COMBATING BLACK MONEY:
MONEY LAUNDERING AND TERRORISM FINANCE, INTERNATIONAL COOPERATION AND THE G8 ROLE

1. Introduction

In the aftermath of September 11th, growing attention has been paid to the role of Non-Cooperative Countries and Territories (NCCT) in money laundering and terrorist financing[1]. Policymakers concentrate their attention on the possibility that NCCT jurisdictions might facilitate the task of terrorists as well as criminal organizations (*black money*). Since 1989 the G7/G8 countries expressed the general commitment to define a strategy to combat black money (Table 1); on October 2001 the G7 Finance Ministers explicitly stressed the urgency to develop a process to identify jurisdictions that facilitate black money and to make recommendations for actions to achieve cooperation from such countries.
Two interacting principles commonly feature in the debate on the relationship between money laundering and NCCTs: a) money laundering is facilitated by lax financial regulation[2]; b) countries adopting lax financial regulation do not co-operate in the international effort aimed at combating money laundering[3]. These two principles characterized the mandate of the Financial Action Task Force (FATF)[4] for the prevention of money laundering. On the one hand, to address the

[1] As Norgren (2004) noted, money laundering is defined as the processing of criminal proceeds to disguise their illegal origin in order to legitimize the gains of crime, while terrorist finance can be characterised as the direct or indirect provision of funds—illegal or legal—with the intention that they should used in terrorist acts. But the techniques are quite similar, or at least overlapping. On similarities and differences between money laundering and terrorism finance (or money dirtying) see Annex I and von Furstenberg 2004; see also Rider (2003), Masciandaro (2004). On the key role of the US legislation in promoting the international financial war against terrorism see Wasserman (2002), Banoun, Cephas and Fruchtman (2002), Preston (2003), Van Cleef (2003); see also Davis (2003).

[2] On the relationship between money laundering and lax financial regulation see Annex II.

[3] See International Monetary Fund (1998), Holder (2003).

[4] The Financial Action Task Force on Money Laundering (FATF) is an inter-governmental organization that seeks to develop and promote policies at both national and international

problems associated with money laundering risks it is fundamental to develop legal standards for rules and regulations. The FAFT standards (Recommendations) became the benchmark for measuring the degree of laxity of financial regulation in every country setting. On the other hand, to monitor the compliance of countries with international standards, the FAFT used a list of specific criteria—consistent with the standards—to determine the NCCT jurisdictions[5].

The FAFT produces periodic reports on the NCCTs, commonly described as blacklists. From June 2000 to February 2004, nine NCCT lists have been published; the FATF has monitored a total of 45 countries, selected for their potential regulation weakness. Using a worldwide data set on the main 130 countries, we can highlight that these 45 countries represent 8% of total GDP, 15% of total population population, and 25% of foreign bank deposits in the world. Obviously these figures understate the overall relevance of the problem, given the relationships between the non-cooperative attitude, on the one hand, and the global economic and social costs due to the growth of the money laundering risks, on the other[6].

Therefore the blacklist instrument represents the cornerstone of the international effort to reduce the risks that single countries or territories became havens for money laundering activities. But is this institutional device effective?

It has been argued[7] that the overall result of the blacklisting mechanism is positive, since transparency regarding which countries do not comply has important effects in the financial markets, increasing the market pressures on the NCCT countries. But why is it, then, that various jurisdictions, notwithstanding the blacklist threat, delay or fail to change their rules, confirming their non-cooperative attitude (*reluctant friend effect*)? Furthermore, it is true that most jurisdictions placed on the black list have enacted regulatory measures in an effort to be

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levels to combat money laundering. The FATF was established following the G7 Summit held in Paris in 1989. G7 members are: Canada, France, Germany, Italy, Japan, the United Kingdom (UK) and the United States (US). Initially, the FATF was convened from the G7 member States, The European Commission (EC) and eight other countries, but it now has a membership of 29 jurisdictions, with the EC and the Gulf Cooperation Council as international member organizations. The 29 member jurisdictions are: Argentina, Australia, Austria, Belgium, Brazil, Canada, Denmark, Finland, France, Germany, Greece, Hong Kong, Iceland, Ireland, Italy, Japan, Luxembourg, Mexico, Netherlands, New Zealand, Norway, Portugal, Singapore, Spain, Sweden, Switzerland, Turkey, the United Kingdom (UK) and the United States (US). The FATF has a small Secretariat that is housed in the headquarters of the OECD in Paris, but the FATF is a separate international body and not part of the OECD. See also Alexander (2001).

[5] On differences and similarities between NCCT jurisdictions and offshore centres see Mitchell (2003), Alworth and Masciandaro (2004); on the offshore centres issues see also Errico and Musalem (1999), Hampton and Christensen (2002), Masciandaro (2004).

[6] On the qualitative and quantitative aspects of money laundering see Tanzi (2000).

[7] Norgren (2004). An economic analysis on the FAFT effects is performed by Johnson and Lim (2002). On the first different country reactions to the blacklisting process see Johnson (2001a) and (2001b).

removed from it. But is regulatory reform sufficient to prove that a country has really changed its non-cooperative attitude (*false friend effect*)?

Perhaps the key problem is that discussions on these often take as a *given* that some countries offer financial services to terrorism and organized crime by adopting lax financial regulations. In other words, lax financial regulation is treated as an *independent variable*. Therefore, any regulatory reform consistent with the international standards is sufficient to prove that the country is attempting to become a cooperative jurisdiction, while it fails to explain why specific countries continue in their non-cooperative attitude, notwithstanding the blacklist stigma.

This paper takes a different perspective. We develop the assumption that lax financial regulation may be a *strategic dependent variable* for national policymakers seeking to maximize the net benefits produced by any public policy choice. Therefore, given the structural features and endowments of their own countries, policymakers may it find profitable to adopt financial regulations that attract capital of illicit origin (money laundering services) or destination (terrorism finance services), therefore choosing to be a NCCT jurisdiction.

From a methodological point of view, we follow the classic intuitions of the new political economy, basing our work on three hypotheses: 1) the definition of regulatory policy is not independent, as in the conventional economics, but endogenous; 2) policy is not determined by maximizing a social welfare function but by taking into account the political cost-benefit payoff[8]; and 3) policymaker maximization is constrained and influenced by the structural framework, economic as well as institutional. We are also indebted to a strand of literature, usually associated with the 'law and economics' movement, which we deem to be strictly, though indirectly, related to the subject matter of our research, i.e. the literature on the competition in regulation. More specifically, we take the approach developed by authors that have tackled the issue in the "transaction cost economics" tradition[9] and apply it in a novel area.

The paper proceeds as follows. The second section provides a simple model to describe, through the policymaker payoff maximization, the relationships between specific country features and endowments, on the one hand, and lax financial regulations, on the other hand. Given that in the real world relatively lax regulation means a non-cooperative attitude in the international fight against money laundering, in the third section we empirically the above theoretical relationship in the case of the NCCT jurisdictions. The policy consequences on the pros and cons of international blacklisting procedures are discussed in the conclusive fourth section.

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[8] For the new political economy see Drazen, (2000) and Persson and Tabellini, (2000).

[9] See Romano (1985), (1993) and (1999).

Table 1 G7/G8 Terrorism Financing and Money Laundering: Main Steps

1978 - Bonn** Statement **on Air Hijacking: Terrorism enters in G7 Agenda.
1981 - Ottawa Summit: Statement on Terrorism.
1984 - The London Declaration on International Terrorism: It's recognized the international character of the terrorist threat.
1986 - Tokyo Summit: international effort against terrorism and first network of expert.
1989 - Paris Summit: G7 recognizes the need of a financial action task force to fight money laundering.
1989 - FATF is created.
1990 - Huston Summit: G7 countries declare to commit to a full implementation of all FATF's 40 Recommendations.
1995 - Ottawa , Ministerial Declaration on Counter Terrorism: guidelines to fight terrorism, among them "depriving terrorist of funds".
1996 - Paris, Ministerial Conference on Terrorism, Agreement on 25 Measures: among them some measures specifically defined to prevent terrorist fund raising (goals No.19,20 and 21)
1997 - Counterterrorism Directory of Skills and Competencies is created.
1998 - G8 Justice and Interior Ministers Virtual Meeting on Organized Crime and Terrorism Funding: It's underlined international cooperation against money laundering and terrorist funding. French proposal for a UN Convention on terrorist financing.
1999 - Moscow Conference: G8 supports the negotiations on the draft international convention against financing of terrorism
2000 - Okinawa Summit: Action against Abuse of the Global Financing System where a comprehensive strategy against money laundering, tax havens and offshore financial centre is defined. G7 declares, if necessary, prepared itself to implement counter-measures against15 non-cooperative countries identified by FATF.
G7 welcomes the creation of FIUs
2001 - Rome, Fighting the Abuse of the Global Financial System (second report) where G7 monitors the FATF's work.
2001 - (AfterSeptember 11): G8, condemning the terrorist attacks in New York and Washington, declares the need of a comprehensive, international strategy against terrorism and highlights the main role of specific financial measures.
2001 - The FATF's mandate to combat terrorist financing is expanded. G8 will implement UN sanctions to block terrorist assets.
Special Recommendation to fight terrorism financing are issued by FATF and the Action Plan of FATF is defined.
2001 - G7 issues *Action Plan to Combat the financing of Terrorism*. It's highlighted the linkage between terrorism prevention and financial abuses prevention. G7 is implementing UNSCR 1333 and UNSCR 1373. All States are called on to freeze terrorist funds and financial assets.
2001 - IMF issues *Communiqué of the International Monetary and Financial Committee* where some specific measures against terrorist financing are set out.
2002 - Ottawa: Progress Report on Combating the Financing of Terrorism: It's monitored the implementation of the strategy against terrorist financing.
2002 - Many countries have set up a FIU.
2002 - Foreign Ministers' Progress on the Fight against Terrorism
2002 - G8 Recommendations on Counter-Terrorism: a revision of the 25 Measures, adopted in Paris, 1996.

2002-G7 *Combating the Financing of Terrorism: First Year Report:* It's monitored the implementation of the G7 Action Plan (2001).
2003-Evian Summit, Building International Political Will and Capacity to Combat Terrorism: a G8 Action Plan: It's underlined the need of an international cooperation and institutional network to support CTC, FATF and to encourage fulfilling UNSCR 1373 obligations. Creation of Counter-Terrorism Action Group (CTAG).
2004-Washington, Joint Statement on Combating Terrorist Financing

2. Country Endowments, Policymakers and Lax Financial Regulation. A Simple Model

To design the key elements of our approach, we shall use a very simple model, in order to present the economic intuitions in a compact and casual framework. Our goal is to discuss the possible relationships between specific country features, policymaker payoff maximization and lax financial regulation against money laundering, highlighting the key variables of the problem.

Let us assume that a policymaker is aware that a potential demand for money laundering exists on the part of one or more criminal or terrorist organizations[10], for a total amount equal to *W*. We analyze a situation in which the international market for money laundering is demand-driven, as it is likely to be in the real world. Therefore every potential lax regulation jurisdiction is a relatively "small country".

The policymaker can decide to launder an amount of money equal to *Y*, where, of course, $0<Y<W$. For the sake of simplicity in our model, the decision on the optimal level of money laundering services is equivalent to the choice of the optimal degree laxity in financial regulation. Calling *U* the payoff function of the policymaker, it is obvious that the expected payoff from unlaundered liquidity is zero, whatever the amount:

$$U(W-Y)=0 \qquad (1)$$

On the other hand every dollar (or euro?)[11] laundered can have a positive expected value for the policymaker, if his country, given scarce natural resources, derives benefits from offering financial services that facilitate money laundering. In particular, we can intuitively assume that the *lower* the national income and the

[10] For a general microeconomic analysis of the money laundering demand see Masciandaro (1996) and (1998). For the peculiar relationship between money laundering demand and tax evasion see Yaniv (1994) and (1999); see also Alldridge (2001).
[11] For the use of dollar or euro in the black economy, see Boeschoten and Fase (1992), Rogoff (1997), Sinn and Westermann (2001).