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).

Note that we are not assuming that b) and c) are necessarily based *outside* the country where the policy maker we are concerned with is based. This is not an assumption, but rather the consequence of our line of argument. As with all policy issues, as long as the costs and benefits of a decision fall within the boundaries of the area of influence of the policy maker, we expect to have an efficient decision. Policy makers in countries where crime or terrorism is pervasive will tend to bear at least some of the costs associated with a decision to favour money laundering.

Countries where organised crime or terrorism is pervasive could appear to play a minor role in the offer of black or grey financial services at the international level, because they are sensitive to *terrorism and crime expected national costs* This might be so because the widespread presence of organised crime or terrorism in the country increases for the policy maker the costs of a regulation that favors money laundering.[20]

Citizens will bear the costs of the decision and will hold the policy maker responsible. Entering the international market for money laundering services has a greater potential for countries that are immune from terrorist or criminal activities. Such countries will almost by definition be able to externalise the costs associated with the increase of predicate offences.[21] A negative correlation between crime rate or terrorist episodes in the country and the role played in the offer of money laundering services appears likely.

As a result of this process, some countries which do not bear the costs associated with money laundering become predisposed to adopt a lax regulation that facilitates money laundering. The other side of the coin is that both criminal organisations and those who bear the costs stemming from money laundering will "naturally" tend to be situated in countries other than the one where the regulation is adopted.

We have thus limited our attention to policy makers that are based in countries other than the ones in which the other actors potentially interested in the regulation are based. From this starting point, the confrontation between those who benefit from money laundering and those who suffer from money laundering is almost a "win win" game for criminal and terrorist organisations. Organised crime and terrorist experiences huge asymmetrical organisational advantages over those who bear the costs of money laundering. A small and powerful group faces a large and dispersed group, thus making the outcome predictable.[22]

To be sure, money laundering regulation could be opposed, and is indeed opposed, by the political authorities that represent the public interest. The dispersion of the costs, however, makes money laundering a low salience issue for the public, and consequently quite low on the

[20] We are here leaving aside the possibility of corruption or even mere lobbying by groups interested in having a regulation favorable to money laundering. Through corruption, organized crime might be able to urge the adoption of legislation that facilitates money laundering. We believe this possibility to be less important than it may appear at first glance. For reasons that are developed *infra* in paragraph 3, a corrupted state will find it difficult to make a credible commitment not to expropriate the assets of illicit origins.

[21] These countries will still be exposed to the other source of costs above identified, i.e. the distortion of the functioning of the financial market. This source of costs, however, can be controlled through "ring fencing" practices. Off-shore centers might thus try to build a Chinese wall that insulates its financial system from the effects of involvement in money laundering schemes. For example, a regime favorable to money laundering might explicitly or implicitly exclude residents from taking advantage of its benefits. Conversely, "firms" which benefit from a given regime may be explicitly or implicitly prohibited from operating in the domestic market. Both of these provisions would ensure the off-shore center that criminal organizations that aim at benefiting from the regime do not "reside" in the off-shore center. A similar goal is served by multi-tiered licensing systems. Under such a system, an off-shore center offers two rather different licenses to financial intermediaries, a "restricted" and an "unrestricted" license. A typical multi-tiered regime states that restricted licensees may not engage in transactions with residents inside the off-shore center. They may not collect deposits or even make certain investments. Similar restrictions may also apply to the ability of restricted licensees to solicit funds from the general public.
The *raison d'être* of rules of the type described above is easily perceived. They aim at generating externalities, or more precisely, at avoiding the internalization of costs associated with money laundering.

[22] See OLSON, (1965) for a classical exposition of the dynamics of collective action.

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)