Quantifying International Pressure

Synthetic Estimates of the Economic Impact of Blacklisting

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Abstract

An important factor in the global adoption of anti-money laundering laws was the use of a blacklist by the Financial Action Task Force (FATF), an international organization dedicated to coordinating the fight against money laundering. Although the blacklist is now defunct, it was an extremely effective tool that allowed the FATF to bring about widespread policy changes in a short period of time. Despite near universal recognition of its success, there is a lack of consensus about how the blacklist functioned and whether it caused financial harm to listed states. We explore several explanations of how blacklisting functioned and argue it primarily relied on economic coercion enabled by the FATF's powerful members. We then test whether blacklisting caused economic harm to listed countries using the synthetic control method, which enables causal estimates by creating a counterfactual "synthetic" control unit using a weighted average of like countries. We find that blacklisting contributed to lower gross domestic product (GDP) per capita in the decade after blacklisting for one third of the countries in the sample. Based on these findings, we argue that blacklisting's legacy as a tool of economic coercion – along with the very real consequences for some listed countries – can help explain the rapid global diffusion of anti-money laundering laws and continues to influence international efforts to address money laundering today.

1 Introduction

Money laundering remains a major international problem despite widespread adoption of anti-money laundering laws.[1] Money laundering (i.e., the process by which criminals disguise

[1] Ninety-six percent of states are compliant or largely compliant with the FATF's directive to criminalize money laundering.

and integrate illegal funds into the legitimate financial system) harms society primarily through its connection to "predicate crimes" that create funds for laundering. One of the fundamental goals of anti-money laundering laws is to decrease crime by catching criminals or discouraging them from committing crimes in the first place by limiting their ability to use illegally-obtained funds.[2] Importantly, implementing these laws requires a coordinated global response because criminals often launder funds in countries other than where initial crimes were committed.[3] Although traditional knowledge holds that failure to enforce anti-money laundering laws is primarily a problem for poor countries and so-called "tax havens,"[5] growing evidence shows that lapses are widespread and also happen in wealthy Western countries.

One major area of weakness is customer due diligence laws, which require banks to screen their customers for money laundering risk. Some lapses have been revealed through data leaks, such as a major data breach from HSBC Switzerland that showed Swiss bankers had helped clients hide 180.6 billion from tax authorities.[6] Another data leak, the Panama Papers, revealed that banks and law firms around the world had routinely violated anti-money laundering laws and conducted business with tax evaders, corrupt officials, members of organized crime, and even terrorists.[7] Similarly, recent field experiments shows that banks often fail to adequately screen their customers for money laundering risk as required by law. Surprisingly, wealthy countries were among the worst offenders, with compliance rates in the United States and United Kingdom at 30% and 52% respectively.[8] These data leaks, experimental evidence, and money laundering cases reveal the breadth of failures to enforce anti-money laundering laws worldwide.

Given these major lapses in enforcement, social scientists seek to better understand the

[2] In 2012, the FATF amended its recommendations to include tax evasion as a predicate crime for money laundering.

[3] For example, money laundering case show heads of Mexican drug cartels have extensively used U.S. banks to launder funds.[4]

[5] Schwarz 2011.

[6] Michel, Davet, and Lhomme 2017.

[7] Lipton and Creswell 2016.

[8] Findley, Nielson, and Sharman 2014, p. 76.

mechanism(s) that led countries to adopt and enforce anti-money laundering laws in order to better understand behavior in the anti-money laundering regime. One such potential mechanism is economic costs caused directly by money laundering itself. Indeed, some scholars argue that money laundering causes significant economic harm for countries, including decreased foreign investment,[9] financial instability,[10] and poor economic growth.[11] This presents a generally optimistic prognosis – if counties are motivated to enforce anti-money laundering laws because they prevent economic harm, the countries with the means to do so will enforce anti-money laundering laws to protect their economies from harm. However, despite the ubiquitousness of this argument in the anti-money laundering literature, there is little documented evidence that money laundering itself causes harm at the national level.[12]

Another potential mechanism that led countries to adopt anti-money laundering laws is the risk of sanctioning by an international organization. Beginning in 2000, the Financial Action Task Force (FATF) – an international organization dedicated to combating money laundering – placed 21 countries on its list of "Non-Cooperative Countries and Territories," which became known as the blacklist; FATF members (including many OECD countries) responded by issuing financial advisories or other sanctions against blacklisted countries until the FATF deemed them compliant and removed them from the list. Although scholars agree that blacklisting was an extremely effective tool in bringing about widespread policy changes, they disagree as to how this process functioned and whether it caused financial harm to blacklisted states.

We explore explanations from the literature about how blacklisting functioned and argue that it relied on the threat and use of economic restrictions by powerful FATF members to pressure states into making policy changes. We test whether blacklisting caused significant economic harm to countries using the synthetic control method, which enables causal estimates by generating a counterfactual "synthetic" control unit using a weighted average

[9] Morse 2019.
[10] Quirk 1997.
[11] Masciandaro, Takats, and Unger 2007.
[12] Reuter 2013; Levi, Reuter, and Halliday 2018.

of like countries. We find that blacklisting contributed to lower gross domestic product (GDP) per capita in the decade after listing for one third of the countries in our sample. Importantly, the size of the services sector appears to have mediated the economic impact of blacklisting, with poorer countries virtually unaffected while wealthier countries with larger service sectors experienced more economic harm. Accordingly, we argue that blacklisting's legacy as a tool of economic coercion – along with the very real consequences for some listed countries – can help explain the rapid global diffusion of anti-money laundering laws and policies, while problems measuring enforcement can help explain widespread lapses today.[13]

The rest of this paper is divided into four main parts. First, we provide background about the process of blacklisting and explore three explanations from the literature about how this process functioned. Next, we detail our research design and discuss our results. We then discuss several conclusions about the legacy of blacklisting and offer a few concluding thoughts about the FATF's role in promoting international cooperation today.

2 Understanding Blacklisting

2.1 FATF Formation and Blacklisting

The G7 countries formed the FATF as a temporary task force in 1989. The FATF's initial mandate was to help coordinate the international response to illegal financial flows stemming from the illegal drug trade, an effort it began by drafting a set of policy recommendations for best practices to combat money laundering. The FATF released these recommendations one year later and then began reviewing member states progress toward these goals; to do this, the FATF established a process of peer review called Mutual Evaluation Reports. Completed by a team of assessors from FATF member states, these periodic reports provide technical evaluations of how states' legal and regulatory systems compare to the FATF's standards. Using this process, the FATF was able to achieve a high level of policy convergence from its

[13]Nershi 2021.

members during the 1990s.[14]

Near the end of the decade, the FATF turned its attention outward toward non-members. The FATF and the G7 countries began encouraging non-members to adopt the FATF's standards by offering technical assistance and other material support, leading many countries to incorporate these new standards into national law.[15] Not all countries were willing to comply, however, as small countries with large financial sectors in particular faced a strong incentive to resist these standards since they challenged the right to financial secrecy.[16] Thus, the FATF turned to a new process to push reluctant states to adopt these standards – the blacklist.

In February 2000, the FATF published criteria and a timeline for reviewing countries for inclusion on a list of "non-cooperative countries and territories in the international fight against money laundering;"[17] this document also included a menu of economic "counter-measures" FATF members should be ready to implement if directed to by the FATF, which ranged from issuing financial advisories up to full economic sanctions.[18] In the next few months, the FATF reviewed 29 jurisdictions and placed 15 on the first blacklist, which was issued in June.[19]

Blacklisting sparked swift and decisive action from nearly all listed jurisdictions. The four biggest offshore financial centers on the list – the Bahamas, Cayman Islands, Liechtenstein, and Panama – responded by quickly meeting all the FATF's demands.[20] Another seven countries – the Cook Islands, Dominica, Israel, Lebanon, the Marshall Islands, St. Kitts and Nevis, and Russia – made significant concessions, while three others – Niue, Philippines, and St. Vincent and the Grenadines – took actions that allowed them to avoid sanctioning

[14]One exception to the cooperative nature of this process occurred when the FATF threatened to remove Austria as a member if the country did not agree to drop one of its financial secrecy laws, which it did (Sharman 2009).

[15]Hülsse 2008.

[16]Simmons 2001.

[17]Financial Action Task Force 2000, p. 1.

[18]For simplicity, we refer to FATF member states as FATF members.

[19]Drezner 2003.

[20]Eggenberger 2018.

Table 1: New Members Admitted to the FATF

Plenary Year	**New Members**
1989	Canada, France, Germany, Italy, Japan, United Kingdom, United States, European Commission, Australia, Austria, Belgium Luxembourg, Netherlands, Spain, Sweden, Switzerland
1990-91	Denmark, Finland, Greece, Ireland, New Zealand, Norway, Portugal, Turkey, Hong Kong, and the Gulf Co-operation Council
1991-92	Iceland and Singapore
1999-00	Argentina, Brazil, and Mexico
2002-03	South Africa and the Russian Federation
2006-07	People's Republic of China
2009-10	Korea and India
2015-16	Malaysia
2018-19	Israel

Source: Financial Action Task Force 2019, p. 69.

by FATF members. Only one country, Nauru, did not make concessions quickly enough to satisfy the FATF, leading the United State and other FATF members to impose full economic sanctions against the country; the FATF later removed Nauru from the blacklist several years later after implementing major policy changes.[21]

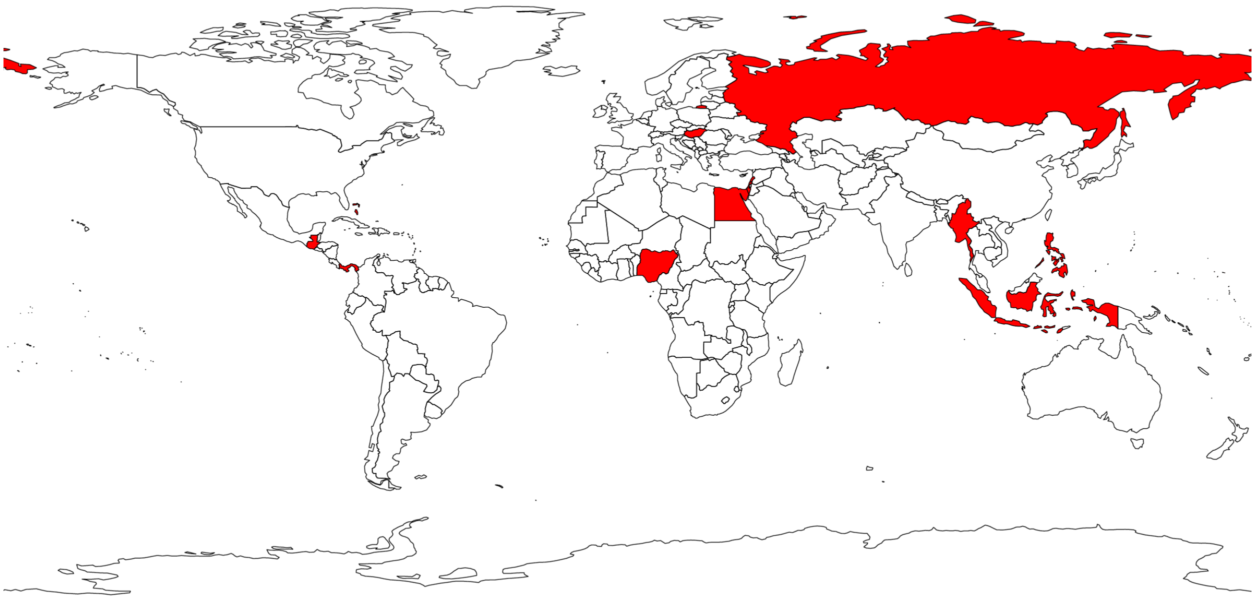
The following year, the FATF reviewed another 18 countries and territories and placed another 8 on the blacklist.[22] These countries also responded quickly to the FATF's stipulations and avoided full sanctions by FATF members. The FATF then abruptly suspended review of new countries for the list in 2002, but continued to review the progress of blacklisted countries until 2006, when the last country was removed from the list.

By nearly all accounts, the blacklist was extremely successful in bringing about policy changes in listed countries.[23] Blacklisting led 73% of listed countries to implement major concessions,[24] and it is also credited with having created a "demonstration effect" that led other reluctant countries to adopt policies to avoid being listed.[25] The FATF also judged blacklisting to be a success, with a representative commenting, "[O]verall the [blacklist] has proved to be a very useful and efficient tool to improve worldwide implementation of the FATF 40 Recommendations."[26] Despite wide recognition of its effectiveness, scholars have proposed several different explanations for how the list functioned, three of which – market driven enforcement, naming and shaming, and economic coercion – we examine in the next section.

Why is understanding how blacklisting functioned important? Chiefly, it can help put the findings regarding blacklisting's economic costs into context, especially since the proposed explanations yield very different conclusions about the process. On the one hand, market driven compliance describes a decentralized process in which economic actors acting in their own self interest create economic pressure that may lead states to implement new policies.

[21]Drezner 2003.
[22]Sharman and Chaikin 2009.
[23]Sharman 2009; Sharman and Chaikin 2009; Drezner 2008; Eggenberger 2018; Hülsse 2008.
[24]Drezner 2003.
[25]Drezner 2005, pp. 852–853.
[26]Hülsse 2008.

Figure 1: Blacklisted Countries



On the other hand, economic coercion suggests that blacklisting was primarily a state-driven process in which powerful states imposed partial restrictions on listed states and threatened more if they did not comply. Somewhere between these two lies a naming and shaming explanation, whereby states played an important role in the process by issuing economic advisories, but both market actors and states responded to this new information in a way that created costs for countries. After considering each of these explanations, we argue that a process of economic coercion best describes how blacklisting led to policy change, as the FATF instructed its members to impose economic countermeasures against blacklisted states.

2.2 Market Driven Compliance

One explanation for how blacklisting functioned is market driven compliance. This explanation rests on the idea that the blacklist served as a source of information for market actors by identifying countries that are at risk for money laundering; investors and financial institutions, who are concerned about the safety of their funds, respond to this information by shifting capital away from listed countries toward safer ones. Importantly, there is no need for coordination on the part of market actors;[27] rather, each investor acting in her own self-interest contributes to a changing wave of capital flows that, in the aggregate, holds the power to inflict significant costs on a state that may lead it to implement policy changes.

Morse (2019) argues that market driven compliance explains how a subsequent FATF noncomplier list – the so-called greylist – functioned, and we examine her broader theoretical argument as an explanation for blacklisting. Morse (2019)'s work is part of a new body of literature that examines how global performance indicators – regularized public ratings of a state's performance for a given issue – can bring about policy change. The thesis behind this research is that by simplifying complex information, global performance indicators can impact state behavior by leveraging states' concerns about reputation. Though scholars have identified several channels through which global performance indicators might create reputation concerns for states,[28] Morse (2019) focuses on one particular channel of influence: transnational market pressure.

Specifically, Morse (2019) argues that unlike Mutual Evaluation Reports – which are several hundred pages long, highly technical, and may be up to eight years old[29] – the FATF's noncompliance lists offer clear, up-to-date information about which countries pose money laundering risk. Because market actors seek reliable information about market conditions, they respond to this information by moving resources away from listed jurisdictions to others that pose less risk. Thus, noncomplier lists shapes how investors and banks view the market by "reduc[ing] uncertainty about country risk and serv[ing] as heuristics that shape expectations about market sentiments."[30] However, there are a few problems when considering this process as an explanation for blacklisting.

[27]Tomz (2012) makes this point in the context of sovereign debt lending.
[28]Kelley and Simmons 2019; Kelley and Simmons 2015; Kelley and Simmons 2020.
[29]Levi, Reuter, and Halliday 2018.
[30]Morse 2019, p. 514.

2.2.1 State Intervention

First, states played a major role in directing how markets responded to blacklists, as the FATF relied on its members to implement countermeasures against blacklisted states. At the minimum, FATF members agreed to issue financial advisories against blacklisted states, which required intermediaries in these countries to perform enhanced customer due diligence for all transactions involving a listed country. This imposed additional costs on intermediaries, which already face significant costs from compliance programs more generally.[31] Indeed, costly compliance measures often lead banks to engage in de-risking, whereby they abrogate business relations with specific types of customers, or even all customers from a specific country, because they are deemed not worth the compliance hassle.[32] Further, because FATF members included the world's biggest and most sophisticated economies, whatever countermeasures they imposed were multiplied by their combined market power. Thus, though some financial institutions severed relations with blacklisted countries, this may have been because the costs of compliance were too high rather than because financial institutions were concerned about reputational harm or the risks posed by money laundering itself.

In addition to financial advisories, some countries also imposed economic restrictions *beyond* the FATF's recommendations; Argentina, for example, issued financial restrictions against blacklisted countries and did not remove these until years after the countries were delisted by the FATF.[33] Further, intermediaries in the United States in particular may have also feared an increased risk of prosecution in money laundering cases involving one of the blacklisted countries given their enhanced political salience.[34] Thus, while markets imposed costs on blacklisted countries, this occurred primarily through state coordination that required intermediaries to participate in national countermeasures.

[31] See Levi, Reuter, and Halliday (2018) for a discussion of these costs.
[32] Levi, Reuter, and Halliday 2018.
[33] Sharman 2010.
[34] Balakina, D'Andrea, and Masciandaro 2017.

2.2.2 Legitimacy Concerns

Another reason market driven compliance does not serve as a good explanation of blacklisting is that unlike in the literature on global performance indicators, which emphasizes that indicators must come from a credible source in order to influence states' behavior,[35] the FATF's role in blacklisting was criticized by many countries as illegitimate.[36]

In particular, many smaller states argued that the process amounted to a group of powerful countries imposing rules on developing countries. For example, a representative of Antigua called the FATF the "creation of a handful of rich countries" and declared it unacceptable that "a handful of states, however powerful, should usurp the right to dictate standards to the rest of the world under the threat of imposition of sanctions;"[37] similarly, another representative of Caribbean states called blacklisting a form of "fiscal colonialism."[38] Thus, many small countries opposed the process of blacklisting by arguing that it violated state sovereignty.[39]

Developing countries also raised concerns about how the process functioned in practice. The FATF reviewed select countries for blacklisting, but there was no clear criteria for how it selected countries to review. Indeed, the FATF did not review any of its members for blacklisting, and if it had, it would have been forced to blacklist two of its members (Switzerland and Luxembourg). The FATF also reviewed countries for blacklisting according to a more stringent set of criteria than its 40 Recommendations, which it used to evaluate efforts by its members.[40] This led to some cases where the FATF required more exacting standards for blacklisted countries than those maintained by its members, such as when the FATF required that the Bahamas license all financial institutions to be removed from the

[35]Kelley and Simmons 2015; Kelley and Simmons 2019; Doshi, Kelley, and Simmons 2019.

[36]Kelley and Simmons (2019, pp. 6–7) note that a source of legitimate authority is trust, which "develops out of a perception that an actor is fair, knowledgeable, and/or competent" and note that a key source of legitimacy for non-state actors is independence from powerful political actors. In the case of blacklisting, however, many states did not view the FATF as an unbiased actor or the process of blacklisting as legitimate.

[37]Hülsse 2008, p. 464.

[38]Sanders 2002.

[39]Sharman 2011; Drezner 2003; Hülsse 2008; Eggenberger 2018.

[40]Eggenberger 2018.

blacklist even though no FATF country had similar requirements.[41] Accordingly, frustrations with this process led a representative of Liechtenstein to comment: "[Liechtenstein] considers the decision of the FATF unreasonable, particularly since FATF's procedures at no point demonstrated the transparency that could be expected in a process of such gravity."[42]

Thus, market driven compliance cannot adequately explain the blacklisting process since states played a fundamental role in coordinating the actions of markets and many voiced serious concerns about the legitimacy of the FATF. Market driven compliance also cannot explain why the FATF dispensed with such a powerful tool so soon after its introduction.

2.3 Naming and Shaming

Another potential explanation for how blacklisting functioned is as a form of "naming and shaming" that created reputational costs for listed countries,[43] as scholars argue that intergovernmental and international organizations can impact state behavior by identifying states that have performed poorly in a certain area. This act of identifying a state as a poor performer holds the constitutive power to transform how actors – including the state itself – view the issue. Thus, the act of naming by an organization can create pressure on the state (shaming) that may lead internal or external actors to push for policy change.[44] Indeed, one might argue that the very act of placing a state on a blacklist is a form of shaming since it publicly "highlight[s] actions or practices that are inconsistent with international norms."[45]

A naming and shaming explanation is similar to a market driven explanation in that both hinge on the role of reputation, although the target audience for naming and shaming is generally much larger. This target audience may include domestic elites – who view their country's reputation as an important asset and may be embarrassed by negative international

[41] Sharman 2011.

[42] Hülsse 2008, p. 465.

[43] Sharman 2009; Eggenberger 2018; Sharman and Chaikin 2009; Masciandaro 2005; Masciandaro 2008; Balakina, D'Andrea, and Masciandaro 2017.

[44] Joachim, Reinalda, and Verbeek 2007; Hendrix and Wong 2013; Lebovic and Voeten 2006; Murdie and Davis 2012.

[45] Eggenberger 2018, p. 483.

attention, leading them to take action; domestic constituents – who may capitalize on the international salience of an issue to pressure their government to make changes; and even government actors themselves – who may use the increased international salience of an issue as justification for pushing through reforms that unpopular domestically.[46] Another difference between the two explanations is that while the scholarship on global performance indicators emphasize that ratings must come from a credible source in order to be influential, the literature on naming and shaming generally does not make an *a priori* judgment about the objectivity of the process through which states are "named."

Accounts that identify blacklisting as a form of naming and shaming emphasize that reputation is a key asset for countries seeking to attract foreign investment, and thus jurisdictions with major financial centers are especially sensitive to reputational concerns.[47] Accordingly, blacklisting stigmatized countries by associating them with criminal activity, which is something actors in blacklisted countries considered much worse than be being called "tax havens."[48] Although some countries did express concern that blacklisting harmed their reputations,[49] we argue that the primary way blacklisting functioned was by leveraging the economic power of its member states.

2.4 Economic Coercion

A third explanation for how blacklisting functioned is as a form of economic coercion. Proponents of this theory argue that blacklisting relied on the coordinated actions of FATF members to threaten states with economic restrictions if they did not comply with the FATF's standard,[50] and we argue this explanation is most convincing given that the process was political and driven by powerful states.

[46] Simmons 2010.
[47] Sharman 2009; Eggenberger 2018.
[48] Eggenberger 2018.
[49] For example, nearly all blacklisted states expressed displeasure at being included in a list with some of the *other* blacklisted states (Eggenberger 2018).
[50] Drezner 2003; Drezner 2008.

We have already established that elements of the blacklisting process can be considered unfair in that non-FATF members were treated differently than FATF members. In some cases, this can be traced directly to politics behind the scenes; Switzerland, for example, was able to withstand pressure to limit its financial secrecy laws due to a tacit agreement with Britain. Although Swiss representatives had previously argued that British trusts created a loophole for tax evaders, Switzerland agreed to drop these objections in exchange for Britain's agreement not to take issue with Swiss financial secrecy laws.[51] This sort of political horse trading was not a viable option for less powerful states, which did not hold a seat at the table during these negotiations.

Further, some argue that the true impetus behind blacklisting was the G7 countries' desire to minimize financial secrecy in offshore financial centers. Drezner (2008) argues that because developed countries stood to benefit from the coordination of international anti-money laundering standards, they had a strong incentive to push for international regulatory convergence. However, because they anticipated opposition from small financial centers and developing countries, they chose to work toward this goal through the FATF – a small organization made up of wealthy states – rather than the IMF or the World Bank, both of which had broader membership bases and consensus-based decision making.[52] Indeed, G7 countries voiced strong support for blacklisting, even going so far as to emphasize their commitment to imposing financial restrictions as part of the process:

> "We are prepared to act together when required and appropriate to implement coordinated countermeasures against those [Non-compliant Countries and Territories] that do not take steps to reform their system appropriately, including the possibility to condition or restrict financial transactions with those jurisdictions."[53]

Although it is unclear whether this was the true motivation behind blacklisting, some blacklisted countries believed it to be. For example, the director of the Caribbean Financial Action

[51]Sharman 2009.
[52]Drezner 2008, pp. 5–11, 124–129.
[53]Drezner 2008, p. 143.

Task Force (a regional FATF-style body) commented, "Caribbean countries feel there is a second agenda... to claw back revenues coming to the offshore centers because of their competitiveness."[54]

Beyond the politics involved in the process, the process itself depended on FATF members' willingness to impose economic restrictions against blacklisted countries, which is clear from firsthand accounts of states' experiences with blacklisting. One example of this comes from the Philippines, which the FATF blacklisted in June 2000 and gave until September of the following year to implement legislation meeting the FATF's standards or else face additional countermeasures. The process was rocky. As the September 30$^{\text{th}}$ deadline approached, Philippines' congress convened to pass a new set of anti-money laundering laws only to see them rejected by the FATF before the president had a chance to sign them into law. This led the president to send the laws back to congress, urging them to quickly amend the legislation so that it would meet all the FATF's standards.[55] One senator likened the situation to that of a dependent territory, commenting, "I thought the Philippines is a Republic, not a commonwealth."[56]

Drezner (2008) describes another amazing scene that unfolded in a U.S. Treasury Department meeting. Representatives of the United States and several other allies sat reviewing an unnamed country's new anti-money laundering legislation line-by-line, noting passages of unclear text or potential loopholes that the country's representative promised would be addressed through amendments. Earlier, the country in question had been blacklisted and now was responding directly to its member states.[57] This presents an incredible scene for scholars of international relations – one where concerns about state sovereignty were pushed to the side as a group of powerful states directly influenced another state's domestic legislation.

[54] Hülsse 2008.

[55] Garcia 2001; Casayuran 2003.

[56] Another senator's comments about the situation were even more colorful: "[The FATF's actions are] a deadly game for the independence of this country. If they don't want us to assert the rights of our people, may be they should now abolish the Senate and the House of Representatives and just appoint people in Congress who will do the bidding of their foreign masters" (Casayuran 2003).

[57] Drezner 2008, pp. xi–xii.

Thus, we conclude that blacklisting primarily functioned as a form of economic coercion based on the power politics involved in the process and evidence from firsthand accounts.

This explanation also comports with the circumstances surrounding the FATF's suspension of blacklisting. In the 2002, the FATF was in talks with the IMF about receiving assistance completing mutual evaluation reports. Although the IMF was supportive of the FATF's goals, it took issue with the practice of blacklisting. Board members from developing countries in particular argued that the process was unfair and incompatible with the character of the IMF as an organization, which centered on consensus-based decision making and voluntary participation by states. Accordingly, the IMF made dropping blacklisting a condition to receive the organization's support, and the FATF complied.[58] These events underscore that even another international organization viewed blacklisting as too harmful.

3 Research Design

The existing literature has found mixed results when considering the impact of blacklisting. Balakina, D'Andrea, and Masciandaro (2017) analyze panel data for 125 countries between 1996-2014 and conclude that noncompliance lists did not cause a significant decrease in capital flows. Kudrle (2009), meanwhile, uses ARIMA (autoregressive integrated moving average) regression analysis and finds no clear effect of blacklisting: the results show a decrease in financial transactions for some countries though not for others. Lastly, Sharman (2009) employs case studies to examine the effect of blacklisting and concludes that blacklisting resulted in significant financial harm for some listed countries (those with primarily institutional business) but produced little harm for others (those with more private client business).

However, several factors limit our ability to draw broad inferences based on these results. Two of these studies estimate the impact of blacklisting in models that also include other less

[58] Scott-Joynt 2002; Hülsse 2008.

powerful forms of sanctioning, which underestimates the potential impact of blacklisting.[59] Specific modeling choices also make it difficult to interpret the findings of one study in substantive terms.[60] And while case studies provide insight into blacklisting through interviews with key players and detailed analysis,[61] they cover only a handful of blacklisted countries and lack comparisons to counterfactuals.

Accordingly, we build on these existing studies in several important ways. First, we expand the analysis to examine more cases than those covered using case studies and analyze *only* the effect of blacklisting. Second, we account for the presence of major macroeconomic trends before and after blacklisting by removing these countries from the sample; this is important since major events like the Asian Financial Crisis greatly impacted some blacklisted countries' financial outcomes, thus biasing an estimate of the effect of blacklisting. Third, our analysis employs counterfactual estimates that offers a means of comparison for blacklisted countries; these counterfactual estimates can account for regional and international trends as well as approximate each country's unique trajectory for a given outcome. This is important since blacklisting could affect countries by causing a decrease in economic *growth* without causing a decrease in the overall levels of other outcomes, something that is difficult to assess without a counterfactual estimate.

We measure the economic impact of blacklisting using the synthetic control method.[62] This method creates a synthetic control unit using a weighted combination of control units based on key characteristics of the treated unit; importantly, this method enables causal inference by estimating the counterfactual for the treated unit in the absence of an interven-

[59] Balakina, D'Andrea, and Masciandaro (2017) consider the impact of blacklisting and greylisting together, even though these were very different processes. Kudrle (2009) combines analysis of both FATF blacklisting and a parallel OECD effort to identify tax havens.

[60] Kudrle (2009) constructs the outcome variable as the share of country's financial transactions out of all financial transactions for tax havens in a given year. However, there is both conceptual and operational murkiness about use of the term "tax haven," and this construction of the dependent variable assumes the existence of direct and cross elasticitities across tax havens, which remains unproven. See Morais, Simioni, and Thomas-Agnan (2016) for a discussion of modeling assumptions when the outcome variable is specified as a share.

[61] Sharman 2009.

[62] Abadie and Gardeazabal 2003; Abadie, Diamond, and Hainmueller 2010.

tion. This approach provides transparency into the case selection of control unit included in the weighted average.[63] Another important advantage of the this method is that it enables comparative case studies when no individual control unit serves as a good counterfactual for the treated unit.[64] This is fundamentally the case for countries, since there are relatively few countries and each is highly idiosyncratic.

We follow the synthetic control method developed by Abadie, Diamond, and Hainmueller (2015), which we summarized here. For simplicity, we consider a case with one treated unit drawn from a sample of $J+1$ units indexed by j. We assume that the first unit ($j=1$) undergoes the treatment, while all other units ($j=2$ to $j=J+1$) do not and are potential donor units that can be used to create a synthetic control unit for the treated unit. We also assume a balanced panel dataset ($t=1,...T$) with both pre-intervention periods (T_0) and post-intervention periods (T_1). The treated unit is exposed to a treatment effect during periods ($T_0+1,...T$) with no effect from the treatment during the pre-period.

Because pre-intervention characteristics for a treated unit can be better approximated using a weighted combination of control units rather than drawing from a single control unit, we develop a vector of weights for all control units. This is represented by a ($Jx1$) vector of weights $W=(w_2+...+w_{J+1}=1)\prime$, with each untreated unit assigned a weight of $0 \leq w_j \leq 1$ and all weights summing to one ($w_2+...+w_{J+1}=1$). Weights are assigned by minimizing the difference between pre-intervention of the actual treated unit and the synthetic control unit, represented by the vector $X_1 - X_0W$. Thus, the synthetic control unit is chosen by W^*, which is the value of W that minimizes:

$$\sum_{m=1}^{k} v_m (X_{1m} - X_{0m}W)^2, \tag{1}$$

where v_m represents the weight assigned to the m^{th} variable.

[63] Abadie, Diamond, and Hainmueller 2015.
[64] Abadie, Diamond, and Hainmueller 2015.

The treatment effect is then estimated as the difference between post-intervention outcomes for the treated unit and the synthetic control estimate, written as

$$Y_{1t} - \sum_{j=1}^{J+1} w_j^* Y_{jt}. \tag{2}$$

3.0.1 Dependent Variable

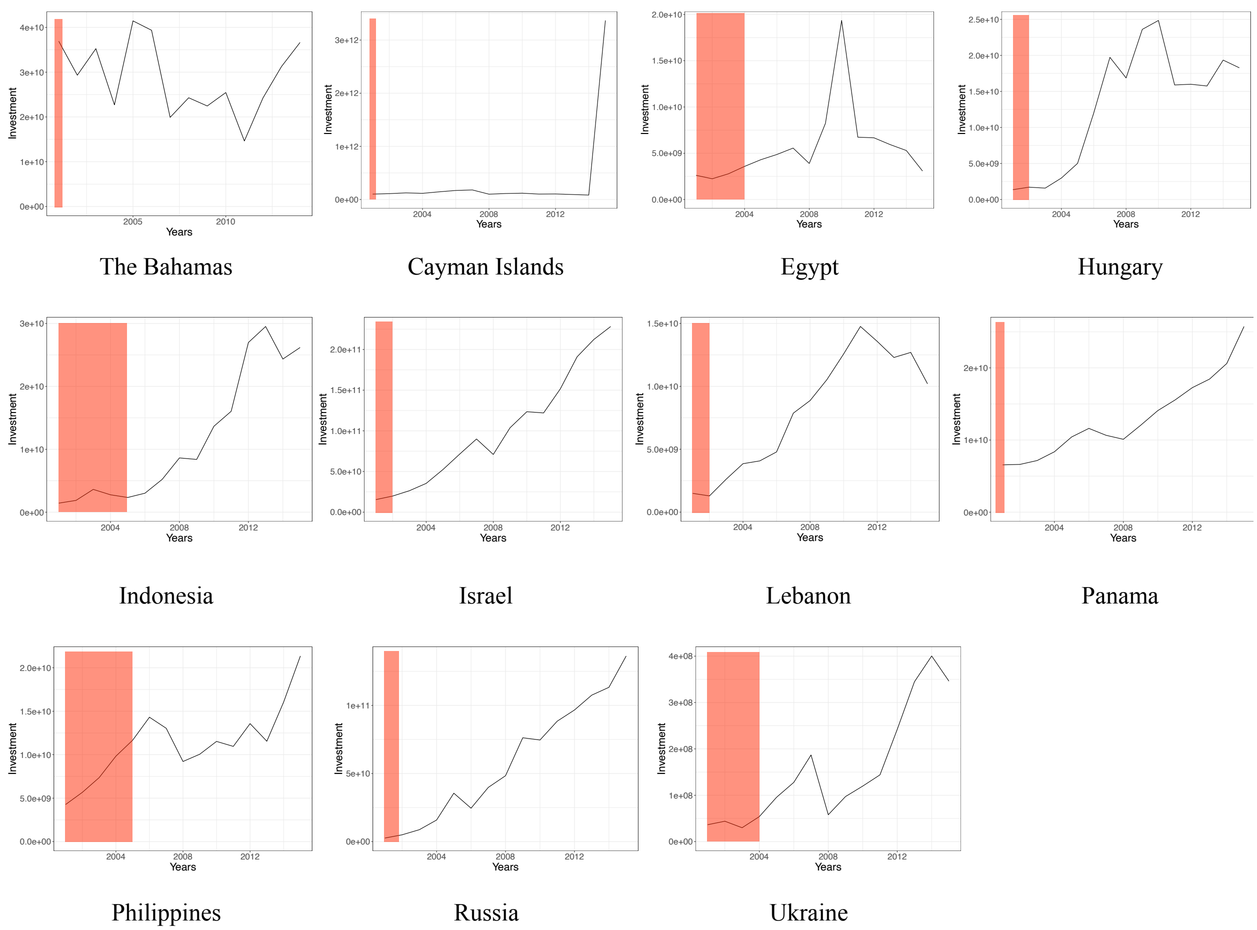
Scholars argue that the primary way blacklisting may harm countries is by leading to a decrease in foreign portfolio investment. Though some studies operationalize the outcome using cross-border bank liabilities (albeit with different specifications),[65] recent studies suggest cross-border portfolio asset investments offer a better outcome to measure the effect of blacklisting because they are a more liquid asset class than cross-border bank liabilities.[66] Figure 2 shows foreign portfolio investment for each blacklisted country with available data (2001-2014) using data on cross-border portfolio asset investments from the Bank of International Settlements. These graphs show that most countries did not experience a decrease in foreign portfolio investment following blacklisting, but without additional information, it is impossible to understand how these levels compare to what the total investment *would have been* without blacklisting. Thus, this outcome cannot be used to measure the impact of blacklisting because data is not available for the years before blacklisting.

Accordingly, we use an aggregate measure of economic output as the dependent variable – gross domestic product (GDP) per capita. This aggregate measure can capture ways that blacklisting might harm the economy independently of foreign investment, such as if fewer new businesses are incorporated in a jurisdiction after blacklisting. However, an aggregate measure also sets a high bar for measuring a potential treatment effect since generally only major exogenous events (e.g., financial crises) impact GDP per capita. Thus, while GDP per capita offers the best outcome variable to test the effect of blacklisting given the lack

[65] Balakina, D'Andrea, and Masciandaro (2017) constructs a measure of bank flows as $BankFlow_{i,t+1} = \log(\frac{BankLiabilities_{i,t+1}}{BankLiabilities_{i,t}})$, while Morse (2019) considers the log of bank liabilities for a given year.

[66] Case-Ruchala and Nance 2020.

Figure 2: Total Investment for Blacklisted Countries



Notes: These graphs show the yearly investment (2001-2014) for each blacklisted country with available data from the IMF Coordinated Investment Portfolio Survey dataset. Shaded portions present time spent on the blacklist.

of available data, we should view this specification as a "hard test" of the prediction that blacklisting causes financial harm.

3.1 Covariates

We also include several covariates identified by the literature as important for predicting GDP per capita using the synthetic control method.[67] These predictors share information about the size of three major sectors of the economy – agriculture, trade, and services – as a percent of GDP.[68] We use yearly data (1990-2014) from the the World Bank World Development Indicators dataset for the dependent variable and all covariates. We choose to anlayze data starting from 1990 since there is a significant decrease in available data on both the dependent and independent variables before 1990.

3.2 Sample

We begin by considering all blacklisted countries and territories, displayed in Figure 2. We remove blacklisted countries that experienced a major macroeconomic event before or after blacklisting that impacted GDP per capita, which could confound an estimate of the impact of blacklisting. Thus, we remove countries that were affected by the Asian Financial Crisis in the late 1990s (Philippines, Indonesia), former Soviet Union countries (Russian Federation, Ukraine), and Lebanon, which experienced a war in 2006.[69] We also remove nine jurisdictions that are missing data on the dependent variable. Afterward, we are left with a sample of 165 control countries and 9 treated countries, roughly 40% of blacklisted countries and territories.

Table 3 shows the means for the actual and synthetic countries across the predictors. These summary statistics confirm a close match between the actual and synthetic blacklisted countries across these variables. The breakdown of the weighted average for each country

[67] Abadie and Gardeazabal 2003; Abadie, Diamond, and Hainmueller 2015.

[68] Trade includes the percent of GDP generated by both exports and imports.

[69] Although Hungary was also a part of the Soviet Union, its GDP per capita does not show unusual activity in the pre-period.

Table 2: Blacklisted Countries

Country	**Years on Blacklist**	**Sample**	**Reason Excluded**
Bahamas	2000	✓	
Cayman Islands	2000	–	Missing data
Cook Islands	2000-2005	–	Missing data
Dominica	2000-2002	✓	
Egypt	2001-2004	✓	
Grenada	2001-2003	–	Missing data
Guatemala	2001-2004	✓	
Hungary	2001	✓	
Indonesia	2001-2005	–	Macroeconomic trends (*Asian Financial Crisis*)
Israel	2000-2002	✓	
Lebanon	2000-2002	–	Macroeconomic trends (*war*)
Liechtenstein	2000	–	Missing data
Marshall Islands	2000-2002	–	Missing data
Myanmar	2001-2006	–	Missing data
Nauru	2000-2005	–	Missing data
Nigeria	2001-2006	✓	
Niue	2000-2002	–	Missing data
Panama	2000	✓	
Philippines	2000-2005	–	Macroeconomic trends (*Asian Financial Crisis*)
Russia	2000-2002	–	Macroeconomic trends (*Former USSR*)
St. Kitts and Nevis	2000-2002	–	Missing data
St. Vincent and the Grenadines	2000-2003	✓	
Ukraine	2001-2004	–	Macroeconomic trends (*Former USSR*)

Notes: This tables presents all blacklisted countries and specifies which are included in the sample. Each country that was excluded from the sample has a reason specified. *Missing data* denotes jurisdictions that are missing data for the dependent variable in the pre-period. *Macroeconomic trends* denotes jurisdictions that experienced a major disruptive event before or after blacklisting.

1.3

Table 3: Predictor Means before FATF Blacklisting

	Agriculture		Trade		Services	
	Country	Synthetic	Country	Synthetic	Country	Synthetic
2000 Blacklist						
Bahamas	2.253	2.254	96.895	96.895	71.219	71.219
Dominica	13.730	13.730	97.655	97.655	60.386	60.386
Israel	1.554	2.015	61.865	61.902	63.956	63.955
Panama	6.739	6.777	143.642	143.648	67.798	67.797
St. Vincent & the Grenadines	9.453	9.453	105.036	105.036	60.445	60.445
Full Sample	15.777		81.803		50.179	
2001 Blacklist						
Egypt	16.132	16.132	49.261	49.262	47.786	47.786
Guatemala	24.318	24.316	43.951	43.962	55.849	55.846
Hungary	5.426	5.427	87.219	87.219	53.476	53.476
Nigeria	24.166	24.166	37.903	37.903	40.682	40.682
Full Sample	15.611		82.331			50.259

Notes: Means for the actual and synthetic controls units for each country during the pre-period for three covariates – the share of GDP (%) produced by agriculture, trade (imports and exports), and services. The full sample includes 165 control countries. The sample mean for countries listed in 2000 includes all control countries between 1990-1999, while the sample sample mean for countries listed in 2001 includes all control countries between 1990-2000.

is also included in Table **??** in the Appendix. This table hows that the majority of each synthetic control unit comes from three or fewer countries, which helps to prevent overfitting through the use of regularization within the algorithm.

3.3 Results

Figure 3 presents the main results of the analysis. These graphs show GDP per capita for the actual (solid line) and synthetic (dashed line) countries, with time spent on the blacklist denoted by the shaded portion of each graph. We find that three countries – the Bahamas, Dominica, and Israel – show lower levels of GDP per capita in the period after blacklisting, while six other countries – Egypt, Guatemala, Hungary, Nigeria, Panama, and St. Vincent and the Grenadines – show little difference between the predicted and actual values. The differences for these listed countries are substantial, with the Bahamas showing an average 19% lower GDP per capita than predicted in the period after blacklisting, Dominica 10% lower, and Israel 4% lower. The effect is also long lasting: Israel's GDP per capita only converges with its synthetic counterpart after ten years, while the Bahamas' and Dominica's actual GDP per capita fail to reach predicted levels in the fourteen years after blacklisting.

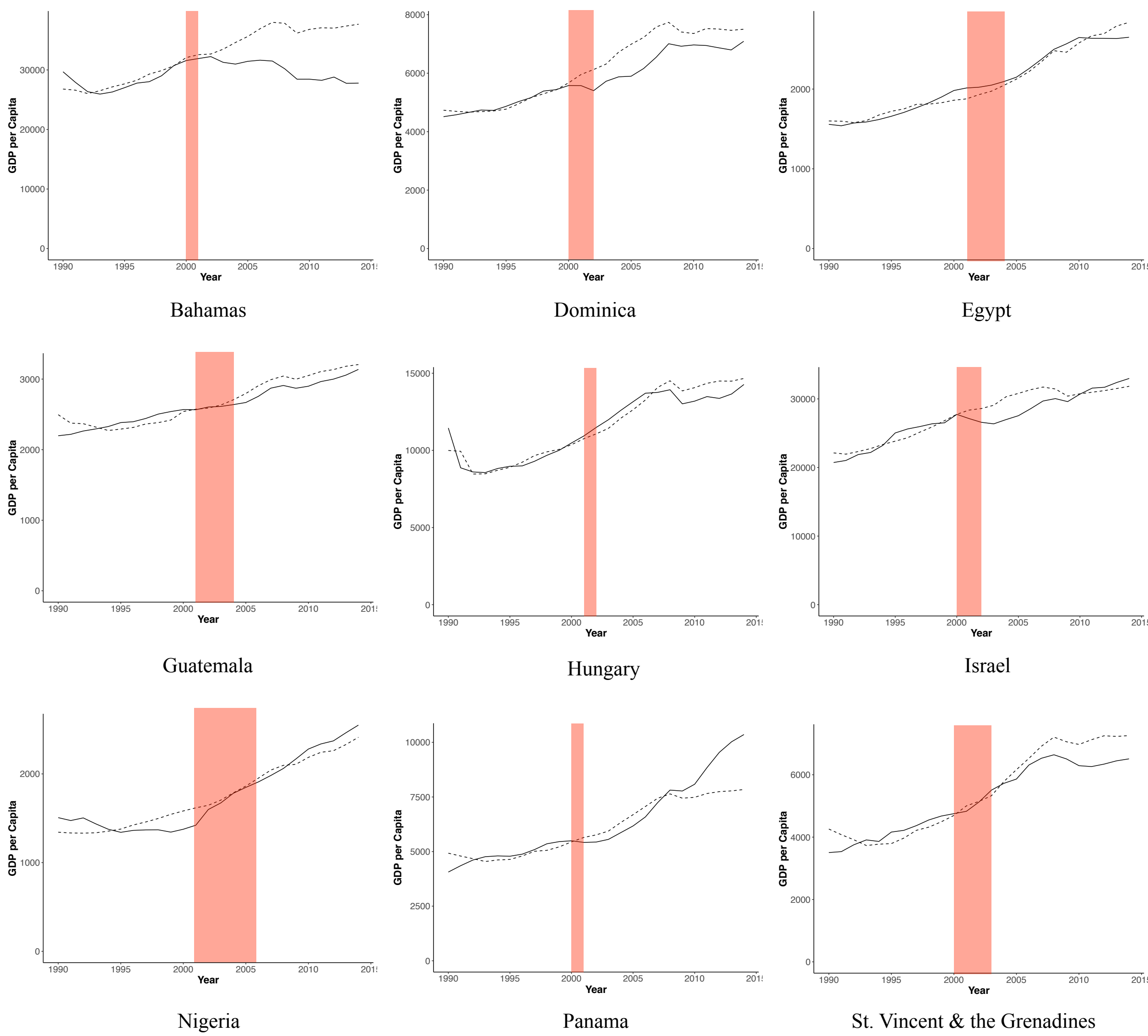
We can also consider the results in terms of effect size. Figure 4 shows the effect size for each country – the difference between the actual and synthetic GDP per capita in dollars by year – on a common scale. From these graphs, we can clearly see that the largest divergence occurs for the Bahamas followed by Israel. Dominica also experienced a negative difference, though it was smaller in absolute terms than the other two. These plots also highlight that there is little divergence between the actual and synthetic GDP per capita at the time of blacklisting for the remaining countries in the sample.

3.3.1 A Mediating Variable: The Size of the Services Sector

What explains variation in outcomes across blacklisted countries? One possible explanation is that the makeup of a country's economy mediates the effect of FATF blacklisting. Specifically, countries whose economies are more dependent on services experience a greater loss as a result of blacklisting than countries whose economies are more dependent on agriculture or industry. This makes intuitive sense, since the services sector (and especially the financial services) is more vulnerable to changes in behavior by international investors than other sectors. Figure 5 plots the percent difference between the actual and synthetic GDP per capita in the period after blacklisting against the size of the services sector (as a percent of GDP); this relationship is approximately linear.

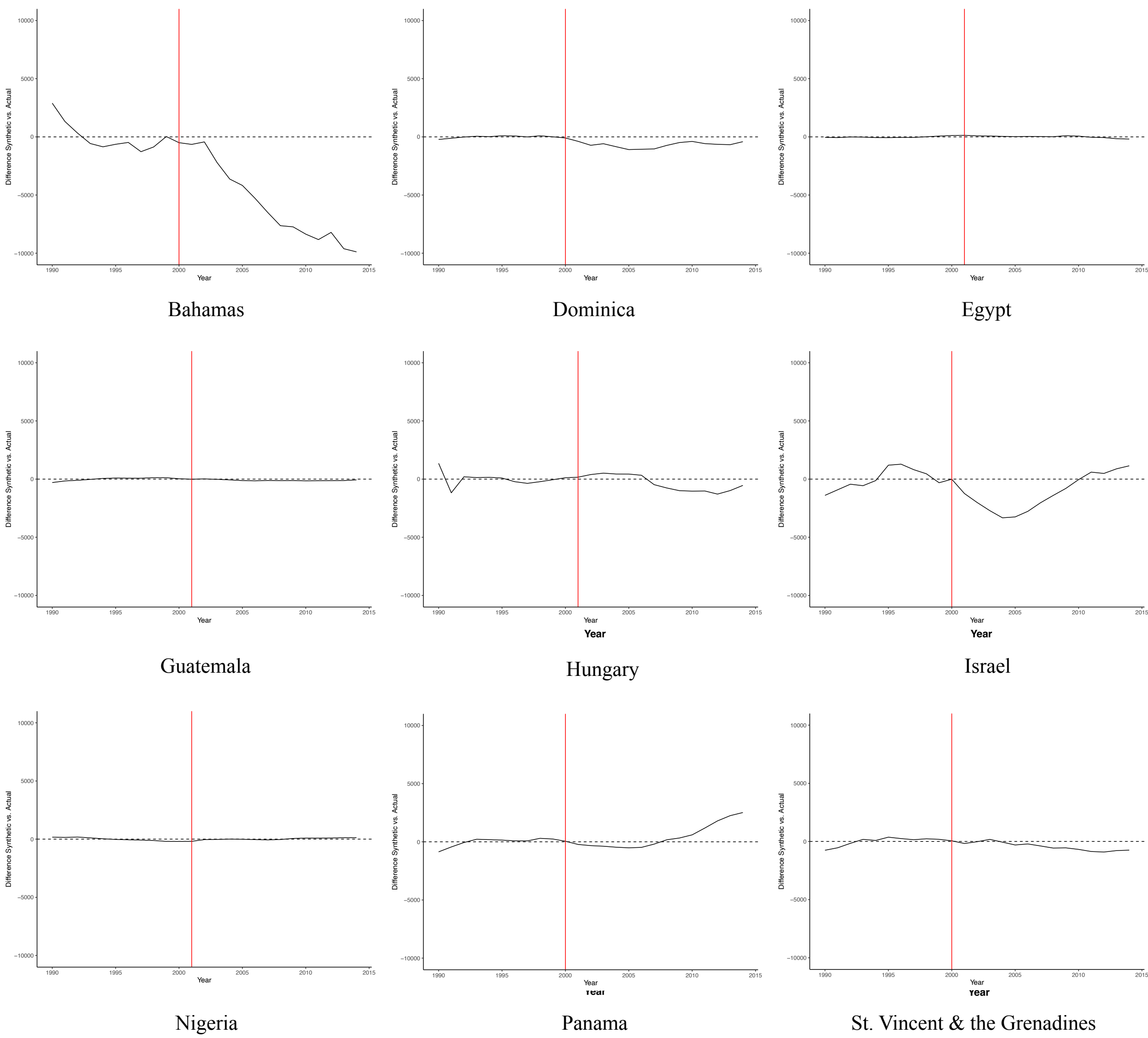
This insight can also help explain why states reacted differently to blacklisting. Because some countries experienced greater harm from blacklisting, they moved quickly to be removed from the list: the Bahamas, Israel, and Dominica acted quickly and were among the first removed from the blacklist, while other countries like Egypt and Nigeria moved more

Figure 3: Synthetic vs. Actual GDP per capita for Blacklisted Countries



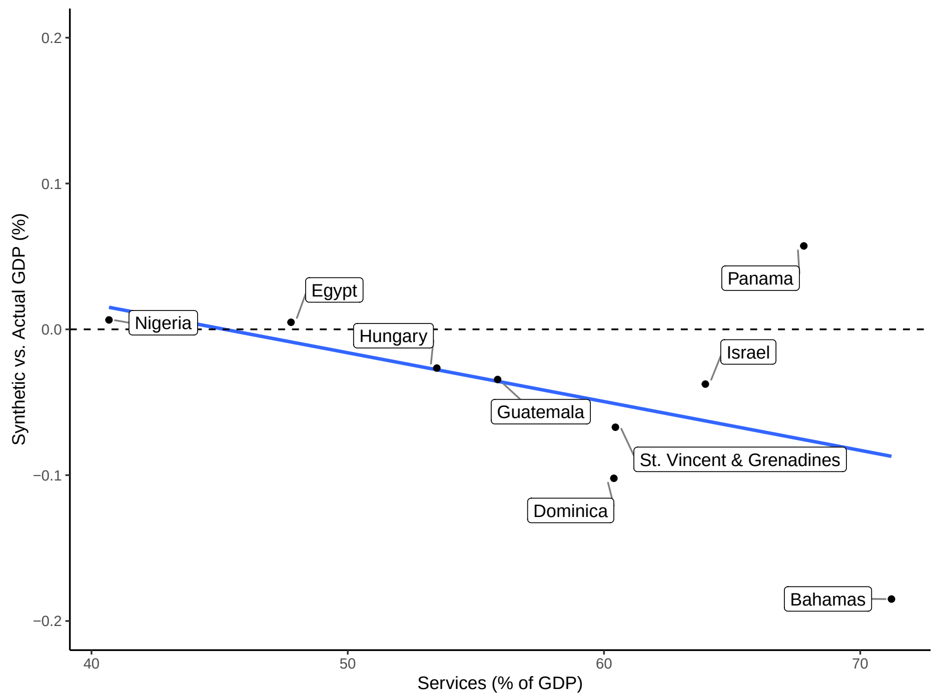
Notes: Synthetic (dashed line) versus actual (solid line) GDP per capita for blacklisted countries (1990-2014). Shaded rectangles denote the years a country was blacklisted.

Figure 4: Effect Size for Blacklisted Countries



Notes: Plots show the effect size – the difference between the actual and synthetic GDP per capita in dollars – for each blacklisted country. Vertical intercepts denote the year a country was blacklisted.

Figure 5: Synthetic vs. Actual GDP for Blacklisted Countries



slowly and consequently spent longer on the blacklist. Thus, while we hesitate to draw firm conclusions given the small sample size, we propose that countries with large service sectors experience more economic harm as a result of FATF blacklisting as a working hypothesis.

4 Discussion

Blacklisting was consequential both in its impact on some countries' economic outcomes and in the far reaching policy changes brought about by the process. Our empirical results show that blacklisting caused substantial economic harm for some blacklisted countries, and we argue these costs were primarily driven by economic countermeasures imposed by FATF members. Below, we discuss three broad conclusions about the impact of blacklisting on international efforts to combat money laundering today.

4.1 Developing States and a "Luxury Good"

Blacklisting played an instrumental role in leading many countries to adopt anti-money laundering laws, but these laws have imposed a significant burden on developing countries without yielding much in the way of results. FATF recommendations require that states make changes to the legal code (criminalizing money laundering and terrorist financing, stipulating the right of regulators to fine financial institutions for anti-money laundering failures, etc.), regulatory changes (expanding the purview of regulators, hiring new personnel, training regulators), and establish a financial intelligence unit – a government agency that coordinates the national response and screens analyzes national data. These requirements pose a significant challenge for any state, let alone developing ones that often lack government resources.

Although developing countries have devoted a great deal of time and resources to creating national anti-money laundering systems, there is little evidence that these efforts have produced benefits for the states themselves or the international financial system as a whole. Developing countries have had few money laundering convictions (many have not tried a single money laundering case) and little in the way of confiscated criminal assets. Niger, for example, which is one of the world's least developed countries, established and staffed a financial intelligence unit, yet 18 months later, the agency had still not received a single suspicious activity report. These underwhelming results are not particularly surprising given that the FATF's recommendations were developed based on the experiences of its members – wealthy states with sophisticated financial systems. This has created mismatches between policies and conditions on the ground in some places, such as the requirement that financial institutions record a customer's address and make copies of identity documents, even though people in some developing countries may lack a fixed address or official documents.[70]

Despite the significant costs and poor results, the FATF has not made revising its policy guidelines for developing countries a priority. This fact speaks to both the path dependency

[70] Sharman and Chaikin 2009.

of the organization and the lack of program evaluation for anti-money laundering laws that has hindered a better understanding of how these laws function.[71] Accordingly, a preeminent scholar has called today's one-size-fits-all anti-money laundering systems a"luxury good" for developing countries, stating that it remains an "article of faith" by developed countries that uniform measures are necessary to achieve an effective international response to money laundering.[72] Some developing countries, meanwhile, have come to view maintaining anti-money laundering systems as a costly "paper exercise" that must be performed to satisfy powerful foreigners.[73] Thus, the field requires more empirical research on the money laundering and terrorist financing risks that developing countries face to determine which policies offer the best defense without placing an undue burden on these states.

4.2 A New Type of List

The FATF has also taken measures to develop better relationships with developing countries in the years since blacklisting, signaling a major shift in the organization's approach. One example of this is the FATF's noncompliance list after blacklisting known as the greylist, which was released in 2009 and war part of the FATF's effort to urge countries to criminalize terrorist financing. Greylisting, which is still in effect today, differs from blacklisting in several important ways. To begin with, it includes two tiers of review: one for "low capacity countries" and another for "vulnerable jurisdictions that are failing to implement effective anti-money laundering/counter terrorism financing systems."[74] The FATF offers technical assistant to the first group while seeking to obtain policy changes from the second through a process of dialogue and persuasion. Notably, this process does not include threats of economic sanctions by FATF members, and the FATF has stated that public condemnation of countries on this list should be a last resort. Thus, greylisting represents a significant

[71] Levi, Reuter, and Halliday 2018.
[72] Reuter 2005, pp. 7, 184.
[73] Sharman and Chaikin 2009, p. 43.
[74] Financial Action Task Force 2008, p. i.

shift in tone for the FATF and has been perceived as less punitive and more equitable than blacklisting.[75]

Further, evidence suggests that greylisting has had far less of a detrimental impact on countries economically than blacklisting. Although one study[76] finds that greylisting led to a significant decrease in financial transactions, analysis of high-frequency SWIFT transaction data[77] and a replication and extension of the aforementioned study[78] find no evidence of decreased financial flows to greylisted countries. These findings also fit within the framework for how the blacklist functioned proposed here. Specifically, because blacklisting was primarily a process driven by states, it produced serious economic costs for some countries, while the decentralized process of greylisting does not appear to have significantly impacted economic outcomes.

4.3 The FATF Today

Lastly, the politics of the FATF have permanently changed thanks to the addition of new members. Since blacklisting, the FATF has admitted seven new members – six of which are developing countries. Some of these new members, and particularly Russia and China, have not hesitated to dissent from the consensus view.

This shift in the organization's politics is discernible in recent discussions over whether Pakistan should be placed on the FATF's greylist. News accounts suggest that Pakistan lobbied Russia and China to block any effort to greylist it and received tacit assurances from these two countries and Malaysia that they would block any such move by other FATF members.[79] This sort of alliance among developing countries – and especially involving countries that are often out of the United States' good graces – would have been unheard of twenty years ago and signals that FATF members are no longer as unified as they once were.

[75] Hülsse 2008.
[76] Morse 2019.
[77] Collin et al. 2021.
[78] Case-Ruchala and Nance 2020.
[79] Masood and Abi-Habib 2019; "FATF keeps Pakistan on grey list until June despite 'significant progress'" 2021.

5 Conclusion

In this paper, we analyze the process of FATF blacklisting and measure its economic impact on countries. We argue that blacklisting primarily functioned as a form of economic coercion since countries were selected for blacklisting through a political process and FATF members (including the most powerful countries in the world) agreed to implement countermeasures against listed countries. Using the synthetic control method, we find evidence that blacklisting led to a substantial decrease in GDP per capita in the decade after blacklisting for one third of the countries in our sample, though this affect appears to be mediated by the size of the services sector. Consequently, we argue that blacklisting's legacy as a tool of economic coercion can help explain the widespread adoption of anti-money laundering laws, while lapses in enforcement today are primarily driven by a lack of reliable data about enforcement at the national level.[80]

Even though blacklisting was highly controversial, there are several reasons to be optimistic about the FATF's role in promoting international cooperation to address money laundering today. For one, the FATF has shown itself willing to pilot and adopt new methodologies and policies. This is an important strength for an organization working in a new field, since the body of knowledge on the topic continues to evolve over time. This flexibility also suggests that the FATF can continue to improve its methodologies over time through a process of incremental improvement.

Another reason to be optimistic about the FATF's role is that it has already accomplished several major feats. These include creating a set of policy recommendations intended to help states combat money laundering, achieving widespread adoption of these laws by countries around the world, and promoting international cooperation in efforts to combat money laundering more broadly. Even though some may take issue with the organization's methods, this should not detract from the major challenges the FATF has surmounted to achieve

[80]Nershi 2021.

these goals. Thus, the FATF has proven itself to be an extremely capable and influential organization, albeit sometimes controversial.

Finally, there is reason for optimism given that the FATF dropped use of blacklisting and has since taken steps to engage with a broader range of national views. More than ever, the international community can benefit from the guidance of a competent organization dedicated to promoting international cooperation to address money laundering. The FATF can fulfill this role by remaining committed to an even-handed approach to promoting efforts by both developing and developed countries.

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