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Determining the Relationship Between Corruption and Money Laundering

MARIJANA BARTULOVIC[1], NEVENA ALJINOVIC[2] and DAMIR PIPLICA[3]

[1] Associate professor, University of Split, University Department of Forensic Sciences, Split, Croatia.
[2] Postdoctoral, University of Split, University Department of Forensic Sciences, Split, Croatia.
[3] Associate professor, University of Split, University Department of Forensic Sciences, Split, Croatia, e-mail: damir.piplica@gmail.com

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ABSTRACT

Corruption and money laundering are phenomena that often co-occur in practice and are so closely linked that it is sometimes difficult to separate one from the other. Corruption, on the one hand, causes money laundering, while at the same time, money laundering strengthens corruption. The research carried out in this paper aimed to clarify the relationship between money laundering and corruption, and their relationship was analyzed using the panel method. Six countries are included in the research sample: Italy, Croatia, Slovakia, Slovenia, Germany, and Sweden, and the research period is from 2011 to 2020. The research results show a positive and statistically significant relationship between corruption and money laundering. The results of the research suggest that the increase in activities aimed at preventing money laundering will result in a decrease of corruption. These results indicate that the efforts of various international and national organizations are justified to promote and improve the money laundering prevention system, as the fight against this phenomenon has a positive effect on the reduction of corruption at the same time. It is undoubtedly necessary to continue to promote and improve transparency in the anti-money laundering system since the increased transparency of the system implies a reduced possibility of corruption among all stakeholders involved in the anti-money laundering system. According to our knowledge, this area is still under-researched, and this paper contributes to clarifying the interrelationship between money laundering and corruption. Indeed, it should be pointed out that there is room for further research in which a larger sample could be included, and the analysis could be extended to more countries. Also, due to their harmful and destructive influence on all social structures, the relationship between these phenomena will continue to occupy the attention of scientists and will be the subject of research interest in the future.

INTRODUCTION

The symbiotic relationship between corruption and money laundering has long been recognized in the scientific community (Chaikin and Sharman, 2009) and has been the subject of numerous studies on economic crime, organized crime, and white-collar crime. Corruption and money laundering are so intertwined that it is difficult to distinguish one from the other. Not only do they appear almost simultaneously in practice, but corruption causes money laundering, and money laundering strengthens corruption. In other words, the presence of one creates fertile ground and enhances the realization of the other (Ahmad. 2019). The World Bank also points out that corruption and money laundering are related phenomena that feed and complement each other (World Bank, 2007). Money laundering and corruption schemes are inextricably linked, with corruption being used either as a "means to an end or as an end in itself" (Mugurura, 2016, 74). Therefore, corruption can be seen both as a cause and as a purpose *per se* since the laundered property represents either the property benefit acquired by a criminal offense or the placement of the illegally obtained property benefit into the legal system was facilitated (by paying bribes) by corrupt officials (Goredema, 2004).

Corruption generates illegal funds that are transformed into legal ones through various money laundering schemes. As one of the fundamental features of both phenomena, it can be pointed out that they are challenging to detect and consequently difficult to investigate. Both phenomena have a destructive effect on social structures, and it is estimated that money laundering and corruption account for 2-5% of the global gross domestic product (Sanyal and Samanta, 2011). The question arises whether money laundering is a by-product of corruption or whether corruption is a predicate crime for money laundering. Many criminal acts are driven by the same goal, which is the acquisition of material benefits. In order to conceal the illegal origin of the property benefit and create the apparent legality of its realization, it is necessary to go through the money laundering process. Money laundering is, therefore, an ex-ante and ex-post phenomenon associated with corruption. To minimize the probability of its detection, corruption requires money laundering (trigger effect), while, on the other hand, money laundering enables the re-implementation of laundered corrupt money into legal flows (multiplier effect). Also, corruption can serve as an effective means of increasing the likelihood that anti-money laundering activities will be ineffective. Namely, it is possible to corrupt financial institutions to prevent the detection of money laundering (accelerator effect) (Barone, 2019).

It is clear from the above that corruption is a predicate criminal offense of money laundering, while money laundering is not (always) a necessary by-product of corruption since smaller sums of money do not require "laundering" because there is no investment, given that they are (most often) spent on the current needs of the recipient, without causing suspicion of increased consumption. The connection between corruption and money laundering was also investigated by Teichmann (2020), who points out that measures to prevent money laundering are essential in the fight against corruption, but also states that a combination of different measures and more rigorous punishment for corrupt behavior is needed. In his work, Mugarura (2016) also highlights the strong connection between these phenomena and emphasizes the importance of the action of international supervisory institutions in the fight against corruption and money laundering because the practice has shown that without the intervention of supervisory institutions, some national governments become the main generator of corruption and money laundering through their poor political management. Chaikin (2008) tried to demystify the relationship between corruption and money laundering by analyzing the legal regulations in this area and pointed out the lack of empirical data on these phenomena so that they could be studied in more detail. In this paper, the authors try to contribute to clarifying the relationship between these two phenomena and investigate the interrelationship between corruption and money laundering. Using the panel method, the authors investigate the relationship between corruption and money laundering, and six countries are included in the research sample: Italy, Croatia, Slovakia, Slovenia, Germany, and Sweden in the period from 2011 to 2020.

The paper is structured as follows. After the introductory part, the theoretical part of the paper deals with the phenomena of corruption and money laundering. It presents previous research on the relationship between corruption and money laundering. The sample and research methodology are discussed in the second chapter, and the results and discussion are presented in the third chapter. The last part of the paper brings concluding considerations on the relationship between corruption and money laundering.

1. THEORETICAL FRAMEWORK

In this chapter, the authors theoretically deal with the phenomena of corruption and money laundering and present previous research on the relationship between corruption and money laundering.

1.1 Corruption and money laundering phenomena

The phenomenon of corruption is difficult to define, and numerous authors emphasize the lack of an official, globally accepted common definition (Saana et al., 2021, p. 7; Peurala 2011, p. 325; Peurala and Muttilainen 2015, p. 14). According to Transparency International, *corruption* can be defined as "*the abuse of (entrusted) power for private gain*." Corruption has a destructive effect on all social structures because, on the one hand, it undermines trust in the work of public services, weakens democracy, and negatively affects economic development. On the other hand, it worsens poverty and encourages social stratification and divisions (Transparency International, 2022). Corruption as a form of economic crime implies a relationship of reciprocity between the involved parties because all involved stakeholders profit through corruption. Corruption presupposes a cumulative intertwining of positions of power/responsibility, abuse (of positions), and realization of personal gain (Peurala and Muttilainen, 2015, p. 14).

Given that corruption can generate (substantial) funds whose origin must be concealed by money laundering (Chaikin, 2008), thas money laundering represents a "*conveyor belt*" of corruption, i.e., a process in which illegally acquired money must be given an apparently legal origin (Levi and Reuter, 2006). The above best illustrates the flagrant nature of their relationship, which is mutually stimulating and sustainable. One of corruption's fundamental (ubiquitous) modalities is generally considered bribery (Peurala, 2011). However, it should be pointed out that corruption is not synonymous with bribery because the latter modality is narrower and more direct than corruption. Bribery is most often paid in cash because it leaves no traces (Mugarura, 2016, 75). It is closely related to money laundering since the real benefit from cash transactions is realized by implementing cash in the financial system. As a result of the above, it is clear that corruption can generate illegal profits that need to be laundered, but it also qualifies as a predicate crime for money laundering (Chaikin and Sharman, 2009; Mugarura, 2016). However, a bribe does not necessarily have a property value. It can be a trip, a discount on products, a favor to a friend, or favoritism (Peurala and Muttilainen, 2015).

Besides bribery, corruption can take several other forms, such as illegal favoritism or influence peddling. Corruption can be classified in many different ways. The most important distinction between corruption is that between private and public corruption. Private corruption (so-called corporate corruption) can be defined as a process in which illegal payments are made to private parties. It is often characterized by the payment or acceptance of a kickback or commission by an individual who is in the non-governmental sector. The goal is simply to induce the individual receiving the bribe to act in a manner favorable to the bribe giver without considering the interests of his employer, principal, fiduciary, or client (Chaikin, 2008; Barone et al., 2019). The classic definition of corruption in the public sector is "*abuse of public office for private gain*" (Svensson, 2005, p. 20). An illegal payment is usually directed or made to a recognizable public official in public corruption. The usual division of public corruption is into petty and grand corruption. Cuervo-Cazurra (2016) further divides corruption into ubiquitous and arbitrary and organized and unorganized corruption. Shams (2001) mentions domestic and transnational corruption. Peurala and Muttilainen (2015, 14) distinguish between black corruption, which includes corrupt criminal acts that everyone condemns, and white corruption, which is generally accepted. Between them is a gray area, which means corruption that is accepted by the elite but condemned by the people.

The prevailing view is that corruption has a negative impact on the affected state (Wei, 1999; Lambsdorff, 2006); therefore, countries with a higher level of corruption are less developed (Mauro, 1995; Mauro, 1998), have lower levels of investment (Lambsdorff, 2003), have lower exports (Lee and Weng, 2013) and a lower level of foreign direct investment (Wei, 2000) from countries with developed anti-corruption laws, but not from corrupt countries (Cuervo-Cazurra, 2006; Cuervo-Cazurra, 2016). Despite the prevailing opinion, there are also arguments that corruption and money laundering in developing countries can contribute to economic development since they can serve as an instrument for the allocation of scarce resources; they can enable investment and strengthen the private sector by reducing uncertainty and even the negative effects of bureaucracy (Julius Otusanya, 2011).

The phrase money laundering implies the transformation of illegal profits so that they can be used as if they were obtained legally. In other words, money laundering involves converting assets known to be illegally obtained into legal forms in order to conceal the actual origin of the assets. Most jurisdictions define money laundering as any financial transaction involving the proceeds of a predicate offense (Alexander et al., 2006, p. 67). Money laundering usually involves three stages: placement, layering, and integration (FATF, 2020). After the predicate crime is committed, the illegal funds are separated from their illegal source and placed in one or more financial institutions domestically or internationally. This begins the first stage of money laundering, the placement, in which the risk of detection is simultaneously the highest. Typical methods include cash deposits, paying off loans, over or under-invoicing, and investing in luxury items. After the successful implementation of illicit money into the financial system, money laundering requires the creation of multiple layers of transactions that further separate the funds from their illicit source. For example, funds are moved from one jurisdiction to another (e.g., through tax havens) to make the origin of illegal funds more difficult to trace. Finally, in the last phase, the integration phase, legal funds are intermingled with illegal ones, and the money is returned to the legal market and continues to be marketed as if it came from entirely legal sources.

1.1 Previous research

Numerous authors write about the inevitable and mutual connection between corruption and money laundering. Shams (2001) conducted extensive research on the fight against extraterritorial corruption and the application of anti-money laundering measures in the fight against corruption. The author points out that the anti-money laundering system can serve as a powerful tool in the fight against corruption, especially in the areas of states that are unwilling to fulfill their obligations in the fight against corruption. Furthermore, the author highlights the crucial role of financial institutions in the fight against corruption and how the anti-money laundering system as an extensive financial regulatory mechanism can ensure the cooperation of financial institutions and their more significant role in the fight against corruption. As Christensen (2011) and Barone et al. (2019) stated, corruption generates demand for money laundering activities, while the possibility of laundering corruptly acquired money offers a supply-side stimulus for corrupt activities. Chaikin (2008) based his research on the relationship between commercial corruption and money laundering primarily on analyzing legal regulations in this area. Based on the obtained data, the author concludes that improving the money laundering prevention system will help prevent and detect corruption. On the other hand, the money laundering prevention system's effectiveness will be improved if its vulnerability to corruption is eliminated and minimized.

Barone et al. (2019), in their work for the first time, analyze the three-way relationship between money laundering, corruption, and measures to combat money laundering. The authors propose a new theoretical framework for monitoring these phenomena and point out that determining the relationship between corruption and money laundering is essential for effectively combating both phenomena. Also, they emphasize the need for increased transparency in the money laundering prevention system in order to reduce corruption among public officials operating in the money laundering prevention system. Markovska and Adams (2015) analyzed the relationship between political corruption and money laundering in Nigeria, where corrupt politicians used European banks to launder illegal funds. Solaiman (2018) investigated the connection between corruption and money laundering in Bangladesh and concluded that corruption is the dominant source of illegal money that needs to be laundered. Costa (2022) also writes about the connection between corruption and money laundering and, among other things, analyzed how money laundering activities and offshore financial infrastructure affect corruption and who are the main actors involved in money laundering and corruption activities. In the end, the author points out that it is necessary to expand the understanding of corruption and understand the latter as a collective, transnational, and financially advanced phenomenon. Cooley and Sharman (2015) showed that contemporary corruption relies on a network of cross-border connections and financial transactions that serve to conceal illicit connections between corrupt political elites and corporations that secure benefits by bribing such actors. Arellano-Gault (2019) describes the internal conditions and endogenous practices used by business entities for repeated corrupt practices, such as the development of hidden communication and decision-making chains within the hierarchical structure of the corporation, the creation of internal departments to manage illicit behaviors, and the definition of guidelines for illegal exchanges.

Teichman (2020) analyzed how effective the measures to prevent money laundering are in the fight against corruption. The research was conducted on a sample of 25 experts in the field of fighting corruption and money laundering and 25 perpetrators of the crime of money laundering. The research results suggest that measures to prevent money laundering are essential in the fight against bribery and corruption, but punishments and anti-corruption measures should also be tightened to reduce corruption. Mugarura (2016) points out in his work that the literature that analyzes the relationship between money laundering and corruption is quite scarce and emphasizes the close and undeniable connection between money laundering and corruption and the need for further research into the relationship between these phenomena. Furthermore, the author emphasizes the importance of supervisory institutions such as the World Bank and the IMF and states that without the intervention of supervisory institutions, some national governments have become the main generators of corruption and money laundering through weak political action.

2. SAMPLE AND RESEARCH METHODOLOGY

Six countries are included in the research sample: Italy, Croatia, Slovakia, Slovenia, Germany, and Sweden, and the research period covers the period from 2011 to 2020. Data on the corruption perception index were taken from the website of Transparency International, while data on money laundering, that is, the number of cases opened with suspicion of money laundering and terrorist financing, were taken from the annual reports of the Offices for the Prevention of Money Laundering. Due to its secrecy, the phenomenon of corruption is difficult to detect and thus to measure and ultimately investigate. Due to the hidden and illegal nature of corruption, investigations and official statistics do not provide a complete picture of its incidence, and the data in the statistics are only the tip of the iceberg (Niinimäki, 2019, 118). In practice, there are different ways of measuring the level of corruption. One of the indices often used to show the level of corruption in a particular country and used in this work is the Corruption Perception Index (CPI) of Transparency International. The purpose of the index is a qualitative assessment of the prevalence of corruption, and the index is often used when comparing the level of corruption in different countries. The index is based on the perception of corruption by international organizations that evaluate the economic environment, and corruption is evaluated on a scale from 0 (very corrupt) to 100 (very clean). The corruption perception index ranks 180 countries worldwide.

The results for the countries included in this research are shown in the following table.

Table 1. Corruption perception index

Ord. num.	*Year*	*Italy*	*Croatia*	*Slovakia*	*Slovenia*	*Germany*	*Sweden*
1	2011	39	40	40	59	80	93
2	2012	42	46	46	61	79	88
3	2013	43	48	47	57	78	89
4	2014	43	48	50	58	79	87
5	2015	44	51	51	60	81	89
6	2016	47	49	51	61	81	88
7	2017	50	49	50	61	81	84
8	2018	52	48	50	60	80	85
9	2019	53	47	50	60	80	85
10	2020	53	47	49	60	80	85
Average		46,6	47,3	48,4	59,7	79,9	87,3

Source: https://www.transparency.org/en/

Based on the data presented, it is clear that the lowest perception of corruption is in Sweden, where the average value of the index in the period from 2011 to 2020 is 87.3. On the other hand, in the observed sample, Italy has the lowest corruption perception index in the analyzed period, and its average value is 46.6. The above indicates that Italy, in the observed sample, is perceived as the most corrupt country. Furthermore, it is worth pointing out that Italy, Croatia, and Slovakia have an index value below 50, and it can be concluded that in these countries, the perception of corruption is at a high level, while in Slovenia, Germany, and Sweden achieve values above 50. Although the corruption perception index is often used to measure corruption, it should be pointed out that it is about the perceived and not the actual level of corruption, so the measurement results should be taken with a degree of caution and interpreted with reserve.

Just like the measurement of corruption, the measurement and investigation of money laundering are accompanied by numerous difficulties because both crimes are carried out in secret. For the purposes of this paper, the authors used the data on the number of open cases with suspicion of money laundering and terrorist financing as an indicator of money laundering. The data was taken from the annual reports of the anti-money laundering offices of the countries involved in the research.

Table 2. Open cases with suspicion of money laundering and financing of terrorism - descriptive statistics

Parameter	*Italy*	*Croatia*	*Slovakia*	*Slovenia*	*Germany*	*Sweden*
Min.	49.075,00	340,00	2.509,00	327,00	13.544,00	9.183,00
Max.	105.789,00	486,00	3.928,00	1.069,00	144.005,00	24.505,00
Average	83.940,20	423,64	3.130,40	641,90	54.935,70	14.676,30
St. Dev.	19.915,91	55,73	556,78	253,59	44.651,65	5.512,11

Source: Author's calculations

Based on the data presented, it can be concluded that there are significant differences in the number of open cases with suspicion of money laundering and terrorist financing. For example, the lowest number of cases was opened in Croatia, with an average value in the observed period of 423.64 cases. On the other hand, in Italy, the average value of the indicator is 83,940.20. Regarding the phenomenon of money laundering as well as corruption, certain differences between countries can be observed - thus, Italy, Germany, and Sweden have a much larger number of open cases compared to Croatia, Slovakia, and Slovenia. What should definitely be pointed out is that the money laundering indicator is growing over time in all countries, which is in line with expectations and is a consequence of improved regulations in money laundering prevention.

The panel method was used to investigate the relationship between corruption and money laundering; that is, static panel models were formed. The results of the Hausman test indicated that the static model with a random effect is more suitable than the static model with a fixed effect, and the researched models can be presented as follows:

$CPI_{i,t} = \beta_0 + \beta_1 * MLT_{i,t} + e_{i,t}$ (1)
$MLT_{i,t} = \beta_0 + \beta_1 * CPI_{i,t} + e_{i,t}$ (2)

where:
β_n = regression coefficients
CPI = Corruption Perception Index – proxy variable for corruption
MLT = number of open cases with suspicion of money laundering and terrorist financing – proxy variable for money laundering
e = model error.

In the first model, impact of money laundering (MLT) on corruption is investigated while the second model analyses the opposite relation. The obtained results are presented in the next part of the paper.

3. EMPIRICAL FINDINGS AND DISCUSSION

The research on the relationship between corruption and money laundering was conducted based on 60 observations. The cause-and-effect relationship between corruption and money laundering was analyzed, that is, the mutual relationship and influence. The proxy variable for corruption is the Corruption Perception Index (variable: CPI), and for money laundering, the number of open cases with suspicion of money laundering and terrorist financing (variable: MLT). In the first model, the corruption perception index (CPI) represents the dependent variable, and the independent variable is money laundering (MLT). For the purposes of the analysis, a static panel model was formed, namely a model with a random effect, and the obtained results are presented in Table 3.

Table 3. The impact of money laundering on corruption - panel analysis

Random-effects GLS regression			Number of obs			60
Group variable: i			Number of groups			6
R-sq: within = 0.0696			Obs per group: min			10
between = 0.0007			Avg			10.0
overall = 0.0022			Max			10
			Wald chi2(1)			4.03
corr(u_i, X) = 0 (assumed)			Prob > chi2			0.0448
CPI	Coef.	Std. Err.	z	P>z	[95% Conf. Interval]	
MLT	0.00004	0.0000199	2.01	0.045	9.35e-07	0.000079
_cons	60.48247	8.115751	7.45	0.0001	44.57589	76.38905
sigma_u	19.987324					
sigma_e	2.9744431					
rho	0.97833349	(fraction of variance due to u_i)				

Source: Author's calculations

The research results indicate a positive and statistically significant relationship (at the 5% significance level) between corruption and money laundering. When proxy variables for both observed phenomena are taken into account, the results of the conducted research show that an increase in activities aimed at preventing money laundering, i.e., an increase in the number of open cases with suspicion of money laundering and terrorist financing, will lead to an increase in the corruption perception index, i.e., will result in a decrease in corruption. Such results further emphasize the need to tighten measures in money laundering prevention since increased transparency and improvement of measures positively affect the perception of the phenomenon of corruption and, consequently, its reduction. These results align with the research and recommendations of Barone et al. (2019), who emphasized the need for greater transparency in the anti-money laundering system because improving the anti-money laundering system will positively affect reducing corruption among public officials who work in the anti-money laundering system. In his work, Teichmann (2020) also points out the importance of mechanisms for preventing money laundering in the fight against bribery and corruption. However, he also points out that a combination of different measures and harsher penalties are needed to combat corruption. The importance of improving the money laundering prevention system and its role in the prevention and detection of corruption is emphasized by Chaikin (2008) as well. The author highlights the interrelationship of these phenomena and states that, on the other hand, the effectiveness of the money laundering prevention system will be increased if its sensitivity to corruption is detected and reduced.

The influence of corruption on money laundering was examined through another model designed in the framework of this research. Corruption creates an illegal benefit, which needs to be washed to appear legal, and in the context of money laundering, corruption qualifies as a predicate crime. In order to minimize the probability of detection of corruption, corruption requires money laundering while, on the other hand, money laundering enables the re-implementation of laundered corrupt money into legal flows. Also, corruption can affect the effectiveness of anti-money laundering measures. Namely, by corrupting officials in financial institutions, it is possible to prevent the detection of money laundering. As a result of the above, it is clear that it is justified to investigate the opposite relationship, i.e., the influence of corruption on money laundering. In this case, too, the research was conducted on 60 observations. The dependent variable is money laundering (MLT), while the independent variable is the corruption perception index (CPI).

Table 4. Impact of corruption on money laundering – panel analysis

Random-effects GLS regression	Number of obs	60
Group variable: i	Number of groups	6
R-sq: within = 0.0696	Obs per group: min	10
between = 0.0007	avg	10.0
overall = 0.0022	max	10
	Wald chi2(1)	2.30
corr(u_i, X) = 0 (assumed)	Prob > chi2	0.1297

predmeti	Coef.	Std. Err.	z	P>z	[95% Conf.	Interval]
CPI	991.3045	654.2734	1.52	0.130	-291.0478	2273.657
_cons	-34705.52	43352.23	-0.80	0.423	-119674.3	50263.29
sigma_u	38679.104					
sigma_e	19558.01					
rho	0.79638133	(fraction of variance due to u_i)				

Source: Author's calculations

The conducted panel analysis showed that the model is not statistically significant; that is, the relationship was not confirmed in the observed sample.

CONCLUSION

Corruption and money laundering are inextricably linked phenomena. Some authors describe the connection between money laundering and corruption as very close, even symbiotic, since they usually co-occur and complement each other. Both corruption and money laundering are favored by the environment of a weak national regulatory system characterized by a lack of necessary laws, weak mechanisms for their implementation, and poor management. In general, the investigation of money laundering is difficult due to the rapid cash transactions characteristic of corruption, complex business structures, and the combination of various methods of money laundering. Also, criminal prosecution and sanctioning of perpetrators are made more difficult due to, for example, difficulties in proving the origin of property benefits in court, especially due to the use of cash payments that leave no tangible trace. However, since corruption and money laundering are mutually conditioned phenomena, they should be attacked simultaneously. In this paper, the authors tried to contribute to the clarification of the relationship between corruption and money laundering. The research covered six countries (Italy, Croatia, Slovakia, Slovenia, Germany, and Sweden) from 2011 to 2020.

Based on 60 observations using the panel method, a positive impact of money laundering on corruption was determined, i.e., the results show that an increase in activities aimed at preventing money laundering will lead to an increase in the corruption perception index, i.e., it will result in a reduction of corruption. The opposite connection, i.e., the influence of corruption on money laundering, was not confirmed in this research. It should indeed be pointed out that this research, to our knowledge, is the first research that attempts to shed light on the relationship between these phenomena in this way through empirical verification of data on corruption and money laundering. A relatively small sample can be cited as a limitation of the research, as the research was conducted on a sample of 60 observations so future research could include more countries and more observations.

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