8. WINNER TAKE NOTHING: A MIXED INCENTIVE STRUCTURE FOR OFF-SHORE CENTERS

On a battlefield where reputation is one of the main weapons, policy makers engaged in the fight against international money laundering schemes should be very cautious in taking initiatives that may affect the reputation of the actors involved.

Contrary to a diffused wisdom, we argue that the adoption of a pure "name and shame" approach may even prove counterproductive. Tampering with reputational mechanisms might, at the same time, not only miss the target but also reach the wrong target. First, there is a high risk of false negatives, i.e. of including in a hypothetical list of countries that supply money laundering services countries that are merely engaged in the offer of financial services of superior quality. The costs of such an error appear great. To put it with the Financial Stability Forum, "not all [Off-shore centers] are the same. Some are well supervised and prepared to share information with other centres, and co-operate with international initiatives to improve supervisory practices. But the Survey carried out by the [Financial Stability Forum] indicated that there are serious concerns by onshore supervisors about the quality of supervision in, and degree of co-operation provided by, some [Off-shore centers]."[21]

Reputation is the basic tool of the trade also for countries that are not involved in money laundering schemes but are merely aiming at attracting capitals from abroad thorough the offer of superior quality financial services. From this perspective, a mistake by the international community that includes the wrong country in the list might cause serious distortions in the competition among jurisdictions. These countries, like victims of friendly fire, will find their reputation in the financial community seriously hampered, to the detriment of their role in the market. In the long run, such types of mistake appear also capable of curbing innovation in the financial sector. Regulatory arbitrage is a powerful force in driving innovation, and the international community should recognize that tinkering with the reputation of the actors involved is a dangerous game.

But even assuming that the international community is capable of effectively singling out off-shores that are indeed involved in money laundering schemes, a cautious approach is still deemed necessary. When the international community points the finger at a given country as a leading supplier of money laundering financial services, it may also be certifying, to the benefit of the country itself, that that country is indeed specialized in that business. The signaling effect embedded in the "name and shame approach" should not be underestimated. The main difficulty for an off-shore is solving credibly the commitment problem: Then, what's best for the off-shore than having the international community, not exactly its closest friends, solving that problem with a public statement? Listing should also be regarded as a sort of third party bonding, which is likely to generate two intertwined effects. First, it is capable of cementing the commitment by the off-shore. Secondly, naming increases the transaction specific character of investments in reputation. The inclusion in a list increases the value of the (sunk) investments in reputation. A state that is engaged in money laundering and that finds itself blacklisted will find it even more difficult to switch course and decide to exit the market, thus being encouraged to compete aggressively in the market. It is like having somebody else burning the ships behind the *Conquistadores*. The final result does not change much. They still need to move forward.

This is not to say that the international community should not endeavor in listing countries that are involved in the market for money laundering services. Quite to the contrary; what this paper argues, is that a *per se* "name and shame" approach, separated from other initiatives, equals to a third party seal on the reputation of off-shore centers. Names should be named, but only if blacklisting goes hand in hand with other measures that are capable of outweighing the positive effects experienced by the off-shore center as a result of the inclusion in the list.

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[21] FINANCIAL STABILITY FORUM, (2000) Executive Summary, at 2.

Appropriate countermeasures should be grounded on the premise that even the most efficient off-shore center will still need, in a globalized world, to be integrated in world financial markets. This implies that no matter how many layers of transactions cover the predicate offence, criminal organizations will still need to place that money within the lawful financial sector. This step is necessary, at a minimum, in order to exploit in lawful uses the capitals, once they have been laundered. Money laundering is by definition instrumental to a later use.

With this regard, it should be noted that there is a fundamental feature of the initiative taken by the Fatf that appears to be pivotal for its success. The Fatf has not limited its initiative to a mere recognition of "non cooperative countries and territories." Fatf member states have also applied "Recommendation 21"[22] to the countries included in the list. "Recommendation 21" requires a higher scrutiny by financial intermediaries in evaluating the possible suspect nature of transactions with counterparts, including legal persons, based in a country listed as non-cooperative. As a result of the Fatf initiative, many countries included in the list have already taken initiatives aimed at overcoming the serious deficiencies observed by the Fatf.[23] These initiatives need to be evaluated in the medium to the long run, because, for example, some of the enacted laws will need secondary regulations to be put in place to become effective, or, more generally, the initiatives taken at the legislative level will need to be followed by concrete actions. However, it can be argued that the threat of being crowded out by the international community has played a great role in spurring the adoption of the above mentioned initiatives.

Competition among jurisdictions is a powerful and positive force. It drives innovation; success rewards policy makers that do not wait and see but rather take the lead and devise efficient policies: Within this framework, regulation is merely one of the many dimensions along which jurisdictions compete.[24] Indeed, competition among jurisdictions is sometimes even stimulated by policy makers. The possibility of choosing among different menus of rules is key to success of multijurisdictional entities, like federal states.

There are, however, instances in which countries engage in race to the bottom. This risk is especially high in settings where jurisdictions compete in the absence of a superior umpire that sets the rules of the game, in order limit their ability to externalize the costs of their actions. This is true also of off-shore countries.

As Masciandaro and Castelli have observed, a sort of "Dual regulation" hypothesis appears to hold.[25] The spread in the quality of regulations concerning money laundering gets larger, through a process in which the good gets better and the bad gets worse. At first glance this result might entail some positive perspectives, in that at least identification of the "bad guys" becomes easier. In fact, this is only apparently so. Off-shore centers that aim at attracting capital of illicit origins need their reputation to be known within the criminal world. Outside that world, however, off-shore centers have an obvious incentive not to be recognized as supplier of financial services to criminals, as this might lead to countermeasures being taken by the international community. The most egregious cases of pathological behavior by off-shore centers will pose less serious problems, as they will be easily detected. Problems start when it comes to off-shores that while offering financial services to criminal customers, try to mimic the behavior of off-shores that are not involved in money laundering schemes. The distinction between an off-shore that aims at attracting capitals through the offer of better services and one which aims at the same goal through the offer of money laundering services is difficult enough to draw in theory; it may completely blur in practice.

[22] See Fatf, (1990). (2000)
[23] See Fatf press communiqué of October 5th, 2000.
[24] On the ever increasing importance of competition among jurisdictions see FAZIO. (2000a)
[25] MASCIANDARO and CASTELLI. (1998)

This problem seems connected with the observation that competition among off-shore centers may show an interesting peculiarity. Generally speaking, emerging as the absolute winner in competition entails a significant success. The resulting monopolist will enjoy supracompetitive profits. This is also true of most instances of competition among jurisdictions. Delaware, for example, detains a consolidated leadership in the market for corporate charters. From this position it derives significant benefits. Competition in the market for money laundering financial services seems to be rather different. The hypothetical off-shore center that emerges as the only supplier in that market may suffer serious consequences for its success. In the very short run, it can enjoy monopoly profits from this situation. Alas for such country, however, when one is the supplier of criminal financial services, countermeasures can be rather easily devised. For example, a sort of "reverse ring fencing" can be easily put in place, banning contacts between entities based in such country and intermediaries abroad. If we can borrow an expression from auction theory, a winner's curse materializes: Complete success in the competition is self-destroying.

The perverse nature of competition among off-shore centers determines an unusual result. Just like there are instances in which a monopoly does not necessarily harm consumers, as in the case of network industries where it is benefits for consumers that push the system towards a monopoly,[26] there are instances in which competition may not generate benefits for consumers. Countries that supply money laundering services share a mixed incentive structure. While they obviously gain from competing successfully, they may also desire not to remain the only supplier of those services. Each off-shore center derives benefits from not being the only supplier of criminal financial services. First, a group of suppliers can more easily than a single one try to mingle with the off-shore centers that are in the market for "ordinary" financial services. Second, money laundering schemes are more effective when capitals flow through many jurisdictions: Multiplying the number of transactions and of jurisdictions involved generates several positive effects. By definition, more transactions imply a longer trace to be reconstructed by law enforcement authorities; at the same time, more jurisdictions involved imply more authorities involved and more frictions deriving from the difficulty in coordinating the response.

This observation may shed some light on a possible strategy for the international response, especially when read in conjunction with the above mentioned observation concerning the cautious approach deemed necessary in tampering with reputation. A strategy that focuses the attention on the leading group of suppliers of money laundering services, clearly identified, seems wiser than a strategy that aims at identifying *all* countries involved, without consideration of the relative weight of the countries in the market. On the one hand, this strategy might imply a lower risk of false positives, thus reducing the costs associated with listing, as identified above. At the same time, a strategy that allows to skim off the countries that pose the most serious threat, against which appropriate countermeasures should be taken, presses criminal organizations to redirect their capitals towards less efficient markets, thus increasing the likelihood of detection by law enforcement authorities.

[26] See PORTOLANO, (1999) PARDOLESI and RENDA. (2000)