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Combating Global "Public Bads"

Three types of objectives for national and global anti–money laundering (AML) regimes have been identified: (1) the central goal of reducing a range of predicate crimes (chapter 5); (2) the more narrowly focused goal of protecting the integrity of the core financial system (chapter 6); and (3) a group of national security or systemic goals under the heading of global "public bads"—terrorism financing, corruption and kleptocracy, and failed states. In examining the progress of the AML regime in achieving this final group of goals, this chapter will consider each of the "bads." The global AML regime can and does play a constructive role in limiting each of these global problems, but the regime is just one tool, the development and use of which poses many challenges given the international context in which these goals must be pursued.

Terrorism

The first complication in assessing AML regime effectiveness in combating terrorism financing is that resources for such activities are laundered before, as opposed to after, the crime. The traditional AML focus is on the placement stage, when funds enter the financial system, but taking action when funds are already in the hands of terrorist organizations can be too late to stop the intended terrorist act.

Thus, the role of the AML regime with respect to terrorism financing is principally prevention in the full defensive sense of the word. Financial trails may be helpful after the terrorist act has occurred in terms of identifying and apprehending supporters of terrorism, but the goal is to stop those acts before they happen. The anti–money laundering enforcement pillar serves at best on the margin as a deterrent to terrorism, perhaps by making potential terrorists recognize the difficulty in acquiring funds. However, enforcement is more relevant to the actual blocking, seizure, and confiscation of resources financing terrorism. As detailed by the GAO (2003b), and R. E. Bell (2003) in the UK context, terrorist organizations use a range of alternative or nontraditional means to earn, move, and store their assets. Consequently, the full panoply of tools of the AML regime must be used to combat terrorism financing. Bell also emphasizes that privacy and human rights considerations are more complex than with respect to conventional anti–money laundering because some sources of financing are legitimate even if the uses are not.

The Eight Special Recommendations on Terrorist Financing adopted by the Financial Action Task Force (FATF) in October 2001 (FATF 2001a) draw a parallel between other forms of money laundering and the financing of terrorism. Hastily assembled following the September 11, 2001, terrorist attack on the United States and based on the model of the original FATF Forty Recommendations, the Eight Special Recommendations emphasize issues that are more relevant to combating the financing of terrorism—such as the role of nonprofit entities and informal funds transfer mechanisms—than conventional money laundering. In general, the Eight Special Recommendations reflect the fact that the AML regime as it applies to terrorism financing is analogous to its application to other money-laundering activities, but with some important differences in concept and application.

The Eight Special Recommendations call for (1) ratifying and implementing the 1999 UN International Convention for the Suppression of the Financing of Terrorism (parallel to recommendation 1 of the original FATF Forty Recommendations to ratify and implement the 1988 Vienna Convention against Illicit Traffic in Narcotic Drugs and Psychotropic Substances); (2) criminalizing the financing of terrorism (parallel to FATF recommendation 4 on criminalizing money laundering); (3) freezing and confiscating funds and assets of terrorists (parallel to FATF recommendation 7); (4) reporting suspicious transactions (parallel to FATF recommendations 15–18); (5) international cooperation (parallel to FATF recommendations 33–34 and 36–40); (6) measures against nontraditional channels of value transmission (analogous to FATF recommendations 8 and 9, extending the framework to nonbank financial and nonfinancial institutions); (7) special attention to wire transfers (analogous to FATF recommendation 9); and (8) reviewing laws and regulations that relate to nonprofit entities (analogous to FATF recommendation 25 with respect to the abuse of shell corporations).

Of course, combating the financing of terrorism predated the September 11 tragedy. In the wake of the bombing of Pan American flight 103 on December 21, 1988, over Lockerbie, Scotland, the 1989 G-7 Summit issued a declaration on terrorism that focused on deterring terrorist acts. President

Clinton invoked the International Emergency Economic Powers Act on January 23, 1995, to prohibit financial transactions with terrorists and groups financing terrorism. Following the bombing in Dhahran, Saudi Arabia, on June 26, 1996, the G-7 Summit issued another declaration on terrorism that included a reference to the financing of terrorism. The United Nations also reached agreement in 1999 on the International Convention for the Suppression of the Financing of Terrorism. In June 2000, the Bremer Commission report on Countering the Changing Threat of International Terrorism was submitted to the US Congress. A tug of war then ensued within the new Bush administration about implementing the report's recommendations, including US ratification of the UN International Convention on the Suppression of the Financing of Terrorism. The inter- and intra-agency infighting was resolved only in the wake of the September 11 attacks, which put combating terrorism financing at the top of the agenda of the US AML regime. September 11 also shifted some of the attention away from an exclusive focus on state sponsorship of terrorism.

The effort to enhance the AML regime to block and seize funds intended to finance terrorism was impressive even scaled by the enormity of the World Trade Center attack. Richard Spillenkothen, director of the division of supervision and regulation at the Federal Reserve Board, testified before the US Senate: "The US government's response to the terrorist attacks on September 11 has necessitated unprecedented cooperation among federal bank supervisors, the private sector, law enforcement agencies, and the international financial community" (Spillenkothen 2002, 1).

From the standpoint of effectiveness, if the AML regime were to prevent a single major terrorism incident each year on the scale of those in Bali, Indonesia on October 12, 2002, or Madrid, Spain on March 11, 2004, then it surely would be judged worthwhile. However, it is difficult if not impossible to establish connections between terrorism averted and any specific element of the AML regime; only where a specific terrorist plot is foiled, fairly late in its development, can a connection be made. In turn, inasmuch as the regime is justified on the basis of preventing international terrorism incidents, it is less likely to be examined on a cost-effectiveness basis as much as on its efficacy in measurably contributing to preventing an incident.[1]

It would be a stretch to consider statistics on the incidence of global terrorism as a useful indicator of the effectiveness of the AML regime per se in reducing terrorism, in part because prevention involves much more than interdicting financial flows, and in part because of the low-cost nature of most terrorist operations. Paul Pillar (2003) argues that financial instruments play a secondary role in counterterrorism because terrorism is cheap

1. Bell (2003, 120–21) in a thoughtful article on combating the financing of terrorism suggests only indirect measures of success: number of forfeiture orders, value of assets diverted, reduced revenues to terrorist organizations, and international cooperation indexed by active participation in blocking operations.

and the modest flows of funds are difficult to track. Unlike some other criminal activities that are financed from the accumulated stock of the proceeds of crime, financing of actual terrorist incidents primarily involves small flows of financial resources in the tens or hundreds of thousands, rather than millions, of dollars.

One should distinguish, however, between the marginal cost of a particular terrorist operation and the much larger total cost of creating and maintaining a sponsoring organization. In this sense, combating terrorism financing has a good deal in common with combating money laundering in the context of conventional organized criminal organizations such as the Mafia, drug cartels, and street gangs. In addition, some countries and organizations that sponsor terrorism are also involved in conventional criminal activities such as drugs and cigarette smuggling.

Similarly, one cannot conclude much about the effectiveness of the AML regime from the total amount of funds frozen or seized since September 11, 2001. The global total as of March 24, 2004, was estimated at $203 million as a result of 173 jurisdictions having issued freeze orders.[2]

A slightly better measure of AML regime effectiveness might be the amounts that are blocked, seized, or confiscated each time a new channel is added to the list of sources of terrorist financing, such as a new charity or a name of a new individual linked to such an activity. By this metric, results since September 11, 2001, are open to a variety of interpretations. As of the end of 2001, $112 million had been blocked or seized, which is a quite substantial amount relative to what is needed for individual terrorist operations. The amount 27 months later had risen to just over $200 million, but only $3.5 million had been added to the total in the final eight of those 27 months, indicating that the process had slowed considerably. Some of the previously blocked funds ($27.7 million) were used to help finance the new government in Afghanistan, and some went to pay legal fees, so the $200 million understates the total of all funds block or seized on a continuous basis.[3] Moreover, freezing often blocks a pipeline for fund transfer. Anecdotal reports suggest that such actions have a negative effect on fundraising, but they do not produce quantitative measures.

To illustrate the difficulty of going from these statistics to measures of effectiveness in preventing terrorism, assume that the unadjusted total of funds frozen, seized, or impeded was $300 million, or about $10 million a

2. This is the sum of blocked or frozen funds plus seized or confiscated funds. Funds are first blocked or frozen and later may be seized or confiscated via a separate legal proceeding. There may be some double counting in the data because they draw on a number of non-US sources. Some funds have been released to finance government activities. The total includes $64 million seized with the balance frozen. The data are from the US Treasury based on Zarate (2004).

3. Some funds may have been blocked and later released by the courts in the countries involved for lack of sufficient evidence to justify the initial blocking or subsequent seizure.

month over the 27 months from December 2001 through March 2004. If the AML regime had a 33 percent success rate, which would be remarkable, then about $20 million a month slipped through the net. On the one hand, if each major terrorist act costs on average $400,000—the FBI estimates the budget for the September 11 attacks at between $300,000 and $500,000 (US Treasury 2003, footnote 50)—as many as 1,350 such acts might have been financed over the 21¼-year period. On the other hand, US intelligence officials have been quoted as saying that al Qaeda operates on a budget in the tens of millions a year (*Washington Post,* December 20, 2003, A16), so an estimate of $300 million blocked, seized, or impeded over this period could be considered significant. This arithmetic is intended neither as an indictment of the AML regime as it has operated to combat terrorism financing since September 11, nor to suggest that the larger amounts frozen or seized imply that more has slipped through the net. Rather, the aim is simply to illustrate the challenge that the regime faces based on this metric, and to demonstrate why we prefer to measure effectiveness through a flow test (how much is blocked in each new antiterrorist financing action) rather than a stock test (total amounts frozen or seized).

Pillar (2003) offers a more positive interpretation of events, citing the interdiction of terrorist finances as "one of the biggest post-9/11 improvements of any of the counterterrorist instruments." In addition to the legal powers expanded as a result of 9/11, he argues that the higher priority attached to terrorism by the US government has stimulated more cooperation from foreign governments.

Prior to September 11, US and non-US official policy toward international terrorism focused to a substantial degree on state-sponsored terrorism and the use of economic sanctions to discourage the harboring of terrorist groups. Even now, the United States continues to designate state sponsors of terrorism, foreign terrorist organizations, and specially designated terrorists, as it has been doing since the early 1970s. This type of sanction has been used against Afghanistan, Cuba, Iran, Iraq, Libya, Sudan, and Syria, with limited impact. Sanctions or the threat of sanctions also can be lifted to provide positive incentives in certain situations, as was done in the wake of September 11. Gary Hufbauer, Jeffrey Schott, and Barbara Oegg (2001, 13) conclude "it would be illusory to expect that the arsenal of economic sanctions can play more than a modest role in the war against terrorism." They cite the limited success against state sponsors, terrorist groups, and major drug lords. Nevertheless, this is an area where modest contributions can be important.

As with other uses of the anti–money laundering regime, AML tools are only one important instrument in the fight against the financing of terrorism. Blocking or seizing funds intended to finance terrorism are only part of the overall effort to combat such activities and their financing. As stated by the US Treasury on August 29, 2003, in a press release about a UN report on sanctions to block the flow of funds to al Qaeda: "The point isn't grabbing dollars in bank accounts when freezing orders go into place, it is destroying the financial infrastructure of terrorism. That means seizing money, but it also involves dismantling the channels of funding, deterring those who would give aid and support to terrorists, and following the leads to terrorist cells." In a modest step along these lines, the US Treasury on May 12, 2004, for the first time invoked a provision of the 2001 USA PATRIOT Act (section 311) to declare the Commercial Bank of Syria—the principal government-owned bank—an institution of "primary money laundering concern" in connection with the bank having been used by terrorists. The action prohibited US financial institutions from having any direct or indirect dealings with the Syrian institution or any of its subsidiaries.

In stressing the complexities and challenges of counterterrorist policy, Pillar (2003, 217) describes terrorism as "a problem managed, never solved." Among his recommendations are to disrupt terrorist infrastructure worldwide, to use all available methods while not relying heavily on any one of them, to legislate sparingly, and to keep terrorist lists honest. Each of Pillar's points provides perspective on the role of the AML regime in combating terrorism financing. The complexities of the phenomena of terrorism, on the one hand, and money laundering, on the other, militate against simplistic, overarching solutions such as the creation of a new international organization dedicated solely to issues involving terrorist financing, as suggested by the Council on Foreign Relations (2002, 27) report on the subject, but dropped from its 2004 update.

The call for honesty in compiling lists of terrorists suggests the need for some care in blocking or seizing assets. Blocking assets in error, even well-intentioned error, only to have them later released via a judicial process, can undermine support for some of the more draconian (but perhaps necessary) methods applied to combating the financing of terrorism. Ron Suskind (2004, 191–93) describes the frantic US efforts to open a financial front in the war on terror on the basis of evidence that might not stand up in court. He concludes with a quotation he attributes to US Treasury General Council David Aufhauser, "It was almost comical. We listed out as many of the usual suspects as we could and said, 'Let's go freeze some of their assets.' "

In this context, any metric for judging the success of the AML regime in combating the financing of terrorism will not be entirely satisfactory.[4] However, the amount of assets frozen or blocked and seized or confiscated is relevant to an overall assessment of the AML regime's contribution. Consequently, after the initial success and more recent modest accomplishments in combating such financing, US and other authorities have stressed better compliance with international obligations in this area and

4. Metrics for judging the success of overall counterterrorism efforts such as arrests, convictions, and attacks prevented (more problematic to measure) often have little to do with the AML regime per se. Recall the discussion in chapter 5 of the temporary surge in terrorism-related SARs in the wake of the September 11 attack.

an increasing focus on informal money transfer mechanisms. The FATF has issued best-practice papers on the freezing of terrorist assets (FATF 2003d) and on combating the abuse of nonprofit organizations (FATF 2002a). The G-7, under US leadership, has also exhorted other countries to cooperate more effectively in combating terrorist financing. For example, the G-7 finance ministers and central bank governors issued a Joint Statement on Combating Terrorist Financing in April 2004 following a meeting with the finance ministers and central bank governors of 12 other countries, the FATF president, and the heads of the International Monetary Fund (IMF), World Bank, and the European Commission. They pledged closer cooperation and emphasized the importance of dealing collectively with the problem of terrorist financing.

As with other objectives of the AML regime, international cooperation is crucial to the success of the regime in combating the financing of terrorism. Notwithstanding various statements of strong support, however, cooperation in this complex area is only as effective as the political will to take costly or politically unpopular stands that might face domestic resistance. For example, the FATF's 2002–03 annual report said that the full compliance rate with its Eight Special Recommendations on Terrorist Financing was only 75 percent. The average full compliance rate by FATF members with the original FATF Forty Recommendations as of the same date was more than 90 percent.[5] Although there were shortfalls in compliance with each of the recommendations on terrorist financing, failures to comply fully were most frequent with those relating to wire transfers and to ratification and implementation of UN conventions and resolutions. For example, as of April 2004 only 112 countries had carried out the first of the FATF's special recommendations, which was to ratify the 1999 UN International Convention for the Suppression of the Financing of Terrorism. Another 41 countries, including six FATF countries, had signed the convention but not yet ratified it.[6] To cover the entire 191 members of the United Nations another 38 countries also would have to accede to the convention via ratification.

In general, efforts to rapidly implement measures to combat the financing of terrorism have met with considerable indifference and resistance. A UN monitoring group (United Nations 2003a) reported that 108 members had failed to submit reports on terrorism financing six months after the

5. Reporting on its pilot project with the World Bank to assess compliance with standards to combat money laundering and terrorism financing, the IMF (2004c) also found that compliance with the original FATF Forty Recommendations was much higher than with the Eight Special Recommendations on Terrorist Financing. The assessment noted that in many countries, the legislation necessary for the latter group of recommendations had not yet been adopted.

6. The FATF countries were Argentina, Belgium, Brazil, Germany, Greece, and Ireland. The United States, leading the war on terrorism, did not itself ratify the convention until June 26, 2002.

agreed submission date. The report said that 25 of those countries were of special interest because of other information suggesting that al Qaeda or its associates might be active within their borders. Among the most prominent were Egypt and Indonesia. Eight European countries also had not submitted reports, including Ireland and Luxembourg.[7] On the other hand, Saudi Arabian authorities touted their passage of the FATF review of Saudi compliance with the 40 + 8 recommendations on anti–money laundering and terrorism financing (*Financial Times,* March 8, 2004, 3), notwithstanding the fact that the actual review, while saying that Saudi Arabia was "compliant or largely compliant" with the recommendations, pointed to the country's lack of a clear definition of terrorist financing, failure to issue implementation rules for its 2003 AML legislation, and shortcomings in the area of customer due diligence (FATF 2004a, annex C, 9). A report by the Council on Foreign Relations (2004), while praising some Saudi actions over the previous two years, is also very critical of the implementation of its regime to combat money laundering and the financing of terrorism.

In addition, a large number of countries have not put in place legislation permitting them to freeze terrorist assets without delay, as called for under UN Security Council Resolution 1373. Following the March 11, 2004, attack in Madrid, the European Council of Heads of Government cited Resolution 1373 and called on all EU members to implement previous decisions on freezing property and evidence by December 2004 and on confiscation of proceeds by June 2004. The council did not list the countries that had thus far failed to comply, but it is reasonable to conclude that there was more than one.

With respect to tightening the US AML regime as it applies to the financing of terrorism, the American Civil Liberties Union has challenged some of the provisions of the USA PATRIOT Act on privacy grounds.[8] Opponents have criticized the elimination of the distinction between criminal and intelligence classifications, and have filed legal briefs opposing post–9/11 policies.[9] The effects of such resistance may well be taking their toll, for better or for worse. After the US government charged US Islamic leader Abdurahman

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7. Another example of the limited urgency attached to international efforts to extend the AML regime to cover the financing of terrorism is the weak response of the 184 members of the IMF to a voluntary questionnaire on anti–money laundering and countering terrorism financing that was authorized in November 2001. By September 2002, only 49 countries had responded, and four G-7 countries (Canada, Germany, Japan, and the United Kingdom) were among those that had not.

8. Steinberg, Graham, and Eggers (2003) make a plea for public guidelines on how these important new powers should be implemented.

9. On the other hand, Richard Falkenrath, former deputy homeland security adviser to US President George W. Bush, wrote in the *Financial Times* (July 7, 2004, 13) that the failure of European governments to eliminate this same "wall" between law enforcement and intelligence has prevented them from "connecting the dots" with respect to terrorist attacks in Europe such as that which occurred in Madrid.

Almoudi with money laundering and engaging in prohibited financial transactions in October 2003, the *New York Times* (October 24, 2003, A19) noted that he had not been charged with terrorist financing, perhaps because prosecutors were gun-shy as a result of mixed results in earlier such cases.

Regarding the previously mentioned UN report on sanctions directed at blocking the flow of funds to al Qaeda, the *Washington Post* (August 29, 2003) reported that the Schengen Information System, used by 13 European Union and two other European countries to monitor border crossings, contained only 40 of the 219 names on the UN list of suspect individuals and institutions. Several members of the Schengen group reportedly are precluded by their national laws from placing the names of their own citizens on national watch lists without an appropriate judicial basis. Following the Madrid attack, the EU resolved once again to step up its efforts to implement a 2001 decision to create a Europe-wide arrest warrant.

As with other aspects of the AML regime, differences in legal as well as regulatory structure and philosophy sometimes get in the way of cooperation. For example, Germany has criticized US and UK authorities for resisting the extension of financial supervision regulations to "underground banks" such as the *hawala* system of international money transmission (*Financial Times,* June 18, 2003). But for the moment, US and UK authorities are satisfied with applying registration, customer due diligence, and suspicious activity report (SAR) requirements to these institutions, stopping short of a full supervisory regime. Similar differences in regulatory philosophy underlie opposing positions regarding the regulation of hedge funds in Germany and France as opposed to the United States and United Kingdom.

Such differences interfere with establishing a seamless global AML regime as it applies to the financing of terrorism. To cite another example, Jochen Sanio, a German then president of the Financial Action Task Force (FATF), said in 2003 that "no German bank had yet filed a spontaneous report saying that someone had transferred money or was suspected of being involved in the financing of terrorism" (*Reuters News Services,* January 14, 2003)—the apparent implication being that such reporting requirements were of limited utility. The United States has been pressing other countries to crack down on cash transfers, in part out of concern that they are increasingly used to channel funds to terrorist groups. On the other hand, a frequent complaint abroad about the US financial enforcement apparatus is that when the Treasury's Office of Foreign Assets Control (OFAC) requests that the assets of certain individuals be frozen, it fails to provide the necessary information that foreign authorities need to defend their actions in court.

The United States has also been urging other jurisdictions, starting with its G-7 colleagues, to introduce cash reporting requirements along the lines of its currency transaction reports (CTRs) and reports of international transportation of currency or monetary instruments (CMIRs). To date, however, the US effort has not been successful. In its report on conducting due diligence on current customers with whom a client relationship had been established prior to April 1994, Pricewaterhouse Coopers (2003, 64) notes: "Firms said that they would be in favor of the current customer review if they thought that it would stop even one terrorist act, but they thought that the likelihood of this was so low that any benefit was negligible."

Costs as well as benefits figure in to decisions regarding application of the AML regime to combating terrorist financing. For some poorer countries, the costs are large and the direct benefits are not valued highly. An appropriate response is stepped-up technical assistance, as was suggested for the United States in the report by the Council on Foreign Relations (2002, 25) on terrorist financing. The G-8 Counter Terrorism Action Group has responded by addressing capacity building, and the FATF uses its Technical Assistance Needs Assessment exercise for the same purpose.

In conclusion, the global AML regime has contributed to combating the particular global pubic "bad" of financing terrorism. However, the regime is just one part of what is a complex effort for which measures of success are imprecise and indirect. Just like the pursuit of other AML objectives, efforts to strengthen application of the global AML regime to terrorism financing face the usual range of challenges associated with aligning different national regimes and structures. In addition, combating terrorism financing involves unique difficulties because of the relatively small amounts of money involved, and because the resources that need to be tracked, rather than deriving from a crime, finance crimes that authorities desperately need to prevent.

Corruption and Kleptocracy

Corruption is a major public policy issue that has been called "the most important economic issue facing the world today" (Hills 2001, 1). "The extent of worldwide corruption is staggering," writes Daniel Kaufmann (2003, 1). "A conservative estimate of the value of corrupt worldwide income would not merely be measured in terms of billions of dollars, but instead in the low US$ trillion range . . . [and] the additional indirect and long-term costs would further enlarge such rough estimates."[10]

Corruption is a manifestation of the economic activity of rent seeking. While empirical studies clearly have demonstrated the substantial economic costs of corruption and the weak governance often associated with it, and while the phenomenon is widely recognized and extensively studied,

10. Kaufmann's estimate of the total annual amount of corruption, which he describes as "rough," is based on surveys. While the precision of his specific estimate is debatable, no one disputes that the amounts involved are large, certainly in the hundreds of billions of dollars annually.

actually designing policy approaches to reduce substantially the incidence and extent of corruption is a major challenge (see Kaufmann, Kraay, and Zoido-Lobatón 1999; Knack and Keefer 1995; and Mauro 1995).

Paolo Mauro (2002) offers a pair of theoretical models to explain the strategic complementarity between corruption and weak governance. In one model, corrupt behavior by a group of officials contributes to the corruption of all officials and helps to explain the resulting multiple equilibria in which rampant corruption mires a country in the "bad" equilibrium. In another model, corruption contributes to political instability because one government official's corruption induces his or her colleagues to follow the example, which shortens the effective time horizon of the government and reduces its chances of reelection. The policy conclusions from such models point toward comprehensive rather than gradual reforms to move decisively away from the bad equilibrium. The conclusions also support improved disclosure and transparency as devices to motivate public opinion and ultimately discipline office holders.

Corruption is a broad phenomenon often found in relationships between the public and private sectors, but some would argue that it occurs in purely private sector activities as well.[11] The World Bank (1997, 8) defines corruption as "the abuse of public office for private gain." Transparency International (1996, 7), the most prominent nongovernmental organization that has focused on this issue, employs a less concise definition: "Corruption involves behavior on the part of officials in the public sector, whether politicians or civil servants, in which they improperly and unlawfully enrich themselves, or those close to them, by the misuse of the public power entrusted to them."

Corruption of a public official is connected de facto with money laundering, regardless of whether corruption is a predicate crime for a money-laundering prosecution in the jurisdiction where the corruption occurs. The public official will place his or her proceeds where they are relatively safe. The safe location may be a business or piece of real estate in the official's own country, but often it is in a foreign country, which reinforces the cross-border link between money laundering and corruption.

Kleptocracy is corruption by high-level public officials who use their positions systematically to line their pockets directly or indirectly with funds from the public purse.[12] Kleptocracy is a subcategory of political

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11. The new UN Convention Against Corruption (United Nations 2003b) does not cover private-to-private sector corruption, to the disappointment of some private sector observers.

12. Moody-Stuart (1997, 63) provides a nice classification of official corruption: "Five percent of $200,000 will be interesting to a senior official below the top rank; 5 percent of $2 million is in the top official's area; 5 percent of $20 million is real money for a minister or his key staff; 5 percent of $200 million justifies the serious attention of the head of state." The kleptocrats are the last and the next-to-last levels of officials in this classification.

corruption, which is more commonly found in societies with less well-developed systems of justice and limited transparency in the public and private sectors. Of course, the line between political corruption and political contributions is not an easy one to draw. The relativistic view of public corruption of Robert Neild (2002, 202) defines it as the "breaking by public persons, for the sake of private financial or political gain, of the rules of conduct in public affairs prevailing in a society in the period under consideration." Not surprisingly, he is not optimistic that the standards for public conduct in much of the world will soon evolve to a level close to those found today in northwestern Europe.

The prevention pillar of the AML regime can play an important role in reducing the incidence and scale of kleptocracy through rigorous application of customer due diligence (CDD) regarding "politically exposed persons," defined by the FATF (2003c) as "individuals who are or have been entrusted with prominent public functions in a foreign country, for example heads of state or of government, senior politicians, senior government, judicial or military officials, senior executives of state-owned corporations, important political party officials." Applying AML procedures such as CDD can help to limit the success of kleptocrats, since they generally have little interest in keeping their ill-gotten gains invested in their own jurisdictions, where any change in government might threaten control of those assets.

The enforcement pillar can play a role as well via both the punishment of kleptocrats and confiscation of the proceeds of their crimes. Both elements of the enforcement pillar are important not only because they punish the individuals but also because they send messages to junior officials who may be tempted into similar behavior.

Such condign punishment outside of the jurisdiction of the underlying offense is particularly relevant to bribery and corruption. Corrupt officials in poor nations who control the justice system there may be unreachable except through money-laundering investigations in other countries. For example, Pavel Nickolayevich Lazarenko, the former prime minister of the Ukraine, was indicted, placed under house arrest, and convicted in June 2004 in the United States for money laundering. This case was the first brought under US money-laundering law using as a legal foundation the proceeds of extortion that was committed entirely overseas. The underlying offenses of receiving bribes and extortion, which notionally occurred in the Ukraine even though the money did not change hands in Kiev, could not be prosecuted there. Prosecution of the prime minister in the United States, based on use of US banks and brokerage accounts, served to improve justice in a salient and important way.

Similarly, the prosecution of kleptocrats and confiscation of the proceeds of their crimes provide a positive example for limiting garden-variety corruption in the home countries. Thus the incidence of corruption is linked to the incidence of kleptocracy. Widespread corruption, in turn, can undermine the integrity of the financial system.[13]

Assessing the effectiveness of the AML regime in reducing kleptocracy more narrowly, and corruption more broadly, relies to some extent on indirect measures such as surveys and other indicators of the prevalence of these phenomena, for example those put out by Transparency International and the World Bank. In general, the AML regime is not the only or even the major element contributing to success in combating kleptocracy, but it has a role to play and can reasonably take some credit for any improvement, or blame for some deterioration, in the incidence of the phenomenon.

A reasonable proximate measure of the effectiveness of the AML regime in dealing with kleptocracy would be the flow of convictions of kleptocrats or the amount of funds frozen and returned to their countries of origin. Unfortunately, data to construct such a measure are not currently available, and anecdotal information is uneven. Various public and private international organizations have made ongoing efforts to raise the profile of work against kleptocracy and corruption, but none has yet developed a comprehensive database that would permit measuring progress in combating these crimes.

Transparency International's *Global Corruption Report 2004* illustrates both the progress to date and the need for systematic database construction. The publication includes a summary table of the activities of 10 major kleptocrat presidents and prime ministers who served from 1965 to 2002, starting with Joseph Mobutu in Zaire and ending with Arnoldo Alemán in Nicaragua (Transparency International 2004, 13).[14] They embezzled amounts believed to have ranged from $78 million to $35 billion while in office. A few of the individuals on the list, such as Alemán as well as Joseph Estrada in the Philippines, were convicted of corruption, and some of the stolen funds located in foreign banks were frozen and returned to their countries. Some of the funds stolen by former president Sani Abacha of Nigeria also were returned to that country.

Transparency International's list demonstrates that, even though a complete database is not yet available, information on kleptocracy and indirectly

13. Note that without the AML regime, criminal funds could be passed through the financial system without any payment of additional bribes. In this sense the regime itself creates a threat to the integrity of the financial system in the form of corrupt practices. The AML regime, in turn, seeks to cleanse banks and other financial institutions not by reducing the problem of bribes paid to violate regulations but by maintaining a distance between the underlying criminal acts and the financial sector.

14. The others in order of the estimated size of their embezzlements are Suharto of Indonesia, Marcos of the Philippines, Abacha of Nigeria, Milosevic of Serbia/Yugoslavia, Duvalier of Haiti, Fujimori of Peru, Lazarenko of Ukraine, and Estrada of the Philippines. Mobuto ranks third on the list and Alemán ninth. The list, of course, is not exhaustive. Any number of other names could have been added—e.g., Benazir Bhutto of Pakistan, Chiluba of Zambia, Moi of Kenya, and Taylor of Liberia.

on the AML regime's role in its prevention and prosecution is gradually being assembled. One reason for the slow progress is the general lack of attention in the policy community to developing systematic measures of the effectiveness of the AML regime. However, there are other reasons as well. The global AML regime has been slow to incorporate public corruption, and by extension kleptocracy, into its set of objectives. In the United States, foreign corruption became a predicate offense for a money-laundering prosecution only with the passage of the USA PATRIOT Act in 2001, despite earlier executive branch proposals and pressures from other countries to do so.

The Organization for Economic Cooperation and Development (OECD) ratified its Convention on Combating Bribery of Foreign Public Officials in International Business Transactions in 1997. But action followed these good intentions rather slowly. The convention did not enter into force until 1999, when 12 countries had deposited their instruments of acceptance, approval, or ratification.[15] Many countries were slow to pass legislation necessary to implement the convention, in particular criminalizing foreign bribery, which the United Kingdom did only as part of legislation passed in the wake of the September 11 tragedy. Prosecutions for foreign bribery, in fact, have been quite limited outside the United States,[16] and the OECD has been criticized for weak enforcement monitoring. Finally, the convention itself has come under fire for loopholes, such as noncoverage of foreign subsidiaries, bribery of officials of political parties, and private-sector bribery (Heimann 2004).

At the international multilateral level, negotiations began on the UN Convention Against Corruption in December 2000, and 95 countries signed the final text in December 2003.[17] The UN convention includes prevention measures such as establishment of anticorruption bodies, requires the criminalization of a range of acts of corruption, mandates increased international cooperation, and, importantly, has a chapter on asset recovery. Of course, the convention does not satisfy everyone—Transparency International, for example, has criticized it for failing to address monitoring mechanisms and for not mandating the criminalization of bribery.

With respect to kleptocrats, in particular, only recommendation 6 of the 2003 FATF Forty Recommendations explicitly addressed "politically exposed persons." One breakthrough in this area was the passage in May

15. As of March 2004, 34 countries, including five nonmembers of the OECD (Argentina, Brazil, Bulgaria, Chile, and Slovenia) had adhered to the convention.

16. Bribery of a foreign official has been a crime under the US Foreign Corrupt Practices Act (FCPA) since the 1970s, but prosecutions are infrequent. In May 2003, James Giffen and ExxonMobil were charged under the FCPA in connection with payment of a $51 million "service fee" in Kazakhstan related to an oil contract. Giffen allegedly received more than $78 million from Mobil and other companies, passing some of the funds on to senior Kazakh officials.

17. At the end of March 2004, Nigeria announced that it would also sign.

2003 of UN Security Council Resolution 1483, which called for freezing the funds, assets, and economic resources of Saddam Hussein and other senior officials of the former Iraqi regime and their immediate family members. However, to date there is little evidence that this requirement has produced financial results.

Pursuing known or suspected kleptocrats before they have been driven from power is politically sensitive for governments that often need the cooperation of other governments on other issues, even if they are corrupt. In this connection, a noteworthy development was the establishment in 2003 of a US government task force to systematically target high-level present and former Latin American officials involved in corruption (*New York Times,* August 23, 2003, A9). Such proactive concern with the issue of kleptocrats appears to have produced some results. When Alemán of Nicaragua was convicted of corruption in December 2003, a US judge approved forfeiture of a multimillion-dollar Florida condominium and seizure of $150,000 from the former revenue director in Alemán's finance ministry. Another important case that emerged in early 2004 was the investigation of a senior official with the Riggs National Bank in Washington, DC (see chapter 6) for alleged involvement with the kleptocratic activities of the president of Equatorial Guinea, Teodoro Obiang, and his son.

It is no easy matter to deal with kleptocrats after they have been driven from office. In part, this is because allegations of corruption may involve the settling of political scores,[18] or because new leaders may not be entirely serious about taking action, as evidenced, for example, by neglecting to provide information that might form the basis for legal action by another country. One reason for such bait-and-switch tactics is that the requesting authorities sometimes are in the process of following the example of their kleptocratic predecessors rather than practicing what they preach. Even when home country authorities are serious, they need authorities in other jurisdictions to share their concern, devote resources to the matter, and cope with due process requirements in their jurisdictions. Such complications often impede the type of quick cooperation necessary to identify, block, and confiscate the proceeds of high-level official corruption. As usual, political and legal standards differ across jurisdictions.

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18. Suspected political motivations for prosecutions in the home countries of alleged kleptocrats may sometimes underlie findings that the evidence presented by those authorities is too weak to justify extradition or the freezing and seizure of assets. In a case that comes close to allegations of kleptocracy, a Greek court, following the example of courts in Spain and the United Kingdom, declined in 2003 to extradite oligarch Vladimir Gusinsky to Russia on money-laundering charges possibly associated with capital flight, which is covered by money-laundering statutes in some countries but is not compatible with FATF recommendations. The reason cited for denying extradition was that Russian authorities had failed to substantiate the charges, and the independent Greek legal system turned them down. The European Court of Human Rights subsequently rebuked the Russian government for its pursuit of Gusinsky (*Financial Times,* October 15, 2003, 4; May 20, 2004, 2).

The Swiss authorities scored a public relations coup with their early pursuit of the assets of Nigeria's Abacha, but that case involved the Swiss legal regime, which has fewer or less cumbersome due process protections than those in many other developed countries. Authorities also benefited from the Abacha family's apparent misperception that their ill-gotten gains were safe in Swiss institutions.[19] Other jurisdictions, however, have been less successful in pursuing the Abachas' assets. The UK's Financial Services Authority announced in 2001 that it had the power to investigate allegations against the Abachas and sanction institutions involved for failing to comply with AML controls but not to freeze assets that may be the proceeds of crime. UK authorities eventually did return about $8 million to Nigeria's Economic and Financial Crimes Commission on the basis that cash previously seized at Heathrow belonged to the Nigerian central bank. By the second half of 2003, however, UK authorities had largely abandoned efforts to track the Abacha family's assets, despite evidence assembled by the Financial Services Authority that as much as $1.3 billion may have been processed through London between 1996 and 2000. No reason was given for the decision, but one can speculate either that Nigerian authorities had not provided the United Kingdom with sufficient information to pursue the matter, that the assets could not be reached, or that UK authorities reached the conclusion that it was not worth the effort to seize assets and return them to Nigeria, where there is no assurance that they might not be stolen again.

In the United States, the White House or the State, Treasury, Justice, or Homeland Security Departments may receive requests for assistance with respect to corruption by former officials in other countries. The US government bureaucracy generally is not structured to respond quickly to such requests, resulting in delays that at the least can be politically embarrassing. For example, the US government in late 1999 received a publicized request from Indonesia for assistance in finding the assets of former president Mohamed Suharto. The request went unanswered for 10 months, and the eventual response was that the Indonesian government would have to provide more detailed information if the US government was to be of any assistance.

Such instances were the principal motivation behind an action item in the US Treasury's 2000 National Money Laundering Strategy that established an interagency working group to streamline and improve coordination in handling such requests and inquiries. The group succeeded in establishing new procedures, but under US law the government is still constrained from responding proactively to assertions by foreign governments that various former officials were corrupt and that their assets in the United States should be turned over to the new government. Requests for assis-

19. It was reported in January 2004 that Swiss authorities are cooperating with Argentine authorities investigating money laundering by 200 former officials of President Menem's administration.

tance must contain a factual or legal basis to allow the US government to act, such as evidence that the funds were the proceeds of a US crime (including corruption). Despite such constraints, the US government has sometimes taken actions, as seen in the previously mentioned Lazarenko and Alemán cases.

Kleptocracy and international bribery cases are complex and expensive, as acknowledged even by those writing on behalf of proactive organizations such as Transparency International. Fritz Heimann (2004, 129) notes: "Prosecutors may be reluctant to bring foreign bribery cases because they lack the professional resources to pursue complex international cases. Procedures for obtaining evidence from abroad are often cumbersome and often unproductive." He prescribes technical assistance in connection with cases in developing countries.

The inquiry by Kenyan President Mwai Kibaki into corruption by the government of his predecessor, Daniel arap Moi, offers a glimpse into both the financial and political constraints to such initiatives. The inquiry has required bringing in a costly team of business investigation consultants working with forensic investigators. Moreover, since many of the alleged recipients of earlier corruption payments are in the new government, the political pressures to scale back the inquiry have been substantial.

Nigeria established the Economic and Financial Crimes Commission primarily to deal with private-sector corruption such as money laundering, fraud, and tax evasion. Given Nigeria's history of public-sector corruption and interference in legal proceedings, however, public- and private-sector corruption are difficult to separate, and resistance is entrenched. The commission faces an uphill battle in getting Nigeria to conform to the global AML standards established by the FATF. Executive Chairman Nuhu Ribadu was granted only 6.25 percent of his budget request for fiscal year 2004—$2.2 million out of a request for $35.5 million (*Financial Times,* February 24, 2004, 3).

In recent years, G-8 summit meetings have addressed corruption issues. Building on an initiative at the Evian Summit in 2003, the Sea Island Summit produced agreements the following year with four countries—Georgia, Nicaragua, Nigeria, and Peru—to combat corruption and promote transparency, with the latter focused on the process for granting licenses in the extractive sectors. Complementary actions by the G-8 are limited to technical assistance, denial of safe havens to convicted kleptocrats, and dealing more effectively with recovering the proceeds of corruption. The last action restated a commitment made the Okinawa Summit in 2000.

In conclusion, the hope is that in the future the AML regime and associated political structures will be more effective in dealing with kleptocrats before and after they have left power. Doing so would improve the anticorruption climate, but substantive progress in the future is likely to be slow, as it has been in the past. As part of this progress, better measures of success than surveys of corruption perceptions should also be developed.

Failed States

Kleptocracy and corruption generally are associated with failed states in which the entire political structure has imploded or been perverted in the pursuit of personal economic or political gain. Examples include Nigeria during the rule of Sani Abacha and Myanmar/Burma under the current military junta. In failed states, governments and public institutions normally expected to enforce laws are actively engaged in undermining or ignoring them, which in turn contributes to economic, financial, and political instability. A high degree of internal or cross-border violence is often associated with such states.

Kleptocracy and corruption, as well as other predicate crimes (such as theft, extortion, and drugs) normally associated with money laundering, contribute to the failure of states. Once a state begins to fail, the process feeds on itself, and those in nominal control of the instruments of the governmental process have an interest in systematically employing those instruments for personal rather than public gain. The systemic concern associated with the global public "bad" of failed states is not just the breakdown of law and order, but the fact that such states become a breeding ground for other public "bads" such as terrorism and other forms of violence, which may then be exported to other countries. Examples in recent years include Afghanistan and the Democratic Republic of the Congo.

The prevention and enforcement pillars of the AML regime have a role to play in identifying, isolating, and ultimately rehabilitating failed states. However, the AML regime is ancillary to broader efforts directed at bringing about profound structural changes in the government and society. Successful implementation of AML regimes requires resources that are generally lacking in failed states because most of their financial resources have been stolen, or because the revenue-raising apparatus of the public sector has broken down. In addition, an effective AML regime requires the political and institutional capacity lacking in failed states.

Money Laundering and Failed States

A number of indicators can be used to assess the relationship between failed states and money laundering, as well as the effectiveness of the AML regime in helping to reduce the number of such states. The focus here will be on the linkages between failed states (based on two political indices and one economic index), money laundering (based on two indicators in particular countries and territories), and corruption (based on the Transparency International index). The information used dates primarily from 2002 or 2003, with the exception of data from the FATF's Non-Cooperative Countries and Territories initiative, which since 1999 has assessed the extent to which countries cooperate with global anti–money laundering efforts. A time series for these various indicators would help measure the progress of the global AML regime in this area, but consistent time series are not available for most indicators.

Table 7.1, which summarizes information on failed states for 2002, draws on what is known as the Polity IV study (Gurr, Harft, and Marshall 2003) and on a study by Robert Rotberg (2003) on indicators of political failure. The latter study describes failed states as "tense, deeply conflicted, dangerous and contested bitterly by warring factions . . . [with] the following features: they have internal violence, they can no longer deliver positive political goods to their inhabitants, they cannot control borders, they have flawed institutions, they have deteriorated or destroyed infrastructures" (Rotberg 2003, 5). Polity IV concentrates on four indicators of violence or political instability: revolutions, ethnic wars, adverse regime changes, and genocides or "politicides."[20]

Polity IV and Rotberg identify the same seven countries as "failed states": Afghanistan, Angola, Burundi, the Democratic Republic of the Congo, Sierra Leone, Somalia, and Sudan. Rotberg also includes Liberia and Polity IV includes Myanmar/Burma in the "failed" category. There is much less concordance between Rotberg's category of 21 "weak states"—defined as countries with a shorter list of dimensions of failure—and Polity IV's category of 20 "complex states," defined as countries with two or more linked wars or crises (box 7.1). Six countries are common to the two lists of "weak" or "complex" states, which will be characterized together here as "failing" states.[21]

With respect to states that have failed or are failing economically, we draw on the most recent Country Policy and Institutional Assessment (CPIA) by the World Bank Group's International Development Association (IDA 2003). A World Bank (2002) task force used this type of analysis in a report on what it called "low-income countries under stress," characterized by weak policies, institutions, and governance. We identified as economically "failed" or "failing" those states that had CPIA ratings or "public-sector management and institutions" ratings in the fourth and fifth quintiles in 2002.[22] The 11 countries in the fifth quintile on both criteria were classified as

20. Adverse regime changes include abrupt shifts in patterns of governance, periods of severe elite or regime instability, and shifts away from democracy and toward authoritarian rule. "Politicides" are defined as civil disturbances that result in the deaths of a substantial portion of a political group.

21. The countries in common are Colombia, Georgia, Indonesia, Lebanon, Sri Lanka, and Tajikistan.

22. Elements of the rating for public-sector management and institutions are property rights and rule-based governance, quality of budgetary and financial management, efficiency of revenue mobilization, quality of public administration, and transparency, accountability, and corruption in the public sector (World Bank 2003b, 11). This is one of four rating categories that make up the overall CPIA rating, which also includes economic management, structural policies, and policies for social inclusion and equity. It should be noted that the CPIA exercise covers only countries that are eligible to borrow from the IDA.

Table 7.1 Failed and failing states in 2002

Country	Failed states			Failing states			Not included on CPIA list[g]
	Rotberg[a]	Polity IV[b]	CPIA[c]	Rotberg[d]	Polity IV[e]	CPIA[f]	
Afghanistan	X	X					X
Algeria					X		X
Angola	X	X	X				
Azerbaijan						X	
Bolivia				X			
Burkina Faso				X			
Burundi	X	X				X	
Cambodia				X		X	
Cameroon						X	
Chad				X	X		
Central African Republic			X				
Colombia				X	X		X
Comoros						X	
Congo, Democratic Republic of	X	X				X	
Congo, Republic of					X		
Djibouti					X		
East Timor				X			X
Ecuador				X			X
Egypt					X		X
Fiji				X		X	
Gambia, The					X		
Georgia				X	X	X	
Ghana				X			
Guinea				X		X	
Guinea-Bissau				X	X		
Guyana					X		
Haiti			X	X			
Indonesia				X	X		
Iran					X		X
Iraq				X		X	
Israel				X		X	
Kyrgyz Republic						X	
Kiribati						X	
Laos			X	X			
Lebanon				X X		X	
Liberia	X					X	
Moldova				X			
Myanmar/Burma		X					X
Niger				X		X	
Nigeria			X				
Pakistan				X			
Papua New Guinea						X	
Paraguay				X			X
Philippines					X		X
Rwanda					X		

(*table continues next page*)

Table 7.1 *(continued)*

Country	Failed states: Rotberg[a]	Failed states: Polity IV[b]	Failed states: CPIA[c]	Failing states: Rotberg[d]	Failing states: Polity IV[e]	Failing states: CPIA[f]	Not included on CPIA list[g]
São Tomé and Príncipe						X	
Senegal					X		
Sierra Leone	X	X				X	
Solomon Islands			X	X			
Somalia	X	X				X	
Sri Lanka				X X			
Sudan	X	X	X				
Tajikistan			X	X	X		
Thailand					X		X
Togo			X				
Tonga					X		
Turkey					X		X
Uganda					X		
Uzbekistan			X				
Vanuatu						X	
Yemen						X	
Zimbabwe			X		X		
Total	**8**	**8**	**11**	**21**	**20**	**23**	**18**

CPIA = Country Policy and Institutional Assessment rating

a. Rotberg defines "failed" states as "tense, deeply conflicted, dangerous and contested bitterly by warring factions."
b. State failure includes four types of events according to Polity IV: revolutions, ethnic wars, adverse regime changes, and genocides or politicides.
c. In the fifth quintile in both the "overall" category and the "public-sector management and institutions" category of the CPIA rating.
d. States with one or more failed state features.
e. Two or more temporarily linked wars or crises.
f. In the fifth or fourth quintile of the "overall" category or the "public-sector management and institutions" category of the CPIA rating and defined as having not failed.
g. Countries rated as politically failed or failing states that are not included in CPIA ratings.

Sources: CPIA ratings in IDA (2003); Rotberg (2003); Gurr, Harft, and Marshall (Polity IV study) (2003).

economically "failed" states; the other 23 countries in either the fourth or fifth quintiles on either criterion were classified as economically "failing."

Table 7.1 shows that only two countries (Angola and Sudan) of the 11 cited as failed economically are listed as failed politically by Rotberg or Polity IV. Five others are listed as failing politically (Haiti, Laos, Solomon Islands, Tajikistan, and Zimbabwe).[23] Three of the nine countries that are listed as failed politically are classified as failing economically (Burundi,

23. Zimbabwe today would probably be classified as "failed" as opposed to "failing" politically. The remaining four countries characterized as failed economically, but which are neither failed nor failing politically, are the Central African Republic, Nigeria, Togo, and Uzbekistan.

Box 7.1 "Failed" or "failing" states

The Polity IV study (Gurr, Harft, and Marshall 2003) provides a time series of "failed states"—states so ridden by conflict as to be essentially ungoverned—and what it calls "complex" or failing states, which are sufficiently conflicted as to be in danger of becoming failed states. Although continuity is considerable, a state may be classified as failed or failing in one year but not similarly classified the next or the previous year. Of the eight states scored by Polity IV as failed in 2002, five were scored as failed or failing a decade earlier in 1992: Afghanistan, Angola, Burundi, the Democratic Republic of the Congo, and Somalia. Liberia also was scored as failed in 1992 by Polity IV, but not in 2002, when it was scored as failed by Rotberg (2003), the other index used in this examination. In addition, three states were scored by Polity IV as failed or failing in 1992 that were scored as failing in 2002: Algeria, Lebanon (scored as failed in 1992), and Tajikistan. The only country that was scored as failed or failing in 1992 and was not in either category in 2002 was Peru.

Polity IV classified 87 countries as failed or failing one or more years between 1992 and 2001. More than 75 percent of those classifications were on the combined list for 2002 shown in table 7.1. The exceptions were two failed states (Bosnia over nine years and Lesotho for two years) and six failing states: Albania (one year), Armenia (two), Belarus (two), Nepal (one), Peru (one), and Zambia (one). More than 80 percent of the countries that Polity IV lists as failed in at least one year between 1992 and 2001 are on the list in table 7.1 as failed or failing in 2002. Again, Bosnia and Lesotho are the exceptions. Those countries most frequently listed as failed (five years or more) are Afghanistan, the Democratic Republic of the Congo, Lebanon, Sierra Leone, and Somalia.

the Democratic Republic of the Congo, and Sierra Leone).[24] Most of the remaining countries classified as failing politically had estimated incomes per capita in 2002 too high to be included as IDA borrowers, for which the threshold in fiscal year 2004 was $865.

For assessments of the seriousness of money laundering in various national jurisdictions, we used information from the money-laundering and financial crimes section of the *International Narcotics Control Strategy Report* (INCSR) of the US State Department (2003), as well as the results of the Financial Action Task Force's Non-Cooperative Countries and Territories (NCCT) initiative.

The INCSR classified 190 national jurisdictions as to whether they are of "primary concern" or "concern" with respect to money laundering, with a final category sued for jurisdictions that are just "monitored." Jurisdictions of primary concern are major money-laundering countries defined by statute as those "whose financial institutions engage in currency transactions

24. The other four countries classified as politically but not economically failed were explicitly not rated by the CPIA process, even though in principle their per capita incomes are low enough that they could borrow from the IDA. Myanmar/Burma, Liberia, and Somalia are inactive IDA borrowers, and Afghanistan lacked the information necessary to receive a CPIA rating as of 2002. East Timor, a new IDA borrower, was not included in the 2002 CPIA exercise because of a lack of information.

Table 7.2 Inclusion of countries in INCSR ratings and FATF reviews (number of countries)

	INCSR rating			
FATF treatment	**Primary concern**[a]	**Concern**[b]	**Monitored**[c]	**Total**
Not reviewed	12	24	78	114
Reviewed	41	26	9	76
Failed[d]	***5***	***1***	***0***	***6***
Failed/passed[e]	***10***	***7***	***0***	***17***
Passed[f]	***7***	***13***	***3***	***23***
FATF member[g]	***19***	***5***	***6***	***30***
Total	53	50	87	190

INCSR = *International Narcotics Control Strategy Report*
FATF = Financial Action Task Force

a. Jurisdictions whose financial institutions engage in currency transactions involving significant amounts of proceeds of narcotics trafficking.
b. Jurisdictions where money laundering takes place but is not considered a critical problem.
c. Jurisdictions reviewed that do not pose an immediate concern.
d. Countries that have failed to satisfy the FATF Non-Cooperative Countries and Territories (NCCT) criteria.
e. Countries that initially failed to satisfy the NCCT criteria, but subsequently satisfied them.
f. Countries that initially satisfied the NCCT criteria.
g. Countries and territories that are members of the FATF and have not been subject to NCCT reviews, but that have been subject to FATF mutual evaluations.

involving significant amounts of proceeds of narcotics trafficking." However, the INCSR recognizes the difficulty of distinguishing between the proceeds of narcotics trafficking and the proceeds of other serious crime and, therefore, explicitly applies a broad definition of the scope of money laundering.

The FATF's NCCT initiative—dubbed the "name and shame" process because it calls countries to task for failing to cooperate with global anti–money laundering efforts—is somewhat different in that it focuses on a jurisdiction's compliance with criteria regarding its legal and regulatory framework, international cooperation on money laundering, and resources allocated to anti–money laundering activities (see box 4.3 in chapter 4).

Table 7.2 summarizes the overlap between the INCSR and FATF rating and review processes. While there are important differences in coverage, the FATF review process includes a substantial number of countries and territories identified in the INCSR as jurisdictions of "concern" with respect to money laundering (about 50 percent) and a higher number of jurisdictions of "primary concern" (about 80 percent). In all, 80 percent of FATF members subjected to multilateral review, including the United States, are rated by the INCSR as jurisdictions of "primary concern" or "concern" because of the substantial amount of money laundering that occurs there despite having adequate AML regimes in place. The six FATF members rated as needing only to be "monitored" by the INCSR are Denmark, Finland, Iceland, New Zealand, Norway, and Sweden.

Table 7.3 Failed and failing states and INCSR ratings
(number of countries)

States and territories	INCSR rating: Primary concern[a]	Concern[b]	Monitored[c]	Total rated	Not rated	Total
Political						
Failed[d]	1	0	5	6	3	9
Failing[e]	10	4	17	31	4	35
Economic (additional)						
Failed[f]	1	0	2	3	1	4
Failing[g]	0	2	9	11	3	14
Total failed or failing	12	6	33	51	11	62
Not failed or failing	35	37	52	124	4	128
Total states	47	43	85	175	15	190
Dependent or autonomous territories	6	7	2	15	0	15
Total	53	50	87	190	15	205

INCSR = *International Narcotics Control Strategy Report*

a. Jurisdictions whose financial institutions engage in currency transactions involving significant amounts of proceeds of narcotics trafficking.
b. Jurisdictions where money laundering takes place but is not considered a critical problem.
c. Jurisdictions reviewed that do not pose an immediate concern.
d. Rotberg (2003) combined with Polity IV study (Gurr, Harft, and Marshall 2003); see notes *a* and *b* in table 7.1.
e. Rotberg combined with Polity IV study (Gurr, Harft, and Marshall 2003); see notes *d* and *e* in table 7.1.
f. In the fifth quintile in both the "overall" category and the "public-sector management and institutions" category of the Country Policy and Institutional Assessment (CPIA) rating.
g. In the fifth or fourth quintile of the "overall" category or the "public-sector management and institutions" category of the CPIA rating, and rated as not failed.

Sources: Country Policy and Institutional Assessment (CPIA) ratings in IDA (2003); Rotberg (2003); Gurr, Harft, and Marshall (Polity IV study) (2003); US Department of State (2003).

Because of the broader coverage of the INCSR, its rating system is used here to assess the link between money laundering and "failed" or "failing" states. Table 7.3 shows that only 18 (35 percent) of the 51 politically or economically failed or failing states that the INCSR rated are classified as jurisdictions of "primary concern" or "concern."[25] This percentage is less than the 52 percent of the 175 countries covered by both classifications that are of "primary concern" or "concern." Those 18 "failed" or "failing" states account for 20 percent of the 90 countries of "primary concern" or of "con-

25. Of the limited number of relevant FATF reviews—nine of the 62 failed or failing states—seven states did not pass their initial reviews. The two that passed were Turkey, which is a FATF member and is classified by Polity IV as politically failing, and Vanuatu, classified as economically failing on the basis of the CPIA review. However, the seven failed or failing states account for only about 30 percent of the 23 jurisdictions that initially failed their FATF reviews.

cern" in the INCSR, less than the 29 percent of the 175 countries covered by both classifications that are "failed" or "failing."[26]

This lack of a close association between money laundering and failed states should not be particularly surprising. As argued by Donato Masciandaro and Allesandro Portolano (2002), money launderers or their clients attach high importance to keeping their money safe and like to exploit legal protections to do so, which is no easy task in politically or economically failed or failing states. The only politically failed state that is rated by the INCSR as of primary concern is Myanmar/Burma, and the only economically failed state is Nigeria. Both failed their NCCT reviews. Myanmar/Burma might be considered in a different category of rogue states where there is order accompanied by violence inflicted by the authorities. Such states—North Korea could be considered to be in the same category—might be content to flout international norms by dealing with criminal gangs that operate globally.[27]

Money Laundering and Corruption

Table 7.4 presents a cross-tabulation of the assessment of the seriousness of money laundering on the basis of the INCSR, and the assessment of the extent of corruption on the basis of the Corruption Perceptions Index (CPI) published by Transparency International (2003). A total of 23 (43 percent) of the 53 countries that are in the fourth or fifth quintiles on the CPI and are rated in the INCSR are classified as jurisdictions of "primary concern" or "concern" as part of that rating process, less than the 56 percent of the 130 countries covered by both classifications that are classified as countries of "primary concern" or "concern." Those states account for 32 percent of the 73 jurisdictions that are classified as a "primary concern" or "concern" by the INCSR and also are ranked by the CPI, less than 40 percent of the 130 countries covered by both classifications that are in the fourth or fifth CPI quintiles.[28] The association between money laundering and corruption is not quite as weak as that between money laundering and failed states, but it is still less than would be expected statistically if there were a positive association.

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26. The calculation excludes dependent or autonomous territories covered by the INCSR that presumptively cannot be full-fledged failed or failing states, such as the Cayman Islands and the Isle of Man.

27. North Korea, however, did not make any of our lists of failed or failing states in 2002, and along with South Korea is rated by the INCSR only as a country of "concern" with respect to money laundering.

28. The association is essentially neutral using the FATF reviews for cross-tabulation with the CPI, but these cover a much smaller sample of countries. Of the 20 countries with CPI ratings that did not pass their first reviews under the FATF's NCCT Initiative, eight (40 percent) were rated in the fourth or fifth CPI quintile.

Table 7.4 Money laundering and corruption (number of countries)

CPI[a] quintile	INCSR rating: Primary concern[b]	Concern[c]	Monitored[d]	Total rated	Not rated	Total
Fifth	6	4	15	25	3	28
Fourth	6	7	15	28	0	28
Fourth and fifth	12	11	30	53	3	56
First to third	31	19	27	77	0	77
Total CPI rated	43	30	57	130	3	133
Not rated[e]	10	20	30	60	12	72
Total	53	50	87	190	15	205

INCSR = *International Narcotics Control Strategy Report*

a. Corruption Perceptions Index (CPI), Transparency International (2003).
b. Jurisdictions whose financial institutions engage in currency transactions involving significant amounts of proceeds of narcotics trafficking.
c. Jurisdictions where money laundering takes place but is not considered a critical problem.
d. Jurisdictions reviewed that do not pose an immediate concern.
e. Rated by the INCSR but not by Transparency International. Includes 14 dependent and autonomous territories that are rated by the INCSR.

Sources: INCSR, US Department of State (2003); CPI, Transparency International (2003).

As with the link between money laundering and failed states, many countries for which the perception of corruption is high do not show up as jurisdictions regarding which there is great concern about money laundering. The explanation may be similar: where there is a lot of corruption, with the possible exception of corruption principally by senior government officials, the proceeds of other crimes, over and above "living expenses," may not be safe. However, the data reviewed here do identify 11 countries that are of "primary concern" or "concern" with respect to global money laundering, are politically and/or economically "failed" or "failing" states, and also score poorly when it comes to corruption: Bolivia, Myanmar/Burma, Ecuador, Haiti, Indonesia, Lebanon, Nigeria, Pakistan, Paraguay, the Philippines, and Yemen.

The lack of evidence of linkages between failed states, money laundering, and corruption does not imply that there is no role for the global AML regime's prevention and enforcement efforts in dealing with failed states. The role, however, may be ancillary to broader efforts directed at bringing about profound structural changes in these countries' governments and societies. A credible AML regime requires the political and institutional capacity necessary to put it in place. Implementation of an effective AML regime also requires resources that failed states generally lack, either because they have been stolen or because the government has limited or no revenue-raising capacity.

Consider the case of Afghanistan, which is still classified as a failing state, though one would hope a postconflict, recovering one. The 2003 INCSR rated it only as a country to be "monitored," and Transparency International does not yet cover it in its ratings of corruption, presumably because there is insufficient international business activity to carry out the necessary surveys for the ranking process. Its apparent progress notwithstanding, Afghanistan remains a potential venue for money laundering because of its location and the fact that the opium sector may account for about half of overall GDP (IMF 2003a, 2). A summary report in 2003 of the views of IMF executive directors reflects these concerns. While commending the creation of a supervision department in the central bank, the executive directors "emphasized the importance of further developing regulatory and supervisory capacities and restructuring and privatizing state banks; urged tighter control of informal mechanisms of financing, the introduction of anti–money laundering, and controlling the financing of terrorism legislation; . . . [and] were concerned about the serious risks posed by the rise in poppy cultivation and the production of opium in Afghanistan to the levels of the late 1990s." In encouraging Afghan authorities to prepare the groundwork for privatization of state-owned companies, the executive directors "saw several key areas of reform as preconditions, including putting in place a functioning financial system, a market-oriented regulatory framework, and a functioning and fair legal system to firmly establish the rule of law and the security of property rights" (IMF 2003a, 3–4).

In this context, it is not difficult to understand why it may be a number of years before Afghanistan graduates from the status as failed or failing state and scores well on anti–money laundering and corruption indices.

The NCCT Process and Global AML Standards

Besides strengthening compliance with the global AML regime, the FATF's Non-Cooperative Countries and Territories initiative has played an important role in distinguishing between jurisdictions that reject making any effort to comply with international norms and standards, and those jurisdictions that accept or can be persuaded to accept such a responsibility. A country that can be persuaded to conform to global norms may be less likely to become a failed or failing state.[29] Two critical questions are: How effective has the NCCT approach been in terms of using the threat of adverse publicity and application of countermeasures to motivate reform? How much improvement has there been as a result of the NCCT process and what can be expected going forward?

29. The NCCT "name and shame" process is a soft type of targeted sanction. The NCCT process has been reasonably successful because the sanctions focus primarily and narrowly on the financial sector, using market forces as incentive devices, and have substantial multilateral support. See Hufbauer, Schott, and Elliott (2004) for a full analysis of economic sanctions and the reasons for their successes and failures.

For the first question, it is instructive to look at the case of Nauru, a Pacific island nation with a population of about 12,500 and an income per capita estimated at $5,000. Nauru is so small that it is not a member of either the IMF or the World Bank, and therefore is not included in the CPIA rating. The INCSR, however, listed Nauru as a country of "primary concern" regarding money laundering, and the country failed its first NCCT review in June 2000. Nauru passed AML legislation in August 2001 at least partly in response to the FATF review, but the provisions in that legislation with respect to supervision and regulation did not cover the offshore banking sector. As a result, the FATF in December 2001 recommended the application of countermeasures to Nauru, which prompted the government to amend its AML legislation to cover offshore banks, but did not lead to their actual licensing and supervision. The legislation was further amended in March 2003, but the FATF still would like Nauru "to take additional steps to ensure that previously licensed offshore banks are no longer conducting banking activity and no longer are in existence" as a condition for considering the removal of countermeasures (FATF 2003b, 12).

What has all this activity accomplished with respect to Nauru? After all, no money actually flows to or through the island in any physical sense in connection with its offshore banking sector; the flows are virtual, electronic, and controlled from elsewhere.[30] Reportedly, there has been a decline in the number of shell banking organizations, or at least in the rate of increase—as many as 400 such banks along with numerous other shell-type entities were said to have been registered in Nauru at one point (FATF 2003b, 11). If they so choose, countries can forbid their banks or nonbanks from dealing with those organizations to the extent that they know their names or whether they are entities known to be incorporated or registered in Nauru. In effect, Nauru and its offshore banking entities can be largely, if not completely, quarantined.

There is some hope that Nauru may further amend its legislation and implementation of it in order to cooperate more fully with the FATF and international law enforcement authorities. While it appears that Nauru has to some extent been made an example for purposes of a "demonstration effect," it has a way to go.[31] On the other hand, it seems unlikely that a large amount of proceeds from crimes in industrial countries has been laundered there—but it is impossible to prepare even a rough estimate without more cooperation from the Nauruan authorities. What is clear is that Nauru has made some progress, and that its money-laundering role has been at least somewhat reduced as a result of the application of countermeasures.

30. Wechsler (2001, 48) notes that Nauru banks were involved in some of the money flows from Russia through the Bank of New York in the late 1990s.

31. We met with the director of Nauru's police force (Bernard Junior Dowiyogo) in January 2003. He informed us that when requests came to him from abroad seeking cooperation in international investigations, he passed them on to the responsible government agency and had nothing further to do with them!

Masciandaro and Portolano (2002) worry that the NCCT process is not uniformly applied and that countries may not effectively implement their AML regimes once they have passed the NCCT review. They argue for complementary measures better to integrate jurisdictions into the global financial system, as well as for the development of stronger sanctions for noncompliance. Guy Stessens (2000) notes two types of "noncooperation" with global AML standards. The first may be an unwillingness to cooperate, in which case the appropriate response is to quarantine the country's financial system to encourage it to modify its behavior. The second may be insufficient capacity due to governance problems or a lack of financial or nonfinancial resources. If the world is serious about establishing a comprehensive and global AML regime, this latter type of noncooperation would seem best addressed with technical assistance.

Regarding the broader issue of moving ahead with promoting compliance with global AML standards, it should be noted that 17 jurisdictions that initially failed FATF reviews subsequently passed.[32] Most were offshore financial centers such as the Cayman Islands, Lebanon, Liechtenstein, and Panama, but the list includes a number of countries of larger significance such as Egypt, Hungary, Israel, Russia, and Ukraine.[33] As of early 2004, three sizable countries remained on the FATF's noncooperation list: Indonesia, Nigeria, and the Philippines. These countries, whose combined population tops 350 million, have made sufficient progress since their FATF reviews so as not to be subject to countermeasures, with which the Philippines was threatened in 2001. It remains to be seen, however, how these countries will perform or be dealt with in the future. If they fail to meet international standards, it will be much more challenging politically and technically to apply a Nauru-type quarantine to them.

In addition, the monitoring of observance of global AML standards was largely turned over to the IMF and the World Bank following development of a common methodology with the FATF (chapter 4). This transfer of responsibility has the benefit that reviews are now conducted by organizations with near-universal membership, rather than by a self-selected group of countries. Because of the broader coverage, the reviews are conducted at arm's length rather than as a peer-review process that sometimes limits frank criticism. The growing number of FATF and FATF-style regional groups also participate in and sometimes conduct the reviews. At the conclusion of the 12-month IMF/World Bank pilot project, a joint report concluded that the wealthier the country, the more developed its

32. The FATF has not excluded the possibility, however, of listing a country or territory as uncooperative if there is backsliding.

33. Russia made it all the way from FATF's "name and shame" list to full membership in the FATF within a very short period principally because it had met the "minimum requirements" for membership with respect to its AML regime and because of its classification as a "strategically important country" (FATF 2003a, 10–18).

AML regime, though jurisdictions regardless of financial resources had shortfalls with respect to frameworks for combating terrorism financing (IMF 2004b, 2). The most frequent implementation weaknesses included intragovernmental coordination problems, ineffective law enforcement, weak supervision, inadequate controls in financial firms, and shortfalls in the area of international cooperation.

Countries must "volunteer" for the IMF/World Bank reviews, and while countries can choose not to have the results published, the reviews are available to other member governments. Still, while the peer pressure, transparency, and accountability of the process are enhanced by the involvement of international institutions such as the IMF and the World Bank, there is today less capacity to apply meaningful pressure than when the reviews were carried out exclusively by the FATF.

For example, China, Colombia, India, Pakistan, Thailand, and Venezuela are six large and politically important countries that are rated as a "primary concern" regarding money laundering by the INCSR but were not reviewed by the FATF.[34] Will they volunteer or be induced to volunteer for an IMF/World Bank review of their compliance with international standards on anti–money laundering and combating terrorism financing, and will they volunteer or can they be shamed into allowing those reports to be published?[35] In fact, a number of IMF executive directors (IMF 2004a, 4) commented critically on the fact that the FATF has reserved the right to conduct further rounds of its NCCT process on its own. Their view was that if the FATF were to take the initiative to place new countries on its NCCT list, the IMF should reconsider its collaborative work in this area. They argued that the IMF's work on compliance with global standards and codes is based on the uniform, voluntary, and cooperative nature of its activities. Moreover, countries may be reluctant to volunteer for reviews if they risk being subjected to sanctions as a consequence. On the other side, a report by the Council on Foreign Relations (2004) has called for reinvesting the FATF with the authority to "name and shame" jurisdictions for falling short in implementing their regimes for combating money laundering and the financing of terrorism.

In India, an anti–money laundering law passed in early 2003 has yet to be fully implemented, and questions have been raised about several ele-

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34. China and India have been targeted for membership by the FATF and will be subject to FATF-style mutual evaluations if they become members. China has stated (Zhou 2004, 5) that the FATF should be more representative.

35. The United Kingdom set a good example by volunteering to be reviewed under the IMF/World Bank program and allowing publication of the report. The United States also volunteered for a review of its compliance with standards and codes on money laundering and the financing of terrorism, but not for the broader financial-sector assessment program. The review was not carried out, and the United States has since "volunteered" for a FATF mutual assessment, which is much less rigorous.

ments of the Indian AML regime as it is being put in place, among them whether suspicious activity reports will be required or voluntary. Interviews in India for this study suggest that money laundering is not perceived as a major problem there, which may be why motivation is lacking to adopt and implement full-scale global AML standards. For example, drugs are said not to be a problem.[36] The informal money transfer system, though technically illegal for international transactions, is widely used in India because of the country's tight exchange regime and other types of financial controls. But as these controls are in the process of being relaxed, the perception seems to be that whatever problems there might be with money laundering will likely fade away.

Apart from the question of whether countries will willingly subject themselves to AML regime compliance reviews is the question of whether the IMF—known for its tough stands on countries' monetary and fiscal policies—can be equally tough on money laundering. The IMF has leverage only when a country comes to it to request financial assistance, but it is unlikely that improving implementation of an AML regime can be justified as a condition for restoring macroeconomic stability—much less gain the support from IMF member countries necessary for adoption.[37]

Take the example of the Philippines, whose AML regime was cited by the FATF as inadequate, and which was subsequently threatened with countermeasures. Compliance with FATF standards, however, could not realistically have been required of the Philippines for access to IMF resources during 2000–03, when that country had an IMF-supported macroeconomic adjustment program.[38] The link between money laundering and macroeconomic stability is simply not sufficiently well developed to sell such a linkage.

Another example is Vietnam, rated by the INCSR as a country warranting "concern" but not "primary concern" regarding money laundering. An IMF review of the Vietnamese economy in 2003, when the country was operating under an IMF-supported adjustment program, urged passage of "an effective anti–money laundering decree by year-end, followed by rigorous implementation," and also emphasized "the importance of an

36. The actual level of drug trafficking in India is extremely difficult to estimate. The UN figures suggest that India has more heroin addicts than any other nation, the combination of a moderate prevalence rate and a huge population, but the estimates are highly conjectural because of the lack of a national survey of drug use.

37. One possible exception might be assistance to failed states, where a case can be made that a substantially improved AML regime could be key to the rehabilitation process, as in the case of Afghanistan outlined earlier in this chapter.

38. Wechsler (2001, 52) does point out, however, that when the United States abstained on a vote on an IMF program for the Philippines in 2000 because of concerns that the country had not fulfilled its previous fiscal, monetary, and financial-sector commitments, the vote was interpreted as a sign of concern about the weak Philippine AML regime.

independent external audit of the central bank in accordance with internationally accepted standards" (IMF 2003b, 4). Vietnam's reluctance to agree to such an audit was holding up an IMF disbursement at the time, and the Fund's support for Vietnam's adjustment program eventually was terminated in April 2004 because of this issue, which had been judged to be central to the IMF's macroeconomic policy concerns.

In sum, the answer to the two questions posed earlier about the effectiveness and improvement associated with the NCCT process is that there has been progress. The global AML regime is now well established, and FATF standards are broadly accepted and have been endorsed by the IMF and World Bank. However, the success rate is far from 100 percent, and effective implementation is difficult both to achieve and to assess.

Conclusion

While the surveys and databases cited in this section have shown some broad connections between global anti–money laundering initiatives and failed states, the major instruments for dealing with such states lie outside the AML regime. At the same time, unless the global AML regime is used proactively as a prevention tool, failing or failed states may become huge gaps in the global AML regime, particularly in the case of large countries such as Nigeria. Moreover, the links between large-scale kleptocracy, money laundering, and the failure of states appear to be stronger than those between garden-variety corruption, money laundering, and state failure. That finding confirms a role for the AML regime in efforts to aid failing and failed states, but it also suggests that the deeper connections between the various global "bads" need to be studied further.