

## 2. A COUNTERINTUITIVE STARTING POINT

We start from a simple question. Imagine two hypothetical countries:

1. Country A is characterized by the widespread presence of criminal organizations, that generate huge flows of capitals of illicit origins. Banks and non bank financial institutions are largely under the control of such organizations. Organized crime is capable of corrupting both public officials - including law enforcement officials - and legislators, thus being able to obtain virtually any regulation deemed necessary to support their criminal activities;
2. In country B, by contrast, organized crime and corruption are completely absent. Country B is a solid democracy, whose legislators actively serve the interest of their constituents.

We ask the reader to leave aside for a moment her personal knowledge of real world countries that offer money laundering services. Which of these countries is more likely to supply money laundering services in the international market?

Intuition would appear to point to country A. The possibility of offering money laundering services would imply several advantages for criminal organizations. First, they could diversify their criminal activities, thus generating further sources of income from the commissions charged to foreign criminal organizations. At the same time, by integrating vertically into the downstream money laundering market, criminal organizations could reduce the cost of the laundering of capitals they generated from other criminal activities.

Yet, if we turn the question on its head and instead ask anyone acquainted with the issues related to money laundering schemes to list real world countries that supply money laundering services, we expect the answer to be rather different. Countries usually associated with the offer of financial services to criminal organizations appear to fit more easily into the “B type” described above.

Take, for example, the list of “Non Cooperative Countries or Territories” published last June by the Financial Action Task Force on the Prevention of Money Laundering (Fatf).<sup>8</sup> It includes Bahamas, Cayman Islands, Cook Islands, Dominica, Israel, Lebanon, Liechtenstein, Marshall Islands, Nauru, Niue, Panama, Philippines, Russia, St. Kitts and Nevis, St. Vincent and the Grenadines.

The vast majority of these countries looks more like the “B type” described above.<sup>9</sup> The reverse argument appears to hold as countries that are renowned for the presence of criminal organizations do not seem to play a prominent role on the supply side of the international money laundering market. Our country is a good example. Organized crime is surely present in Italy, and yet Italy does not appear to play a great role as a supplier of criminal financial services. To be sure, capitals of illicit origin tend to return in Italy, but only after having been laundered in one of the many well known international washing machines.

Going back to the list, it includes some obvious exceptions, i.e. countries that are closer to the “A type” described above. However, these exceptions may be explained on different grounds, once we recognize the nature of the exercise conducted by the Fatf. We take the list as the only, if not the most reliable, proxy of countries that are involved in the international market for money laundering services. A fundamental caveat is however mandated. We are concerned with off-shore countries that attract money of illicit origins. With this respect, the list is likely to be over-inclusive. The Fatf list is neither a list of countries that offer money laundering services, nor a list of off-shore countries. Rather, it is a list of countries that do not cooperate in the global fight against money laundering. The perspective taken by the Fatf has several implications. The lack of

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<sup>8</sup> FATF. (2000)

<sup>9</sup> Of course this observation leaves aside any evaluation of the different relative weight these countries have in the market.

cooperation, might depend on factors other than a precise attitude of the country towards money laundering. For example, the country might lack the necessary resources in technical, financial, and human capital necessary to actively and effectively cooperate at the international level. Second, and most importantly for our analysis, the Fatf has focused attention on *all* non cooperative countries. The list might thus include two very different types of countries: On the one hand, countries for which non cooperation is part of a wider strategy aimed at attracting foreign illegal capitals; (the ones with which we are concerned) on the other hand, countries for which non cooperation is more usefully thought of as a means through which the country aims at protecting domestic illegal capital from investigations undertaken abroad.

Furthermore, although we just depicted the extreme cases, there is the obvious possibility that non cooperation might be the result of a mixed set of factors, like inadequacies in the bureaucratic structure, strengthened by pressure from criminal organizations aimed at protecting their business. Consider Russia. Although we did not conduct any specific research on Russia,<sup>10</sup> it appears fair to say that the lack of cooperation is not rooted into a strategic decision not to cooperate, but is rather the result of a situation of huge institutional problems connected with the transition to a market economy. Moreover, organized crime in Russia, if anything, appears to be a buyer rather than a supplier of money laundering services in the international market, as some well known scandals appear to suggest.

### **3. A SUPPLY AND A DEMAND SCHEDULE FOR MONEY LAUNDERING REGULATION**

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, or it can decide to make the opposite choice, devising a regulation that facilitates money laundering.

Money laundering generates costs as well as benefits for the parties involved. The costs for society, as underscored above, depend on the circumstance that more predicate offences will be committed if money laundering is possible and on the possible negative impact that money laundering will have on the financial system. The benefits of money laundering accrue, first of all, to criminal organizations, that can employ the proceeds of crime avoiding the threat of being prosecuted for predicate offences. On the other side of the transaction, money laundering offers to the launderer the possibility to earn a commission in exchange for its services. Four different categories of actors potentially interested in the regulation can be identified: a) the policy maker; b) criminal organizations; c) those who bear the costs of money laundering; d) the financial community. Starting with the latter, it does not appear easy to predict which side will the financial community take. For the sake of simplicity, 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, thus probably making them disinterested in the choice taken by the policy maker. The interests of b) and c) are obviously incompatible, as the gains of the former depend on the loss of the latter; a) is in the middle, having to decide which demand schedule to follow.

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 is pervasive will tend to bear at least some of the costs associated with a decision to favor money laundering.

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<sup>10</sup> Or, for what matters, on any other country. This is not an empirical paper, and the references to characteristics of countries included in the list should be taken as little more than anecdotal evidence.