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Ethics, Corruption, and Economic Freedom

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The subject of ethics has increasingly been present in economic analysis,[1] although not without considerable debate. Some economists believe that the importance of economics is purely technical. Others believe that moral considerations in economic analysis provide a more accurate picture of possible outcomes since it takes into consideration the human aspect of economic actors—that is, people.

I confess that, as an economist, it makes me nervous to insert subjective measures such as morality and ethics when I do my own analysis, both because my conclusions may be applicable only to a few cases and because morality and ethics are hard to measure. But since economics is the study of choice, human behavior cannot be ignored in economic analysis if we want to have a meaningful insight into people's economic life.

I will try to explain corruption, therefore, in economic terms and show how economic freedom removes opportunities for corruption and promotes ethics not just for its moral implications, but also because of its economic value.

Ethics, according to Merriam-Webster's dictionary, is "the discipline dealing with what is good and bad...." In general, we call unethical those actions for

1. See Daniel Hausmann and Michael McPherson, "Taking Ethics Seriously: Economics and Contemporary Moral Philosophy," *Journal of Economic Literature*, Vol. XXXI (June 1993), pp. 671–731. See also Leonard Silk, "Ethics in Economics," *American Economic Review*, Vol. 67, No. 1 (February 1977).

Talking Points

- As Frederick von Hayek foresaw more than 60 years ago, economic freedom is required in all aspects of economic life in order for countries to improve their economic efficiency and, consequently, the living standards of their people.
- It is essential to understand that corruption is a symptom—of overregulation, lack of rule of law, a large public sector—not the root of the problem.
- Countries must advance economic freedom in all possible areas of the economy, with particular emphasis on regulations affecting small and medium business, in order for corruption and informality to decrease.
- Economic freedom with a strong rule of law will foster a culture of investment, job creation, and institutional respect—all essential factors in massively improving the living standards of ordinary people.

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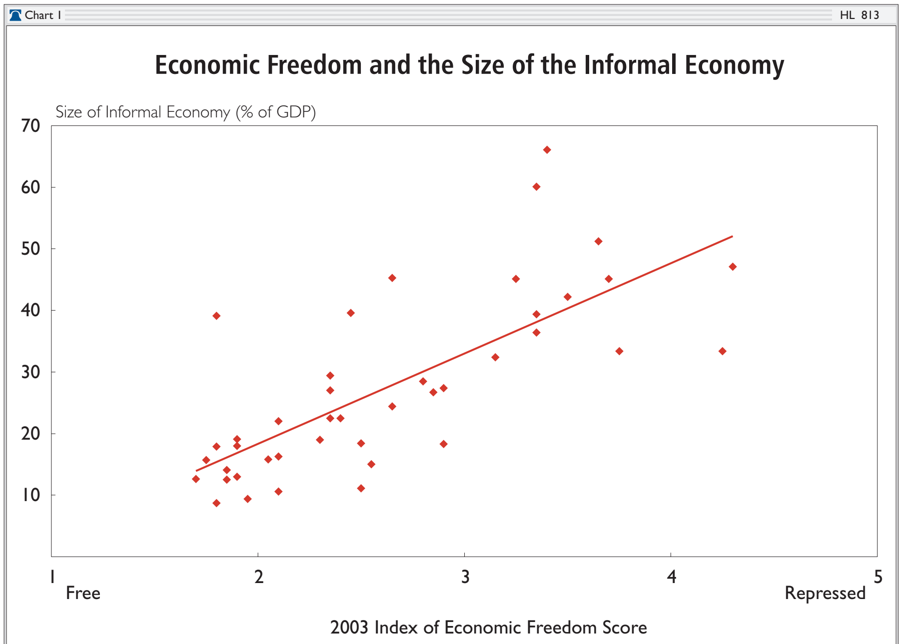
which there is a social consensus that they are a bad thing.

Corruption has several meanings, depending on whether it takes place in the public or private sector; however, for most people corruption is something unethical, something considered a wrongdoing. A closer look at human behavior in economic life suggests that, in some instances, corruption does not reflect so much a lack of ethics as it reflects a lack of economic freedom.

Economic Freedom and Corruption

To better understand the link between corruption and economic freedom, let me first describe economic freedom and then explain how its absence fosters corruption. I will examine the relationship between economic freedom and corruption both in the form of informal economic activity and in the public-sector bureaucracy.



Note: Data for 22 Transition Economies is 2000/01 average, and data for 21 OECD countries is 2001/02 average.

Sources: Friedrich Schneider, "The Size and Development of the Shadow Economies and Shadow Economy Labor Force of 22 Transition and 21 OECD Countries: What Do We Really Know?" Paper prepared for the conference, Unofficial Activities in Transition Economies: Ten Years of Experience, Institute of Public Finance, Zagreb, Croatia, October 18–19, 2002. Gerald P. O'Driscoll, Jr., Edwin J. Feulner, and Mary Anastasia O'Grady, *2003 Index of Economic Freedom.* (Washington, D.C.: The Heritage Foundation and Dow Jones & Company, Inc., 2003).

According to The Heritage Foundation/*Wall Street Journal* annual *Index of Economic Freedom*, economic freedom is "the absence of government constraint or coercion on the production, distribution, or consumption of goods and services beyond the extent necessary for citizens to protect and maintain liberty itself."[3]

The *Index* measures the level of economic freedom in 161 countries around the world. To measure economic freedom, it focuses the study on 10 different factors:

- Trade policy,
- Fiscal burden of government,
- Government intervention in the economy,
- Monetary policy,
- Banking and finance,
- Capital flows and foreign investment,
- Wages and prices,
- Property rights,
- Regulation, and
- Informal market.

The *Index* provides a framework for understanding how open countries are to competition; the degree of state intervention in the economy, whether through taxation, spending or overregulation; and the strength and independence of a country's judiciary to enforce rules and protect private property. The 10 factors of the *Index* allow anyone to see how much or little economic freedom a country has.

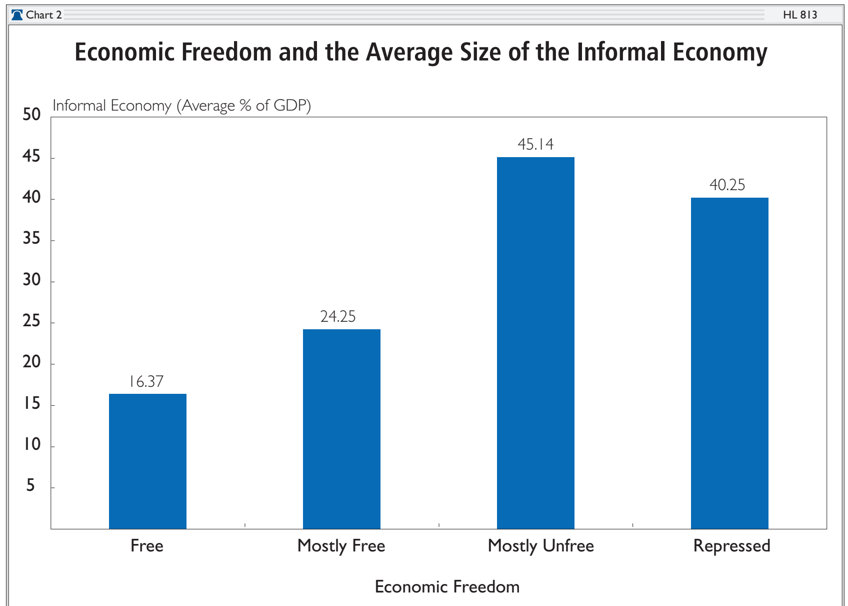
Some countries may have freedom in all factors; others may have freedom in just a few. One of the most important findings of the *Index* is that, as Frederick von Hayek foresaw more than 60 years ago,

2. *Merriam-Webster's Collegiate Dictionary*, Tenth Edition (Springfield, Mass.: Merriam-Webster, 2002), p. 397.

3. Gerald P. O'Driscoll, Jr., Edwin J. Feulner, and Mary Anastasia O'Grady, *2003 Index of Economic Freedom* (Washington, D.C.: The Heritage Foundation and Dow Jones & Company, Inc., 2003), p. 50.

economic freedom is required in all aspects of economic life—that is, in all of the 10 factors—in order for countries to improve their economic efficiency and, consequently, the living standards of their people.

The *Index* shows that corruption does not always reflect inherent unethical behavior. This is particularly the case for those who are forced out of the formal economy into the informal economy through burdensome regulations, taxation, and weak property rights.



Note: Averages are taken for 11 free countries, 20 mostly free countries, 9 mostly unfree countries, and 2 repressed countries.

Sources: Friedrich Schneider, "The Size and Development of the Shadow Economies and Shadow Economy Labor Force of 22 Transition and 21 OECD Countries: What Do We Really Know?" Paper prepared for the conference, Unofficial Activities in Transition Economies: Ten Years of Experience, Institute of Public Finance, Zagreb, Croatia, October 18–19, 2002. Gerald P. O'Driscoll, Jr., Edwin J. Feulner, and Mary Anastasia O'Grady, *2003 Index of Economic Freedom* (Washington, D.C.: The Heritage Foundation and Dow Jones & Company, Inc., 2003).

Economic Freedom and the Informal Economy

Charts 1 and 2 illustrate the relationship between economic freedom and the size of the informal economy as a percentage of GDP in OECD [Organisation for Economic Co-operation and Development] countries and 22 transition economies.[4] Chart 1 shows a positive correlation between these two factors. As economic freedom vanishes, the informal economy takes a larger share of GDP.

On average, as shown in Chart 2, the size of the informal economy in economically unfree and repressed economies is almost three times the size of the informal economy in free economies, and almost double the size of the informal economy in mostly free economies.

These charts illustrate the perverse effect of economic repression on the ethics of ordinary people and on the perpetuation of their poverty conditions. For example, in most developed countries, people have a better standard of living thanks to credit access. In the United States, for example, without credit, I would not have a house, or a car, or a TV, or a vacation, or many of the products that add comfort and convenience to my life. Credit makes it possible for me, an ordinary middle-class person, to improve my standard of living in many ways.

To have access to credit, however, I need to prove that I have an income or property. To prove that I have income, I need a formal job, and to prove that I have property, I need a property title.

The amount of available formal jobs depends, of course, on how easy or difficult it is for people to invest, whether in a small retail shop to sell groceries or in a big factory. The friendlier the business environment, the more likely formal jobs will be

4. Friedrich Schneider (see Charts 1 and 2) used the physical input (electricity) method, designed by Daniel Kaufmann and Aleksander Kaliberda. Overall (official and unofficial) economic activity and electricity consumption have been empirically observed throughout the world to move in lockstep with an electricity/GDP elasticity that is usually close to 1. By having a proxy measurement for the overall economy and subtracting it from estimates of official GDP, Kaufmann and Kaliberda derive an estimate of unofficial GDP and DYMIMIC method (dynamic multiple-indicators multiple-causes, a model that measures the link between the unobserved variables [the shadow economy] to observed indicators) to measure the size of the informal economy in transition countries in Central and Eastern Europe and in states of the former Soviet Union. For the OECD countries, either the currency demand method (first used by Phillip Cagan, who calculated a correlation of the currency demand and the tax pressure—as one cause of the shadow economy—for the United States over the period 1919 to 1955) or the DYMIMIC method is used to estimate the size of the shadow economy.

available. According to the *Index of Economic Freedom*, however, in most low- to middle-income countries, it is extremely difficult for small and medium investors—which are the largest source of jobs—to operate, both because of the regulatory environment and because of the lack of a strong rule of law.

Consider labor regulations in Argentina. In this country, an employer must grant, by law, several employee benefits, including holidays, vacations, sick leave, health insurance, paid overtime, an annual bonus, and some paid months before laying off an employee.[5] Or take France, where employers must grant, by law, at least 2.5 working days of paid vacations per month; pay over 30 percent in contributions to social security; offer a complementary pension scheme, 35 hours of work per week, and time off; and abide by a burdensome bureaucratic procedure to dismiss employees.[6]

The immediate problem with this kind of legislation is that it assumes that all employees are equally good, equally responsible, and equally productive, which is not true. If the employee arrives late, treats customers poorly, and makes the employer lose money, the law grants that employee the same benefits that it grants to a good employee.

Perhaps large businesses, like a multinational factory, can afford to comply with these regulations because of the size of the business and its diversification around the world. But the burden of these regulations destroys small and medium entrepreneurs, who may put their entire savings at stake in their investment.

Small and medium businesses therefore choose to do business and create jobs in the informal sector, where these benefits are negotiable and tied to performance, and not forced by law. This is a clear case in which the rules of the state create perceived unethical behavior by private employers and employees when what is really in question is the ethics of such a regulatory burden in the first place.

If they do not have a job, people can still get access to credit if they have a property title to use as collateral. According to Peruvian economist Hernando de Soto, many of the poor in the developing world have property but the bureaucracy they have to go through in order to get a property title is, at best, huge.[7] For example, in Perú, "to obtain legal authorization to build a house on state-owned land took six years and eleven months, requiring 207 administrative steps in 52 government offices…. To obtain a legal title for that piece of land took 728 steps."[8]

It is just as bad in other countries, such as Egypt, where it takes 77 steps in 31 government offices (anywhere from six to 14 years), or the Philippines, where it takes 168 steps through 53 offices (anywhere from 13 to 25 years). The poor own many things that they could use as collateral, but it is bureaucratically impossible for them to validate their property rights. As a result, they are unable to convert what they own into capital and, therefore, raise their standard of living.

Informality is a response to economic repression, not to something inherently unethical in those who circumvent legislation. What is most unethical about informality is the condition in which the government forces the poor to live. Informally employed people are condemned to a standard of living that is significantly lower than that of formally employed people, who have credit access. Also, informality creates a culture of contempt for the law and fosters corruption and bribery in the public sector as a necessary means to navigate the bureaucracy.

Economic Freedom and the Rule of Law

Charts 3 and 4 illustrate the relationship between economic freedom and the level of corruption in 95 countries around the world.[9] Chart 3 shows a strong correlation between these two factors. As economic freedom vanishes, corruption flourishes. On average, as shown in Chart 4, the level of perceived morality—as a contrast to corruption—in economically free

5. *The Labor Market and Its Legal Context*, Executive Summary, Deloitte & Touche, July 2003.
6. *Country Commerce: France*, Economist Intelligence Unit, June 2002.
7. Hernando de Soto. *The Mystery of Capital: Why Capitalism Triumphs in the West and Fails Everywhere Else* (New York: Basic Books, 2000).
8. *Idem*.

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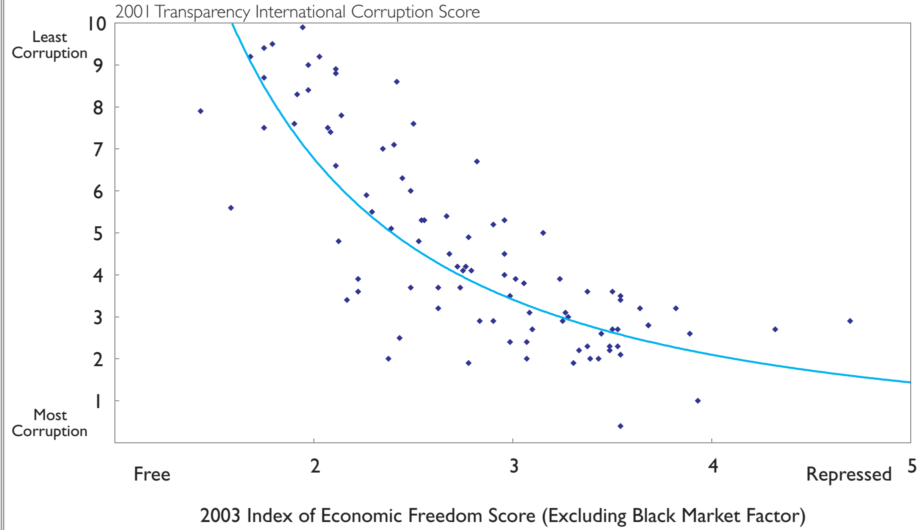
Economic Freedom and Corruption



Sources: Gerald P. O'Driscoll, Jr., Edwin J. Feulner, and Mary Anastasia O'Grady, *2003 Index of Economic Freedom* (Washington, D.C.: The Heritage Foundation and Dow Jones & Company, Inc., 2003); Transparency International, *The Corruption Perception Index 2001 and 2000*, Berlin, Germany, 2001 and 2000; available at *http://www.transparency.org/cpi/2001.html and http://www.transparency.org/cpi/2000.html.*

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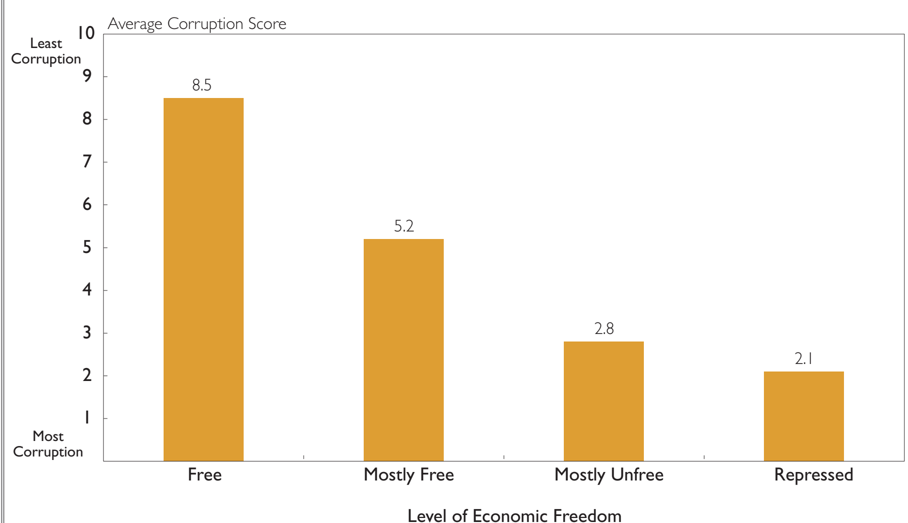
Economic Freedom and Corruption



Sources: Gerald P. O'Driscoll, Jr., Edwin J. Feulner, and Mary Anastasia O'Grady, *2003 Index of Economic Freedom* (Washington, D.C.: The Heritage Foundation and Dow Jones & Company, Inc., 2003); Transparency International, *The Corruption Perception Index 2001 and 2000* , Berlin, Germany, 2001 and 2000; available at *http://www.transparency.org/cpi/2001.html and http://www.transparency.org/cpi/2000.html.*

countries is almost four times the level of perceived morality in the public sector in mostly unfree or repressed economies, and almost 60 percent greater than in mostly free economies.

Having a weak rule of law significantly adds to the level of corruption in the public sector as well as the amount of informal activity. A weak judiciary is a "blind eye" on anything done outside the law. With a weak judiciary, corruption goes unpunished and informality flourishes.

This is one of the most serious problems we find in the world today. Of 161 countries evaluated in the *2003 Index of Economic Freedom*, 108 received bad scores in both regulation and property rights," undermining any effort to improve the living standards of the poorest in those 108 countries.

Conclusion

To be sure, there are cases of corruption that respond to the unethical nature of the corrupt individual. But for the most part, the unethical behavior stems from the environment in which individuals must interact. Convoluted regulations and weak rule of law foster a culture of corruption and informality both in the private and public sectors.

In the public sector, convoluted regulations and weak rule of law provide ample opportunities for public officials to accept bribes without punishment. In the private sector, those two factors push some people to do business informally as a means to survive and others to profit far more than they would if the possibility of bribery did not exist. The result is an increasingly unequal society, in terms of the opportunity to create wealth and improve living standards.

To fight corruption and informality, it is essential to understand that corruption is a symptom—of overregulation, lack of rule of law, a large public sector—not the root of the problem. The perceived problem is unethical/corrupt behavior of the private sector, which leads the government to press more on private-sector activities. The real problem is the government action/regulations causing undesired behavior of the private sector. The optimal solution would be to eliminate burdensome regulations so that unethical behavior does not occur.

Countries must advance economic freedom in all possible areas of the economy, with particular emphasis on regulations affecting small and medium business, in order for corruption and informality to decrease. The *Index of Economic Freedom* is an excellent guide to identify what is obstructing economic activity and, therefore, perpetuating poverty.

Countries must also preserve the independence and effectiveness of the judiciary to punish corrupt actions. Economic freedom with a strong rule of law will foster a culture of investment, job creation, and institutional respect—all essential factors in massively improving the living standards of ordinary people.

—*Ana Isabel Eiras is Senior Policy Analyst for International Economics in the Center for International Trade and Economics at The Heritage Foundation. These remarks were delivered at a conference on the "Ethical Foundations of the Economy" in Krakow, Poland.*[10]

9. The TI Corruption Perceptions Index (CPI) ranks countries in terms of the degree to which corruption is perceived to exist among public officials and politicians. The CPI focuses on corruption in the public sector and defines corruption as the abuse of public office for private gain. The lower the score, the higher the level of corruption. For details about how the CPI is done, see *www.transparency.org*.

10. The author would like to thank John Lyneis, an intern at TheHeritage Foundation, for his valuable research assistance.