# 1. INTRODUCTION

On May 2002, the OECD Council at Ministerial Level, stated that:

"The scope for financial crime has widened with the expansion and increased integration of financial markets. Money laundering, terrorism financing and tax crime have all changed in both nature and dimension. Today the potential for financial abuse can threaten the strategic, political and economic interest of sovereign states. Widespread financial abuse undermines the integrity of the international financial system and raises new challenges for policymakers, financial supervisors and enforcement agencies. In certain jurisdictions such abuse may go so far as to undermine the democratic basis of government itself." And then:

"Poorly regulated financial markets not only open up new opportunities for financial crimes but also threaten the stability of the international financial system. As new technologies reduce the importance of physical proximity to major on -shore financial centres, so a new generation of Offshore Financial Centres (OFCs) have emerged. Remote jurisdictions bereft of natural resources and too isolated to benefit significantly from the global economy have established OFCs characterised by strict bank secrecy, criminal penalties for disclosure of client information and a policy or practice of non-co-operation with regulatory, supervisory and law enforcement agencies of other countries. This new generation of OFCs has succeeded in attracting brass plate banks, anonymous financial companies and asset protection trusts".

Do be precise, offshore banking is a generic term that is applied to a variety of financial centres, offering a wide range of services to their customers in a loose regulatory, supervisory, accounting and tax environment. In the most general sense this term should also apply to activities such as trust business, financing vehicles and other corporate vehicles. It is common for these centres to benefit from bank secrecy laws. Offshore banking centres (OFCs) have been used for decades by corporate entities to reduce their tax burden through complex tax planning strategies and by individuals for tax avoidance and evasion. Similarly many of these same centres could be utilised for money laundering.

Therefore, in order to analyse the relationship between the terrorist and organised crime finance, on one side, and the design of financial regulation, on the other side, we prefer to introduce the definition of Lax Financial Regulation (LFR) countries. An LFR country is a jurisdiction in which the features of the financial regulation increase the probability to offer money laundering services, utilised by the terrorist and criminal organisation[1].

The role of LFR countries in international money laundering schemes has long attracted the attention of policy makers. Virtually all initiatives aimed at combating money laundering, both at the domestic and international level, tackle the issue. In the aftermath of "September 11th," growing attention has been paid to the role of LFR countries in ensuring terrorist financing, adding new perspectives to the debate concerning the initiatives to be taken against such countries.

As a matter of fact, as correctly it has been pointed out[2], the first official reaction against terrorism after the September 11 attacks was a financial one: not two weeks has passed since

[1] It's important to stress - as Rider (2002) noted - that the laundering process is determined by the need of those agents and organisations seeking to hide or to be disassociated from the wealth, there are important differences between terrorists and conventional criminal organisations.

[2] Wasserman (2002)

the attack when President Bush signed an executive order freezing the U.S. asset of suspect organisations and individuals[3].

Policy makers concentrate their attention on the qualitative [4] and quantitative[5] negative effects of money laundering and on the possibility that LFR centres might facilitate the task of terrorist and criminal organisations. Concerns are raised by regulation adopted in LFR centres, that may greatly contribute to launder money of illicit origins.

Two intertwined postulates commonly feature in the debate concerning the international market for money laundering services: a) money laundering is facilitated by lax financial regulation; b) countries that do not co-operate in the international effort aimed at combating money laundering adopt lax financial regulation. The ensuing observation is that non-co-operative countries contribute to the functioning of the international market for money laundering, and therefore to the world social and economic pollution due to terrorism and organised crime.

The Financial Action Task Force (FATF) for the prevention of money laundering, has endeavoured in an initiative aimed at identifying countries that do not co-operate in the global fight against money laundering. Since 2000, the FATF has monitored 45 countries, that, following our definition, can be identified as potential LFR countries. Using a world-wide data set on the main 130 countries - the United Nation member countries are 189 - we can highlight that this 45 countries represent the 8%, respect to the total GDP, the 15%, respect to the overall population, the 25%, respect to the world foreign bank deposits. And, as OECD pointed out, other LFR countries can exist or emerge.

The FATF produces periodic reports on non-co-operative countries and territories (NCCTs) in an international effort to combat money laundering, commonly – if somewhat incorrectly – described as Black-lists. Since June 2000 five NCCT's lists have been published (June 2000, June 2001, September 2001, February 2002, July 2002) indicating the jurisdictions that fail to conform to the criteria.[6]

Therefore, the issues related to the link between black finance and lax financial regulation seem to be qualitatively and quantitatively relevant.

Discussions concerning these issues, however, take often as a *given* the existence of some countries that offer financial services to terrorism and organised crime, via the adoption of Lax Financial Regulation. In other words, the supply of money laundering services is treated as an *exogenous variable*.

This paper builds on previous work by the same authors,[7] taking a different perspective. We start from the assumption that financial regulation may be a strategic variable for countries that aim at maximising revenues produced by money laundering. A country may find profitable the adoption of a of a financial regulation that attracts capitals of illicit origins or destination We argue that LFR countries are structurally different from other countries. More specifically, we will argue that:

[3] On the US new legislation on money laundering see BANOUN, CEPHAS and FRUCHTMAN (2002), and RIDER (2002)

[4] Policy makers are mainly concerned with two sources of costs stemming from money laundering. Firstly, the possibility of laundering proceeds of crime affects the incentive of a potential criminal. In a world where money of illicit origins cannot be laundered the possibility of linking the capital to the crime reduces the *ex ante* incentive of the criminal to commit the crime in the first place. At the margin, more crimes will be committed if money laundering is possible. From this perspective, combating money laundering is equal, in the aggregate, to combating predicate offences. Secondly, capitals that are laundered return to the legal financial sector generating serious negative effects: Competition is distorted; the allocative efficiency of the market is undermined.

[5] The size of money laundering flows is unknown by definition. The IMF (1998) estimated the laundered funds as 2-5% of global GDP.

[6] See paragraph 7.

[7] Masciandaro and Portolano (2001)

1. the utility function of countries that favour money laundering is positively correlated to the existence of terrorism or criminal activities abroad;
2. the utility function of such countries is not influenced by the negative effects of such illegal activity, i.e., they do not bear the negative consequences of the terrorist and criminal activity.

Our view is that there may be features of a given country that will naturally support the decision to adopt financial regulation that may in fact facilitate money laundering. In so doing, we take a relational approach, on the assumption that it takes two to tango: we treat regulation that can affect the ease with which money of dirty origins is laundered as a product. Within this framework, we focus on the relationship that is established between a given off-shore country and its customers, i.e. terrorist and/or criminal organisations.

We are less concerned with the main product offered by LFC countries to potential launders (i.e., for example, a strict banking regime) and more concerned with the features of the LFR country that help to support the exchange between that jurisdictions, on one side, and terrorist and criminal organisations, on the other side.

These features may be of various nature. Particular attention will be paid, however, to the economic and institutional environment, generally defined.[8] We look for features in the legal system as well as for specific rules that help to sustain the relation that LFR countries and terrorist or criminal organisations establish, thus determining the ultimate success of some LFR centres over others.

Looking at the determinants of success in the competition among LFR countries, it is hoped, will help identify which countries are likely to be involved in money laundering. Grasping the factors that determine the success of some countries in the race to the bottom might also prove useful for policy makers in devising the most appropriate countermeasures.[9]

In examining the factors that may put a given country in an advantageous position over other countries we take an evolutionist perspective.[10] These factors need not necessarily be the result of a "conscious" choice of the country. Rather, they need to prove useful in the competition with other countries. The competitive advantage of a country might also be ascribed to the accidents of history, to geographical factors, or even to sheer chance. For example, the language spoken in the country might obviously play a role in the choice made by criminal or terrorist organisations. An evolutionist approach implies that while we expect a great degree of functional convergence, different countries may choose different strategies to the same end.

In discussing the possibility that some countries may act in order to maximise profits stemming from money laundering, we make a simplifying assumption, in that we treat single LFR country as a unitary decision agent. The assumption, albeit naïve, is coherent with the goal of the paper, that is to say, an evaluation of the dynamics of competition among jurisdictions, via the identification of "typical" features of LFR countries.[11]

[8] For example, as defined in NORTH, (1990) institutions include both formal and explicit rules and less formal rules such as norms.

[9] Our attention focuses on countries that try to attract proceeds of crime through the offer of financial services to criminal organisations abroad. We leave aside the broader question of the possible role of off-shore centres in generating and facilitating international financial crises. The latter issue has obviously attracted the attention of policy makers. This interest has also been spurred by the ever increasing integration of financial markets, which has increased the threat to financial stability posed by off-shore centres. See ERRICO and MUSALEM, (1999) FINANCIAL STABILITY FORUM. (2000)

[10] As defined in ALCHIAN, (1950) and BECKER. (1962)

[11] However, we will sometimes try to shed some light on the black box, in order to look at the possible role of interest groups within the off-shore center. Further research may try to write a thorough "public choice" history of the confrontation that we expect to take place in the political arena within each off-shore country

Finally, some remarks on our interdisciplinary methodology. On the economic literature point of view, we clearly follow the classic intuitions of the new political economy, basing our work on the three hyphoteses: the definition of the regulation policy is not exogenous, as in the conventional economics, but endogenous; that policy is not determined maximising a social welfare function, but taking account the political cost - benefit analysis[12]; the policymaker optimisation is constrained and influenced by the institutional design[13] .

We are also indebted toward a strand of literature – usually associated with the "law and economics" movement – that we deem to be strictly, although indirectly, related to the subject matter of our research, i.e. the literature on the competition for corporate charters among the American States that compose the Union. More specifically, we apply in a novel area the approach developed by authors that have tackled the issue in the "transaction cost economics" tradition[14].

The importance of institutions is the common element of both our economic and law references. Therefore it is quite natural to acknowledge the suggestions of the recent Law, Endowments and Finance literature[15]. In fact the importance of the institutional determinants of different national financial structures originates two different body of works: the law and finance theory[16], more focused on the legal traditions, and the endowment theory[17], more concentrated on the geography/disease endowments. In our work we try to consider both the tradition and natural endowments in determining the degree of laxity.

The paper proceeds as follows. In the first part (paragraphs 2-4) we explore, from the more general point of view, the possible determinants of success of a given LFR country in the market for money laundering. In other words, we try to examine the conditions under which becoming a LFR country can be "convenient" for a given country: what are the geographical, institutional, and economic features that increase the probability that a given country become an LFR country?

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12 For the new political economy see DRAZEN (2000) and PERSSON and TABELLINI (2000).

13 See for example, GRILLI, MASCIANDARO and TABELLINI (1991).

14 See ROMANO, (1985), (1993). (1999). To be sure, the situation we examine is not directly comparable with the one examined by American corporate law scholars. The most obvious difference is that competition among the fifty American states takes place under the eye of Federal authorities, namely the Federal Government and the Supreme Court. Especially the latter has shown remarkable attention to the need to reduce the externalities produced by the states. On the other hand the results of a lively debate - dating almost 30 years – allow us to grab fundamental insights even in the context we deal with. The results of such a strand of literature help to develop a theoretical framework of analysis whose application to the subject with which we are concerned appears promising. The circumstance that competition among states takes place in completely different environments – be it the United States, the European Union, or the international market for money laundering services – does not obliterate the idea that competition is likely to respond to the same logic.

Indeed, what started out in the mid 1970s as a purely theoretical debate, evolved over the years into a feast of empirical studies. Measuring the impact of competition on the value of listed companies allows testing the validity of the theoretical conclusions. Despite the sometimes mixed evidence, that literature has gained a solid hold on the dynamics of competition among jurisdictions. More specifically, there appears to be a certain degree of consensus on when and why competition will evolve into a race to the bottom or to the top. We expect empirical research on competition among off-shore countries to be extremely difficult. Obvious factors predict an almost complete lack of information: Parties to money laundering schemes do not publish reports on the success of their operations. By contrast, listed companies supply a goldmine of data for financial economists to measure the impact of the different actions taken by the actors involved. The precision reached by event or accounting data studies does not appear duplicable in the context of the competition among off-shore centres. We therefore have at our disposal an analytical framework whose reliability has been thoroughly tested on the field.

15 See BECK, DEMIRGUC-KUNT and LEVINE (2002).

16 LA PORTA, LOPEZ-DE-SILANES, SHLEIFER and VISHNY (1998).

17 ACEMOGLU, JOHNSON AND ROBINSON (2001).

The second part of the paper (paragraph 5) provides a formal theoretical analysis and description of the possible dynamics that govern the policy maker decision to design the financial regulation in order to enter the market for money laundering.

In the third part (paragraph 6) we empirically verify whether the theoretical features of a LFR country are consistent with those of the countries in the FATF's analysis of effective and potential NCCTs. The empirical evidence – as we shall see – is consistent with the hypothesis. However, we may be ever consider the possibility of facing both Type I and Type II errors. On the one hand, there may be *de facto* LFR countries that are not included in the FATF analyses; on the other hand, the evidence shows that the NCCTs included in the lists are not entirely homogeneous.

Both observations appear to be important for an overall assessment of the adequacy of the international response, in the conclusive paragraph 7.

## 2. LAX FINANCIAL REGULATION: KEY CONCEPTS

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, and thus to terrorism and organised crime, or it can decide – at the other extreme – to make the opposite choice, devising a lax regulation that facilitates money laundering.

Money laundering generates costs as well as benefits for the parties involved. The costs for society depend on the circumstance that more predicate offences will be committed by terrorist or criminal organisation if money laundering is possible and on the possible negative impact that money laundering will have on the financial system[18]. The benefits of money laundering accrue, first of all, to terrorist and criminal organisations, that can employ the proceeds of crime avoiding the threat of being prosecuted for predicate offences (money laundering *strictu sensu*), or that can use legal capital in order to finance illegal activities (money dirtying).

On the other side of the transaction, money laundering offers to the host country the possibility to earn a "commission" in exchange for its services, what we can call *the expected national benefits* due to lax financial regulation.

Four different categories of actors potentially interested in the regulation can be identified: a) the policy maker; b) terrorist and criminal organisations, deriving utility from the possibility of laundering money; c) those who bear the costs of money laundering; d) the financial community and in general the citizens that received benefits from the inflow of foreign black and grey capitals. Starting with the latter, it does not appear easy to predict which side will the financial community take. In general, 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 (*pecunia non olet*), if we think that they simply maximise the expected revenues, and that, given the asymmetric information issues, they are not able to distinguish clearly the customers' nature, legal or illegal[19] The interests of b-d) and c) are obviously incompatible, as the gains of the former depend on the loss of the latter; a) appears to be caught in the middle, having to decide which demand schedule to follow.

[18] For an economic analysis of money laundering as multiplier of the economic and financial impact of criminal organisations see MASCIANDARO (1999) and (1998).

[19] For an economic analysis of the role of banking and financial intermediaries in the money laundering process see MASCIANDARO (1996) and JOHNSON and LIM (2002).