



The interaction effect of economic freedom and democracy on corruption: A panel cross-country analysis

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ABSTRACT

This paper examines the effects of economic freedom, democracy and its interaction term on controlling corruption. Interactive results indicate that economic freedom and democracy significantly combat corruption. Economic freedom reduces corruption in any political environment. Democracy increases corruption when economic liberalization is low.

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1. Introduction

In defining the causes of corruption, economists have argued that lack of competition fosters corruption. The focus on competition and its impact on corruption have been noted in two different perspectives. One is political liberalization or democratization and the other is economic liberalization or decentralization. Competition between public officials reflects democratization that includes political rights, civil liberties and press freedom, whereas economic competition fosters economic liberalization that reflects the degree of government intervention in a country. In this paper we evaluate the impact that democracy and economic freedom have on the existing level of corruption and its interactive effect in 100 countries.

In many market-oriented economies government restrictions on economic activity give rise to rents in various forms, and people often compete for the rents (Krueger, 1974) thus giving rise to varying degrees of corruption.¹ Like competition between firms, competition can also take place between government officials who possess the

discretionary power to deliver public goods. Rose-Ackerman (1978) first suggested that competition between officials keeps the level of bribe relatively low and may eliminate entirely due to the possibility of overlapping jurisdictions, i.e. low bribe returns and the honesty of some officials may push the market-clearing bribe-price still lower, inducing other officials to give up corruption.

To explain the relationship between democratization and corruption several studies have used trade openness, government size, government intervention or composite economic freedom indices as the control variables (Treisman (2000), Tavares and Wacziarg (2001), Chowdhury (2004), Bohara et al. (2004), Shen and Williamson (2005), Goel and Nelson (2005)). On the other hand, studies by Ades and Tella (1999) and Fisman and Gatti (2002) on economic liberalization and corruption utilize political rights and/or civil liberties as the controlled variables. Furthermore, civil liberties act as an instrumental variable for describing the effect of corruption on competitiveness (Emerson, 2006).

By far, although most empirical findings confirm that democracy and economic freedom alone does reduce corruption, to the best of our knowledge, there is no cross-country study which captures the interaction effect of these two factors. Investigation of the interaction effect between democracy and economic freedom is vital since countries such as Hong Kong and Singapore show a very low level of democracy and at the same time have a very low level of corruption although there exists a very high level of economic freedom in these countries. On the other hand, in spite of India's high level of democracy it experiences a

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¹ Other studies also support the view that greater state control leads to the possibility of high levels of corruption (Shleifer and Vishny, 1993; Mauro, 1997; Acemoglu and Verdier, 2000). Ades and Tella (1999) note that more competition in the economy reduces the level of profits or rents so that officials have less incentive to engage in corruption.

Table 1

Interaction effects of democracy and economic freedom on corruption: panel estimation.

	(1)	(2)	(3)	(4)	(5)
DEMO	0.463*** (0.061)	0.435*** (0.055)	0.104* (0.061)	0.152** (0.064)	0.092 (0.058)
EF	−0.721*** (0.036)	−0.465*** (0.039)	−0.471*** (0.040)	−0.020 (0.049)	−0.089** (0.043)
DEMO*EF	−0.098*** (0.009)	−0.085*** (0.008)	−0.019** (0.011)	−0.033*** (0.010)	−0.029*** (0.009)
Log(RGDP)		−0.884*** (0.079)	−0.825*** (0.089)	−0.456* (0.259)	−0.842*** (0.135)
Gini index		0.028*** (0.005)	0.045*** (0.006)	0.118*** (0.010)	0.097*** (0.008)
Unemployment		0.017*** (0.005)	0.019*** (0.004)	0.002 (0.008)	0.014** (0.006)
Literacy rate		0.029*** (0.003)	−0.004 (0.004)	−0.031*** (0.012)	0.008 (0.007)
Latin America			1.005*** (0.378)		
Middle East			0.39 (0.372)		
East Asia			1.924*** (0.419)		
South East Asia			1.067*** (0.385)		
South Asia			1.113*** (0.399)		
Eastern Europe			2.076*** (0.394)		
Central Asia			1.426*** (0.422)		
Africa			−0.213 (0.372)		
Western Europe			0.844** (0.421)		
Northern Europe			−0.419 (0.443)		
North America			−0.032 (0.483)		
Australasia			−0.56 (0.496)		
Constant	9.563*** (0.145)	11.91*** (0.659)	12.523*** (0.866)	7.932*** (2.512)	8.974*** (1.101)
Number of observations	981	978	978	978	978
Adj R-squared	0.72	0.78	0.84	0.96	0.33

Standard errors are in parentheses. ***, **, * indicate significance level at the 1%, 5% and 10%, respectively.

very high level of corruption but has a low level of economic freedom. Thus, it is of interest to ask how these two factors, i.e. democracy and economic freedom, work together in affecting corruption. Is it always true that democracy is a cure for corruption in any environment with different degrees of economic freedom? And, does economic freedom work more or less effectively in controlling corruption in an environment that enjoys more political freedom?

This study differs from earlier literature as we explicitly examine the interaction effect of democratization and economic freedom on corruption. Following Shen and Williamson (2005) the measure of democracy used here includes political rights, civil liberties and press freedom. This measure of democracy reflects the idea of broad democracy introduced by Barro (1999). Economic freedom index used in this study is a composite index that considers a broad view of economic variables in the business sector.² Some studies have used trade openness and foreign direct investment to explain the effectiveness of economic openness in reducing corruption (see Larrain and Tavares, 2004). In a systematic examination of the hypothesis and extending the sample size from previous studies we quantify cross-country panel estimations for 100 nations over the period 1995 to 2004.

2. Data and models

The study utilizes Transparency International's annual corruption perception index (CPI) as the dependent variable.³ The Freedom House reports subjective indices for political rights, civil liberties and media freedom that are used to construct democracy index.⁴ Economic freedom index is sourced from the Heritage Foundation. We rescale the ranking of CPI from 0 (least corrupt) to 10 (most corrupt); and democracy (DEMO) and economic freedom (EF) indices

on a scale of 0 to 10, where maximum score indicates the highest level of freedom.

To measure what levels of democracy and economic freedom matter to influence corruption the following model is specified as:

$$CPI_{i,t} = \beta_0 + \beta_1 DEMO_{i,t} + \beta_2 EF_{i,t} + \beta_3 DEMO_{i,t} * EF_{i,t} + \beta_4 \log(RGDP)_{i,t} + \beta_5 GINI_{i,t} + \beta_6 UNEM_{i,t} + \beta_7 ALR_{i,t} + \varepsilon_{i,t}, \quad (1)$$

where four socio-economic control variables are utilized, i.e. per capita real gross domestic product (RGDP), unemployment rate (UNEM), gini index (GINI) and adult literacy rate (ALR).⁵ ε is error term, i is country, and t is time. The coefficient β_3 captures the interaction effect of democracy and economic freedom, which is the main focus in this study. In addition, the partial effects of democracy and economic freedom on corruption are computed as follows:

$$\Delta CPI_{i,t} / \Delta DEMO_{i,t} = \beta_1 + \beta_3 EF_{i,t} \quad (2a)$$

$$\Delta CPI_{i,t} / \Delta EF_{i,t} = \beta_2 + \beta_3 DEMO_{i,t}. \quad (2b)$$

If $\beta_3 < 0$, then Eq. (2a) implies that a one percentage point increase in democracy index yields a greater reduction in the level of corruption with a higher level of economic freedom. Similarly if $\beta_3 < 0$, then a one percentage point increase in economic freedom index in Eq. (2b) yields a greater reduction in the level of corruption with a higher level of democracy.

3. Empirical evidence

We examine the relationship of democracy, economic freedom and their interaction effect on corruption utilizing different estimation methods. First, the panel least square (PLS) result (Table 1) of column (1) shows that democracy (DEMO), economic freedom (EF) and the interaction term are all significant at the 1% level. It suggests

² Economic freedom index is a equally weighted index based on eight individual freedoms: business freedom, trade freedom, monetary freedom, freedom from government, fiscal freedom, property right, investment freedom and financial freedom. Freedom from corruption component is deleted to avoid the circular relationship problem with the dependent variable. See <http://heritage.org/Index/> for details.

³ The CPI measures the degree of corruption as seen by business people, academics and risk analysts. For details see http://www.transparency.org/policy_research/surveys_indices/cpi.

⁴ See <http://www.freedomhouse.org> for details.

⁵ Data sources are Groningen Growth and Development Centre (2004) <http://www.ggd.net/index-dseries.html>; The Political Risk Services Group (2004) East Syracuse, New York; World Bank (2005) World development indicators, data on CDROM, Washington, D.C.; World Institute of Development Economic Research (2004) World income inequality database, <http://www.wider.unu.edu/wiid/wiid.htm>.

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