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Trust, perceptions of corruption, and demand for regulation: Evidence from post-socialist countries

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ABSTRACT

While the tradeoff between market failure and government failure has been explored both theoretically and in practical policy design, the question of whether this trade-off appears in the calculus of citizens' demands for government regulation remains underexplored. We first clarify the channels through which concerns for market failure, as proxied by trust in market participants, and concerns for government failure, as proxied by perceptions of corruption, jointly affect individuals' demand for government regulation. We then investigate these effects empirically, using data from post-socialist countries. Our analysis confirms the previously established result that trust has a negative effect on demand for regulation. Perceived corruption, however, affects demand for regulation primarily via a negative interaction effect with trust. Our findings suggest that, in post-socialist countries, both concerns for market failure and concerns for government failure are indeed in citizens' minds and that concerns about the anticipated 'grabbing-hand' effect from government involvement are particularly salient.

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1. Introduction

One of the key principles of economics states that when markets fail, government intervention might improve social welfare. Government regulation, however, might introduce another problem—government failure. Regulation, in fact, has been viewed in the public choice literature (see, e.g., Mueller, 2003; Shleifer, 2005) as a rent-seeking and corruption-inducing activity that benefits only a few at the expense of society and consequently introduces additional distortions in the economy.

The tradeoff between government failure and market failure has been explored both theoretically (see, e.g., Acemoglu and Verdier, 2000) and as a component of practical policy design (see, e.g., Winston, 2006). However, an issue that still remains underexplored is whether this trade-off appears in the calculus of citizens' demands for public policy, which presumably influence politicians and their choices of institutions.

Existing literature on the determinants of individuals' demand for regulation is scarce (Di Tella and MacCulloch, 2009; Aghion et al., 2010; Pinotti, forthcoming) and, in particular, has neglected to examine individuals' demand for regulation through the lens of the trade-off between market failure and government failure (see below). In this paper, we suggest that when deciding whether to demand regulation or not, rational individuals should weigh their concerns for market failures (a justification for regulation) against their concerns for government failures (an argument against regulation). That is, in contrast to the existing literature, we argue conceptually and demonstrate empirically that demand for regulation can be adequately understood *only* when taking into account both the bright side and the dark side of regulation.

To illustrate the channels through which concerns for market failure and concerns for government failure affect demand for regulation, we present a simple conceptual framework. Consistent with the arguments of Aghion et al. (2010) and Pinotti (forthcoming), in our framework, 'helping-hand' government regulation reduces anticipated harm from externalities caused by uncivic market participants. The anticipated harm from externalities is smaller when individuals have fewer concerns about market failure. Concerns for market failure are, in turn, captured by trust, which reflects beliefs about whether other people (and economic agents more

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generally) are 'uncivic' (Aghion et al., 2010, pp. 1015–16; Pinotti, forthcoming).[1] Consequently, anticipated harm from externalities decreases with trust. In line with Di Tella and MacCulloch (2009), our framework also allows for the possibility that government regulation is advantageous because it punishes the 'unpleasant capitalists' who prosper in a corrupt environment (see Section 2).

Government regulation, however, comes with concerns for government failure when government is perceived as corrupt (see, e.g., Acemoglu and Verdier, 2000). Perceptions of corruption reduce the anticipated efficacy of the 'helping hand' and thus render government regulation less attractive. We refer to this effect as the anticipated 'efficacy-reducing' effect. In addition, perceived corruption increases the expected costs when, for example, a corrupt government bureaucrat 'frames' an innocent (i.e. civic) market participant. We refer to this effect as the anticipated 'grabbing-hand' effect (Shleifer and Vishny, 1998). Because the likelihood of encountering a government official in general increases with the extent of individual's market activity, which in turn increases with trust in market participants, trust and perceptions of corruption interact in determining an individual's attitude toward government regulation.

Within this framework, we show (see Section 2) that trust in market participants exhibits an unambiguously negative effect on individuals' demand for regulation. In contrast, the signs of both the effect of perceived corruption and the interaction effect of trust in market participants and perceived corruption on demand for regulation are, at least in theory, ambiguous and thus left to the empirical exercise.

An empirical investigation of the joint, interactive impact of concerns for market failure, as proxied by trust in market participants, and concerns for government failure, as proxied by perceptions of corruption, on demand for regulation therefore requires a straightforward extension of the estimating equation featured by Aghion et al. (2010, Sec. IV) and Pinotti (forthcoming, Sec. 2.1) or Di Tella and MacCulloch (2009, Sec. III. B). In our empirical specification, in contrast to Di Tella and MacCulloch (2009), Pinotti (forthcoming), and Aghion et al. (2010), trust in market participants and perceptions of corruption, as well as their interaction, all appear *jointly* as focal explanatory variables.

In carrying out our empirical analysis, we focus exclusively on a set of countries at comparable stages of development: the emerging-market economies in Eastern and Central Europe and Central Asia. Because post-socialist countries experienced a complete overhaul of their political institutions and an abrupt introduction to market economy, concerns for both market and government failures, as respectively captured by trust in market participants and perceived corruption, may be particularly salient in these economies. We utilize the Life in Transition Survey (LITS), which gives us a comprehensive dataset of all post-socialist countries in Central and Eastern Europe and the former Soviet Union.

Our empirical results suggest that trust in market participants and perceptions of corruption are both important determinants of demand for government regulation and, in particular, that they should be considered jointly. This finding indicates that the trade-off between market failure and government failure is clearly in citizens' minds when expressing the desirable extent of government's involvement in regulating the economy.

Specifically, using ordered probit estimation and controlling for a number of individual-level characteristics as well as country fixed effects, we find a robust statistically significant negative average marginal effect of trust on demand for regulation, thereby confirming the results of Aghion et al. (2010) and Pinotti (forthcoming). Moreover, our empirical findings suggest that the negative effect of trust in market participants on demand for regulation is non-negligible in magnitude.

In contrast, we do not find a robust statistically significant effect of perceived corruption by itself on the demand for regulation. Consistent with our conceptual framework, this finding suggests that when perceived corruption increases, individuals seem to be at least as concerned about the resulting anticipated 'efficacy-reducing' and 'grabbing-hand' effects of government regulation (which decrease the attractiveness of government regulation) as they might be, following Di Tella and MacCulloch (2009), about punishing the 'unpleasant capitalists' (which increases the demand for government regulation). Unlike Di Tella and MacCulloch (2009), whose analysis is based on the broad set of countries covered by the World Values Survey, we do not find evidence that, as a result of perceiving more corruption, individuals in post-socialist countries demand more government regulation.

We do, however, find compelling evidence that perceived corruption affects demand for regulation via a negative interaction effect with trust in market participants. That is, the decrease in demand for regulation due to greater trust in market participants is greater (in absolute terms) for individuals who perceive more corruption than for individuals who perceive less corruption and this effect is non-trivial in magnitude (see Section 4). Based on our conceptual framework, our finding on the effect of perceived corruption indicates the possibility that concerns about the anticipated 'grabbing-hand' effect of government regulation are on average stronger than concerns about the anticipated 'efficacy-reducing' effect (see Section 2).

Our paper contributes to the emerging literature exploring individuals' preferences for different economic systems and institutions. One strand of this literature (Luttmer, 2001; Alesina et al., 2001; Corneo and Grüner, 2002; Alesina and Fuchs-Schündeln, 2007) explores the determinants of preferences for redistribution and, more generally, characteristics of the welfare state. We examine the determinants of individuals' demand for government regulation, defined as government intervention in markets and public ownership.

Aghion et al. (2010) and Pinotti (forthcoming) demonstrate that demand for government regulation increases with individuals' concerns for market failure, as proxied by individuals' distrust in people and other market participants.[2] Aghion et al. (2010) and Pinotti (forthcoming), however, sidestep accounting for individuals' concerns for government failure. Di Tella and MacCulloch's (2009) framework addresses neither individuals' concerns for market failures, nor individuals' concerns for government failure; instead, they suggest that demand for government ownership increases with individuals' desire to punish the 'unpleasant capitalists', who thrive in an unregulated corrupt environment (Di Tella and MacCulloch, 2009, p. 294).[3] We add to the literature on individuals' attitudes toward government regulation by clarifying and empirically elucidating the importance of the *joint*, *interactive* effect of concerns for market failure and concerns for government failure, as respectively proxied by trust in market participants and perceptions of corruption.[4]

[1] This view of trust is in line with the notion of 'moralistic trust' as 'belief in the goodwill of the other' (Uslaner, 2003).

[2] Zingales (2009, p. 397) similarly conjectures that the lack of trust could explain why demand for regulation increases after every major crisis.

[3] Likewise addressing neither concerns for market failure nor concerns for government failure, Landier et al. (2008) show that individuals' attitudes towards competition and 'capitalism aversion' are influenced by history and path dependence. Bjørnskov and Paldam (forthcoming) aggregate individual-level data at the country level to establish that preferences for private vs. public ownership vary with income, legal quality, left-right politics, and culture.

[4] By placing both trust and perceptions of corruption at the center of analysis, our paper also contributes to, and combines, two other, by now voluminous,

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