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Impact of Political Stability and Corruption on Money Laundering in Developing Nations

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Abstract

The main aim of this study is to analyze the factors influencing money laundering in developing nations and to assess the role of governance institutions in mitigating it. The research employs Ordinary Least Squares (OLS) and Feasible Generalized Least Squares (FGLS) techniques to evaluate how governance indicators such as political stability and control of corruption along with economic variables including foreign direct investment (FDI), official development assistance (ODA), GDP growth rate, and inflation, impact the extent of money laundering across 127 developing countries during the period 2004 to 2024. The results reveal that a 1% improvement in political stability and control of corruption can decrease money laundering by approximately 36.4 million dollars. Drawing from these findings, the study also proposes key policy measures aimed at reducing illicit financial outflows and strengthening governance frameworks in developing economies.

Keywords: *Developing Countries, Governance, Illicit Financial Outflows, Institutions, Money Laundering*

1. Introduction

Money laundering is a global issue that poses a major challenge to the international financial system (Buchanan, 2004; Van Fossen, 2003; Walker, 1999). It threatens not only global financial stability but also the governance structures of countries worldwide (Unger et al., 2006). This is largely due to the fact that the funds laundered typically originate from illegal or illicit sources (McDowell & Novis, 2001).

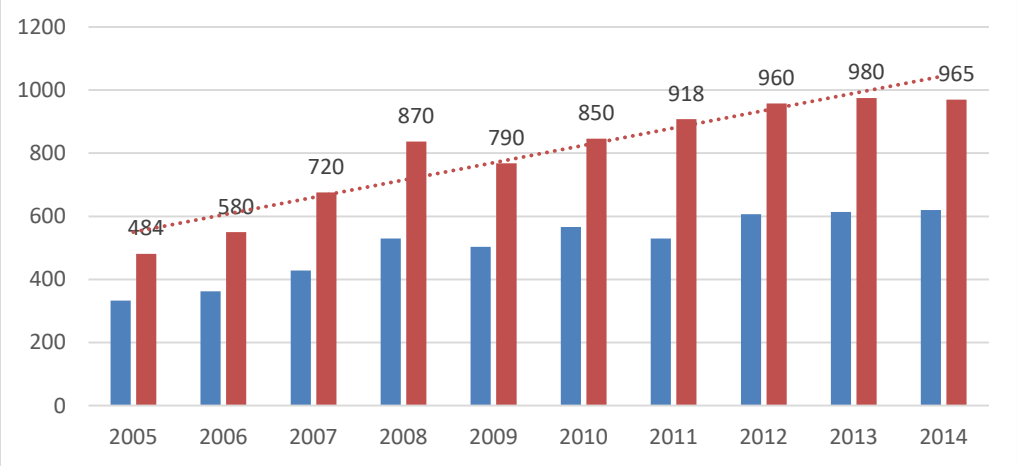
One of the major outcomes of money laundering is its role in financing terrorism a notable example being the 9/11 attacks in the United States (Kingdon, 2004). In addition, criminal and financial laundering activities disrupt a nation's economy and lead to harmful macroeconomic consequences (Quirk, 1997; Hendriyetty et al., 2017). Research also indicates that money laundering negatively impacts a country's economic growth (Issaoui et al., 2019). Furthermore, illicit financial practices damage not only the financial institutions but also the real sectors of the economy, while undermining international trade and capital flow systems.

Overall, the study determines that money laundering adversely affects all three major sectors of an economy the financial, real, and external sectors (Bartlett, 2002). Due to magnitude of the problem of money laundering, an inter-governmental body was set up in the year 1989 by the name of Financial Action Task Force. The main objective of this organization is to implement the regulatory and legal measures to counter the problem of money laundering and to inhibit terrorist financing. In order to bring about reforms of legislative and regulatory nature, the organization works as a policy-making body.

Moreover, by developing recommendations, the organization has set up international standards to combat the problem of money laundering and for universal application of combating measures. In recent, the FATF has placed Pakistan along with eight other countries into the category of strategic deficiencies and grey list.

According to the Global Financial Integrity Report (2017), illicit financial flows represent approximately 14% to 24% of the total trade volume of developing nations. The report further highlights that in 2014 alone, these illegal financial movements ranged between 2 trillion and 3.5 trillion US dollars. As illustrated in Figure 1, illicit financial outflows showed a consistent rise from 2005 to 2014.

Figure 1: Pattern of illegal monetary Outflows



Money laundering has deep roots in Pakistan. Over the past three decades, the phenomenon has taken a rise due to increased political influence, rent-seeking behavior and corrupt means of living. Unfortunately, the successive governments have remained incapable to curb this menace and its causes such illegal sources of earning money such as drug trafficking, gambling, smuggling, kidnapping and corruption.

Only in the year 2007, the government of Pakistan formulated Financial Monitoring Unit (FMU) in order to curb money laundering transactions and terrorism financing. The Anti-Money Laundering Ordinance also came into force in the same period. After this, the State Bank vigilantly started to monitor Suspicious Transaction Reports (STRs). However, no strict action was adopted against the money launderers.

Due to Pakistan's anti-money laundering framework's structural flaws and strategic limitations, the Financial Action Task Force placed the country on its grey list, bringing the issue of money laundering to the fore in recent years. The fact that Pakistan's position on the Basel AML index has not improved was another factor in the inclusion of the country on the grey list. Pakistan's overall score in 2018 was 6.49, placing it in 25th place. Furthermore, Pakistan is the fifth most terrorist-prone nation in the 2017 Global Terrorism Index survey.

FATF was not wrong in its evaluation of Pakistan as in recent the distinguished political leaders of Pakistan have failed to explain sources of their wealth in courts. Moreover, a large number of fake bank accounts and the involvement of Omni group in money laundering has come to the front. Therefore, it goes without saying that it is vital to analyze the phenomenon of money laundering in Pakistan. The aim of this research is to examine the key factors that drive money laundering in developing nations and to assess how institutional governance contributes to its prevention. The study is structured into several sections. Section 2 presents a review of previous relevant literature. Section 3 outlines the theoretical framework and the model proposed for the analysis. Section 4 offers an in-depth discussion of the empirical findings, and the final section provides the study's conclusions along with policy recommendations for the future.

2. Literature Review

This section mainly reviews the past literature regarding money laundering, the determinants of money laundering and the anti-money laundering regimes all over the world. Money laundering has evolved into a global concern, with international trade systems providing opportunities for offenders to conceal their illicit assets more effectively. It has become one of the primary challenges to the stability and integrity of the global financial system. Undoubtedly, money laundering is among the most complex crimes to detect and prosecute (Buchanan, 2004).

To assess its magnitude, the International Monetary Fund (IMF) estimated that money laundering accounts for approximately 2% to 5% of the world's GDP. Similarly, the United Nations reported that global illegal trade amounts to between 400 and 500 billion US dollars annually. For the effectiveness of anti-money laundering efforts, it has been emphasized that

success should not solely be measured by the reduction in money laundering activities, but rather by the extent to which related criminal activities such as terrorism, corruption, and drug trafficking are brought under control (Reuter & Truman, 2005). Furthermore, given the transnational nature of the crime, only a comprehensive, coordinated, and globally enforced regulatory framework can effectively counter money laundering (Alldridge, 2008).

One of the first efforts against money laundering were done by United States in the year 1970. The country came up with the Bank Secrecy Act which was mainly the monitoring of banks with the country only. The main objectives of anti-money laundering regime were to reduce crime, restrict use of illegal money, preserve integrity of financial systems and control terrorism (Alexander, 2001).It was after this initiative that international regime of regularize money laundering took a lead. The efforts started a pact after the advent of attacks on the twin tower in USA (Reuter, 2005).

Currently, USA is also the leader of the 33-member forum, established in the year 1989, known as the Financial Action Task Force which is based in Paris. This forum has developed 40 recommendations in total in order to measure governance of various governments all over the world against money laundering. This system has been made in order to make money laundering difficult for launderers.

According to Shams (2001), corrupt officials often engage in bribery and subsequently launder the illicit proceeds by investing them abroad. Therefore, tackling corruption is essential for reducing money laundering activities. Similarly, Cavalcante and Andrade (2006) discovered that in African and Latin American countries, economic growth was positively correlated with the enforcement of anti-money laundering laws. However, their findings indicated a negative relationship in developed European countries.

In terms of political instability, Atuobi (2007) argued that higher levels of political unrest in a country tend to increase the prevalence of money laundering. Vaithilingam and Nair (2007) further emphasized that advancements in technology, the availability of skilled human resources, and the presence of strong legal systems help limit the spread of money laundering across 88 developed and developing nations. The key outcome of their research suggested that a robust legal structure and high ethical standards within financial institutions play a crucial role in mitigating money laundering activities.

Chaikin (2008) examined the connection between commercial corruption and money laundering, revealing that private-sector corruption and money laundering are interlinked and influence one another simultaneously. With corruption, billions of dollars are generated to get them laundered. At the same time, corruption took place especially in the private section financial institutions at the time of anti-money laundering measures are taken. Resultantly, a channel of higher levels of corruption and money laundering comes into place.

Ferwerda (2009) analyzed various strategies aimed at reducing money laundering and concluded that, among factors such as the rule of law, institutional strength, the involvement of financial institutions in enforcement, and international collaboration, international cooperation

proved to be the most effective policy measure. Aluko and Bagheri (2012) highlighted that money launderers tend to exploit weak tax systems and vulnerable financial institutions. They further noted that ongoing political instability, civil unrest, and corruption are strongly linked to the prevalence of money laundering in developing economies.

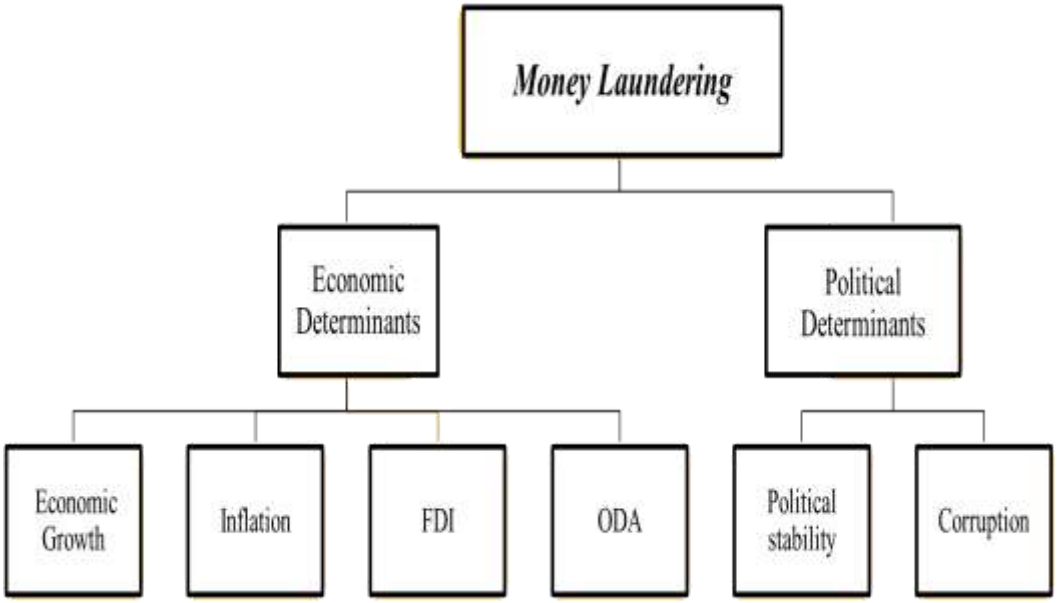
Pérez et al. (2012) conducted an empirical investigation into the role of Foreign Direct Investment (FDI) in promoting money laundering. Their findings suggested that FDI can facilitate illicit financial outflows, which eventually contribute to money laundering. The study revealed that FDI outflows are often directed toward countries with high levels of money laundering. Using an econometric approach, the researchers determined that illicit financial flows significantly distort the scale of global FDI outflows, estimating that approximately 6–10% of total FDI outflows and more than 20% of FDI directed toward high-risk countries are linked to illicit financial movements worldwide.

Murinde et al. (2014) found that robust economic growth serves as a deterrent to money laundering within a country. In contrast, political corruption tends to intensify money laundering activities, making it more difficult to address the issue (Markovska & Adams, 2015). Kar and Spanjers (2015) further argued that external borrowing contributes to the rise of money laundering, based on their analysis of 39 African countries over the period 1970–2010. Additionally, the Global Financial Integrity Report (2018) highlighted that for every one dollar received by developing nations in the form of Official Development Assistance (ODA) and Foreign Direct Investment (FDI) during 2012, approximately ten dollars were illicitly transferred out of these countries.

3. Theoretical Framework and Model Specifications

This study mainly explains the methodology and theoretical framework in order to achieve objectives of this study. Moreover, the hypotheses of this study are discussed in detail which directly relate to objectives of our study. This research mainly takes into account panel data composed of developing countries. The description of data collection, functional forms and model formulated for the purpose of this study will be discussed under this section. The various approaches and diagnostic tests which will be used to analyze the model will also be the purview of this section. The theoretical framework based on the literature review and past research is as follows:

Figure 2: Theoretical Framework of the study



Money laundering in a country is influenced by a variety of factors, which can generally be categorized into economic and political determinants. According to previous research, the economic factors include economic growth, inflation, official development assistance (ODA), and foreign direct investment (FDI), while the political factors involve political stability and the level of control over corruption.

In developing countries, economic growth often reflected through rising GDP or GDP per capita can contribute to increased money laundering activities. This is largely because such countries frequently experience high levels of corruption, bribery, and a significant informal economy, creating opportunities for illicit funds to be transferred abroad, thereby amplifying illicit financial outflows. Conversely, high inflation can discourage money laundering, as elevated domestic interest rates may incentivize individuals to keep their funds within the country, thus reducing illegal capital movement. Similarly, when official development assistance is provided in environments characterized by bribery and political corruption, it may facilitate higher levels of money laundering. Lastly, foreign direct investment in countries with weak institutional frameworks can also promote money laundering, as poor regulatory oversight enables the misuse of foreign capital for illegal financial activities.

Political factors such as political stability and effective control over corruption play a crucial role in curbing money laundering activities. In politically stable nations, governments are better positioned to implement robust financial regulations and enforce strict monitoring mechanisms, which help reduce illicit financial transactions. Moreover, strong anti-corruption measures and reduced levels of bribery limit the size of the informal economy, thereby minimizing opportunities for money laundering.

This study uses panel data consisting of 127 cross-sections from 2004 to 2024. Moreover, the developing countries selected are mainly on the criterion followed by the

International Monetary Fund. As the study deals with panel data, thus it goes without saying that the study will use the estimation approach of panel data and further the FGLS model. Also, the theoretical model depicts the relationship of six variables with the dependent variable mainly illicit financial flows. Hence, the variables which will be used in the study are mainly: Illicit Financial Flows, Political Stability, Control of Corruption, Inflation, GDP growth rate, Foreign direct Investment and Official Development Assistance.

Model Specifications

Eberhardt (2011) and Pedroni (2008) suggest that when dealing with panel data, the pooled OLS estimator often yields inconsistent outcomes because of issues like correlation and heteroskedasticity. To address these issues, econometric models such as Fixed Effects (FE) and Random Effects (RE) are typically applied. However, if these models fail to adequately handle cross-sectional heteroskedasticity and autocorrelation, the Feasible Generalized Least Squares (FGLS) method is then employed as an alternative (Gujarati, 2009).

The reasons this study uses panel data is that it provides large amount of data and with variable information. In this manner, the determinants, factors and impact of variables can be better measured (Gujrati, 2009). With the help of panel data, the selectivity biases and omitted variable bias can also be dealt with handily[1]. Panel data is also used for the purpose of analyzing social behaviors. Panel data is better than the cross-sectional data as it provides variation at single unit level and with the help of panel data the sample size also enlarges (Andreß et al.,2013).

According to (Greene, 2001), Feasible Generalized Least Squares Model (FGLS) there can be problems of heteroskedasticity and autocorrelation in the OLS models. The FGLS model mainly normalizes the data mainly in cases of heteroskedasticity and autocorrelation. The advantages of FGLS model are that it provides results that are unbiased and consistent.

The functional form used in the study is as follows:

$$LIFF_{it} = \alpha + \beta_1 PS_{it} + \beta_2 lnCC_{it} + \beta_3 LINF_{it} + \beta_4 LFDI_{it} + \beta_5 LODA_{it} + \beta_6 GDPGW_{it} + e_{it}$$

Where;

LIFF= Represents the logarithm of illicit financial outflows, expressed in millions of U.S. dollars

PS = Denotes the political stability score, ranging from 0 to 100
CC = Refers to the control of corruption indicator, which varies between 2.5 and 2.5
LINF= Logarithm of the annual inflation rate
LFDI = Stands for the logarithm of foreign direct investment, measured in U.S. dollar

LODA = Indicates the logarithm of official development assistance, also measured in U.S dollars
GDPGW = Captures the GDP growth rate in annual percentage terms
The term μ_{it} represents the error component, where i identify the country and t denotes the time period

4. Estimation Results

First of all, the pooled OLS model has been applied as the data used in this study is mainly panel data composed of countries from the year 2004 to 2024. Further, in order to check the reliability of the results, diagnostics have been applied. The results of pooled OLS model are as follows:

Table 1: Pooled OLS Estimations

Source	**SS**	**Df**	**MS**	**Number of obs**	=	1,270
				F(6, 1263)	=	39.41
Model	1786.222	6	297.7037	Prob > F	=	0
Residual	9541.273	1,263	7.554452	R-squared	=	0.1577
				Adj R-squared	=	0.1537
Total	11327.5	1,269	8.926316	Root MSE	=	2.7485
Liff	**Coef.**	**Std.Err.**	**t**	**P>t**	**[95% Conf. Interval]**	
Ps	-0.45857	0.120275	-3.81	0	.6945301	-.2226094
Cc	-0.03189	0.157659	-0.2	0.84	.3411911	.2774132
Lfdi	0.220492	0.017363	12.7	0	.1864279	.2545553
Loda	-0.09547	0.016649	-5.73	0	.1281339	-.0628101
Linf	0.127016	0.080129	1.59	0.113	.0301857	.2842171
Gdpgw	0.009917	0.011997	0.83	0.409	.0136197	.0334529
_cons	3.152313	0.475667	6.63	0	2.219128	4.085497

The results of the above model depict that the F-statistic has a significant p-value at 99% percent confidence interval. The value of r-square is low at 15.77 percent which shows that the independent variables do not fully explain the dependent variable. The coefficients of political stability, foreign direct investment and official development assistance are significant as their p-values are less than 0.05. The negative signs of political stability and control of corruption show that these result in decrease in illicit financial outflows. An increase in foreign

direct investment results in an increase in money laundering while increase in inflation and GDP growth rate results in increase in money laundering in developing countries.

The diagnostics of pooled OLS model shows that that the residuals of the model are not normal as the p-value of the kurtosis and skewness test is less than 5 percent confidence interval. Moreover, there is problem of time series heteroscedasticity as the value for Breusch Pagan test is significant at the 5 percent confidence interval and the regression shows time effects in which majority of them are insignificant. Also, the F test it is significant this shows that there is no time heterogeneity. The time dummies represent the qualities which are same across the countries but different in time. There is also problem of time series autocorrelation as the residuals of the model correlate with the past residuals. The panel data heteroscedasticity Wald Test has a significant p-value which is also evident of the fact that there is presence of cross sectional heteroscedasticity. The Durbin Watson value is below the ideal value of 2 which shows that there is hint of positive autocorrelation in the data.

Bell & Jones (2015) are of the view that fixed effects model and random effects model is not appropriate in a case of cross-sectional heterogeneity which is the problem in the above mentioned pooled OLS results. This is because the difference between the cross sections is not addressed by these models. In this case, the Feasible Generalized Least Squares Model will be appropriate. In order to turn heteroscedasticity model into a homoscedasticity model, it is better to use FGLS model[2]. The advantages of GLS estimators are that they are efficient, unbiased and even standard errors of it are unbiased and consistent[3]. This model is specifically applied to those regressions which have problems of heteroscedasticity and autocorrelation.

There are four different types of models for panel data. The first model is mainly the Pooled OLS model which makes an assumption that cross-sections in the panel data are homogenous. Fixed effects and Random Effects are the second and third models which allow intercepts to vary according to the cross sections (Gujarati, 2009). The fourth and the last panel data model is Feasible Generalized Least Squares (FGLS) model which is used when the cross-sections are heterogenous and influence the standard errors of the estimates (Judge et al. 1985; Davidson and MacKinnon 1993; Greene 2012). This specific model allows cross-sectional heterogeneity, time series autocorrelation and cross-sectional autocorrelation. It calculates cross-sectional specific errors of coefficients. Based on the benefits and reliability of results of FGLS model, this thesis applies the model; the results of which are mentioned below:

Table 2: FGLS Regression Estimates

liff	Coef.	Std. Err.	Z	P>z	[95%	Interval]

					Conf.	
Ps	-0.36417	0.0625153	-5.83	0.000	-0.4867	-0.24165
Cc	-0.01059	0.0899649	-0.12	0.006	-0.18692	0.165734
lfdi	0.235035	0.0144016	16.32	0.000	0.206808	0.263261
loda	0.06679	0.005234	12.76	0.000	0.07704	-0.05653
linf	0.121409	0.0414833	2.93	0.003	0.040103	0.202715
gdpgw	0.025243	0.0083849	3.01	0.003	0.008809	0.041678
_cons	2.60693	0.3356995	7.77	0.000	1.948972	3.264889

The results of FGLS model depicts that independent variables such as political stability, control of corruption, foreign direct investment, official development assistance, inflation and GDP growth rate effects the level of money laundering in a country. All the independent variables effect illicit financial outflows significantly other than control of corruption for the case of 127 developing countries. The political stability, control of corruption have negative relationship with the money laundering and foreign direct investment, inflation and GDP growth and official development assistance have positive relationship with the money laundering.

The above estimated results show that political stability and illicit financial outflows have inverse relationship as predicted by the literature. The coefficient of -0.364 shows that by a unit increase in rank of political stability of a country the illicit financial outflows decrease by 36.4 million dollars. At a 95 percent confidence interval, the coefficient of political stability is significant as the p-value is 0.000. This result is similar to (Aluko & Bagheri; Blankenburg, & Khan, 2012). This signifies that a politically stable environment can reduce money laundering in a country. This result is important as political stability is a component of governance and with better political environment the institutions work inclusively and acts as institutions of restraint against financial crimes (Joshi, 2013).

5. Conclusion and Suggestions

The purpose of this research was to identify the factors influencing money laundering in developing nations. The findings reveal that governance institutions play a crucial role in determining the extent of money laundering in these countries. Specifically, governance indicators such as control of corruption and political stability are key determinants of illicit financial outflows. This study expands upon the work of Global Financial Integrity (GFI),

which measures illicit financial flows using trade misinvoicing and discrepancies in the balance of payments.

The analysis indicates that improvements in political stability and control of corruption can lead to a reduction in illicit financial outflows by approximately 36.4 million and 1 million dollars, respectively. Consistent with the findings of Orkoh et al. (2017), the study also establishes a link between inflation, foreign direct investment (FDI), and illicit financial outflows. Moreover, the results suggest that in developing countries, official development assistance (ODA) is often diverted from its intended developmental purposes, ultimately contributing to financial outflows instead.

To effectively combat money laundering, developing countries should prioritize both short-term and long-term reforms aimed at strengthening governance systems. It is essential to empower and enhance the capacity of key institutions, including anti-corruption bodies, law enforcement agencies, and forensic investigation units, to ensure accountability and transparency in financial governance.

In addition, financial regulatory authorities must take strict measures to prevent the illegal outflow of funds from the country. Informal channels of financial transactions should be completely prohibited, as they often facilitate illicit financial movements. Promoting the documentation of the economy can also play a significant role in reducing money laundering activities.

Although most developing countries have already introduced anti-money laundering (AML) legislation, effective enforcement mechanisms are still lacking. Strengthening legal implementation and ensuring the efficient functioning of relevant institutions are therefore essential. In the case of trade-based money laundering, customs officials should be adequately trained and empowered to identify suspicious transactions, particularly those involving overvalued goods.

By adopting these strategies, countries can significantly limit money laundering practices. It is therefore recommended that the governments of developing nations focus on strengthening both political and financial governance institutions, eliminating informal money transfer systems, promoting economic documentation, enhancing the role of financial regulators, and training and empowering customs authorities to detect and prevent trade-related financial crimes.

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