Birds of a feather do business together

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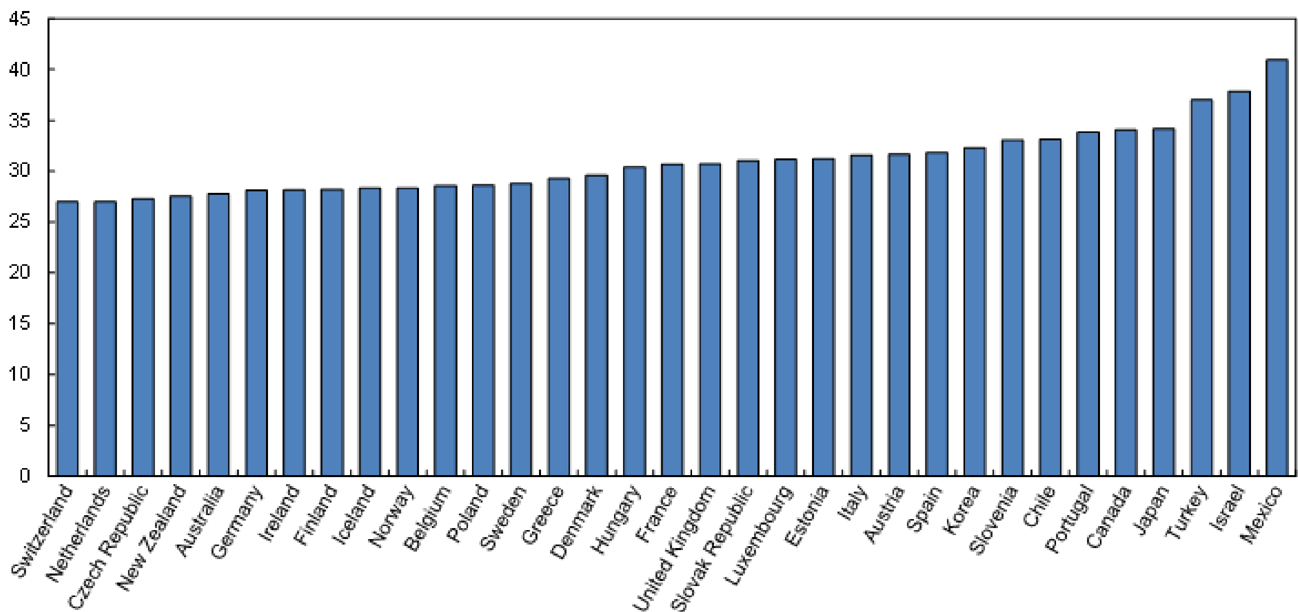
Numerous international agreements and free trade areas have reduced trade and foreign investment restrictions dramatically. This is one factor that has boosted international trade, which has risen about one and a half times faster than GDP since the Second World War. Globalisation has made it possible to reap economies of scale and has given access to cheaper goods.

Beyond the explicit barriers to international trade and investment, firms also face national regulatory hurdles. Firms have to deal with numerous specific rules in other countries which can be complex. This complexity has a cost. Simplification and harmonisation of regulations boost trade and FDI.

The OECD collects detailed data on product market regulations that hamper competition, including, for instance, the involvement of the state in business operations, licencing systems or sector-specific regulations (e.g. regulations of telecommunication firms). Regulations that do not discourage competition (e.g. safety requirements applied to all firms) are excluded. These data allow one to look at differences of regulatory settings between country pairs. This reveals that there is a sizeable heterogeneity in regulatory settings across countries (Figure 1).

Figure 1. Product market regulation heterogeneity

Average bilateral heterogeneity, 2013, per cent



Note: The bilateral heterogeneity is the share of answers to the OECD product market regulation questionnaire that differ between pairs of countries; it is computed for each country pair. The US PMR data are available until 2008 only, and hence the United States is not shown in this figure.

Source: OECD, *Product Market Regulation database* and OECD calculations.

My research shows that firms prefer to invest in a country with a similar regulatory environment. A broad reform package that would cut regulatory differences by one fifth could increase foreign direct investment by about 15%. Such a pace of convergence has been observed between 2008 and 2013 for pairs of countries such as Austria and the Slovak Republic. Regulatory differences in some fields reduce FDI more than others. This is especially the case for antitrust exemptions, regulatory barriers in service sectors, command and control regulations and barriers in network sectors. Belonging to the EU Single Market has a positive effect on foreign direct investment, reflecting the implementation of common area-wide rules. My work also confirms that the stringency of explicit FDI restrictions reduces foreign direct investment, which was also found in many other studies. Last, the stringency of employment protection legislation and the complexity of regulations also have a large negative impact on foreign

direct investment.

Reducing regulatory differences and regulatory stringency also boosts trade as shown in this working paper. For instance, a broad reform package that would align product market regulation to the average of the best performers and, at the same time, cut regulatory heterogeneity by one-fifth can increase trade intensity within the European Union by more than 10%. There is also specific evidence that anti-competitive regulations in network sectors such as airlines and telecom reduce trade.

Find out more

Fournier, J.-M. (2015a), "The Negative Effect of Regulatory Divergence on Foreign Direct Investment", *OECD Economics Department Working Papers*, No. 1268, OECD Publishing.

Fournier, J.-M. (2015a), "The Heterogeneity of Product Market Regulations", *OECD Economics Department Working Papers*, No. 1182, OECD Publishing.

Fournier, J.-M. *et al.* (2015), "Implicit Regulatory Barriers in the EU Single Market: New Empirical Evidence from Gravity Models", *OECD Economics Department Working Papers*, No. 1181, OECD Publishing.