Extensive market regulation may increase corruption risk in OECD countries

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Corruption in regulatory processes divert benefits away from the many and into the hands of the few. While corruption is often considered a developing country problem, there are reasons to believe that corruption risk is also present in OECD countries. Analyzing the relationship between market regulation and corruption in the context of OECD countries, we find that larger extents of market regulation seem to be associated with higher corruption risk.

It is commonly argued that corruption impedes development, distorts markets, undermines governance, and reinforces poverty. Corruption is often interlinked with other forms of crime such as tax evasion or cartel collaboration. While corruption is often considered a developing country problem, daily media coverage of extensive corruption scandals involving large companies, politicians and other state actors, paints a somewhat different picture of the OECD countries. The cases uncovered reveal large-scale bribes and gains from corrupt deals and its proceeds.

Corruption risk may arise in regulatory processes due to the discretionary authority of politicians and regulators, the informational advantages they hold over the broader society, and lack of sufficient monitoring mechanisms. Expected government intervention in markets may create an arena for political corruption. The more profit or market power at stake, the greater incentives firms have to exert undue influence on regulatory decisions.

In an empirical analysis we find a positive association between the extent of market regulation and corruption levels. We use two different indicators of corruption levels in OECD countries, Transparency International's Corruption Perception Index and the World Bank's Control of Corruption Index. The extent of market regulation is based on the OECD Services Trade Restrictiveness Index (STRI), a relatively new dataset covering the OECD countries and the largest emerging economies. In order to account for omitted variable bias we add a number of control variables such as GDP per capita, income inequality and education levels.

The results from the empirical analysis indicate that the risk of corruption in OECD countries seems to be higher when markets are more heavily regulated. However, finding a positive association between larger extents of market regulation and more corruption does not necessarily lead to straight-forward policy conclusions. Extensive market regulation can be based on legitimate motivations such as ensuring competitive, fair, and efficient markets. Different regulations may also have different effects in different countries or markets.

It is thereby uncertain whether reducing the extent of market regulation is the better choice, even though it may be associated with lower estimated corruption. It is not the case that interventionist policies are unnecessary or that the possible corruption risks necessarily outweigh the benefits of market regulation. It is also important to note that our empirical results should be interpreted with caution as they are based on a relatively narrow sample, and suffer from limitations due to the quality of data available and challenges of simultaneity biases often present when studying macro-level phenomena such as corruption.

Nevertheless, our findings emphasize the importance of considering the full effects of regulatory policies in the presence of corruption risk, and to ensure better knowledge about the results of market regulation. Corruption risk associated with market regulation could also be countered from many different angles, including by supplementing criminal law regulation of corruption with non-criminal measures and a focus on all forms of market distortions. In this respect, extending the mandates of competition authorities may strengthen law enforcement at the national level. Reducing the risk of corruption in regulatory processes also depend on international collaboration, for example taking part in peer reviews, offering mutual legal assistance, and allowing international teams of experts to evaluate regulatory policies.