International Review of Law and Economics 30 (2010) 244–252

Contents lists available at ScienceDirect

International Review of Law and Economics

# Dancing with the devil: Country size and the incentive to tolerate money laundering

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ARTICLE INFO

*Article history:*
Received 14 August 2008
Received in revised form 29 March 2010
Accepted 23 April 2010

*JEL classification:*
H27
H23
L38

*Keywords:*
Money laundering
Policy competition
Systems competition

ABSTRACT

The incidence of money laundering, and the zeal with which international anti-money laundering (AML) policy is pursued, varies significantly from country to country, region to region. There are, however, quite substantial social costs associated with a policy of toleration, and this begs the question as to why such a variance should exist. In this paper we claim that, due to the globalisation of crime, if a single country should break the "chain of accountability", then it will provide a safe haven for criminals and attract the total financial proceeds of crime. Because smaller economies are best able to insulate themselves from the costs of crime, we argue that smaller countries bear only a tiny share of the total costs relative to the potential benefits of investment that money laundering offers, and so have a higher incentive to tolerate the practice compared to their larger neighbours. As such, we claim that the existence of a money laundering market is due to a policy of AML 'defection', and that the degree of 'defection' depends largely on the size of the country. We present a simple model of policy competition which formalises this intuition, and conclude by exploring a number of policy recommendations which flow from this.


## 1. Introduction

Money laundering is the process by which criminals and criminal organisations attempt to "conceal or disguise the nature, location, source, ownership or control" of their ill-gotten gains,[1] so as to make it possible to invest or consume the proceeds of crime.

The existence of a money laundering market is, as we will see in the course of the literature overview presented in Section 2, a well-recognised threat to the stability of the legitimate economy (see, Unger, 2007). So much so, in fact, that European legislators have suggested that the presence of a money laundering market threatens to "shake the very foundations of society" (Directive 2005/60/EC). Money laundering acts as a multiplier for crime, corruption, bribery and terrorism, and so comes at a significant total cost to society.

Despite this fact, the zeal with which international anti-money laundering (hereafter AML) policy is pursued varies significantly from country to country, and from region to region. So significant is this variance, in fact, that the Financial Action Task Force (FATF), the anti-money laundering organization founded by the then G-7, and now located in the OECD, has felt it necessary to identify a number of "Non-Cooperative Countries and Territories" (NCCT), and to label these as having "severe deficiencies" in their AML regimes (Force, 2002).[2] The most extreme of these, the Seychelles, actively encouraged money laundering, and publically invited criminals to invest their ill-gotten gains under the promise of an immunity from prosecution (Unger & Rawlings, 2008).

At the present time, it is quite unclear as to why this should occur, and why money laundering should be tolerated in some jurisdictions and not in others. In the course of Section 3, however, we will present a simple model of policy competition, which attempts to explain the existence of a money laundering market by simultaneously considering the existence of heterogeneities between countries on the one hand, and the strategic actions of the policy makers that govern them on the other.

We will show that, in a closed economy, there is a strong incentive to regulate, and to prevent money laundering. In a closed economy the total social costs of crime will be borne, we suggest, by the domestic community, and as these costs will outweigh any

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[1] See Stages of the Money Laundering Process, A Report to Congress in Accordance with 356(c) of the USA PATRIOT Act, December 2002.

[2] There are currently no countries on the list of NCCTs. It has been suggested, however, that this may be due to political considerations, and that many of the countries listed in 2000/2001 may have been removed for 'apparently' rather than actually complying with AML best-practice (Masciandaro, 2005; Unger, & Ferwerda, 2008).

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doi:10.1016/j.irle.2010.04.004

potential benefits that come from a policy of toleration, we will show that financial transparency will be maximised. In a closed economy, the costs of crime outweigh the benefits of criminal investment, and so money laundering will not be tolerated. Because criminals are, at least in our set-up, motivated by the attainment of profit, the supply of crime will, consequently, suffer an adverse shock.

In an open and globalised economy, however, we will show that this result no longer holds. Openness and globalisation, we find, means that the costs of crime, and the investment benefits that come with a policy of toleration, can easily be separated. Domestic arbitrageurs can compete, in the hope of profiting from the crimes committed in other jurisdictions. So too can states. As a consequence, our model suggests that we will observe a beggar-thy-neighbour policy in relation to criminal finances, as countries attempt to attract the proceeds of crime, and an international "regulatory race to the bottom", as they attempt to facilitate criminal investment by lowering domestic standards on financial transparency. As a result, we claim that the existence of, and variance within the money laundering market is due to a policy of AML 'defection', and that the degree of 'defection' depends largely on the size or economic significance of the country. Countries with a large legitimate economy can, we suggest, be expected to avoid the money laundering market, while smaller, developing economies will be more likely to "dance with the devil", and to embrace it. The implications of this finding will be explored in the course of Section 4, after which Section 5 will conclude by exploring the policy implications of this finding.

By doing so, this paper contributes to the literature in a number of ways. Firstly, it presents an integrated model, which simultaneously considers the existence of heterogeneities between countries and the strategic actions of the policy makers that govern them. This is to our knowledge new to the literature, as previous contributions analysed one or the other factor in isolation. Secondly, it shows that countries exert a *laundering externality* on each other, because they fail to take into account the cost of laxity on other countries when setting their AML policy goals. This is an important finding, with many real world policy implications, which we will discuss. Thirdly, it derives what will be referred to as an endogenous "Seychelles effect" – named after the Seychelles' policy of deliberately inviting criminal investment – which results from the fact that small and developing countries are low-cost producers of money laundering. This shows that smaller countries need to bear only a small part of the social cost they generate, and provides the theoretical reasoning for the observed variance in AML regimes.

## 2. Literature and hypothesis development

### 2.1. Crime and criminal proceeds

Variously defined as "deviant behaviour [which] violates the prevailing norms and cultural standards on how humans ought to behave", as a "public wrong" and as an exploit "injurious to the community" (Ormerod, 2005), crime exists and endures because it offers the individual an opportunity to gain. Crime provides the individual with a cost effective source of power, influence and authority, and so crime, it must be recognised, is the unavoidable consequence of human ambition and creativity, and the flip-side of entrepreneurial spirit. It is held to be "wrong" and "injurious" because the private gain it creates typically benefit the criminal far less then they cost society. Estimates place the cost of crime to the US, for example, at about $1 trillion per annum (Anderson, 1999; Reuter, Peter & Truman, 2004; Takats, 2007).

Thus, inevitable as it may be, society can tolerate only a low level of crime and, as a result, is forced to 'tip the scales' in favour of legitimate activity by criminalising all 'injurious' behaviour. In observing that crime is often motivated by profit, 'balance' can be achieved, and social welfare can be maximised, through the manipulation of the criminal profit formula. By increasing the risks of capture, for example, or the duration and severity of punishment, the costs of crime can, it is suggested, be easily be made to outweigh the benefits (Blumstein & Nagin, 1977; Ehrlich, 1973; Wolpin, 1978).

In a world where the proceeds of crime are measured in the tens of billions (Unger, 2007; Unger & Rawlings, 2008), however, and where the sheer complexity of the criminal operations often makes the risk of detection and the threat of punishment too remote a possibility to act as a serious deterrent, many believe that this is simply not enough. Many are therefore choosing to supplement these traditional methods of punishment with the practice of institutionalised ostracism; governments and international institutions are increasingly refusing the criminal, and his proceeds, access to the legitimate economy.

### 2.2. Understanding the market for money laundering

But desirable as this may sound, many uncomfortable questions are raised by the process of institutionalised ostracism regarding the substitutability of money (Unger, 2007).

By direct intention the distinction between legal and illegal monies means that a 'dirty dollar' earned in the criminal economy is worth less then a "clean" one earned in the legitimate economy, and so the profitability of crime is reduced. Criminal incomes are effectively"taxed' at a rate equal to the state's enthusiasm for a crime free society. Because crime already pays less (Wilson & Abrahamse, 1992), any loss in profitability implies an adverse shock to the supply of crime, and so criminal activity will be reduced.

As an unintended consequence, however, a demand for "money laundering" services will be created. These services—broadly defined as financial services conducted "to conceal or disguise the nature, location, source, ownership or control" of money aim to make it possible for criminals to invest or to consume the proceeds of crime, and to circumvent the crime-stopping efforts of government.[3]

The Bank of International Settlements (BIS), the Organization of Economic Cooperation Development (OECD), the G8 and G20, the European Union (EU), several departments of the United Nations (UN), the World Bank (WB), the International Monetary Fund (IMF), and the Financial Stability Forum (FSF) are all involved in efforts to assess and reduce money laundering. Between them they have created a plethora of bilateral and multilateral rules and agreements – despite the widespread uncertainty of what actually constitutes money laundering (Unger, 2007) – and the diverging definitions which are now employed by them at both the national and the international level makes estimation a difficult task (Van Duyne, 2007, 2006, 2003). It has been suggested, in fact, that measuring money laundering is no more possible then measuring a "fata morgana" (Van Duyne, 2006).

A number of heroic attempts have been made, however, "to measure the immeasurable" (Unger, 2007). The IMF (International

[3] See Stages of the Money Laundering Process, A Report to Congress in Accordance with 356(c) of the USA PATRIOT Act, December 2002. Within the European legal framework the: (1) conversion or transfer of property; (2) the concealment or disguise of the true nature, source, location, disposition, movement, rights with respect to property; or (3) the acquisition, possession or use of property, knowing that such property is derived from criminal activity, are all activities which, when committed intentionally, are considered to be acts of money laundering. See also Council Directive 91/308/EEC of 10 June 1991 on prevention of the use of the financial system for the purpose of money laundering.