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Corruption and the Economic Role of the State

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Abstract

Some recent literature on corruption has stressed the negative consequences of high levels of government intervention in the economy. However, many of the nations where the public sector has grown largest are widely regarded as amongst the least corrupt in the world. The answer to this paradox is that government intervention is multifaceted, and some features of 'big government' may well be perfectly compatible with low levels of corruption. This article seeks to disentangle which features of government intervention are linked to corruption and which are not. It finds that the degree of regulation of private business activity is the strongest predictor of corruption, and that high levels of public spending are related to low levels of corruption in countries where business activity is regulated lightly and unobtrusively. It is concluded that advanced welfare capitalist systems, which leave business relatively free from interference whilst intervening strongly in the distribution of wealth and the provision of key services, may be a useful model for developing countries seeking to reduce corruption whilst maintaining the state's capacity to achieve social goals.

Key words: Corruption, state, government intervention, welfare capitalism, regulation, public enterprises

Introduction

Some recent research on corruption identifies overbearing government intervention in the economy as the main culprit. In contrast to the prevailing view of the 1940s, 1950s and 1960s, which saw the state as a 'helping hand' in economic and social development, it is now common to see government portrayed as a 'grabbing hand', controlled by politicians who 'do not maximize social welfare and instead pursue their own selfish objectives' (Shleifer and Vishny 1998: 4). The emergence of 'big government' over the postwar period, with higher taxes and spending and more invasive regulation, is often identified as a major cause of corruption (Tanzi 2000: 108-9). Even more cautious analyses, whilst recognizing that deregulation and privatization will not inevitably defeat corruption, often share the view that 'smaller government may indeed be cleaner government' (Rose-Ackerman 2000: 99). This view, which draws on the 'return to the market' advocated by the public choice school (see Tanzi 2000: Ch.2), has fed directly into the policy choices of developing countries through the pressures of international institutions such as the World Bank and the IMF (see Johnston 1998, Abed and Gupta 2002).

There is much that is valuable in this literature, and it is not our intention to suggest growing the public sector as a 'solution' to corruption. However there are good reasons to believe that the interventionism-corruption case has been overstated. Surveys of corruption regularly place the high-spending Scandinavian social democracies at the very top of their league tables of 'clean government', and the market-oriented United

States does not perform better than the much-criticized welfare states of continental Europe. This rather simple observation forms the basis of the analysis presented here. In this article we depart from the pessimistic view of the public sector promoted by the public choice school, and try to untangle some of the intricacies of the link between government intervention and corruption, drawn from observation of the varied experiences of advanced industrialized nations. This forms the basis for a quantitative analysis of the relationship between government intervention in the economy and corruption in a sample of 51 countries from the developed and developing world. A similar analysis is also carried out for a sub-sample of 23 advanced industrialized democracies. The results suggest an explanation of the low levels of corruption found in some countries with very large public sectors, an explanation which may have important implications for the anti-corruption strategies followed by developing countries.

Corruption as a Government Pathology

The decade of the 1990s saw corruption emerge as an important concern of economics research, and in particular that of the public choice school. Building on the pioneering work of Rose-Ackerman (1978) and Banfield (1975), scholars have developed an 'economic' account of corruption which has become increasingly influential in policy circles. This focus on corruption is a logical corollary of economists' growing interest in institutions (eg. Drobak and Nye 1997), and draws inspiration from the critical analysis of government activity advanced by the public choice school. Public choice challenged

the Pigovian view of government as a 'benevolent dictator' capable of pursuing economic efficiency, and instead applied the tools of economic analysis to the politicians and bureaucrats who manage the government machinery (Tanzi 2000: 18-19). Government personnel are assumed to be just as self-interested as any other economic actor, and will therefore exploit their monopoly over certain decisions to generate rents. Public choice scholars have argued, for example, that governments tend to reward narrow rather than encompassing interests (Becker 1983), provide poor quality services at high cost (Tanzi and Schuknecht 2000), and manipulate macroeconomic policy for political ends (Alesina *et al* 1992). In this view, corruption is a particularly stark manifestation of the rent-seeking behaviour in which government officials engage, and a very damaging one in view of its consequences for economic performance (Mauro 1995, Knack and Keefer 1995).

A number of economists and political scientists have therefore related corruption to degrees of government intervention, advocating reductions in the scope of government activity as the most effective way of constraining corruption (eg Harriss-White 1996). The bluntest version of this diagnosis is Gary Becker's recommendation that 'if you want to cut corruption cut government' (Becker and Becker 1997: 203). Others present the same equation in more prudent terms. IMF economist Vito Tanzi, for example, claims that 'the growth of corruption is probably closely linked with the growth of some of the activities of the government in the economy' and concludes that 'corruption will be reduced mainly in those countries where governments are willing to substantially reduce some of their functions' (2000: 133). Susan Rose-Ackerman argues that 'the elimination

of spending and regulatory programs can be a potent corruption-reducing strategy' (1999: 42), although she is cautious enough to warn that such changes can worsen the problem under certain conditions (see in particular Rose-Ackerman 2000). Ades and di Tella advocate an 'economist's approach' to the problem of corruption, arguing that corruption is inversely related to the level of competition in the economy (1997a: 497, also 1999), and that government should privatize public companies and introduce market-like mechanisms in those areas where it needs to retain control. Goldsmith finds negative correlations between economic liberalization, administrative centralization, and corruption (1999). One fairly typical summary of the corruption literature talks of 'a general consensus (…) that the reduction of state bureaucracies and the encouragement of more transparent, free-market operations, along with improving the government's capacity to regulate these processes and to enforce the law, are the most effective methods of controlling corruption' (Tulchin and Espach 2000: 5).

This line of argument fits neatly with the policy prescriptions of the 'Washington consensus', under which governments are urged to deregulate, privatize and roll back redistributive spending in order to maximize economic efficiency. Indeed, international organizations such as the IMF have been quick to emphasize the link between corruption and the government's role in the economy. The IMF Guide *Promoting Good Governance and Combating Corruption* states baldly that 'corruption thrives in the presence of excessive government regulation and intervention in the economy', and goes on to suggest that corruption can emerge 'when the government provides goods, services and resources at below-market prices' or 'when officials take decisions that are potentially

costly to private individuals or companies' (IMF 2002). Although the Fund is careful not to suggest a neat 'intervention=corruption' equation, the clear implication is that extensive government intervention poses at the very least an enhanced risk of corruption. The World Bank, for its part, has argued that 'deregulation of prices or other aspects of production or trade are important steps towards reducing opportunities for corruption' and advocated 'enhancing competition' in order to create a 'vibrant and corruption-free private sector' (World Bank 2004a; see also World Bank 1997). These international institutions have drawn heavily on recent academic research into corruption, particularly by economists, in developing their policies.

It would be unfair to attribute to this line of scholarship a naïve belief in the powers of markets to defeat corruption. Indeed, a striking characteristic of current research into corruption is its avoidance of monocausal explanations, and its emphasis on the need for reformers to address corrupt mechanisms in a variety of arenas (see for instance the review in Kaufman 2003). As well as advocating the withdrawal of the state from some areas of activity, recent economic research has sought to look inside the state machinery, in order to identify the institutional structures and practices which seem to encourage corruption. Economists have sought to model the incentive structures which underly bureaucratic corruption, looking at the impact of bureaucratic pay, recruitment and structure (Rose-Ackerman 1999: Ch.5, van Rijckeghem and Weder 2001), the administration of tax collection (Chand and Moene 1997, Tanzi and Davoodi 2000), the territorial structure of government (Treisman 2000, Fisman and Gatti 2002) and patterns of public spending and investment (Tanzi and Davoodi 1997, Goel and Nelson 1998,

Mauro 1998). Other work by economists and political scientists has stressed the importance of democracy and democratic tradition (Treisman 2000, Montinola and Jackman 2002[1]), and within democracies, the extent to which electoral institutions promote competition amongst politicians, reducing rent-seeking and limiting the growth of the state (Myerson 1993, Persson and Tabellini 1999). This kind of work suggests a more nuanced understanding of the relationship between government intervention and corruption.

Nevertheless, the dominant view remains broadly skeptical about the possibilities for extensive government intervention in the economy. Economic liberalization and the slimming down of the public sector may not be presented as a panacea, but remain a central feature of the strategies for improving governance promoted by international organizations and Western governments. Yet several of the 'best governed' countries in the world are advanced industrial nations with large public sectors (La Porta *et al* 1999). Moreover, although most western nations have embarked at least to some degree on the kinds of market-friendly liberalization programmes advocated by organizations such as the IMF, there is little evidence that such reforms have reduced levels of corruption. In fact, advanced industrial nations, for the most part, have long intervened heavily in their economies whilst enjoying low levels of corruption. The experience of the world's richest nations therefore offers little support for the anti-corruption agenda being pressed on the developing world[2].

In the remainder of this article, we aim to move the discussion forward by identifying the broad types of public intervention in the economy which are most

damaging for corruption-free governance. The purpose of this analysis is to explain how Western European welfare capitalism manages to combine large public sectors with low levels of corruption. We will present evidence that some kinds of government intervention in the economy characteristic of Western European welfare states may in fact be inimical to corruption, or at the very least unrelated to it.

Public Spending, Regulation and Corrupt Incentives: Disentangling Government Intervention

There are a number of ways of distinguishing between different forms of government intervention. Here we adopt Stiglitz's (1989) simple division of government economic activity into production and consumption, subdivided in turn into different types of government intervention in production and consumption[3]. On the production side, government indirectly intervenes in private production through regulation, subsidy, fiscal policy and public services; it directly intervenes through producing some goods itself (Stiglitz 1989: 12-13). On the consumption side, government both redistributes income, and directly purchases goods and services (p.14). An analysis of some standard measures of these various kinds of intervention provides useful insights into the corruption problem.

The most straightforward way of measuring the extent of government intervention in the economy – calculating the level of tax raised by the state, or the money spent by the state, as a proportion of national income – focuses, for the most part, on government

intervention in consumption. Some studies have found a relationship between government size and corruption, concluding that higher government expenditures simply create more opportunities for rent-seeking (Scully 1991, Nitzan 1994, Goel and Nelson 1998). Other research has disaggregated public expenditure, finding that corruption is inversely related to education spending (Mauro 1998), but positively correlated with public investment (Tanzi and Davoodi 1997) and military spending (Gupta, de Mello and Sharan 2001).

Any simplistic association between government size and corruption is difficult to square with the low levels of corruption, and high levels of public spending, in advanced Western-style democracies. Indeed, Figure 1 shows that, amongst 23 advanced industrialized states, there is no relationship at all between government size (in terms of total government expenditure as a share of GDP) and corruption (Transparency International's ratings for 1999-2001, inverted; see annex). Finland, the 'cleanest' government, and Italy, the second most corrupt, have very similar levels of public spending; the biggest spending government (Sweden) is rated as almost as clean as the 21st (Iceland). Amongst the wealthy democracies at any rate, corruption seems to have nothing at all to do with the amount of money government raises and spends. This finding is all the more significant in view of the rather wide variation in corruption ratings amongst these cases (ranging from 0.1/10 to 5.8/10, 64% of the range of ratings across the 90 countries surveyed by Transparency International). Moreover, a multivariate analysis of a far larger sample of both advanced and developing countries by La Porta *et*

al (1999) found that a broader measure of the quality of government also correlates negatively with government size (see also Tanzi 2000).

(Figure 1 about here)

A disaggregated analysis of public spending does little to enhance explanation of corruption. We carried out, again for advanced industrialized nations, a series of regression analyses of corruption ratings with a variety of spending categories, using data collected by Tanzi and Schuknecht (2000: Ch.2), and controlling for per capita GDP and overall levels of public spending. For all but one of these categories, the analysis yielded no significant correlation[4], and it is worth noting that no relationship was found between corruption and either public investment or military spending, two areas highlighted in the literature. The most important exception is that the model for government spending on education found a negative and significant correlation with corruption (adjusted r sq=.372, *p*=0.05), replicating Mauro's (1998) findings for a larger sample of countries. Overall, however, the evidence suggests that government size *per se* has little to do with corruption and that, if anything, they are negatively correlated (La Porta 1999).

Our attention therefore turns to the ways in which governments intervene in the 'production' side of economic life. Two broad areas are of interest here. First, direct government intervention in production through public enterprises, identified by some economists as an important source of corruption (Ades and di Tella 1997b, Tanzi 2000: Ch.2), and well documented as an arena for illicit political fund-raising in some advanced

industrialized nations (most notably Italy, McCarthy 1997: Ch.5). Second, the broad area of regulation, which has been signalled as an important source of unhealthily close relationships between business interests and public officials (Stigler 1971, Peltzman 1998, Glaeser and Shleifer 2003). There is now a broad consensus in the corruption literature that regulations which impose costs and allocate scarce benefits provide incentives for bribery (Rose-Ackerman 1999: Ch.4, Tanzi 2000: Chs.2, 3, 6, 7; Djankov *et al* 2002). If a licence or permit is required in order to carry out some economic activity, this potentially gives the public official discretionary power which has economic implications for citizens; put bluntly, if the authorization will make a citizen richer and refusal will make her poorer, then the citizen will probably be prepared to pay in order to ensure the official provides it. Particularly damaging is 'quasi-fiscal' regulation, through which governments with a weak revenue service pursue redistributive goals (Tanzi 2000: Ch.3). The more cumbersome the regulation of economic life, the more likely it is that citizens and officials will engage in corrupt exchange. Moreover, pervasive corruption can be a cause of further cumbersome regulation, as corrupt officials seek to extend regulations in order to create and extract ever greater rents (Djankov *et al* 2002: 2-3; for a case study Golden 2003).

Regulation is more difficult to measure than taxation and spending, and has so far been absent from most empirical analyses of corruption (for exceptions, La Porta *et al* 1999, Paldam 2001, Djankov *et al* 2002). However, useful indicators of the weight of regulation in an economy have recently become available. The OECD has put together an extensive database of indicators of regulation over time for 21 OECD countries (see

Alesina *et al* 2002), although its sample of advanced countries is a limitation for the study of corruption. The World Bank study *Doing Business in 2004* (World Bank 2004, Djankov *et al* 2002, Botero *et al* 2003) offers measures of regulation over a wider sample of developing and developed countries. A broader measure of state interference in business activity is provided by the Fraser Institute's Economic Freedom data (Gwartney and Lawson 2001; also 1996). This data source seeks to capture the extent to which governments interfere in economic life and, more generally, the amenability of social and political conditions for business activity. We draw on both these latter sources in this analysis.

The Fraser Institute's comprehensive 'Economic Freedom Index' (Gwartney and Lawson 2001: Ch.1) covers a broad range of indicators, and has been employed in the analysis of corruption by Paldam (2001). This comprehensive index, however, presents some problems. First, corruption itself is included as a one of the indicators used in the index (in Area II, Legal Structure and Security of Property Rights), although as just one indicator amongst many this is unlikely to substantially affect the scorings. Second, the comprehensive index covers such a broad range of impediments to economic freedom that it does not serve our purpose of trying to disentangle the direct effects of government economic intervention on corruption. For instance, the index includes government size (Area I), which we treat separately, and some broad macroeconomic issues (Area III, Access to Sound Money, Area IV, Freedom to Trade With Foreigners, Area V, Regulation of Capital and Financial Markets) which certainly relate to corruption, but tend to do so rather indirectly. Our analysis therefore takes two components of the Fraser

Institute index (see annex): Area Ic, the weight of government enterprises in the economy, and Area VII, Freedom to Operate and Compete in Business, which captures most of the features of the kind of 'quasi-fiscal' regulation which creates corrupt incentives (see annex for more details).

Preliminary analysis suggests that this latter measure of business freedom is a strong predictor of corruption amongst the advanced industrialized nations. Figure 2 shows quite clearly the strong positive and significant relationship between high levels of invasive regulation of business (1999), and corruption (1999-2001). More corrupt countries such as Greece and Italy also rate poorly on this aspect of the Fraser Institute index, whereas the 'clean' governments of Northern Europe perform very well. With the exceptions of Greece and the United States, both of which are more corrupt than their measures of business regulation would predict, the advanced industrialized nations all fall close to the regression line. It is particularly notable that business regulation does not have a linear relationship with government size: there are 'big' governments both in the corrupt and regulation-heavy area of Figure 2 (Italy, France), and amongst the 'clean' and lightly regulated cases (Finland, Denmark, Sweden). Substituting the Fraser Institute variable with the World Bank regulation of entry variable produces very similar results, but we prefer the former measure since it presents a broader picture of the kind of government interference in business activity which can facilitate widespread and durable corruption (see annex).

(Figure 2 about here)

This preliminary analysis, limited to the advanced industrialized world, suggests an answer to the big government-low corruption paradox. Independently of government size, the countries with unobtrusive regulation of business activity perform well in the corruption rankings. Amongst these countries, some (United States, United Kingdom, Australia) choose to keep public spending comparatively low, whilst others (Denmark, Sweden, Finland) intervene far more heavily in the redistribution of income and the provision of public services, maintaining high levels of public spending. In other words, provided private business activity is regulated effectively and unobtrusively, governments can choose to intervene more or less heavily in consumption and the provision of public services without running the risk of promoting corruption. The following section subjects this hypothesis to more rigorous statistical analysis in order to estimate the effects on corruption of a variety of indicators of state intervention in the economy: government size in terms of public spending, government ownership of enterprises, and the regulation of business activities and the labour market.

Multiple Regression Analysis

In order to test our hypothesis, we conduct a simple OLS regression analysis of the link between corruption and different measures of government intervention in the economy. The main aim of this exercise is to test what kind of positive association can be found between the broad contours of 'big government' on the West European model on

the one hand, and levels of corruption, on the other. Additional independent variables which control for the initial level of GDP per capita and the degree of democracy are also included in the model as control variables. The basic model adopts the following form:

$$corr_{it} = \alpha + \beta_1 govnt_i + \beta_2 \ln GDP_i + \beta_3 democr_i + \varepsilon \tag{1}$$

where

> *corr* is the degree of corruption in 1999-2001
>
> *govnt* denotes the level of government intervention in the economy at the end of the twentieth century;
>
> *GDP* denotes the average gross domestic product per capita between 1997 and 2001, measured in 1995 US dollars;
>
> *democr* is the inverse of a composite of the Freedom House index of democracy, representing the average for the period 1997-2001;
>
> *i* represents the country;
>
> *t* the period of time being analysed;
>
> and α and β are the regression coefficients and ε the error term.

The level of government intervention in the economy is, in turn, divided into five separate variables:

> *pubexp* denotes the level of total government expenditure as a percentage of GDP for 1999;
>
> *govcon* represents the average general government final consumption expenditure for the period 1997-2001, as a percentage of GDP;

govent is the inverse of the Fraser Institute's index of the share of government enterprises and investment in GDP in 1999 (high scores imply extensive government enterprise and investment);

labreg represents the average score of each country over the three areas of labour market regulation analyzed in Botero *et al* (2003) (high scores imply high levels of labour market regulation);

freebus represents the capacity of economic actors to conduct business without interference for 1999, as measured by the Fraser Institute (Area VII);

The types of government intervention whose effects we are exploring are precisely those traditionally associated with the various kinds of Western European welfare capitalism. As well as government spending and the level of regulation of business activity, both examined in the previous section, we also include two other kinds of government intervention which have often been extensive in Western European welfare states: the state control of production in the form of publicly owned enterprises, and the regulation of the labour market through laws governing employment, industrial relations, and social security arrangements. A more detailed description of each variable is included in Annex 1.

Six stepwise regressions are performed for two sets of countries. The first set includes 51 countries for which Transparency International corruption indicators and Fraser Institute economic freedom indicators are readily available. The second subset is limited to the 23 most advanced industrialized democracies. We conduct a separate

analysis using the sample of the most advanced democracies in order to better highlight the connection between government economic intervention and corruption in countries with a similar stage of economic and political development, thus avoiding some of the problems caused by the huge differences in democratic and wealth levels between countries in the larger sample. Given that the Freedom House index of democracy has little variation across most advanced industrialized nations, this variable is dropped for this subset of countries. The available data does not permit a tractable time series analysis so data points from the late 1990s early 2000s period are taken. Given the variables are (or can be hypothesized to be) rather slow-moving, we do not envisage that this biases the results significantly.

The first two regressions in each sample concentrate on the simple relationship between government size and corruption: Regression 1 comprises the level of public expenditure as a percentage of GDP and Regression 2 the levels of general government consumption. Public expenditure and government consumption are included in separate regressions in order to avoid obvious problems of multicollinearity. Regressions 3 and 4 reproduce the same scheme including the other variables that depict the degree of government intervention in the productive side of the economy (*govent*, *labreg* and *freebus*) and Regressions 5 and 6 contain the natural logarithm of GDP per capita and, in the case of the larger sample, the index of democracy. VIF and Moran's I tests have been carried out in order to check for multicollinearity and spatial autocorrelation respectively. Any violation of assumptions is reported.

Table 1 presents the results of the regression analysis for the sample of 51

developed and less developed countries. Although, taken individually, high levels of public expenditure seem to be associated with lower corruption (Regression 1), this relationship disappears when the per capita wealth of a country is taken into account (Regression 5). The link between expenditure and corruption appears thus to be encapsulated in the differences in GDP per capita: richer countries tend to have more developed governments and public administrations, a higher public expenditure and, as a general rule, a lower degree of corruption (as found by La Porta *et al* 1999). Government consumption expenditure, which is also negatively and significantly correlated with a country's level of corruption (Regression 2) remains, by contrast, significant (although with a reduced coefficient) even if differences in GDP per capita are taken into account (Regression 6). The introduction of the business freedom variable from Regression 3 onwards produces the most important changes in our perception of the link between the degree of government intervention in the economy and corruption. Contrary to the findings of Ades and di Tella (1997b), government ownership and management of enterprises has no relationship with corruption in any of the models in which it is included (Regressions 3, 4, 5 and 6). The coefficients of the degree of labour regulation within a country are not significant, with the exception of Regression 4 where it is associated with *lower* corruption. The inclusion of the degree of democracy in the model has little influence on the results, as its coefficients are insignificant and close to zero. As a whole, at a global level, corruption seems to be fundamentally related to the capacity of firms to conduct business without interference and to the level of development. Countries with a higher GDP per capita and that leave business relatively free from interference

(except in the labour market) are, everything else being equal, less corrupt. Corruption thrives, by contrast, in poor countries with high barriers for businesses to compete and operate. If these factors are taken into account, 'big government', measured either by the degree of public expenditure and government consumption, or by public ownership of enterprises and labour regulation, is either irrelevant or associated with lower, rather than higher, corruption.

(Table 1 about here)

When only the subset of the most advanced industrialized nations is considered, important nuances in the interpretation emerge (Table 2). In contrast to the results for the larger sample, there is no significant link between the level of public expenditure or government consumption and the degree of corruption in advanced democracies, if these relationships are considered in isolation (Table 2, Regressions 1 and 2). When other indicators of government intervention in the economy are included in the regression however (Regressions 3 and 4), the panorama changes radically. As in the larger sample, the freedom to conduct business variable is the strongest predictor of corruption. Countries that interfere less with business activities are generally more less corrupt. Under these conditions, public expenditure and government consumption become robust and negatively connected to corruption (Regressions 3 and 4). In advanced industrialized nations therefore, not only is public expenditure not associated with corruption, but it seems that the higher the level of public expenditure, the lower the level of corruption.

Moreover, the share of government enterprises (*govent*) and the degree of labour regulation (*labreg*) display no association with measured corruption in advanced industrialized nations whatsoever (Regressions 3 and 4). Finally, and in contrast with the larger sample, the overall wealth of a nation is irrelevant for corruption. The introduction of GDP per capita in the analysis results in weak and not significant negative coefficients and leads to no changes in the sign or strength of the association of the above mentioned government intervention coefficients with corruption.

(Table 2 about here)

Conclusions

Overall, the results of our analysis show that the magnitude of government intervention in the economy in its broadest sense has little to do with corruption. High levels of public expenditure or government consumption are associated with low levels of corruption – strongly amongst advanced nations, less so in the larger sample. Instead, restrictions on business activity through heavy regulation and cumbersome bureaucracy are a powerful predictor of corruption, as is the average wealth of the country in the larger sample. There is no apparent association between corruption and government-owned enterprises, or with the level of labour regulation. This confirms that the relationship between government intervention and corruption is far from straightforward, and that many of the features of 'big government' associated with Western European

welfare capitalism are if anything negatively correlated with corruption.

What is clear from this analysis is that corruption is positively correlated with one particular feature of government intervention: the degree of regulation of business activity (see also Djankov *et al* 2002, World Bank 2004b). This suggests that governments should remove the kinds of cumbersome regulations which create opportunities for public officials to offer 'fast-track' treatment in return for cash. To this extent, the efforts of international organizations such as the IMF, the World Bank and the OECD to improve the effectiveness and integrity of public administrations do indeed go to the heart of the problem. However, our analysis also implies that governments that follow this advice should feel free to intervene extensively in the redistribution of income and the provision of social services, without such intervention necessarily undermining the quality of governance. Even regulation of the labour market and state-controlled enterprises, two examples of the kinds of interventionist policies which the current orthodoxy condemns (on both efficiency and governance grounds), have no statistically significant relationship with corruption in our analysis.

Moreover, the negative correlation between corruption and public spending amongst advanced nations is particularly striking, suggesting that government intervention through welfare programmes is associated with lower corruption (although the analysis presented here does not allow us to assess the direction of causality). Recent research indeed shows that universalistic welfare states (such as those in the high-spending social democracies) strengthen citizens' trust in public institutions, thereby enhancing compliance with state rules and decisions (Rothstein year…). This intriguing

finding runs counter to assumptions that more state intervention means more opportunities for corruption. Indeed, there is a remarkable lack of qualitative or quantitative evidence that corruption has increased in those countries which have had a large public sector over a long period of time.

In sum, 'big government' has many guises, and many of them are either unassociated, or indeed even negatively associated, with corruption. The findings presented here suggest an answer to the paradox we signaled at the beginning of this article. The Scandinavian social democracies, and to a lesser extent the continental European welfare states, manage to combine extensive state intervention with low levels of corruption because they have effective and unobtrusive institutions for regulating business activity. Recent research into regulatory frameworks finds that ease of entry into product markets is greater in the high-spending welfare states Norway and Denmark, than in liberal Britain (Djankov *et al* 2002). All three countries rank highly in the Transparency International corruption league table, but the attitude towards government intervention, particularly in the areas of welfare provision and public services, varies considerably: Britain has opted to 'roll back' the state, whilst the Scandinavian social democracies have continued to intervene significantly in economic life through high levels of public spending and, to an extent, by regulating the labour market. The social consequences of these two strategies are of course very different.

In the light of developments in high-profile cases such as Russia and some Latin American countries, advocates of anti-corruption strategies based on liberalization and privatization have recently become increasingly cautious in their assessments of the ways

in which government intervention in the economy relates to corruption. It has recently been stressed that 'the optimal level of government intervention is not zero' because government capacity to define and enforce property rights is crucial in establishing a functioning and transparent market economy. The analysis presented here goes further: we have presented evidence that key features of government intervention associated with West European welfare capitalism can confidently be ruled out as causes of corruption. This suggests a lesson for developing countries faced with problems of both endemic corruption and entrenched poverty: corruption can be defeated without abandoning the state's role in protecting society from the rough edges of the market economy. Policy advice should therefore reflect the fact that much of the time, 'the problem is not so much that the government is too big, but that it is not doing the right thing' (Stiglitz 2002: 54). The widely shared goal of reducing corruption should therefore not be conflated with the rather more ideological programme of reducing the economic role of the state in general.

Figure 1

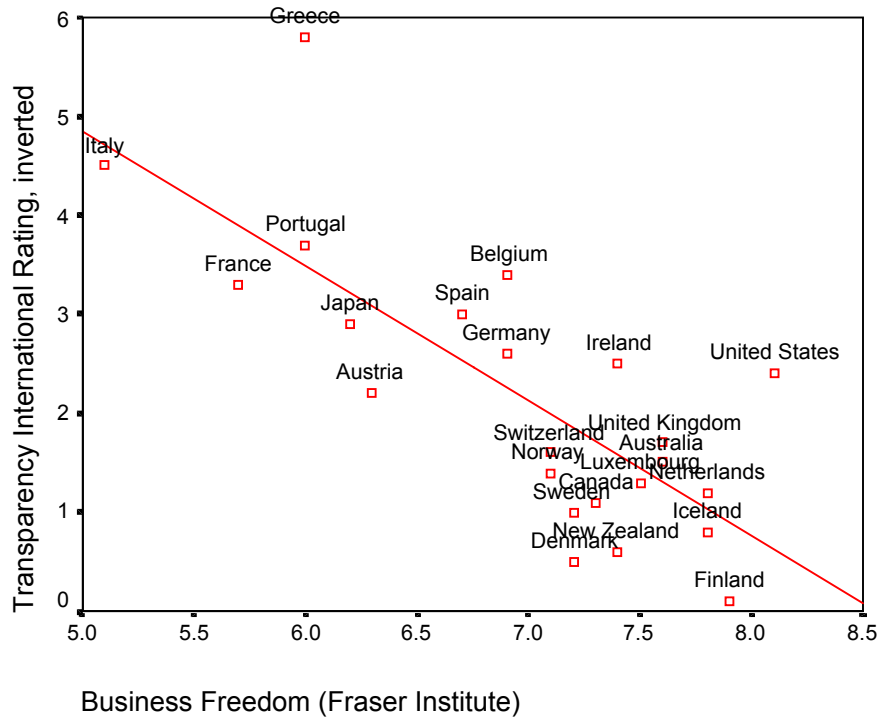**Government Spending and Corruption in Advanced Industrialized States**
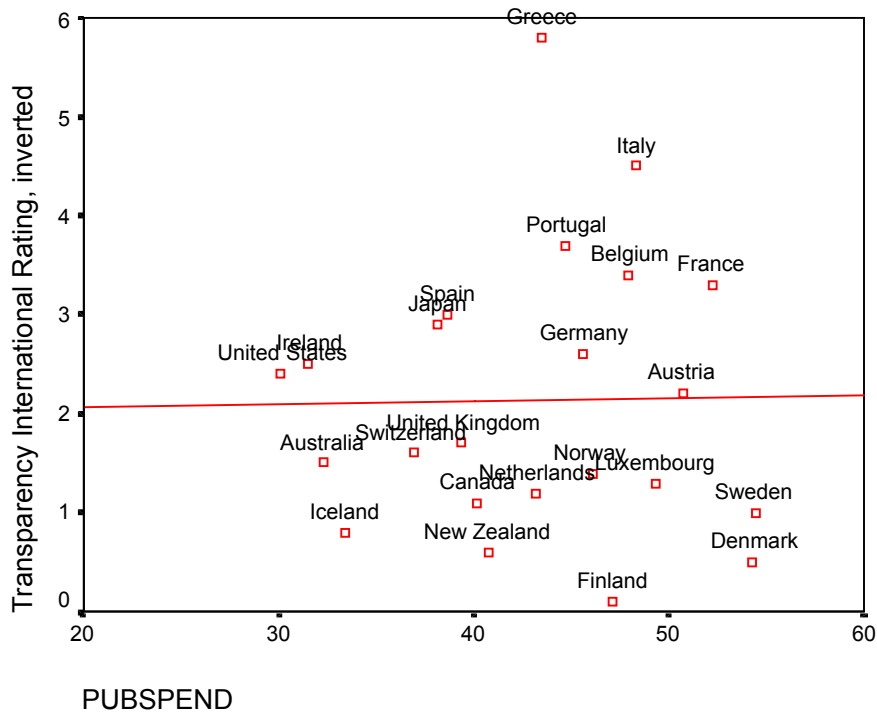
R square= 0.000, *p*= .940

Sources: TI rating = Transparency International (2000); public spending = Gwartney and Lawson (2001) (see annex).

Figure 2

Business Freedom and Corruption in Advanced Industrialized States

R square = .586, *p*= .000

Sources: TI rating = Transparency International (2001); freedom to do business = Gwartney and Lawson (2001) (see annex).

Table 1

Corruption and Government Intervention in the Economy, World

Indep. Var.	[1]	[2]	[3]	[4]	[5]	[6]
pubexp	-0.493***		-0.264***		-0.104	
	-3.963		-3.512		-1.356	
govcon		-0.518***		-0.231***		-0.146**
		-4.239		-2.951		-2.253
govent			0.129	0.117	0.014	0.029
			1.663	1.452	0.190	0.435
labreg			-0.148	-0.185**	-0.015	-0.009
			-1.992	-2.469	-0.210	-0.122
freebus			-0.788***	-0.799***	-0.525***	-0.479***
			-8.891	-8.568	-5.236	-4.880
lnGDP					-0.424***	-0.446***
					-4.027	-4.791
democr					-0.026	-0.026
					-0.329	-0.352
F	15.704	17.970	50.296	46.177	49.033	53.431
Prob>F	0.000	0.000	0.000	0.000	0.000	0.000
df	1,49	1,49	4,41	4,41	6,39	6,39
R^2	0.243	0.268	0.831	0.818	0.883	0.892
Adj. R^2	0.227	0.253	0.814	0.801	0.865	0.875
Multicollinearity	No	No	No	No	No	No
Sp. Autocorrelation	Marginal	No	No	No	No	No

Standardized coefficients reported. t-statistics in italics under coefficients

***,**, and * denote significance at the 99%, 95%, and 90% level respectively

Table 2

Corruption and Government Intervention in the Economy, Advanced Industrialized Nations

Indep. Var.	[1]	[2]	[3]	[4]	[5]	[6]
pubexp	0.017		-0.418**		-0.381**	
	0.076		*-2.378*		*-2.229*	
govcon		-0.346		-0.364**		-0.324*
		-1.688		*-2.260*		*-2.039*
govent			-0.008	-0.076	0.099	-0.029
			-0.035	*-0.345*	*0.431*	*-0.127*
labreg			0.096	0.179	0.001	0.076
			0.475	*0.856*	*-0.003*	*0.354*
freebus			-0.859***	-0.674***	-0.779***	-0.617***
			-4.470	*-3.276*	*-4.043*	*-3.024*
lnGDP					-0.231	-0.222
					-1.485	*-1.391*
F	0.005	2.848	8.549	8.234	7.796	7.358
Prob>F	0.940	0.106	0.001	0.001	0.001	0.001
df	*1,21*	*1,21*	*4,16*	*4,16*	*5,15*	*5,15*
R^2	0.000	0.119	0.681	0.673	0.722	0.710
Adj. R^2	-0.047	0.077	0.602	0.591	0.630	0.614
Multicollinearity	No	No	No	No	No	No
Sp. Autocorrelation	No	No	No	No	No	No

Standardized coefficients reported. t-statistics in italics under coefficients

***,**, and * denote significance at the 99%, 95%, and 90% level respectively

[1] Treisman also looks at the impact of religious tradition, whilst Paldam 2001, 2002, La Porta *et al* 1999 examine both religious and legal traditions.

[2] Moreover, there is an increasing recognition that this approach has not been as successful as hoped in developing countries either; see Tulchin and Espach 2000.

[3] A third role, that of economic stabilization, is left outside the scope of this analysis.

[4] No statistically significant correlations were found between corruption and the following spending items: government employment, defence, subsidies and transfers, health, pensions, unemployment benefits, income transfer programmes other than unemployment benefit, and public investment. These analyses were run for the 17 industrialized nations included in Tanzi and Schuknecht (2000). Results available on request.

Annex

Description of variables

corr

The inverse of country scores on the Transparency International corruption perceptions ranking for 2001. The TI corruption perceptions index is based on surveys of business people and reflects respondents' perception of the likelihood of bribes being demanded by public officials in the course of business dealings in the country concerned. We use the 2001 index, which is based on data compiled between 1999 and 2001. We chose the TI rating because it is freely available and because it offers more up-to-date measures than alternatives such as the International Country Risk Guide (in any case the various measures correlate closely; see Fisman and Gatti 2002). The index uses a 0-10 scale in which 0= very high corruption (low transparency) and 10= very low corruption (high transparency). We invert the index for ease of exposition, so that higher scores imply higher levels of corruption.

pubexp

Total government expenditures as a percentage of GDP, 1999. Taken from the Fraser Institute Economic Freedom Index, Area I, Ia (Gwartney and Lawson 2001).

govcon

The World Bank's *World Development Indicator* measure of the average general government final consumption expenditure for the period 1997-2001, as a percentage of

GDP (www.WorldBank.org/data).

govent

The inverse of the Fraser Institute's index of government enterprises and investment as a percentage of GDP in 1999 (Area I, c). The Fraser Institute regards awards higher scores to countries with lower level of public ownership of enterprises and lower public investment (Gwartney and Lawson 2001: 25). In order to make the interpretation of results more compatible with the other government intervention variables in the analysis, we invert the index so that high scores imply higher levels of intervention.

labreg

The average score over the three areas of labour regulation examined by the World Bank *Doing Business* study (see Botero *et al* 2003). The scores estimate the degree of state regulation in the following areas: employment laws, industrial relations laws, and social security laws. Higher scores indicate a greater degree of state intervention, lower scores indicate that labour market relations are more likely to be regulated by private contract. We also ran the regressions with the Fraser Institute's data on labour regulation (Gwartney and Lawson 2001) which produces very similar findings. Results available on request.

freebus

A Fraser Institute measure of the capacity of economic actors to conduct business without

interference for the year 1999. Here we take the 'Area VII' scores which specifically measure 'Freedom to Operate and Compete in Business'. Area VII includes administrative conditions and new businesses, time spent in dealing with government bureaucracy, the requirements involved in starting a new business, the extent of local competition, the magnitude of irregular payments to public officials (which we remove for evident reasons of endogeneity) and bank credit for business (for more detail on how these measures were gathered, see Gwartney and Lawson 2001: Ch.2). Countries where economic actors are deemed to be able to pursue business without interference have higher scores.

The other components of the more comprehensive index were excluded from our analysis either because they included the dependent variable (Area II, Legal Structure and Property Rights), because they included variables that we entered into the model separately (Area I Government Size), or because they dealt with issues outside the theoretical and empirical scope of this article (Area III Access to Sound Money, Area IV Freedom to Trade with Foreigners, Area V Regulation of Capital and Financial Markets). (http://www.fraserinstitute.ca/). This has the added benefit of avoiding the biases which may result from Gwartney and Lawson's weighting of the various measures in the comprehensive index (Heckelman and Stroup 2000; see also Sturm, Leertouwer and de Haan 2002, Heckelman and Stroup 2002).

Recent research supported by the World Bank has provided new data sets on regulation which have improved our knowledge in this area. We also ran the same regression analysis using the World Bank research's measure of 'regulation of entry' (Djankov *et al*

2002) as a surrogate for the unobtrusiveness of the regulatory environment. The results were very similar, with only a very slight reduction in the coefficient (results available on request). The World Bank and Fraser Institute measures in fact correlate very strongly (Pearson's r= .898**). We adopt the latter, since the regulation of entry is an important variable for determining levels of competition and efficiency in product markets, but is rather too specific for the purposes of assessing the types of business conditions which favour widespread and durable corruption. It might be added that the Fraser Institute's declared support for limited government and free markets makes it an unlikely source of evidence for the benefits of Western European welfare capitalism. Although we take the data to be reliable, any potential bias would add to the robustness of our findings.

GDP

The World Bank's *World Development Indicators* constant measure of GDP per capita in 1995 US dollars, as an average for the period between 1997 and 2001.
(www.WorldBank.org/data)

democr

The inverse of the composite variable resulting from averaging the political rights and civil liberties indices of the Freedom House annual Freedom in the World survey for the period 1997-2001 (http://www.freedomhouse.org/). Each country is rated on a scale from 1 to 7 with 1 representing the highest, and 7 the lowest level of political and civil liberties.

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