political agenda. The man on the street simply does not feel the bite of money laundering, and political actors will act consequently.

These hyphoteses - i.e. the role of *expected national benefits* and of *terrorism and crime expected national costs* - will be formalised in the analytical part of the paper and tested in the empirical one.

The above described line of argument will help us in the following paragraphs to shed light on the explanations for the casual observation that LFR countries tend to be small, most often they also tend to be islands. In explaining the determinants of the size of "political units", economic historians have focused on the pressure that are generated by the need to internalise costs associated with economic activities. For example, North and Thomas explained the growth of nation states in the middle age with the need for "political units" that may internalise the costs required to support the expansion of trade.[23]

In the competition among "political units", only those that were able to grow were able to exploit the opportunities from the expansion of trade. A converse effect appear to be at work when we come to LFR countries. The need to externalise costs associated with money laundering generates pressures that tend to select countries that are better equipped for the job, countries that may keep organised crime or terrorism – and the costs associated to it – outside of the country.

3. OPPORTUNISM , COMMITMENT AND REPUTATION: LAX FINANCIAL REGULATION AS CONTRACTUAL DEVISE

The paragraph above shows that some countries will be able to externalise the costs associated with lax financial regulations, thus being in an advantageous position *vis-à-vis* their competitors in the supply of money laundering services. This advantage, however, does not resolve all problems faced by a potential LFR country.

A closer look at the exchange reveals the problems that need to be solved by both parties. For sake of simplicity, we will juxtapose two parties, Criminal (or Terrorist) and LFR country. Consider a single money laundering operation: It is not a simultaneous game. Parties do not exchange at arm's length a service for a price or a good for a price. It is rather a game in which one party moves first and the other one moves second. That is to say, Criminal or Terrorist has to move first, deciding whether to put his assets into the hands of LFR country or not. Criminal (Terrorist) is, therefore, a particularly vulnerable consumers of LFR country's products. Assume that Criminal (Terrorist) decides to move. Once the capitals are in the domain of LFR country, the latter moves. The agreement is to the effect that the LFR country will launder the assets, keep a commission for this services, and then return the laundered assets to Criminal (Terrorist). By so doing, LFR country will earn the commission, a fraction of the overall amount of the assets. LFR country, however, may choose another strategy. It can decide not to co-operate and rather to appropriate the assets. By definition, this strategy implies that the pay off to LFR country will be bigger than if it decided to co-operate.[24] In game theoretical jargon, the strategy of non co-operation is a strictly dominant strategy: LFR country will always decide to appropriate.[25]

There is, in short, the threat of *ex post* opportunistic switches by LFR countries. In the context of the relation among LFR countries and illegal organisations, appropriation might take

[23] "The countries that altered their fundamental institutional arrangements to exploit these opportunities grew, but it was not inevitable that this would occur. For as trade was expanding a need was created for larger political units to define, protect, and enforce property rights over greater areas (thus internalizing some of the costs of long-distance commerce)", North and Thomas, 1973, at 94.

[24] That is to say that the pay-off to Off-shore will be represented by the *whole* amount of the assets and not by a mere commission.

[25] For a classical account of an *ex post* opportunistic breach by a state see GRANDY. (1989)

several forms, running the full gamut from outright taking to merely not responding to the need of keeping financial regulation up to date.

The threat of opportunistic behaviour feeds back into the incentive structure of Criminal (Terrorist). *Ex ante* the exchange, Criminal (Terrorist) perceives the possibility that LFR country will appropriate the assets; this result unravels thus implying that Criminal (Terrorist) will not put the assets in the hands of LFR country in the first place, in order to avoid a sure loss. The threat of *ex post* opportunistic behaviour by LFR country translates into the lack of any exchange.

Note that this is a negative result for both parties to the (potential) exchange. Had they been able to co-operate and to realise the exchange they would have both gained, Criminal (Terrorist) from the laundering of the proceeds, and LFR country from the price charged for the service. Despite the potential for a mutually beneficial exchange, the non-simultaneous nature of the game will result in a Pareto move non being made. Unless Criminal (Terrorist) will be assured that LFR country will not behave opportunistically, the exchange will not take place. In other words, the problem is one of transforming a non-co-operative game into a co-operative one.

The problem is exacerbated by the environment in which the relation between Criminal (Terrorist) and LFR country takes place. As it is well known,[26] the existence of a state providing an efficient contract law and an efficient enforcement system might manage to help the party to co-operate. LFR country and Criminal (Terrorist), however, bargain in the absence of a superior authority that might perform such function. The threat of opportunistic behaviour is further exacerbated by the circumstance that one of the parties, i.e. LFR country, plays also the role of the enforcer.

But this is not the end of the story. To be sure, Criminal (Terrorist) perceives the threat of *ex post* opportunistic behaviour by LFR country and will act consequently, but also LFR country perceives that Criminal (Terrorist) will not accept the exchange. Solving the problem is in the interest of both parties: In the absence of a superior authority this becomes the province of endogenous mechanisms of governance.[27] More specifically, the parties will have two different but interrelated lines of action, that are capable of transforming a non-co-operative game into a co-operative one.

On the one hand, a non-co-operative game may become a co-operative game if repeated over time.[28] We expect LFR country and Criminal (Terrorist) to develop a relational contract, a relation between parties that lasts over a long period of time.[29] Rather than playing single money laundering games with different counterparts, parties will have an incentive to play repeatedly with the same opponent. From this point of view, *the regulation adopted by LFR country can be regarded as the contractual devise* which will govern the relationship as events unfold.[30] This is the main reason why in our view, in order to analyse the optimal policy against terrorism finance and organised crime finance we have to concentrate our attention on the regulation architecture.

The second and interrelated line of action aims at reinforcing the relationship. If the main difficulty for LFR country is gaining Criminal's (Terrorist's) confidence that it will not renege on the agreement, then the issue becomes one of devising a credible commitment not to behave

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[26] See, for example, COOTER et al. (1999)
[27] WILLIAMSON, (1985). (1996)
[28] This is only true, however, leaving aside end game problems, i.e. problems that arise when it comes the last period and the parties know that they will not play together anymore. See AXELROD. (1984)
[29] The literature on relational contracting is immense; leading contributions are WILLIAMSON, (1979), (1985); (1996) MACNEIL. (1978)
[30] Of course, bounded rationality implies that this contract cannot be complete, i.e. it cannot foresee all contingencies. As we shall see in the next paragraph, this limitation has fundamental consequences for the governance of the relationship, mandating the adoption of some form of *ex post* governance structure.

opportunistically. The competition for attracting the black capital will be won by countries that will be able to credibly resolve the commitment problem.

On its face, this observation explains why do not expect to find "corrupted" or "criminal" countries on the supply side of the market for illegal financial services. A Banana Republic, for example, would face immense difficulties in making a credible commitment not to switch course in the middle of the contract. The mere threat that a *coup d'état* may at any moment overthrow the current regime makes the commitment not credible. Successful states will tend to show a stable political situation.

Extreme cases of political instability aside, however, the way LFR country can commit not to behave opportunistically *ex post* the exchange depends on its ability to invest in what Williamson terms "transaction specific assets."[31]. Transaction specific assets cannot profitably be redeployed outside the original relation. Once a party has invested in such assets, therefore, it has an incentive to continue the relationship, lest it will lose the value of the investment. In other words, LFR country will need to post a hostage,[32] i.e. an asset whose value will be lost in case the relationship breaks down due to an opportunistic switch by the LFR country itself.

The most obvious hostage, commonly used in such settings, is reputation. Reputation is often of one and only one use, thus making investments in such asset sunk. While asset specificity is a common feature of reputation, reputation for offering efficient money laundering services, free from the risk of *ex post* opportunistic behaviour, appears to show an extreme degree of asset specificity. Such reputation requires an intricate set of rules and mechanisms. More specifically, regulation of the financial sector will need to be tuned to reach this goal: The rules concerning banking secrecy, incorporation of business entities, co-operation with supervisory authorities abroad, the duties to report suspicious transactions, to identify and register customers, all these rules will need to be shaped according to the goal of providing an efficient money laundering service.[33] Investments need to be made in order to gain a reputation for providing such an efficient service.

Paradoxically, the value of these investments in the closest use is probably negative, rather than being merely zero or little more. A country that has chosen to invest into the financial technology necessary to build a solid reputation as a supplier of first class money laundering services will experience serious difficulties in converting such investments into the next best use. Potential partners of the financial sector situated abroad may be rather sceptical about the credibility of the change in strategy by the LFR country. Should these LFR countries decide to switch course and convert their financial system to lawful uses, they may well start from a negative point rather than merely from zero. Investments will be needed in order to nullify the reputation as a supplier of criminal financial services; once this goal is reached, further investments will be required in order to build from scratch a new reputation, as a supplier of lawful financial services. On this point of view, in the theoretical section we have to investigate the role of such *international reputation expected costs.*

So far we have examined reputation as a pre-committing device. LFR country however, may use another means to the same results. LFR countries tend to rely on income generated by their financial activity; therefore a change in the policy would be extremely costly for them. This is so because they would experience a severe damage to their level of income.

This observation helps to explain why we can image to find among LFR countries that experience a low level of income and a high dependence from the financial industry revenues: they need to continuously offer financial services to criminal and terrorist organisations because they

[31] WILLIAMSON, (1985). (1996)

[32] WILLIAMSON. (1983)

[33] Of course for some of the subjects mentioned in the text the efficient rule, from the reputational point of view, will be simply no rule, as it is the case with duties to report suspicious transaction reports.

want to preserve their level of income or maybe increase it. Furthermore, dependence on income generated by money laundering is yet another committing device.[34] A country whose level of income is dependent on the supply of illegal financial services will be committed to offer those services. Such a country might need to fight vigorously in order to preserve its level of income. Countermeasures taken by the international community may urge it to aggressively defend its position. Compare this case with the one of a country whose level of income stems from several sources. The loss generated by the repeal of a policy that attracts capitals of illicit origins will be equal to a fraction of the overall income generated by the state. The incidence of the loss is thus, by definition, less severe.

Dependence on revenues - i.e. the level of *expected national benefits* - produced by money laundering makes an LFR country a hostage to its own success. In turn, this hostage-like dependence reinforces the bilateral relationship between criminal and terrorist organisations and LFR countries. The former is exposed to the threat of opportunistic behaviour, but the second is exposed to the risk of losing reputation and revenues should it behave opportunistically. Both parties gain from preserving their relationship.

4. LAX FINANCIAL REGULATION AND INSTITUTIONS

Some natural features of certain countries appear to be capable of putting them in an advantageous position in comparison with other countries. The reference to the "natural" character of such features should be intended to imply that they are not only the result of a specific choice of the LFR country. It is rather the other way around. These features are sometimes the result of the accidents of history; in some cases they have even been imposed on the LFR country. Take the adoption of a given legal system, which is virtually always the result of the colonisation of the country by another country that adopted that system. The "natural" features of a winning LFR country will show a sort of "macro" aspect: A low crime rate, the lack of natural resources, the adoption of a common law regime, for example.[35]

However, once these features have put the specific LFR country down the path of competition with other LFR centres, a demand will arise for institutions that help the LFR country to compete more vigorously. Competitive pressure will urge the adoption of tools that prove useful in the struggle for survival. Starting from the initial positions, a process of refinement through the adoption of newer institutions seems likely. As this process unravels, "micro" institutional devices will be put in place. Interest groups inside the FLR centre will lobby for complementary institutions that increase the value of the existing ones. The institutional environment inside the LFR country will thus be driven, domino-like, by a chain of linked complementary institutions,[36] that will add to the survival value of the overall package.

The task of newer institutions appears to be twofold. First, they need to contribute to the overall efficiency of the regulation offered to customers of the off-shore. For example, a strict banking secrecy regime, or rules that protects the anonymity of beneficial owners of accounts.

[34] ROMANO, (1993) interprets Delaware's dependence on income generated by franchise taxes as a pre-committing device.

[35] Of course the distinction between "macro" and "micro" institutional devices should not be regarded as one of "quality" but rather of "quantity," and we use it for mere sake of exposition. With the former we refer to more general and profound institutional features, that tend to characterize a given country with respect to another. By "micro" institutional devices, by contrast, we mean rules that have a more detailed character.

[36] The observations in the text are based on GILSON. (2000)