other than the one where the regulation is adopted.

We have thus limited our attention to policy makers that are based in countries other than the ones in which the other actors potentially interested in the regulation are based. From this starting point, the confrontation between those who benefit from money laundering and those who suffer from money laundering has only one possible result. It is simply a "win win" game for criminal organizations. Organized crime experiences huge asymmetrical organizational advantages over those who bear the costs of money laundering. A small and powerful group faces a large and dispersed group, thus making the outcome predictable.[14] Even assuming that organized crime 1) commits the predicate offences in a given country, 2) launders the proceeds abroad, and 3) then lets the capital flow back into the first country, the costs are spread throughout the society.

However, the costs can be spread even further. Predicate offences can thus be committed in the country where organized crime is based, while the capitals can be introduced, once laundered, into a different country. The overall costs of money laundering will therefore fall on an even larger community, spread over (at least) two countries, thus exacerbating the collective action problem faced by those who bear the costs of money laundering. A single citizen will bear an even smaller fraction of the costs, thus creating the scope for enormous free riding problems that prevent a reaction from the public.

To be sure, money laundering regulation could be opposed, and is indeed opposed, by the political authorities that represent the public interest. The dispersion of the costs, however, makes money laundering a low salience issue for the public, and consequently quite low on the political agenda. The man on the street simply does not feel the bite of money laundering, and political actors will act consequently.

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[11] We are here leaving aside the possibility of corruption or even mere lobbying by groups interested in having a regulation favorable to money laundering. Through corruption, organized crime might be able to urge the adoption of legislation that facilitates money laundering. We believe this possibility to be less important than it may appear at first glance. For reasons that are developed *infra* in paragraph 4, a corrupted state will find it difficult to make a credible commitment not to expropriate the assets of illicit origins.

[12] These countries will still be exposed to the other source of costs above identified, i.e. the distortion of the functioning of the financial market. This source of costs, however, can be controlled through "ring fencing" practices, on which see *infra*, in the this paragraph.

[13] MASCIANDARO and CASTELLI. (1998)

[14] See OLSON, (1965) for a classical exposition of the dynamics of collective action.

Not surprisingly, banking and finance supervisory authorities play a prominent role in the front line against money laundering. Their need to closely supervise the stability of the financial system makes them extremely concerned with the threats stemming from the involvement of financial intermediaries in money laundering schemes. The interests they represent suffer serious damages from money laundering. For supervisory authorities, money laundering represents a strategic problem, capable of undermining the stability and competitiveness of the financial system. This observation helps to explain why supervisory authorities, rather than political actors, take the lead of initiatives aimed at combating money laundering.

At the international level, for example, the 1988 "Basel Declaration of Principles"[15] predated initiatives taken by the political actors. The European Union Directive on Money Laundering,[16] for example, was issued only in 1991. The Italian case shows an even more striking example of this trend. Banca d'Italia adopted in 1993, in the absence of a specific provision in the text of the law, Operational Guidelines aimed at facilitating compliance with the suspicious transactions reporting duty by the intermediaries.[17] This initiative was grounded on the recognition of the strategic relevance of such duty and of the importance of a clear-cut set of rules for the intermediaries. Four years after Banca d'Italia had issued the Operational Guidelines, the legislative decree n. 153 of 1997 acknowledged the importance of the matter, expressly vesting in Banca d'Italia the power to issue instructions for the intermediaries. Again, political authorities followed the path shown by supervisory authorities.

Supervisory authorities share a common interest in fighting money laundering and will act consequently. Doubts can be raised, however, as to whether actions taken may directly affect the direction taken by financial regulation within each off-shore. It seems more likely that such actions will only indirectly affect the regulation implemented in off-shore countries. For example, internationally introduced limitations on the ability of intermediaries to transact with counterparts based in off-shore centers might, in the long run, result in the latter being crowded out. This might in turn generate, inside the off-shore, demand for less sympathetic regulation towards money laundering. Quite obviously, however, these effects may only occur in the long run. But before the long run comes, the supply side of money laundering regulation may well be driven by the demand of organized crime abroad. The policy maker may thus choose to introduce a regulation that makes money laundering easier, in order to attract capitals from abroad. Such services will generate commissions that are the pay-off to the policy maker.[18]

The problem posed by international money laundering schemes becomes one of asymmetric distribution of costs and benefits. The parties to the exchange have an obvious incentive to exacerbate such asymmetry, the ideal situation being for them one in which they share the benefits while the costs fall entirely elsewhere.

This is a more general problem of competition among jurisdictions, that reaches well beyond the scope of money laundering. Territorial entities have an incentive to let somebody else bear the costs of the policy they implement, as it is well known by those who write constitutions. Constitutions are likely to include rules that aim at reducing the ability of the different entities that compose the state to impose externalities on fellow communities. For example, section 127, par. 3, of the Italian Constitution might appear to serve such a purpose. S. 127 allows the central

[15] BASEL COMMITTEE ON BANKING SUPERVISION. (1988)

[16] Dir. 91/308/CEE.

[17] The initiative of Banca d'Italia was taken two years after the introduction of the suspicious transactions reporting regime by law n. 197 of 1991. See Banca d'Italia. (1994)

[18] More precisely, the policy maker is best understood in this context as an agent of interest groups inside the center, that will get the ultimate financial profits stemming from money laundering. The policy maker is thus rewarded only in an indirect way, through support from the interest groups.

Government to oppose laws enacted by a Region that are deemed to be "in contrast with the national interests or the interests of other Regions."[19]

The existence of rules that prevent the most blatant cases of imposition of externalities affects the incentive of states within a federal state or, more broadly speaking, of territorial entities within a non-federal state. These entities will try to contract around the default rule, devising mechanisms that impose externalities although in a more subtle way.

Taxes are the easiest means to the end of externalizing the costs of a given policy. A state may structure taxes that apparently fall in a non-discriminating way on both in- and out-of-state interests, while in practice affect in a much more significant way the latter. When Seychelles or Cuba impose an ecological tax on scuba diving they are most likely letting out-of-state interests fund the preservation of the environment in those countries.

With this regard, off-shore centers face a simple scenario. The lack of a superior authority frees the hands of off-shore countries, facilitating the task of keeping the costs of money laundering outside the center while retaining the benefits. We have pointed to two different sources of costs stemming from money laundering, the first associated with predicate offences, the second with the effects of money laundering on the functionality of the financial system. Having decided to strike a bargain with organized crime, the off-shore center faces the problem of avoiding the full burden of the costs associated with this activity. What would a regulation aimed at externalizing the two above mentioned voices of costs look like? Well, the answer is not difficult, because this type of regulation does indeed exist in some off-shore countries.

We have already seen that we expect to find, on the supply side, states that have a low crime rate. This feature helps them to externalize the costs associated with money laundering. But this is necessarily so only at the beginning of their involvement with money laundering. From then on, however, they experience the constant threat that contact with criminal organizations might result in crime spreading inside the country. To avoid this problem, a simple rule might suffice, a rule stating that all the advantages of a given regime are lost if the "firm" that benefits from the regime or its representatives commit a crime *inside* the off-shore center. Criminal organizations will thus need to trade the gains stemming from the financial regulation offered by the off-shore against those that could be derived from committing crimes inside the off-shore center. As long as the former exceed the latter, criminal organizations will refrain from searching expansion inside the off-shore center. Recall that as argued above, off-shores that emerge as offerors of criminal financial services are likely to lack resources that make them potentially interesting for criminal organizations. However, success in the competition with other off-shore will entail the growth of a rich financial sector. This natural development may alter the trade-off for criminal organizations, making the off-shore more attractive. Paradoxically, success may be counterproductive, in that it may result in increased pressure from organized crime to take control of the off-shore's financial sector.

Aware of this threat, off-shores are expected to put in place defenses aimed at protecting their financial sector. Protection against the increase in predicate offences emerges naturally as a result of competitive pressure that will select off-shores that are less attractive for criminal organizations. By contrast, protection against the costs of money laundering on the financial market requires that specific action be taken. Off-shore centers will try to minimize the effects of money laundering on their financial system. This result may be achieved through instruments which can be grouped under the label of "ring fencing practices." Off-shore centers might thus try to build a Chinese wall that insulates its financial system from the effects of involvement in money laundering schemes. For example, a regime favorable to money laundering might explicitly or implicitly

[19] See also the widespread use that the United States' Supreme Court has done of the "dormant commerce clause", in the Constitution, in order to limit the ability of the states to impose externalities over other states. Within the European Union, the "non discrimination" principle controls the externalities generated by member states.

exclude residents from taking advantage of its benefits. Conversely, "firms" which benefit from a given regime may be explicitly or implicitly prohibited from operating in the domestic market.[20] Both of these provisions would ensure the off-shore center that criminal organizations that aim at benefiting from the regime do not "reside" in the off-shore center.

A similar goal is served by multi-tiered licensing systems. Under such a system, an off-shore center offers two rather different licenses to financial intermediaries, a "restricted" and an "unrestricted" license. A typical multi-tiered regime states that restricted licensees may not engage in transactions with residents inside the off-shore center. They may not collect deposits or even make certain investments. Similar restrictions may also apply to the ability of restricted licensees to solicit funds from the general public.

The *raison d'être* of rules of the type described above is easily perceived. They aim at generating externalities, or more precisely, at avoiding the internalization of costs associated with money laundering.

4. INTERNATIONAL FINANCIAL REGULATION AND OFF-SHORE CENTRES

In the above paragraph we stressed that the meeting between the demand for money laundering expressed by organized crime and the supply of laundering services offered by an offshore country makes the objective function of the latter quite special.

The specific nature of this objective function must be considered when analyzing how best to design international regulations against money laundering, which is none other than the endogenous final result of strategic interaction between the club of the "virtuous" countries—virtuous in the sense of sensitivity or propensity to combat laundering—and the individual offshore countries. We shall analyze this problem area by using simple game theory formulations.

Let us assume initially that the game structure involves two players: the club of virtuous countries (A) and a generic country inclined to launder money (B). The analysis leads us to establish under which conditions the first player can ensure the collaboration of the second.

In this initial formulation, we use the simplest possible structure, a matrix representation. Let us bear in mind that this formulation implies a game in which the players enjoy perfect information, i.e. each is aware of the actions of the other.

The club can choose between two moves: "seek collaboration" (SC) or "not seek collaboration" (NSC). In the first case, it promises the laundering-inclined country recompense equal to T if the country undertakes to refrain from conduct damaging to the members of the club. If, on the other hand, it chooses the move "not seek collaboration" (NSC), it promises nothing and passively endures the actions of the laundering country.

Country (B), for its part, can choose between "favor laundering" (F) and "not favor laundering" (NF). In the first case it obtains a benefit equal to R, while in the second it must sustain costs and its *payoff* is equal to $-C$. In the case of NF, however, it can hope, if A has chosen SC, to obtain a subsidy of T.

The conduct of B generates the following consequences for A: if B conducts itself virtuously, A enjoys a greater level of integrity in the international financial system, and therefore obtains a *payoff* equal to I. In the opposite case, this integrity declines and A receives NI.

[20] The example of "ring fencing" in the text is derived from OECD, (1998) at 27.