



Corruption and the effects of economic freedom

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ABSTRACT

The prediction that economic freedom is beneficial in reducing corruption has not been found to be universally robust in empirical studies. The present work reviews this relationship by using firms' data in a cross-country survey and argues that approaches using aggregated macro data have not been able to explain it appropriately. We model cross-country variations of the microfounded economic freedom–corruption relationship using multilevel models. Additionally, we analyse this relationship by disentangling the determinants for several components of economic freedom because not all areas affect corruption equally. The results show that the extent of the macro-effects on the measures of (micro)economic freedom for corruption, identified by the degree of economic development of a country, can explain why a lack of competition policies and government regulations may yield more corruption. Estimations for Africa and transition economy subsamples confirm our conjectures.

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1. Introduction

Much attention has recently been devoted to testing the relationship between economic freedom and corruption, with the expectation that economic freedom leads to reduced levels of corruption.¹ While empirical studies do tend to support this expectation (see Chafuen and Guzmàn, 2000; Paldam, 2002b; Graeff and Mehlkop, 2003; Shen and Williamson, 2005; Carden and Verdon, 2010), there has been some inconsistency in the results. Certainly, economic freedom is found to reduce corruption when it is regressed on the entire distribution of corruption subdivided by its components, and when the relationship is tested for subsamples of countries. However, Billger and Goel (2009) found that, among the most corrupt nations, greater economic freedom does not reduce corruption and may even exacerbate it, indicating that nations respond differently to levels of economic freedom, depending on their level or stage of development conditions.² In addition, Graeff and Mehlkop (2003), while arguing against the use of an aggregate indicator of economic freedom to evaluate their effects, find support for the counter-intuitive influence of the size of government on corruption, as a specific component of economic freedom. The literature has also invoked an institutional dimension to explain some unexpected results. Lambsdorff (2007) argued that government intervention may not be sufficient if it aims only to avoid market failures, and that “good” government regulations may be important in reducing corruption. Thus, the effect of aspects of economic freedom on corruption may depend on how efficient government intervention is in countries which are more highly “regulated” or “have high levels of economic freedom”.

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¹ Berggren (2003) defines economic freedom as “a composite that attempts to characterise the degree to which an economy is a market economy, that is, the degree to which it entails the possibility to enter into voluntary contracts within the framework of a stable and predictable rule of law that upholds contracts and protects private property, with a limited degree of interventionism in the form of government ownership, regulations and taxes”.

² Lambsdorff (2007) provides a review of studies in which the relationship between economic freedom and corruption is insignificant or in which the effects of economic freedom increase corruption.

This paper, in contrast with most of the existing research focusing on cross-country studies, reviews the relationship between economic freedom and corruption using firm level data, following the approach originally developed by [Milgrom and Roberts \(2008\)](#). It also considers macro-effects, such as the level of economic development and the quality of institutions (which are known to provide a fertile breeding ground for corruption), by means of a multilevel modelling framework. This mitigates the mismatch between macro- and micro-evidence, with the aim of keeping micro-relationships robust and identifying the socio-economic and institutional factors which are responsible for cross-country differences. It thus contributes to empirical work investigating whether more freedom lowers corruption ([Chafuen and Guzmán, 2000](#); [Paldam, 2002a,b](#); [Apergis et al., 2011](#)), although it follows from [Graeff and Mehlkop \(2003\)](#) in considering how different aspects of economic freedom affect corruptive practices. This paper is also influenced by the extensive literature which considers how corruption can undermine the strength of public institutions and hamper economic growth and development (and vice versa), including [Shleifer and Vishny \(1993\)](#), [Mauro \(1995\)](#), [Bardhan \(1997\)](#), [Treisman \(2000\)](#) and [Méon and Sekkat \(2005\)](#), the more limited empirical analyses which use micro-data to investigate corruption and its determinants ([Swamy et al., 2001](#); [Svensson, 2005](#); [Mocan, 2008](#)) and the work of [Hodgson \(2006\)](#) and [Hodgson and Jiang \(2007\)](#), who consider the role of institutions in affecting corruption.

We begin our work by documenting basic facts regarding the key variables of our empirical model and discuss the conceptual framework to explore why some dimensions of economic freedom are likely to affect corruption at firm level. We then provide information concerning data extracted from the World Business Environment Survey (WBES) and how we derive variables for empirical analysis. [Section 4](#) presents multilevel models, a more realistic framework in which to test the hypotheses of our work. Estimating the micro-economic links in a multilevel model allows us to assume that the unexplained, insignificant or mitigated relationships of corruption with the components of economic freedom may be explained by differences in country characteristics. Thus, unlike models, which include conditioning variables to explain why the effect of economic freedom on corruption is not linear, we specify the broadest class of multilevel models and propose a selective strategy in which nested and non-nested multilevel models are tested. The rest of the paper estimates the parameters of these models. Although the results in the full sample are sufficiently in line with standard economic predictions, attention to firms' heterogeneous responses and cross-country effects is crucial in explaining empirical variations of outcomes. The results highlight the fact that government regulations in African countries and transition economies may reduce corruption although, as suspected, the large variability across countries is identified not only by differences in economic prosperity but also by quality institutions.

2. Economic freedom and links with corruption

When we aim at measuring corruption in empirical studies, we find a number of possible indicators. The highest profile measure is provided by Transparency International, which uses survey methods to produce the corruption perception index (CPI). Although such perception-based indices may not provide robust estimates of corruption within countries, they do remain informative when used for cross-country comparisons across countries.³ The economic freedom index published by the Economic Freedom of the World (EFW) is designed to measure the quality of a country's institutions and policies ([Gwartney and Lawson, 2000, 2003](#)) and to affect the effectiveness of individual incentives, productive effort, and the effectiveness of resource allocation ([North and Thomas, 1973](#); [de Haan and Sturm, 2003](#)). The key components of the index are 'objective' measures, such as government consumption as a share of total consumption, and transfers and subsidies as a share of GDP, which are collected from external sources (International Monetary Fund, World Bank and World Economic Forum), and 'subjective' measures based on surveys, expert panels and case studies.⁴ The scores for each country are then given for five areas of economic freedom: i) size of government; ii) legal structure and security of property rights; iii) access to finances and sound money; iv) freedom to trade internationally, and v) regulation of credit, labour, and business. The mean scores give the aggregate EFW index, which ranges from 1 to 10, where 10 is the maximum degree of economic freedom.

The EFW index shows that economic freedom has improved over time, as the average value has increased from 5.8 in 1990 to 6.6 in 2000, and then rises in the first decade of the 21st century. For some idea of the probable relation with corruption, [Fig. 1](#) shows the EFW index and the CPI corruption index (measured inversely in terms of good governance) across world countries for the year 2000, and illustrates the clear positive association between the indices, implying that higher economic freedom is associated with lower corruption.⁵

While cross-country regressions of economic freedom and corruption give results in line with the prevailing view, that corruption is reduced by an increase in economic freedom, this may hide heterogeneity at sectoral level, particularly in the degree and nature of government intervention. [Graeff and Mehlkop \(2003\)](#) looking at the components of the economic freedom index find a more complex picture, with ambiguous correlations among the components of economic freedom and corruption. This suggests that the weight of the components of the aggregate index influences the effect on corruption, implying that the results are sample-sensitive. In addition, [Lambsdorff \(2007\)](#) argues that corruption may also arise in sectors with greater economic freedom, as not all aspects of economic freedom deter corruption. Some government regulations may have the effect of increasing

³ For a discussion on this topic see, for example, [Gorodnichenko and Sabirianova \(2007\)](#).

⁴ The number of variables used to construct this index is not constant over time. For example, 21 components of economic freedom were considered in 2005, and 23 in 2008.

⁵ For an application of the association between economic freedom and growth, see [de Jong and Bogmans \(2011\)](#).

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