

# ECONOMIC FREEDOM AND CORRUPTION

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*“Either force or corruption has been the principle of every modern government, unless the Dutch perhaps be excepted, and I am not well enough informed to except them absolutely.”*

—Thomas Jefferson

The effects of corruption on economic freedom have been debated intensely by economists and political scientists for many years, fueled by each new allegation of bribery, extortion, or fraud involving public officials.

We began to consider this issue seriously during an ongoing debate on patents in Argentina in 1996. At that time, Argentina’s president, who had championed several free-market reforms, was trying to bring the country’s intellectual property rights laws in line with those of the free world, but his efforts were being stymied by special-interest groups, such as the powerful local pharmaceutical industry that had been exempt from respecting patents since 1864. The ability of these groups to prevent such a change in law received wide press coverage in Argentina and prompted letters of protest from the governments of the United States and the European Union. Indeed, it led to our hypothesis that corruption could prove to be a major stumbling block to economic reform.

Cases of allegedly corrupt practices in countries implementing market-oriented reforms heighten

criticisms that free-market policies and a so-called neo-liberalism merely fuel greed and encourage corruption. If such criticisms are correct, then the historical record should show that, as economic freedom in a country increases, so does corruption. If economic freedom and corruption prove to be inversely related, then the criticisms have little merit.

To understand the relationship between economic freedom and corruption, and to test our hypothesis, we analyzed data compiled in previous editions of The Heritage Foundation’s *Index of Economic Freedom*, the Fraser Institute’s *Economic Freedom of the World 1975–1995*,<sup>1</sup> Freedom House’s *World Survey of Economic Freedom 1995–1996*,<sup>2</sup> and the less rigorous Transparency International index on the perception of corruption.<sup>3</sup> The findings of our first analysis were published in 1997 by the Center of Public Studies in Santiago, Chile, in a paper entitled “The State and Corruption.”<sup>4</sup> Since then, we have continued to update and analyze the data, and the findings continue to show not only that economic freedom is *not* responsible for corruption, but also that—more important—economic freedom is a major deterrent of corruption.

Economic freedom, however, does not produce automatic effects, and where corruption is entrenched, many institutions of civil society must become involved to deter and eliminate it.

## A PERVASIVE PHENOMENON

As the authors of the *Index of Economic Freedom* explain, economic freedom is “the absence of government coercion or constraint on the production, distribution, or consumption of goods and services.”<sup>5</sup> For our purposes, economic freedom is the right of individuals to try to do what they want with what they earn, build, create, or own. What they own is what they have acquired voluntarily within the limits of just laws. Corruption, on the other hand, is using to one’s own advantage, and outside a just rule of law, what one does not have the right to own or control. For the sake of this discussion, the authors are concerned only with corruption that takes place within the scope of goods and services handled by the authorities entrusted by the government of a civil society.

Judging by today’s headlines, corruption among government officials is fast becoming a major growth industry, perhaps rivaling even the growth of the Internet. A recent news article, for example, reported that, according to senior U.S., British, and Russian law enforcement officials, “Russian organized crime figures laundered at least \$15 billion through two New York banks at the direction of President Boris Yeltsin’s government.... [T]he money includes at least \$10 billion in International Monetary Fund loans.”<sup>6</sup> The U.S. investigation is continuing.

Meanwhile, in early October 1999, it was reported that a “Federal grand jury in Manhattan indicted three Russian immigrants and three of their companies.” The grand jury’s action marked “the first criminal charges to come out of the investigation” led by the Federal Bureau of Investigation.<sup>7</sup>

Even a former Deputy Director of the Russian KGB, General Nikolai Leonov, has acknowledged the high level of corruption among government officials in Russia. In his words:

Everyone violates the law. Law has been totally undermined.... Corruption, theft are everywhere: the cancerous metastasis of corruption has practically penetrated the country. This is recognized by the United States of America; we even recognize it. It is not a secret. It is painful to speak in this way about one’s own country, but we must find a solution to our evils.<sup>8</sup>

Similar reports of corruption, though perhaps of smaller magnitude, have involved officials in Bulgaria, France, Mexico, Nigeria, Pakistan, South Korea, and the United States. The effect of such corruption on an economy is not lost on economists. For example, Pasuk Phongpaichit, an economist at Chulalongkorn University in Bangkok, remarked last year that “It would not be wrong to say that corruption is the single most important reason for our economic meltdown.”<sup>9</sup>

One of the side effects of corruption is a loss of public confidence in government. This has been well illustrated by the findings of a recent survey conducted in Latin America by *The Wall Street Journal Americas*. A stunning 69 percent of respondents said that corruption is a “very serious” problem in their countries; “moreover, an overwhelming number—88%—said corruption has gotten worse in ‘the last few years.’ In Venezuela, that perception was shared by an almost unanimous 96%” of respondents.<sup>10</sup> The current political turmoil in Venezuela—which could delay market-oriented reforms for decades—is not unrelated to this widespread perception of corruption.

Not long ago, Michel Camdessus, managing director of the International Monetary Fund (IMF), wrote that “governments must demonstrate that they have no tolerance for corruption.... [T]hey must establish a simple and transparent regulatory framework that is equitably enforced, and guaranteeing the professionalism and independence of the judiciary.”<sup>11</sup> One might expect from such a statement that the IMF (and organizations such as the World Bank) would have zero tolerance for corruption among recipients of its economic assistance packages. Yet these organizations repeatedly make loans to countries that are plagued by corruption. Indeed, in Russia’s case, it is clear that “the Central Intelligence Agency uncovered what its analysts believed to be conclusive evidence of [Russian Prime Minister Victor] Chernomyrdin’s personal corruption in 1995,”<sup>12</sup> long before another \$4.5 billion in IMF credits was approved last July. It is likely that a study of the majority of the recipients of IMF and World Bank grants and loans would show a positive correlation with corruption.<sup>13</sup>

Corruption is anything but a new phenomenon. For centuries, corruption has been associated with government’s excessive involvement in the economy. In 17th century Spain, for example,

Pedro Fernández de Navarrete wrote that monarchs often lose their kingdoms through excessive governmental expenditures. People who dispense government funds with largesse “easily fall prey to the temptations of bribery, thievery and other bad actions that violate the laws of justice. When expenditures exceed the possibilities of the treasury, there is no guarantee of honesty, incorruptible ministers or fair judges.”<sup>14</sup>

Corruption holds no monopoly on a period of history, a culture, or a particular country. Even democracies are susceptible. Two centuries ago, Thomas Jefferson wrote that Alexander Hamilton “was indeed a singular character. Of acute understanding, disinterested, honest, and honorable in all private transactions...duly valuing virtue in private life, yet so bewitched and perverted by the British example, as to be under thoro’ conviction that corruption was essential to the government of a nation.”<sup>15</sup> The importance of limiting the effects of corruption led the Founding Fathers to enumerate carefully the powers of the government.

### **The Merits of an Economic Analysis of Corruption**

Ludwig von Mises wrote in *Human Action: A Treatise on Economics* that “An analysis of interventionism would be incomplete if it were not to refer to the phenomenon of corruption.”<sup>16</sup> Our study reviewed all the relevant economic literature of the past three decades. Scholars of the Chicago School,<sup>17</sup> the Virginia School,<sup>18</sup> and various other traditions in economics<sup>19</sup> have analyzed the interaction of political agents, the demand for regulation, and the effects of corrupt and opportunistic conduct on an economy. These analyses show a lack of incentive for voters’ control of government activities. Gordon Tullock, for example, has written that “in strict cost benefit terms, he [the voter] is rational to be ignorant.... [T]he influence his individual vote has on almost any election is so small that even very modest information costs swamp expected net benefits from informed voting.”<sup>20</sup>

In general, the economic literature emphasizes that the structural characteristic of political markets—in which there is little incentive for control by the voters and strong incentives for self-serving politicians to cater to interest groups—is a principal factor in corruption. These scholarly contributions have resulted in a robust and consistent

analytical framework which shows that overexpanded and overregulatory governmental structures create incentives for corruption by encouraging the seeking of privileges.

As our analysis shows, corruption is pervasive in areas that lack economic freedom. On one hand, corruption is the cost of obtaining privileges that only the state can “legally” grant, such as favoritism in taxation, tariffs, subsidies, loans, government contracting, and regulation. On the other, corruption is the result of attempts to avoid the restrictions that accompany the use of privileges, taxes, and barriers to free trade. The *1999 Index of Economic Freedom* included corruption as a variable in three of the factors used in its measurements: Corruption within the judiciary influences respect for property rights; corruption within the bureaucracy affects regulation; and the existence of black markets is also an indicator of corruption.

Indeed, economic history over the past few decades provides ample evidence of interventionist policies that lead to corruption. These policies include:

- **Access to loans at below-market rates.** Many government-owned banks were created with the excuse that they would provide credit to the poor. Soon they were giving credits at subsidized rates to individuals, companies, or sectors that had high political importance. In some countries, privileged favors went to the industrial sector; in others, they went to the agricultural sector. Mortgages at negative interest rates were given to party members or figureheads. In 1996, a local banker in Bulgaria described the pervasive corruption in his country this way:

You’ve got a corrupt system that enabled a group of people to steal other people’s savings.... Banks took people’s savings and continued to lend to state-owned enterprises that were making losses and to private enterprises—none of which had any intention of repaying. The enterprises could only stay in business if the Government or banks kept them afloat.... So-called entrepreneurs clustered in “economic groups”—made up of former senior Commu-

nists and security officials with links to the Government—were given loans by banks to buy raw materials. These were sold to enterprises that were in turn propped up by the Government or banks. The end products, usually chemicals or steel, were then sold at large mark-ups abroad.<sup>21</sup>

In Chile, it has been estimated that between 1940 and 1973, government banks awarded \$4.6 billion in direct subsidies through “soft” loans.<sup>22</sup> Receiving loans at subsidized interest rates when inflation is over 100 percent a month is a sure way to become rich.

- **Foreign trade restrictions.** In several countries, officials who had the authority to grant import or export permits, determine preferential exchange rates, fix import and export duties, or waive internal taxes used their powers to become rich or make others rich.<sup>23</sup> A clear example occurred in Venezuela with the creation in 1983 of a system of differential exchange rates (*Régimen de Cambios Diferenciales*, or RECADI). One of the most widely used textbooks on economics in that country acknowledges that “RECADI turned into one of the largest sources of corruption in the history of Venezuela.”<sup>24</sup>
- **Government procurement.** So-called public works projects are also opportunities for corruption. From New York City to Tierra del Fuego, cases can be found in which government officials abused their authority to grant building and maintenance contracts by giving them to political allies.
- **Price controls and regulation.** Price controls, key facilitators of corruption throughout the history of civilization, have been practically eliminated in most countries and in most areas of the economy. Regulation, however, still reigns almost unchallenged. Many projects today cannot proceed without health, safety, environmental, and other licenses and permits. Not granting a permit or delaying a permit can tip the balance in favor of the government’s friends. Facilitating bids may channel immense financial resources to a bureaucrat or his friends and allies. The mere access to information or to a

friendly official could give the overwhelming competitive advantage to one bidder over another. Government representatives from countries that have important influence in institutions like the World Bank, Investment Development Bank, IMF, or Export–Import Bank have even proffered the enticement of their “pull” with these organizations in exchange for such contracts. Corrupt officials point to the economic development or jobs generated by such acts of favoritism as a source of national pride and “good government.”

- **State ownership of utilities and natural resources.** Government control of water, electricity, communications, and oil and gas companies creates ample opportunities for corruption. The governments of Argentina and Mexico, for example, have controlled hundreds of companies, and this has made corrupt activities in procurement, foreign trade, credit markets, and even advertising markets possible given the size of their budgets. In analyzing India’s state-run irrigation system, Professor Shyam Kamath of California State University at Hayward wrote:

Public-sector irrigation systems everywhere are typically plagued with cost and time overruns, endemic inefficiency, chronic excess demands, and widespread corruption and rent-seeking. In India, government functionaries and system operators—who control the allocation of water supplies—routinely extort high rents from farmers.<sup>25</sup>
- **Secret or discretionary funds.** Governments that establish reserved or secret discretionary funds enable corrupt officials to use those funds to supplement the salaries of congressmen and technocrats or for personal benefit. Consider the case of South Korea. In 1996, shortly after two former presidents of that country were convicted of corruption, several heads of international businesses were convicted primarily for contributing to a \$620 million political slush fund:

The scene was unthinkable in the old South Korea: nine of the country's wealthiest and most influential business leaders facing a judge one rainy day in August to be sentenced as criminals, payers of bribes totaling hundreds of millions of dollars. One after the other, the heads of Daewoo, Samsung and other global Korean companies got prison terms or suspended sentences. Coming just hours after two former South Korean presidents were convicted of sedition and corruption, the judge's action was welcomed here as another blow....<sup>26</sup>

- **Credit bailouts.** Bank bailouts and government or central bank purchases of bad debt at prices higher than currently available on the market also open the door to corruption. Cases in which owners of private banks, especially those who favor the government, received the equivalent of hundreds of millions of dollars through such bailouts are not infrequent. The current focus on how IMF money may have flowed from Russia through international banks should also provoke investigations of similar international bailouts and huge transfers of money because of the likelihood of corruption.

Examples of these types of corruption would be easy to document in almost any country. Because they involve people working under very different political and economic systems, it is tempting to blame human nature. However, a careful review of various recently published studies measuring corruption and economic freedom permits us to analyze the direct correlation between corruption and the level of economic freedom.

## THE CORRELATION BETWEEN ECONOMIC FREEDOM AND CORRUPTION

All measurements, by definition, are subject to error. Indexes such as those we used for data in our original 1997 analysis can never give exact measurements of the object being studied. But they do make it easier to grasp trends and tenden-

cies in the data in order to select or discard alternative hypotheses. Thus, while the correlations presented in this chapter are important to an understanding of the effects of corruption on economic freedom, they are not the ultimate proof of the validity of our theory. The statistical information presented here is relevant; it corroborates the logical analysis that incentives created by government intervention in an economy, coupled with the weaknesses of human nature, create opportunities for corruption.

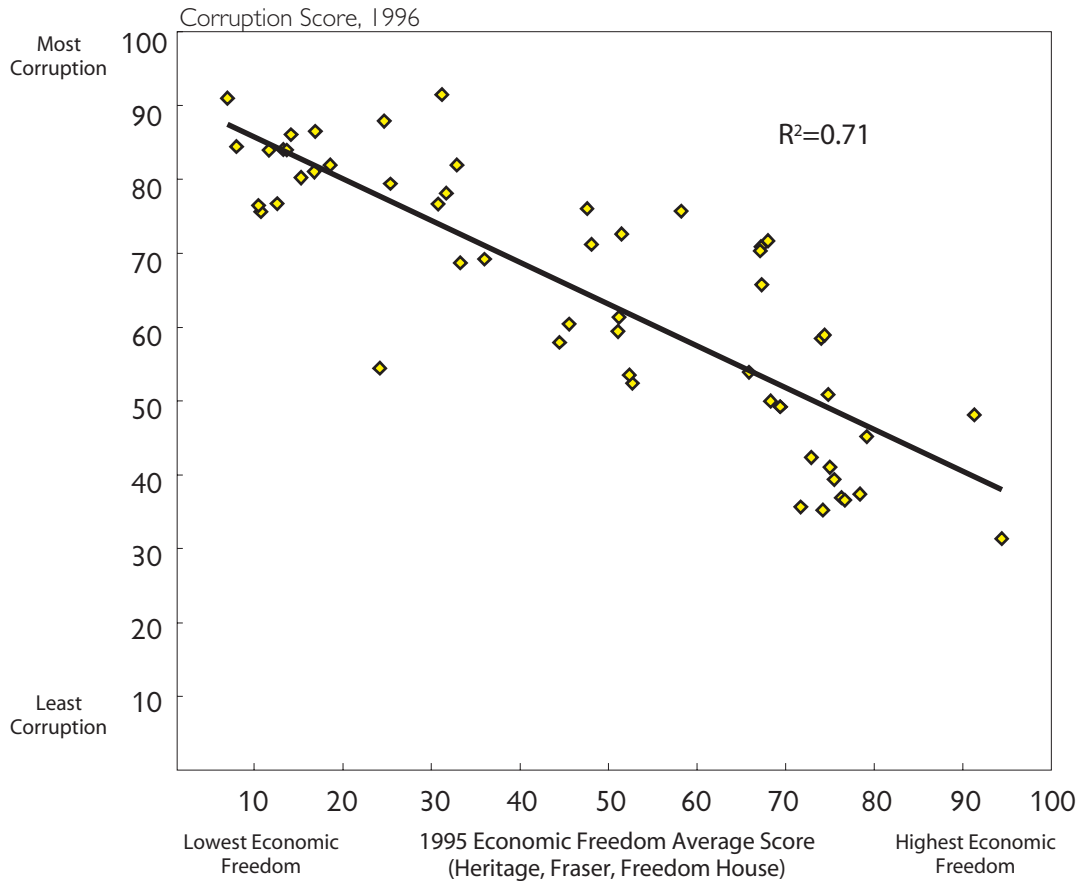
**Measurements of Corruption.** Transparency International (TI) publishes an annual corruption index that is an average of several surveys. Its 1996 index, for example, was the result of 10 different surveys.<sup>27</sup>

From a methodological point of view, TI's index has limitations. It evaluates the level of corruption as it is perceived by executives of multinational organizations and the impact they feel this corruption is having on social life and commercial activity. Such a subjective measurement of perceptions can diverge from reality. The TI figures are at least an approximation of the level of corruption. Nevertheless, using "objective information" based on, say, the number of judicial sentences or litigated complaints also has drawbacks. The different degrees of efficiency among judicial systems in detecting cases of corruption make international comparisons almost impossible.

The original TI index gave a zero rating to the most corrupt country and a 10 to the "cleanest." For our studies, these grades have been converted to a percentile scale that enables us to construct clearer correlations with the indexes of economic freedom, where zero equals the least amount of corruption and 100 represents the most amount of corruption.

**Measurements of Economic Freedom.** Three independent organizations produced the data on economic freedom that we used in our initial 1997 study. In addition to The Heritage Foundation's 1996 *Index of Economic Freedom*, we used the Fraser Institute's *Economic Freedom of the World 1975–1995* and Freedom House's *1995 Survey of Economic Freedom*. There was a difference in the countries and the number of countries they analyzed. That

### As Economic Freedom\* Rises, Corruption Tends to Fall



**Note:** \*Economic Freedom score represents a simple average of the non-corruption related economic freedom scores of The Heritage Foundation, the Fraser Institute's "Is2" Index, and Freedom House.  
**Sources:** Economic Freedom score based on 1996 *Index of Economic Freedom*, The Heritage Foundation; Fraser Institute, *Economic Freedom in the World, 1975–1995*; Freedom House, *World Survey of Economic Freedom 1995–1996*; Corruption Index score based on 1996 data from Transparency International Web site.

year, of the 140 countries analyzed by The Heritage Foundation, 95 appeared in Fraser's index and 69 in Freedom House's index.<sup>28</sup>

Despite all the methodological and philosophical difficulties the authors of these studies encountered in measuring economic freedom, choosing indicators, and gathering reliable information, the three indexes reached remarkably similar results. There is, in fact, a high degree of correlation among their rankings. In our 1997 study, we found that the correlation between the Fraser Institute and Heritage Foundation indexes was 0.87, and that the correlations between these two and the 1995 Freedom House index were 0.84 and 0.79, respectively. These correlations are not only high, but also significant.

For our original study, we chose to use a Fraser index that had a higher association with the indexes of The Heritage Foundation and Freedom House.<sup>29</sup> We followed the same methodology we used to convert the TI index and changed the country scores to their comparable score on a scale of 1 to 100, with 100 signifying the highest degree of economic freedom. To give more validity to the estimation, we averaged the different index scores, which should have improved the predictive capacity of the regression.

Because both Freedom House and Heritage included corruption in some of their factors, we wanted to avoid the positive slant that using multiple variables measuring corruption would give the regression analysis.<sup>30</sup> We therefore

## Economic Freedom with Justice, 1998

Top 10 Countries		Bottom 10 Countries			
1.	Singapore	91.33	10.	Honduras	32.81
2.	New Zealand	87.97	9.	China	32.78
3.	Hong Kong	85.53	8.	Tanzania	32.42
4.	Switzerland	85.47	7.	Russia	32.14
5.	Denmark	84.03	6.	Nigeria	31.72
6.	Finland	83.42	5.	India	31.17
7.	Canada	82.11	4.	Venezuela	30.94
8.	Netherlands	81.81	3.	Ukraine	29.28
9.	United Kingdom	81.69	2.	Cameroon	26.44
10.	Luxembourg	81.69	1.	Vietnam	18.06

Source: Authors' calculations, based on 1998 data in the *1999 Index of Economic Freedom* and on Transparency International data.

eliminated scores for factors that included corruption and adjusted the indexes accordingly. The resulting correlations did not suffer great variation.

**Empirical Results.** All the indexes of economic freedom showed a high negative, or inverse, correlation with the index of corruption. Using the average of the three index scores, we found a slightly higher correlation and lower unexplained variances. All correlations clearly showed that *the higher the index of economic freedom, the lower the level of corruption.* (See Chart 3.1.)

Although the correlation between the index of corruption and the index of economic freedom is high, it does not allow us to see how the components of these indexes relate to each other. For example, a country that unilaterally reduces its import tariffs to zero and sells all state-owned companies will be economically freer. A country that eliminated an income tax or de-monopolized the money supply would also have a freer economy. As a result, the reader should carefully consider each particular case before making a conclusion about the impact of economic policy changes on corruption within specific countries.

### Measuring Economic Freedom with Justice

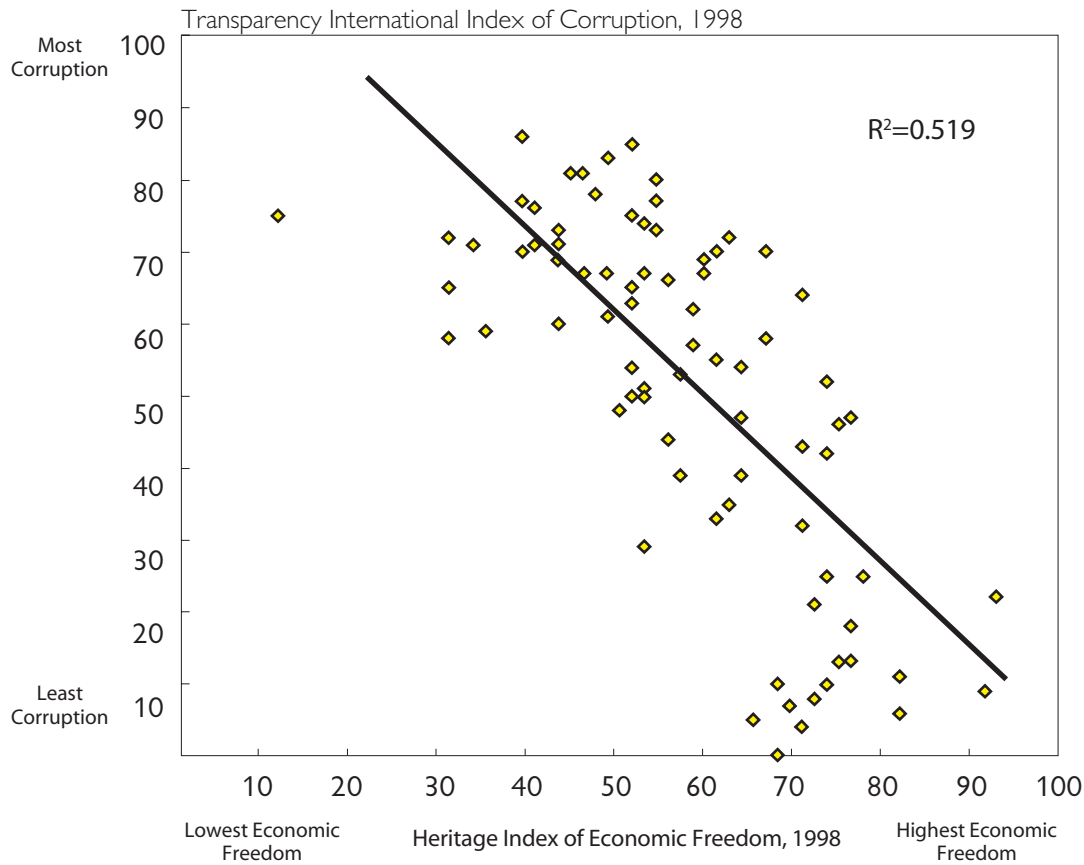
True economic freedom is possible only under a system of limited government with a strong rule

of law. Economic freedom has little value if corruption in government means that only a few will enjoy it. Therefore, the rule of law, under limited government, is the essence of a just society—one in which the rights of persons are respected and individuals are free to improve their personal and social lives through their own efforts and according to just laws, unencumbered by corrupt government actions. To see how countries fared in this regard, we ranked them according to their level of “economic freedom with justice.” (In this case, the term “justice” does not imply the redistribution of wealth.)

In order to rank the countries, we used 1998 data from the *1999 Index of Economic Freedom* and the Transparency International Web site.<sup>31</sup> We converted the scores in these indexes by assigning 100 to the best score on countries with the most economic freedom and the least amount of corruption. Table 3.1 shows the rankings for the 10 best-performing and 10 worst-performing countries. The best countries are those in which the current laws and recent economic performance show a high degree of economic freedom and where businessmen perceive low levels of corruption.

Singapore’s ranking is the only one we found questionable. In *Singapore’s Authoritarian Capitalism*,<sup>32</sup> Christopher Lingle, a visiting associate professor of economics at Case Western Reserve University, argues that because of corruption,

## Higher Heritage Economic Freedom Scores Are Highly Correlated with Lower Corruption Scores



**Note:** Economic Freedom score represents the non-corruption related economic freedom score.  
**Sources:** Economic Freedom score based on *1999 Index of Economic Freedom*, The Heritage Foundation and *The Wall Street Journal*; Corruption Index score based on data from Transparency International Web site, [www.transparency.de/documents/cpi/index.html](http://www.transparency.de/documents/cpi/index.html).

Singapore should not receive a high mark for economic freedom. However, if businessmen in Singapore who have been surveyed by Transparency International were aware of the type of bureaucratic harassment that Lingle encountered, then perhaps an element of cautious fear encouraged them to respond favorably to TI’s questions. We used the data provided by TI in our analysis because, despite its problems, the TI index is still the most respected index measuring corruption available today.

The correlation between economic freedom and corruption shown in Chart 3.2, using the above data (Heritage’s *1999 Index of Economic Freedom* and Transparency International’s 1998 index), confirmed the results of our original study.

The correlation coefficients of this comparison are high and significant. The coefficient of determination ( $R^2$ ) is high, showing that 51 percent of the variance is explained by the level of economic freedom. Statistical analysis would note that a 1.0 percent increase in the economic freedom index produces a decrease of more than 1.0 percent in the level of corruption. This high association between these measurements suggests that critics would find it hard to prove that any perceived surges in corruption were in fact caused by increases in economic freedom.<sup>33</sup>

**Additional Concerns.** Our analysis of “economic freedom with justice” does not allow us to answer all the questions that arise in discussions



about corruption. For example, we were not able to test:

- Whether there is a greater possibility of corruption in government operations requiring major transfers of money to one major contractor, such as public works, than in transfer agencies themselves;
- For any special effect of a policy, such as discretionary, differential exchange rates;
- Whether the increase in the need to reallocate resources (such as when a country suddenly opens its borders or demolishes its socialist structure) combined with judicial insecurity would facilitate greater corruption; or
- What effect illegal drug trafficking and the drug war have on economic freedom and corruption.

Among the factors that could lead to a deficiency in the corruption measurement is the difficulty in capturing the effects of certain regulations. In several countries, the level of corruption remained high despite moving toward a market economy and efforts to reduce state involvement in the economy—reforms that were not accompanied by institutional changes.

If such reforms are carried out by executive order, they can be reversed rapidly and arbitrarily. Argentina, Bolivia, Colombia, the Czech Republic, the Philippines, and Thailand, for example, achieved relatively high scores for economic freedom but also showed high levels of corruption. Germany and France received low scores for corruption but may in fact have benefited from the way in which the TI surveys were handled. For example, the Singapore government banned Siemens A.G., a German telecommunications company, from doing business with the government after the company was accused of paying millions of dollars to government officials,<sup>34</sup> and Thomson-CSF, the French aerospace company, was accused by U.S. intelligence sources of bribery in Brazil.<sup>35</sup> Such bribes will be regarded conveniently as corruption by “foreign” officials rather than as corruption by officials in the country in which the transaction originated; thus, they are likely to be misrepresented in TI’s surveys on corruption.<sup>36</sup>

We anticipate that Transparency International will make an effort to improve its methods of

measuring corruption, but we also do not expect these improved measurements to alter our conclusions. Measurements of economic freedom can also improve. Scoring variables such as the freedom to choose a retirement plan or health care coverage, the freedom to advertise (commercial free speech), and the freedom to maintain trade secrets, for example, could improve measurements of economic freedom.

In addition, a highly competitive political sector of an economy can serve as an important deterrent to corruption, even when there is little or no competition in the provision of some goods. For example, when opposition groups are in constant competition for the control of government, corrupt practices on the part of one party may be exposed and become key tools in bringing about its electoral demise. Nevertheless, the level of political freedom shows a weaker statistical association with corruption than it does with economic freedom.<sup>37</sup>

## CONCLUSIONS

The results of our analysis for this edition of the *Index of Economic Freedom* support the hypothesis that the higher the level of economic freedom, the lower the likelihood of encountering corrupt government practices. Our analysis, of course, is influenced by the fact that we believe economic freedom is intrinsically connected to the level of government activity in an economy. The fewer resources (including assets and regulatory power) a government controls, the fewer the opportunities for corruption. Both the number and amount of resources controlled by a government and the ability of its officials to grant privileges can influence the level of corruption.

This does not mean, however, that a lack of corruption will exist automatically in countries that have a minimum level of government intervention in the economy. As long as opportunities exist for the provision of goods held in common, it is reasonable to expect that some corruption will occur.

This study generates many other questions as well. For example, what impact do different government activities have on corrupt practices? A policy of differential exchange rates could generate a set of perverse incentives quite different from

those generated by a policy of high but uniform import tariffs,<sup>38</sup> and subsidized loans might produce different corrupt activities than direct subsidies.

It should be understood that countries with similar degrees of economic freedom can exhibit very different types of corruption as well as differences in the absolute level of corruption. In some cases, a perception of increased corruption exists in countries that have carried out market reforms. We believe this may occur when:

- So-called market reforms are cases in which monopolies are given to political allies;
- Access to information about potentially corrupt activities is cheaper to obtain and disseminate;
- There is a change in the structure of a government's intervention in the economy; and/or
- The globalization of the economy is helping to disseminate economic power.

We are inclined to focus on the latter two circumstances. For example, throughout most of the 20th century, government intervention in less-developed countries was easily disguised by claims that the activity “served the common good” or fulfilled a social function. The excuse that “credit should go to the needy” or to “strategic” industries allowed numerous governments to exercise cronyism. The ability of government to expropriate property and adjudicate the expropriated property provides an opportunity for corrupt officials and their friends to obtain special privileges (or “rents”).

In addition, in the past, foreign trade restrictions and controls provided ample opportunities to disguise corrupt activities as benign interventions. Distributing “scarce” foreign reserves allowed government officials to choose between those they would enrich and those they would send into bankruptcy. Most people would refrain from criticizing those corrupt policies for fear of losing access to the foreign currencies needed for their business or travel plans. With the globalization of the economy and the expansion in foreign trade, however, the cost of conducting and hiding such activities has increased; moreover, fewer people are likely to “look the other way.” Thus, while corruption is being concentrated in fewer events and even fewer actors, the diffusion of economic

power and access to information allows many private parties who have the interest, will, and position to complain about corruption to do so.

The instruments used to maintain a closed economy, and typical of the import-substitution model promoted by the United Nations Economic Commission for Latin America and the Caribbean (ECLAC),<sup>39</sup> were also ideal tools for conducting corrupt activities that appeared to benefit a large part of a population. Throughout Latin America, for example, it was widely believed that countries in the “Center” exploited countries on the “Periphery,” so protectionism was seen as a “good” tool to help the poor of the South from being exploited by the rich of the North. But while the allocation of foreign currency and the erection of import barriers appeared to be motivated by the will to protect the general interest, in reality they ended up protecting special interests and fueling corruption.

There is no question that it is getting cheaper to disseminate information, and this capability helps those who want to expose corrupt practices. Two hundred million people have access to the Internet. The increased awareness of the high cost of inflationary policies, negative interest rates, and closed economies has helped curtail the traditional methods by which governments frequently bought votes. Yet opportunities for corruption remain—in contracting out for services, selling state-owned companies, and assigning procurement contracts. Corruption, which may have benefited many people in the past, both rich and poor, primarily benefits a small number of government officials today.

Finally, it must be said that changes in corrupt practices are not automatic responses to changes in economic freedom. The process of adjustment takes time. Countries with high levels of corruption took time to get to that level. Corrupt officials first will incorporate their perceptions of costs, risks, and benefits of a corrupt activity and then will compare them with alternative courses of action. In other words, corruption entails a discovery period and then a process of evaluation of the different institutional responses that will be confronted.

We are aware that in certain cases, corruption can be seen as an escape from an unjust society. Lord Acton wrote that “The purchase of judicial appointments is manifestly indefensible; yet in

the old French monarchy that monstrous practice created the only corporation able to resist the King. Official corruption, which would ruin a commonwealth, serves in Russia as a salutary relief from the pressure of absolutism.”<sup>40</sup>

Nevertheless, the same corrupt activity that might enable one person to avoid the burden of an unjust law might also allow someone else to avoid complying with just laws. The bureaucrat who accepts a bribe to help one person with a contract might also accept a bribe to leave someone else out of business. Officials who accept bribes to accelerate a regular bureaucratic errand might also accept a bribe to leave someone defenseless against blackmail. Executives of U.S.-based corporations find themselves frequent victims of such bureaucratic behavior.

Thus, Thomas Jefferson’s perspective on corruption is no less true today:

*Human nature is the same on every side of the Atlantic, and will be alike influenced by the same causes. The time to guard against corruption and tyranny, is before they shall have gotten hold of us. It is better to keep the wolf out of the fold, than to trust to drawing his teeth and talons after he shall have entered.*<sup>41</sup>

## Notes

- <sup>1</sup> James Gwartney, Robert Lawson, and Walter Block, *Economic Freedom of the World 1975–1995* (Vancouver, B.C.: Fraser Institute, 1995).
- <sup>2</sup> Richard E. Messick, ed., *World Survey of Economic Freedom 1995–1996* (New Brunswick, N.J.: Transaction Publishers, 1996).
- <sup>3</sup> The latest Transparency International index is available at <http://www.transparency.de/documents/cpi/index.html>.
- <sup>4</sup> Alejandro A. Chafuen with Eugenio Guzmán, “The State and Corruption” (“Gobierno y Corrupción”), Centro de Estudios Públicos, Santiago Chile, *Working Paper* No. 274, November 1997. An updated version appeared as a chapter in *Corrupción y Gobierno* (Santiago: Libertad y Desarrollo, November 1998).
- <sup>5</sup> See the discussion of economic freedom in Chapter 5, “Methodology: Factors of the *Index of Economic Freedom*,” *infra*.
- <sup>6</sup> Jack Kelly, “Russian Fraud Case at \$15B; Yeltsin’s Daughter Among Those Under Investigation,” *USA Today*, August 26, 1999, p. 1A.
- <sup>7</sup> Timothy L. O’Brien, “Jury Charges 3, One a Bank Aide, in Russian Case: On the Trail of Billions,” *The New York Times*, October 6, 1999, p. A1.
- <sup>8</sup> Translation from *Estudios Públicos* 73, Santiago, Chile, Summer 1999, p. 48.
- <sup>9</sup> Joseph Kahn, “Folk Hero Strips Teflon from Thailand’s Corrupt,” *The New York Times*, April 26, 1998.
- <sup>10</sup> “The Free Market Still Scores Highly Among Latin Americas,” *Wall Street Journal Americas*, n.d.; poll conducted in Latin America from December 1998 to January 1999.
- <sup>11</sup> Michel Camdessus, “Adjustment to the Global Economy: Lessons from Argentina,” *Facing the Globalized Economy: The IMF Experience: Four Addresses* (Washington, D.C.: International Monetary Fund, 1996).
- <sup>12</sup> Eric Schmitt, “Russian Ex-Premier, in the U.S., Says Corruption Is Exaggerated,” *The New York Times*, September 30, 1999, p. A14.
- <sup>13</sup> See, for example, Jim Rogers, “The Ponzi Pair: The IMF and the World Bank Keep Issuing Larger and Larger Loans to Their Borrowers—A Practice That Has All the Earmarks of a Classic Financial Swindle,” *Worth*, May 1998, pp. 43–45.
- <sup>14</sup> *Conservacion de Monarquias*, Discurso XXXI (Madrid, 1619).
- <sup>15</sup> Thomas Jefferson, *Autobiography, Notes on the State of Virginia, Public and Private Papers, Addresses, Letters* (New York: Literary Classics of the United States, 1984), p. 671.

- <sup>16</sup> Ludwig von Mises, *Human Action: A Treatise on Economics*, 3rd ed. (Chicago: Regnery Press, 1966), pp. 734–736.
- <sup>17</sup> See Gary S. Becker, “If You Want to Cut Corruption, Cut Government,” *Business Week*, December 11, 1995, p. 26. See also Becker’s scholarly articles “Crime and Punishment: An Economic Approach,” *Journal of Political Economy*, Vol. 76, No. 2 (March–April 1968), and “A Theory of Competition Among Pressure Groups for Political Influence,” *Quarterly Journal of Economics*, Vol. XCVIII, No. 3 (August 1983).
- <sup>18</sup> For good examples, see Charles K. Rowley, *Public Choice Theory* (London: Edward Elgar, 1993), and Robert D. Tollison, “Rent Seeking: A Survey,” *KYKLOS*, Vol. 35 (1982).
- <sup>19</sup> One of the most complete analyses of corruption appeared in Italy in Alberto Vannucci, *Il mercato della corruzione* (Milano: Società Aperta, 1997). It includes an extensive bibliography.
- <sup>20</sup> Gordon Tullock, *Rent Seeking* (Brookfield, Vt.: E. Elgar, 1993), p. 34.
- <sup>21</sup> Jane Perlez, “Looted By Its Own Officials, Bulgaria Faces the Day of Economic Reckoning,” *The New York Times*, October 28, 1996, p. A6.
- <sup>22</sup> Joaquín Lavín, in *El Enriquecimiento de las Personas en Chile* (Santiago: Ciencia y Tecnología, 1980).
- <sup>23</sup> Manuel Ayau, *La Década Perdida* (Guatemala: n.p., 1989), pp. 1–10. Ayau describes in detail how exchange controls and other regulations created a fertile ground for corruption.
- <sup>24</sup> Jose Toro Herdy, “RECADI llegó a transformarse en una de las mayores fuentes de corrupción que ha conocido la historia de Venezuela,” in *Fundamentos de Teoría Económica: Un Análisis de la Política Económica Venezolana*, ed. Panapo–CEDICE, Caracas, 1993, p. 634.
- <sup>25</sup> Shyam Kamath, “Foreign Aid in India’s Leviathan State,” in Doug Bandow and Ian Vásquez, eds., *Perpetuating Poverty: The World Bank, the IMF, and the Developing World* (Washington, D.C.: Cato Institute, 1994), p. 223.
- <sup>26</sup> Sandra Sugawara, “Can S. Korea Do Business Without Bribes?” *The Washington Post*, October 6, 1996, p. H1.
- <sup>27</sup> See Transparency International’s Web site at <http://www.transparency.de/>.
- <sup>28</sup> Heritage consistently analyzes more countries (over 160) than does the Fraser Institute (around 120). Freedom House constructed only one index grading 82 countries.
- <sup>29</sup> The “Is2” index used in Fraser’s 1975–1995 analysis.
- <sup>30</sup> A problem called multicollinearity in econometrics.
- <sup>31</sup> See Transparency International, 1998 Corruption Perceptions Index, at <http://www.transparency.de/documents/cpi/index.html>.
- <sup>32</sup> Christopher Lingle, *Singapore’s Authoritarian Capitalism: Asian Values, Free Market Illusions and Political Dependency*, The Locke Institute, Virginia, 1995. According to James Fallows, Washington editor of *Atlantic Monthly*, “Lingle makes dramatically clear in this book [that] he suffered persecution and financial near-ruin merely for exercising rights that most modern societies respect—and that most Asian citizens want to enjoy.” The book describes a “legal” case brought against Lingle for remarks that allegedly were contemptuous of Singapore’s judicial system. Those willing to defend Singapore’s position in the TI ranking (which primarily asks about bribery) might point out that nowhere in the book does Lingle describe being asked to pay a bribe to “settle” his problem.
- <sup>33</sup> The statistical results show an  $R = 0.72056$ ,  $R^2 = 0.51921$ , and an adjusted  $R^2 = 0.51305$ .  $CI\ 98 = 118.12 - 1.169244\ IEF$ , where CI is the corruption index, IEF is the index of economic freedom, and 118.12 is the constant (the theoretical intersection point with no economic freedom and no corruption). The slope is  $-1.169244$ , which is significant at the 0.01 percent level. An improvement of 1 percent in economic freedom should reduce corruption by more than 1.16 percent.
- <sup>34</sup> Edmund L. Andrews, “29 Nations Agree to Outlaw Bribing Foreign Officials,” *The New York Times*, November 21, 1997.
- <sup>35</sup> Todd Lewan, writing for the Associated Press on March 25, 1996, reported that “on Sept. 16, 1993, the government asked companies in 16 countries for bids to supply SIVAM’s hardware [Portuguese acronym for the Amazon Surveillance System]. After an eight-month competition, Raytheon and Thomson–CSF of France went to a runoff. In February 1995, *The New York Times* quoted a CIA

official as saying that Thomson–CSF had offered bribes to members of the selection committee. Thomson–CSF denied bribing anyone. But a week after the *Times* story, the French government expelled four Americans it said were CIA agents, drawing further attention to the bribery allegation against Thomson–CSF. Last May 27, Brazil signed a five-year contract with Raytheon, subject to the Senate approving the financing. The U.S. Export–Import Bank is to provide 75 percent of the money, which troubles some Brazilians wary of U.S. intentions.”

<sup>36</sup> See also Glenn R. Simpson, “Foreign Deals Rely on Bribes, US Contends,” *The Wall Street Journal*, February 23, 1999, p. A13. “The U.S. government received allegations that bribes were used to influence the outcome of 239 international contract competitions between May 1994 and April 1998.” The report mentioned European countries primarily: “About half the allegedly tainted contracts involved military procurement. Other prominent sectors were aerospace, communications, infrastructure, energy and transportation.”

<sup>37</sup> For a comparison of how political freedom and other factors such as ethnic homogeneity and per capita income compare with economic freedom, see Chafuen and Guzmán, “Estado y Corrupción,” *Corrupción y Gobierno* (Santiago: Libertad y Desarrollo, November 1998), pp. 67–73.

<sup>38</sup> Chile’s aggressive but uniform tariff rate, for example, discourages special-interest lobbying.

<sup>39</sup> *Comisión Económica para América Latina y el Caribe* (CEPAL).

<sup>40</sup> Lord Acton, *Essays in the Liberal Interpretation of History*, ed. William McNeill (Chicago: University of Chicago Press, 1967), p. 245.

<sup>41</sup> Thomas Jefferson, *Autobiography, Notes on the State of Virginia, Public and Private Papers, Addresses, Letters* (New York: Literary Classics of the United States, 1984), p. 671.

