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.

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[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)

Far more interesting for the subject of this paper appears to be, however, the second function of these "micro" institutional devices: Over time, institutional devices that buttress the commitment by the LFR centre are likely to materialise.

How will these pre-committing devices look like? Anything that limits the ability of the LFR country to renege on the agreement with the criminal organisations will do the job. The process of differential survival will select the solutions that serve the pre-committing function. While we expect to observe functional convergence, we also expect to observe a diversity within these devices, whose spectrum is likely to range from a formal and explicit set of rules, for example constitutional rules, to mere norms.

The most obvious example is a supermajority requirement for the repeal of certain pieces of legislation. A rule that states that banking secrecy regulation can be repealed only upon the vote of, say, two thirds of the legislative body makes it more difficult for the LFR country to switch course after Criminal or Terrorism has moved.[37] A second device could be a provision to the effect that repeal or modification of a given piece of regulation requires prior approval by organisations representing interests that benefit from regulation sympathetic to money laundering.

For example, the need to obtain the consensus of the bankers' association or the bar will make it more difficult for LFR country to renege on the agreement. Financial institutions, lawyers, and any other group that makes a business out of the supply of financial services within an international money laundering scheme will fiercely lobby against any initiative that undermines the credibility of the commitment. Even a mere customary norm that requires consultations with the interest groups involved will do, as long as it increases for LFR country the costs of changing course of action and behaving opportunistically.

To be sure, none of these devices is, in itself, a showstopper. Any rule that aims at making the procedure more cumbersome might be repealed thus allowing for the subsequent repeal of the pro-money laundering rule. Take a procedural rule that requires consultations to be held before any modification of rules concerning the financial system may be approved. In anticipation that the financial sector will oppose a change in the regulation that would imply an opportunistic switch, the legislative might first vote to repeal the procedural requirement, and then move on to approve the modification of the regulation. Yet, such a procedure is on its face cumbersome itself. The rule still reaches the goal of increasing the costs of an *ex post* opportunistic switch, thus helping to fortify the credibility of the commitment.

A last remark: the contractual relation between LFC countries and Criminal or Terrorist is governed, in the first place by the regulation put in place by LFR country. In a world of bounded rationality, however, contracts are hopelessly incomplete. The implicit contract stipulated by LFC country and Criminal or Terrorist is no exception. The regulation cannot specify *ex ante* all future contingencies. Gaps in contracts are always inescapable, but in the setting we are concerned with the problem appears to be exacerbated by the possibility that one party to the exchange might not reveal all relevant information to the other. The illicit nature of the capitals involved appears to create an incentive for Criminal (Terrorist) to hide some information to LFR country. In fact, there may well be instances in which Terrorist or Criminal will have a clear incentive to disclose false information to LFR country. Beyond the ordinary incompleteness deriving from the costs necessary to write contract clauses,[38] there is an increased risk that the contract will suffer from "strategic incompleteness."[39]

[37] See ROMANO (1993), for the description of a similar provision in Delaware.
[38] On which see WILLIAMSON. (1985)
[39] Strategic incompleteness is explored in AYRES and GARTNER. (1989)

Be it the result of transaction costs or of strategic behaviour, less information translates into more gaps in the contract. The need arises for gap filling devices that allow the party to work out contingencies that were not provided for at the outset.

A country that will be able to offer gap filling devices of superior quality will be in an advantageous position. This shifts the focus of attention towards those features of the legal system that come under severe pressure when it comes to the *ex post* governance of unspecified contingencies.

We focus on one specific feature that supports the exchange, i.e. the judicial system. The regulation adopted by LFR country fills gaps *ex ante*, up to the point where the marginal cost and benefit of an added rule are equalised. Remaining gaps will be filled, *ex post*, by judges. To be sure, the probabilities that a given dispute between illegal organisations and their counterpart inside the LFR centre will go to court might appear low, and indeed it seems reasonable to assume so. At the same time, however, the huge amounts of capitals at stake implies that even with a low probability of a dispute actually going to court, an efficient judiciary might still entail for the parties a high present value. An efficient judiciary works as a last resort mechanism, capable of generating positive externalities on ongoing relations, regardless of whether they actually go to court.

Keeping the quality of regulation constant, therefore, the package that will include the most efficient judicial system will tend to prevail in the competition.

The importance of the judicial power in ensuring the success of an LFR country appears underscored also from a different perspective. The need to fill gaps *ex post* does not necessarily imply that the gap filling function *has* to be entrusted to judges. At a purely theoretical level, LFR countries could chose to allocate the gap filling function in the same decisional center responsible for the adoption of the regulation. This solution would probably be infeasible for very practical reasons. When the decision making agent that has written the regulation in the first place is a collective body, say a parliament, entrusting in it the gap filling function would be very impractical.[40] But assume *arguendo* that the *ex ante* and *ex post* gap filling functions are joined. Problems of opportunism aside, this might imply greater familiarity with the issues involved and therefore a higher probability that gaps will be filled in a way consistent with the interest of both parties. By contrast, this advantage is partially lost if the function to decide *ex post* what the parties involved would have wanted is shifted to a third party.

Putting the threat of opportunistic behaviour back in the picture, however, reveals another advantage of an efficient judiciary. An increased role of judges in filling gaps can also be thought of as one more tool in the "pre-committing" package that a country offers to potential customers. Assigning the task to fill the gaps in the incomplete contract to a judge might also serve another function: *À la* Madison,[41] fragmenting the powers among many decision making agents helps to ensure that none of them will be able to abuse those powers. An opportunistic switch by the legislative body is likely to require validation by the judiciary. The country that strictly separates the *ex ante* from the *ex post* gap filling function will make its commitment more credible.[42]

[40] Every dispute should be examined by a structure whose decision making costs are high, especially if compared with those borne by a single decision making agent, say a judge. The latter can ensure a much higher speed of response, thus being able to handle more issues than the former. Quite obviously, the mere circumstance that in the real world the task to resolve disputes *ex post* the exchange is indeed entrusted in third parties shows that different solutions would be impracticable.

[41] See the famous *The Federalist n. 10*, MADISON. (1787)

[42] This observation obviously paves the way for questions concerning the procedures with which judges are appointed and the possible effects of the procedure on the incentive structure of the judge. For example, life tenure is likely to produce different results from a three year term with the possibility of being appointed again.