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**CAUSES OF CORRUPTION: AN EMPIRICAL
INVESTIGATION IN A CROSS-COUNTRY
FRAMEWORK**

A thesis presented in fulfilment of the requirements for the degree of

Doctor of Philosophy

In

Economics

Massey University, Turitea Campus, Palmerston North

New Zealand

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2009

ABSTRACT

In recent years corruption has come to be considered as a pervasive phenomenon, and a major obstacle in the process of economic development. However, there exist few studies that discuss the factors that cause corruption and why some countries are more corrupt than others. This research contributes to that rather scanty literature and focuses on the causes of corruption. More importantly, the study empirically investigates various causes of corruption, in particular the role of economic development, democracy and economic freedom in explaining the observed variations in corruption across countries, and the nexus between democracy and economic freedom in combating corruption.

The study first tests the reliability of the recent quantitative innovations in the study of corruption in terms of the Corruption Perception Index, constructed by Transparency International. Using theoretical and empirical analysis, various hypotheses regarding corruption and its determinants are examined using panel data for 100 countries during the period 1995 to 2004. The empirical findings show that the subjective indexing process of corruption perception eventually converges to a common consensus. In evaluating the relationship between economic development and corruption, the results suggest that income per capita, education, unemployment, income inequality, economic freedom and democracy are among the factors which determine and help explain the cross-country differences in corruption. Furthermore, the assessment of the relationship between democracy and corruption shows that an 'electoral democracy', represented by 'political rights', is not in itself sufficient to reduce corruption. Instead, for low levels of corruption to exist, the presence of an advanced fully-formed mature democracy is required.

A characteristic of a mature democracy is the existence of an environment where the probability of being caught, if acting corruptly, is very high. In addition, the examination of the interaction between economic freedom and democracy suggests that economic freedom reduces corruption in any political environment, and the effect

is substantially larger with a high level of democracy. The interesting and important findings of the analysis indicate that there exists a non-linear relationship between corruption and the level of income as well as democracy. The findings suggest that developed countries have succeeded in controlling corruption through higher levels of economic development along with the economic and political freedoms that their peoples enjoy.

ACKNOWLEDGEMENTS

I would like to express my gratitude to my principal thesis advisor Associate Professor Rukmani Gounder, for walking me through the journey of PhD study and for being there at every step as a source of inspiration, motivation and moral support. Dr Gounder's excellent supervision, invaluable guidance, suggestions, corrections and empirical skills have helped shape much of this thesis. I would also like to extend deepest appreciation to my associate advisor Associate Professor Neil Campbell (now at Bond University) for his invaluable guidance and encouragement throughout this study. I also extend my thanks to Dr. Jen-Je Su (now at Griffith University) for consenting to be a member of my advisory committee and for offering invaluable comments and suggestions for empirical analysis.

I am extremely grateful to Professor Srikanta Chatterjee for his constant source of guidance, support and encouragement throughout my study. I am also grateful to Associate Professor Subhas Mukhopadhyay and Associate Professor Jeffrey Kline (Bond University) for providing their mathematical expertise and guidance in the theoretical aspect of the chapter. I would like extend my thanks to both Dr. James Obben for sharing his knowledge and expertise, and Dr Andrew Coleman of MOTU Research for his valuable feedback.

My thanks are also extended to Professor Anton Meister and Professor Martin Young for providing me the financial support as a graduate assistantship in the department during my PhD study. I extend special thanks to the members of the administrative staff of the Department of Economics and Finance, particularly Ha-Lien Ton and Sue Edwards for their support.

I am deeply indebted to Saptarshi Mukherjee, who has been the motivational force in my life, and thank him for his patience, understanding and invaluable support during the PhD study. I am grateful to my mother, brother and sisters for their selfless and unreserved support over the years.

TABLE OF CONTENTS

Abstract.....	i
Acknowledgement.....	iii
Table of Contents.....	iv
List of Tables.....	viii
List of Figures.....	x
List of Abbreviations.....	xi

Chapter 1 Introduction

1.1 Background of the Thesis.....	1
1.2 Aims and Objectives.....	2
1.3 Chapter Outline.....	4

Chapter 2 Corruption: Literature Review

2.1 Introduction.....	7
2.2 The Concept of Corruption.....	8
2.2.1 What is corruption?.....	8
2.2.2 Measurements of corruption.....	12
2.3 The Impacts of Corruption.....	16
2.3.1 Effects on growth.....	16
2.3.2 Effects on efficiency.....	20
2.3.3 Effects on distribution.....	25
2.4 Factors Behind Different Incidence of Corruption.....	27
2.4.1 Socio-economic factors and corruption.....	27
2.4.2 Democracy and corruption.....	28
2.4.3 Economic freedom and corruption.....	30
2.5 Empirical Evidence on the Causes of Corruption.....	32
2.6 Summary.....	34

Chapter 3 Corruption Perception Index: A Deeper Insight

3.1 Introduction.....	36
3.2 CPI and It's Standard Deviation of Rankings.....	37
3.2.1 Corruption perception index.....	38
3.2.2 Standard deviation of the CPI rankings	39
3.3 Empirical Analysis.....	40
3.3.1 Empirical results for the CPI scores.....	40
3.3.2 Empirical results for the standard deviation of CPI rankings..	46
3.4 Conclusion.....	53

Chapter 4 Does Economic Development Matter for the Causes of Corruption?

4.1 Introduction.....	54
4.2 Determinants of Corruption: Theory.....	55
4.3 Models, Data and Methodology.....	58
4.3.1 Model specification.....	59
4.3.2 Data description.....	61
4.3.3 Econometric methodology.....	63
4.4 Estimation Results.....	65
4.4.1 Panel estimation results for all countries.....	65
4.4.2 The per capita income and corruption relationship in LICs, Mics and HICs	72
4.4.3 Real GDP per capita and corruption: non-linear estimation.....	76
4.5 Sensitivity Analysis.....	80
4.5.1 Cross-section estimations.....	80
4.5.2 Two-stage estimations.....	83
4.6 Conclusion.....	85

Chapter 5 The Role of Democracy in Controlling Corruption: A Theoretical Perspective

5.1 Introduction.....	96
5.2 Democracy-Corruption Association: An Overview.....	98
5.3 The Model.....	102
5.4 Non-Linear Democracy-Corruption Relationship.....	106

5.5 Democracy, Income and Corruption.....	109
5.6 Conclusion.....	111

Chapter 6 Democracy and Corruption: An Empirical Analysis in a Cross-Country Framework

6.1 Introduction.....	115
6.2 Conceptual Issues of Democracy Indices.....	117
6.3 Data, Models and Methodology.....	119
6.3.1 Data description.....	119
6.3.2 Model specifications.....	120
6.3.3 Econometric methodology.....	121
6.4 Panel Estimation Results.....	122
6.5 Sensitivity Analysis.....	129
6.5.1 Cross-section results.....	131
6.5.2 Alternative corruption measure.....	133
6.5.3 Alternative measure of democracy.....	134
6.6 Non-Linear Estimation.....	135
6.6.1 Partial estimation.....	140
6.7 Conclusion.....	141

Chapter 7 The Interactive Effect of Economic Freedom and Democracy on Corruption

7.1 Introduction.....	149
7.2 Economic-Political Liberalistion and Corruption: An Overview	150
7.3 Demand-Supply Analysis of Democracy, Economic Freedom and Corruption.....	152
7.4 Empirical Models and Methodology.....	154
7.4.1 Models with the interaction term.....	154
7.4.2 Methodology.....	155
7.5 Empirical Evidence.....	156
7.5.1 Robustness analysis.....	160
7.5.2 Partial effect.....	163
7.6 Conclusion.....	167

Chapter 8 Conclusion and Further Research

8.1 Introduction.....	169
8.2 Conclusion and Policy Implications.....	170
8.2.1 Conclusion.....	170
8.2.2 Policy implications.....	173
8.3 Further Research.....	175
Bibliography.....	177

LIST OF TABLES

Table 3.1 Estimated standard deviation values of CPI scores over 1995-2006.....	41
Table 3.2 Movement of countries between groups over time, 1995-96 to 2005- 2006.....	45
Table 3.3 Regression results of significant improvement/deterioration of CPI scores.....	47
Table 3.4 Average standard deviations of the rankings of CPI over the period 1995- 2006.....	52
Table 4.1 Dependent and independent variables and their expected signs.....	58
Table 4.2 Determinants of corruption.....	67
Table 4.3 The RGDP per capita and corruption relationship in LICs, MICs and HICs.....	74
Table 4.4 Non-linear relationship between per capita income and corruption.....	77
Table 4.5 Turning points of the real GDP per capita.....	79
Table 4.6 Determinants of corruption: OLS estimation.....	82
Table 4.7 Two-stage least square regression results for CPI and CCI.....	84
Table 5.1 Corruption perception index for India, Singapore and South Korea.....	102
Table 5.2 Relationship among democracy level, probability of detection and punishment and proportion of bribe takers.....	108
Table 6.1 Impact of narrow and broad democracy on controlling corruption: Corruption perception index as dependent variable.....	124
Table 6.2 Impact of other indicators of democracy on controlling corruption	127
Table 6.3 OLS estimates for democracy and corruption relationship.....	132
Table 6.4 Effect of narrow-and broad-democracy on the control of corruption index, ,1996-2004.....	134
Table 6.5 An alternative measure of democracy and corruption, 1995–2004.....	135
Table 6.6 Estimated results for the non-linear relationship between corruption and various components of narrow-and broad-democracy democracy.....	137
Table 6.7 Turning points for the level of various democracy indices.....	139

Table 6.8 Number of countries with high and low levels of political rights and press Freedom.....	139
Table 6.9 Partial effects of narrow-and broad-democracy on corruption.....	141
Table 7.1 Interaction effects of democracy and economic freedom on corruption: panel estimation.....	159
Table 7.2 Interaction effects of democracy and economic freedom on corruption: OLS and 2SLS estimation.....	161
Table 7.3 Partial effects of democracy and economic freedom on corruption.....	164
Table A4.1 Descriptive statistics of the variables.....	87
Table A4.2 Data sources.....	88
Table A4.3 List of countries included in the analysis.....	89
Table A4.4 Anova table.....	89
Table A4.5 Determinants of corruption: white period standard error corrected.....	90
Table A4.6 Determinants of corruption: generalised least square (cross-section weights).....	91
Table A4.7 Determinants of corruption: generalised least square (period weights). 92	
Table A4.8 Relationship between per capita income and infant mortality rate and sanitation.....	93
Table A4.9 Relationship between corruption and regional dummies without control variables.....	94
Table A4.10 List of countries by income classification.....	95
Table A5.1 Transparency International 2005 corruption perceptions index.....	112
Table A6.1 Descriptive statistics of the variables.....	144
Table A6.2 Impact of narrow-and broad-democracy in controlling corruption.....	145
Table A6.3 Average values of political rights and press freedom.....	146
Table A7.1 Descriptive statistics of the variables.....	168

LIST OF FIGURES

Figure 3.1 Kernel fits of standard deviations of CPI ranking and CPI scores.....	48
Figure 3.2 Variation of the average standard deviations of CPI rankings over time.	50
Figure 3.3 Boxplots of standard deviation of the rankings of CPI, 1995 to 2006.....	53
Figure 4.1 RGDP per capita and CPI for LICs, MICs and HICs.....	75
Figure 4.2 Range of CPI in LICs, MICs and HICs.....	76
Figure 4.3 Kernel fit plots of log (RGDP) and corruption for LICs, MICs and HICs.....	78
Figure 5.1 Relationship between democracy and probability of getting caught and punished.....	109
Figure 6.1 The relationship between democracy indicators and corruption.....	130
Figure 7.1 The optimum level of corruption in various level of democracy.....	153
Figure 7.2 Levels of economic freedom in less and more democratic countries.....	157
Figure 7.3 Economic freedom and corruption: less and more democratic Countries.....	157
Figure 7.4a Partial effects of democracy on corruption.....	166
Figure 7.4.b Partial effects of economic freedom on corruption.....	166

LIST OF ABBREVIATIONS

2SLS	Two Stage Least Squares
CCI	Control of Corruption Index
CPI	Corruption Perception Index
FDI	Foreign Direct Investment
FE	Fixed Effect
GDP	Gross Domestic Product
HICs	High-Income Countries
IV	Instrumental Variable
LICs	Low-Income Countries
MCLEAN	Mostly-Clean Countries
MCOR	Most-Corrupt Countries
MEDCOR	Medium-Corrupt Countries
MICs	Middle-Income Countries
OECD	Organisation for Economic Co-operation and Economic Development
OLS	Ordinary Least Squares
PFERD	Period Fixed Effect with Regional Dummies
PLS	Panel Least Squares
RE	Random Effect
TI	Transparency International
US	United States