Purpose - The aim of this research paper is to discuss the crucial difference between financial offshores and fiscal offshores. Design/methodology/approach - The paper combines narrative with argument and analysis. Findings - It is shown that the decision of a few countries and territories to adopt lax financial regulation do not coincide with those that institute competitive taxation policies. From a methodological point of view, the classic intuition of Becker is intertwined with the new political economy approach, in order to review and comment on empirical tests. Originality/value - The paper suggests common guidelines for the design of international policy against money laundering and the financing of terrorism. [PUBLICATION ABSTRACT]

Introduction

After September 11, 2001, governments in "onshore countries" have expressed increasingly concern about the role of offshore centres (OFCs) in money laundering and terrorist financing. Also the main international institutions concentrated their attention on the possibility that OFC jurisdictions might facilitate the task of criminal organizations as well as terrorists.

The OECD, the Financial Action Task Force (FATF), the BIS, the IMF, the European Commission as well, all have highlighted the importance to shed light on the operations in OFCs.

Two interacting principles commonly feature in the debate on the relationship between money laundering and OFCs: money laundering is facilitated by lax financial regulation; countries adopting lax financial regulation do not co-operate in the international effort aimed at combating money laundering. These two principles characterized the adoption in the international fora of the so-called "named and shamed" (N&S) approach. The blacklist instrument represents the cornerstone of the N&S approach, aiming 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 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 blacklisted 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 removed from it. But is regulatory reform sufficient to prove that a country has really changed its lax 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 organized crime and terrorism 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, for example, why specific countries continue de facto in their non-cooperative attitude.

The economic and political analysis ([2], [3] Masciandaro, 2004, 2005) can suggests a different perspective. It can be introduced and developed 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 can attract also capital of illicit origin (money laundering services) or destination (terrorism finance services). the economic perspective suggests that money laundering can be considered a case of externalities, and
the puzzle consists in the possibility to find a way to internalize the relative costs in the objective function of the OFC policymakers.

From a methodological point of view, we develop the classic intuitions a’ la Becker using the new political economy approach, basing our work on three hypotheses: H1. The definition of regulatory policy is not independent, as in the conventional economics, but endogenous; H2. Policy is not determined by maximizing a social welfare function but by taking into account the political cost-benefit payoff; and H3. Policymaker maximization is constrained and influenced by the structural framework, economic as well as institutional. In other words it is possible to theoretically discuss and empirically test the relationships between specific country features and policymakers’ choices toward lax financial regulation. In particular, it is possible to discuss the two postulates of the International Policy on OFCs.

**First, postulate (offshore as a catalyst of money laundering risk)**

The mechanisms of laundering criminal money and financing terrorism can be implemented in the world wide financial network, because in that network there are “weak” nodes or “black holes” represented by offshore financial centres.

The theme of the potential vulnerability of the world financial network due to the presence of OFCs can be explored with various methodological approaches.

Firstly, beginning with the financial aspects, we began by observing that the onshore countries, represented by the major industrialized countries, view as vulnerable those countries and territories whose regulations are relatively accommodating compared to their own, in the sense that greater risks exist that money-laundering or terrorism financing transactions can be concealed.

But why do the offshore financial centres possess these lax regulations? We answer the question by applying the latest instruments of economic, institutional and political analysis. The two key terms are a surplus of economic benefits that the OFCs receive by having lax regulations, which forcefully clashes with a deficit of political legitimacy in the directives of the onshore countries and international institutions, as perceived by the OFCs.

Thanks to recent empirical analyses, it possible to demonstrated that the non-cooperative countries (NCCT) display relatively uniform structural characteristics, economic as well as institutional.

Let me to briefly review these empirical results. We assume that NCCTs share common structural features and can test for this using econometric techniques. In fact financial regulatory regimes can be viewed as resulting from a continuous, unobserved variable: the optimal degree of financial laxity, consistent with the policymaker payoff. Each regime corresponds to a specific range of the optimal financial laxity, with higher discrete index values corresponding to a higher range of financial laxity. Since, we will use a qualitative ordinal variable as laxity indicator, the estimation of a model for such a dependent variable necessitates the use of a specific technique.

In particular, given a constant international environment, we assume that an jurisdiction has: scant physical resources to spend in international trade, which gives an incentive for lax financial regulation; the potential for developing financial services and can gain from lax financial regulation; social characteristics that shield it to some extent from the risks of terrorism and/or of organized crime, and thus reduce the expected cost of lax financial regulation.

Since, June 22, 2000, the FATF has been publishing a periodic report on the NCCT jurisdictions: the blacklist. The report lays down several criteria, that, if violated, identify the national rules that in each country are detrimental to international cooperation in the fight against black money. Using a worldwide data set on the main 130 countries[1], we do a probit analysis. The dependent variable is a binary probit variable equal to one for the 45 potential NCCTs and zero otherwise.

The estimated equation is as follows: Equation 1 [Figure omitted. See Article Image.] where $A_1$, land use[2]; $B_1$, GDP per capita[3]; $C_1$, foreign deposits per capita[4]; $E_1$, terrorism and organized crime[5] Index[6].

The results of Table I [Figure omitted. See Article Image.] confirm that the probability of being an NCCT jurisdiction depends on specific country endowments. The probability that a country is a NCCT jurisdiction tends to be higher the lower the level of economic development - measured by per-capita GDP and degree of land exploitation; the higher the flow of foreign deposits; the lower the extent of terrorism and organized crime. Given data limitation, we could not test for the role of international reputation sensitivity.

Therefore, the laxity of financial regulation ultimately becomes a case of free lunch: the expected internal benefits of
laxity, in terms of increasing the value produced by the financial industry, are evident, while they do not perceive the potential external costs, represented by greater international risks of increasing terrorism and organized crime. Furthermore, the action suggested by the international organizations suffers from a marked lack of legitimacy, in the eyes of jurisdictions that express more or less accentuated and consolidated forms of national sovereignty.

Thus, more than the robustness of the first postulate, which is tautological per se - OFCs are those jurisdictions defined as such by the onshore countries - it is important to cast some light on the structural economic and political causes that may explain the birth and development of countries with relatively lax financial regulations. Understanding the deep roots of financial laxity is the first goal of the economic and political analysis.

Second postulate (equivalence of offshore centers as a catalyst of both money laundering risk and harmful fiscal competition risk).

The weak nodes in the network are particularly dangerous because they not only facilitate the money laundering and the financing of terrorism but also facilitate unfair fiscal competition among sovereign nations.

The second postulate is false. We explored the possibility that offshore financial centres are more prone to regulatory laxity than non-OFCs (Table II [Figure omitted. See Article Image.]). The dependent variable acquires a value of unity when a country is listed as an OFC by the OECD, otherwise it is zero. With the exception of the crime and terrorism index, none of variables have any explanatory power. This seems to suggest that the underlying economic characteristics of OFCs and our NCCTs tend to differ. In general, we can reject the hypothesis that the causes of lax financial regulation decisions and of offshore activities are exactly the same.

The decision of a few countries and territories to institute highly advantageous taxation policies, in some cases highly aggressive, and the relative determinants do not coincide with those to adopt lax financial policies, although areas of overlapping and partial coincidence do exist. Using a graphic image, in general the set of fiscal OFCs does not coincide with the set of lax financial OFCs, although there is an area of intersection. Fiscal competition, if regulated by the principles of transparency and correct conduct of business, tends to be different from financial laxity.

Not only: on the theoretical level, while a relative consensus exists regarding the potential damage of financial laxity, the same cannot be said for fiscal competition. Various theories exist regarding the possible effects of tax competition. To attempt a summary, we might identify two opposing schools: on the one hand, the advocates of perfect fiscal competition, on the other, the supporters of total tax harmonization.

The supporters of perfect tax competition are those who feel that capital must be completely free to circle the globe, in search of the most advantageous tax regime. The possibility of capital to arbitrate freely among various national regulations becomes the key to an increasingly efficient allocation of resources. In other words, they are proposing the establishment of an international setting useful to promote a perfect demand of arbitrage: each citizen, in every country of the world, must be free to choose the tax regime for his own income and wealth.

At the same time, each country must have the possibility of providing a perfect supply of arbitrage, proposing its tax regime to capital flows throughout the world. The basic idea is that competition will punish the less efficient countries, characterized by harsher tax regimes, and thus reduce the risks of "country failure" to the advantage of all.

The advocates of tax harmonization, on the other hand, stress that the individual and collective advantages of perfect competition can be exalted only by those who conceal the market failures that characterize the real functioning of the markets, national and international. First, the presence of various forms of transaction costs and information asymmetries make the actual mobility of the individual production factors, and the capacity of choice of the various categories of citizens, highly heterogeneous and variable from country to country, so the demand for arbitrage, if satisfied, might in reality produce allocation inefficiencies and inequalities.

In parallel, the supply of arbitrage and competition among tax regimes must take into account that for each country, especially if it is characterized by a democratic regime, the design of public intervention, and therefore the relative fiscal burdens, does not respond solely to the criterion of efficiency but must also consider other public priorities, which may be summarized as fairness and sustainability.

Furthermore, the traditional principle of neutrality of capital - i.e. its origin and destination are irrelevant - can no longer be affirmed, especially since September 11, 2001, so the international objective of safeguarding integrity against the risks of capital contamination by organized crime and terrorism must be taken into account. This is another reason, therefore, for not allowing the debate on tax competition to coincide with that on the war on terrorism and organized
crime. Cutting the misleading link between fiscal competition and financial laxity becomes the second goal of economic and political analysis.

In the light of these considerations, it is possible to suggest common guidelines for the design of international rules for the financial war on organized crime and terrorism? The possible indications, useful on both the microeconomic and macroeconomic levels, revolve around four fundamental words: specificity, information, incentives and legitimacy.

Firstly, the phenomenon of money laundering and terrorism financing have a specificity of its own, linked to the coexistence of three characteristics: the transnational, damaging and illegal nature of the of the financial flows. Fiscal arbitrage is also a transnational phenomenon, but in fiscal arbitrage, which can arise from forms of evasion, neither the origin nor the destination of the funds is illegal, just the decision not to contribute part of the funds to tax revenues. The specificity of money laundering and financing terrorism must always be borne in mind, since the definition of policies for preventing and combating them must not passively follow the schemes of action devised for combating tax evasion.

Secondly, it is evident that the more widespread information asymmetries to the detriment of various categories of authorities (sectoral, investigative, inquiring) are in the banking and financial industry, the more developed and effective the money laundering will be. A necessary, but not sufficient, condition for designing effective rules and enforcement at both the national and international levels is the generation and collection of relevant information.

But the production and collection of relevant information - and this is the third point - can never reach satisfactory levels unless it places us in the perspective of providing proper incentives to the various players involved, starting with the individual intermediaries and operators, passing through the authorities and arriving at the countries, be they onshore or offshore. Combating the money laundering and the financing of terrorism must be beneficial at all the various levels that are potentially involved in a rather complex operation of dirty money.

The theme of incentives is thus strongly intertwined with that of information. There must be clear separation between the objective of information accessibility in the financial and economic system and the potential collaboration of financial intermediaries, and operators and companies in general, in the generation of useful information.

This difference is fundamental. The first objective is to enable authorities investigating a suspect to collect relevant financial information effectively: this means being able to access information with minimal time and cost, thanks to the availability of the information assets of intermediaries, companies and professionals (passive collaboration).

A second, more ambitious objective is to activate inverse channels of information from economic agents to the authorities (active collaboration). In general, the action of active collaboration involves expected costs to economic agents - in terms of reputation, efficiency, reprisal - that are much higher than the expected benefits, and the path to follow is certainly not that of sanctions, including criminal sanctions, that seem perhaps unjust, undoubtedly ineffective. Rather, to increase the active collaboration from the economic agents involved, the path to take with decision is that of incentives and mutually agreed regulations, especially where sovereign offshore jurisdictions subject to blacklisting are concerned. Designing incentive compatible regulations - both at national and international level - represents the third goal of economic and political analysis.

On this point focusing on the OFC debate, we emphasized that countries deemed lax have some uniform structural elements in common, while there are significant differences between those countries and those judged accommodating on the fiscal level. Hence, three indications emerge for define international prevention and enforcement policies.

Firstly, the financial blacklist must be formulated and updated with particular care, so as to avoid errors in the formulation of relative incentives or sanctions. Secondly, the fact that a country simply brings its formal rules into compliance does not automatically mean that it is not a potentially lax country on the financial level, since the incentives to laxity may have deep-running structural, economic and institutional roots.

Thirdly, the international community must seek to act positively on these roots with specific country-by-country policies, precisely because the degree of laxity and its rationale may not be identical from case to case.

Last but not least, the theme of regulations mutually agreeable to both the onshore and offshore countries leads us to the decisive question of the political legitimacy of the action by international institutions. The more each country and territory, active or passive party to the action under an international code of conduct for the war against the financing of terrorism, recognizes the political legitimacy of the international institutions guaranteeing that code, the more
Effective the code will be.

Economic benefit and political legitimacy are therefore the pillars on which to build rules for governing international capital flows that observe the cardinal principles for the proper functioning of a market economy: efficiency and integrity. The win-win strategy have to be the progressive erosion of the institutional segregation of offshore from onshore financial affairs, sharing common principles and best practices.

[Footnote]

1. Given the 267 world countries (UN members = 180), our 130 countries (BRI sample) represent the 98 percent of the world GDP and the 90 percent of the world population.

2. Landuse: This entry contains the percentage shares of total land area for five different types of land use: arable land - land cultivated for crops that are replanted after each harvest like wheat, maize, and rice; permanent crops - land cultivated for crops that are not replanted after each harvest like citrus, coffee, and rubber; permanent pastures - land permanently used for herbaceous forage crops; forests and woodland - land under dense or open stands of trees; other - any land type not specifically mentioned above, such as urban areas. Source: CIA.

3. Gdp-capita: This entry shows GDP on a purchasing power parity basis divided by population (year 2001). Source: CIA.

4. Fordepositscapita: The data on foreign deposits are derived from reporting as such or calculated by subtracting separately reported data on positions other than deposits from total external assets and liabilities. The only exception is The Netherlands Antilles, which does not provide this information separately (year 2001). Source: BRI. The deposit data are then divided by the population (year 2001).

5. Regarding the organized crime dummy, the size of the drug market dimension is evidently an indirect and imperfect indicator of the organized crime problem. At the same time, the drug market has given organized crime its massive resources. It has been correctly noted that during the 1970s the drug trade became far too profitable and easy for even traditional and "conservative" organized crime organisations to ignore (14) Rider, 2002, p. 17), Furthermore, it is also noted there that even terrorist groups entered the market and by so doing became virtually indistinguishable from "ordinary" organized crime.

6. Terrorism and organized crime index: we built this variable by summing two separate variables for each country: organized crime dummy =1 if there is drug production and/or drug markets in the country, 0 otherwise (Source: CIA); Normalized Terrorism Indicator=average number of terrorist episodes in the country (years 1968-1991) / max average number of terrorist episodes in a country (1968-1991); the Terrorism indicator therefore ranges from 0 to 1 (Source: [1] Blomberg et al., 2002). Consequently, our Index ranges from 0 to 2.

[Reference]


[Appendix]
Corresponding author
Donato Masciandaro can be contacted at: donato.masciandaro@unibocconi.it

[Author Affiliation]
Donato Masciandaro, Bocconi University, Milan, Italy

[Illustration]
Equation 1

Table I: Binary laxity index determinants (130 countries and territories)
Table II: Binary offshore index and binary laxity determinants (130 countries and territories)

Indexing (document details)

Subjects: Money laundering, International law, Guidelines, Terrorism, Offshore, Political economy
Author(s): Donato Masciandaro
Author Affiliation: Donato Masciandaro, Bocconi University, Milan, Italy
Document types: Feature
Document features: References
Publication title: Journal of Money Laundering Control. London: 2006. Vol. 9, Iss. 4; pg. 365
Source type: Periodical
ISSN: 13685201
ProQuest document ID: 1150398221
Text Word Count: 3421
DOI: 10.1108/13685200610707617
Document URL: http://proquest.umi.com/pqdweb?did=1150398221&Fmt=3&clientId=8631&RQT=309&VName=PQD

Copyright © 2008 ProQuest LLC. All rights reserved.