Product market reforms under the microscope

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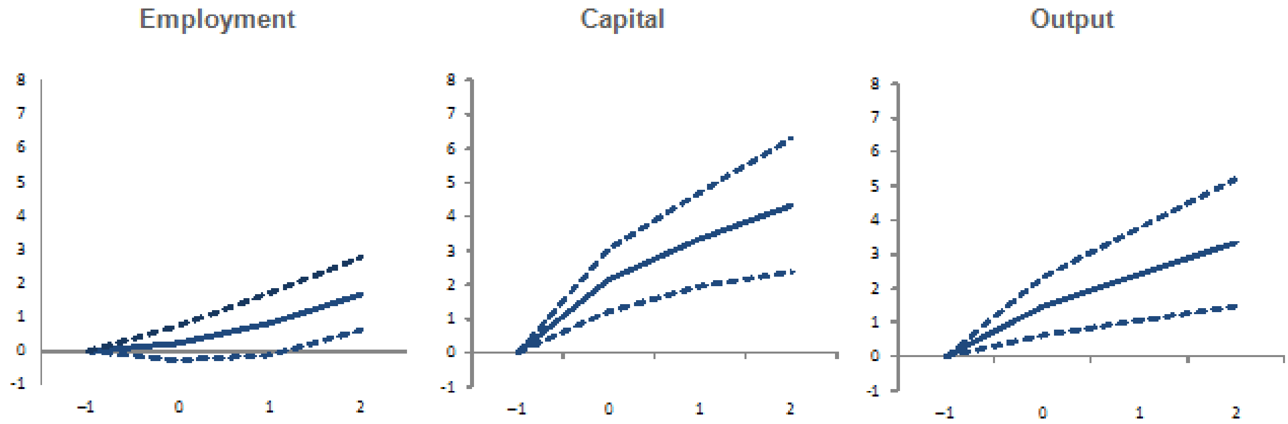
Given the secular decline in productivity growth and the persistent weakness of the economic recovery in many advanced economies, increased attention is being paid to the potential role of structural reforms for restoring economic growth. While structural reforms concern many policy areas (e.g. banking supervision, property right laws and employment-protection rules), product market regulation (PMR) feature particularly prominently on the agenda of many advanced economies (OECD, 2015). Understanding the dynamics effects of reforms in this area may provide important insights with respect to the way such reforms are designed, the political economy of reforms and the potential need for complementary policies. In a recent paper (Gal and Hijzen, 2016), we attempt to open up the black box of pro-competition product market reforms by providing a comprehensive analysis of their short-term impacts across firms that differ in terms of the main sector in which they operate, the size of their operations and their financial health.

Our main findings on the impacts of major product market reforms are as follows:

- *First, the short-term, firm-level effects of reducing regulatory barriers to product market competition are positive and strengthen over time (Figure 1).* The effects are immediate for both output and investment, and increase further to 4% and 3% respectively after two years. The effects for employment are considerably smaller and only materialize after two years.

Figure 1. The short-term effects of product market reforms on incumbent firms

Percentage change in the outcome variable of interest in years after the reform

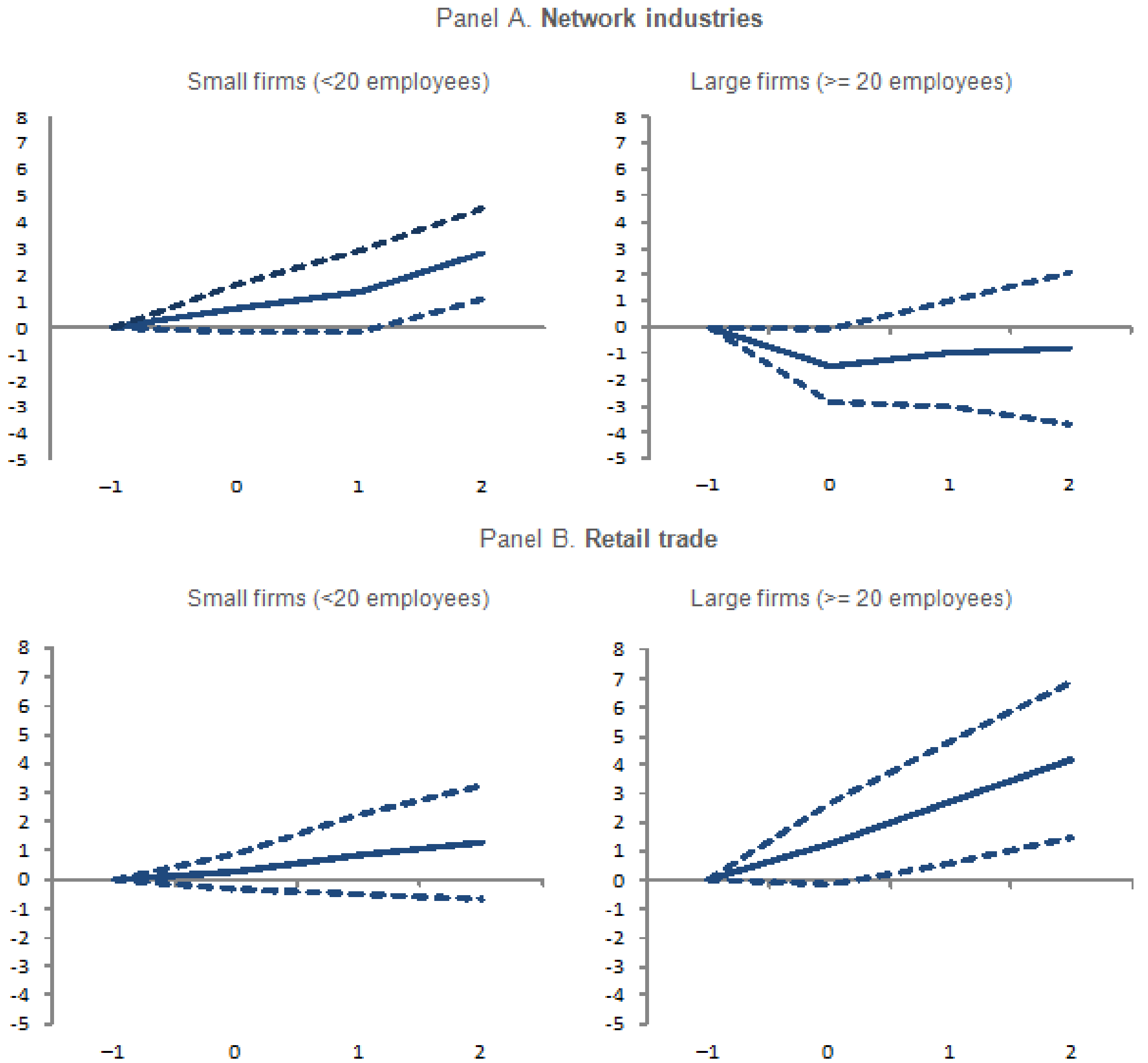


Solid lines represent impulse response functions based on the estimated coefficients of major product market reforms; dashed lines represent 90% confidence intervals. Major reforms are defined to be those that correspond to absolute changes in the extended OECD PMR indicator larger than 0.5, which roughly capture the 5% most intensive changes. See Gal and Hijzen (2016) for details.

- *Second, there are systematic and plausible differences in the effects of reforms across firms of different sizes across different industries (Figure 2).* More specifically, in network industries, small firms tend to benefit most from pro-competitive product market reforms, while larger ones downsize to reduce costs and maintain market shares. By contrast, in retail trade, large and potentially more efficient firms tend to benefit more from such reforms.

Figure 2. The short-term effects of product market reforms on incumbent firms

Percentage change in employment in years after the reform



Solid lines represent impulse response functions based on the estimated coefficients; dashed lines represent 90% confidence intervals. See Gal and Hijzen (2016) for details.

- *Third, financial difficulties faced by firms weaken the short-term impact of product market reforms on investment.* These findings highlight the importance of addressing the problem of weak bank balance sheets when considering product market reforms, and points to the complementary role of financial sector reform more generally. This is particularly relevant in those countries where the flow of credit is still weak and the case for product market reform is relatively strong (e.g. some countries in Southern Europe).

In sum, the present findings confirm the positive effects of pro-competitive product market reforms on economic performance in the medium to longer term, while also providing rich new insights on the way the effects of such reforms materialize over time across different types of firms. More specifically, these findings help to understand why it can be difficult to implement product market reforms in certain sectors, but less so in others. For example, the pace of product market reforms could be slowed down in network industries since large incumbent firms have a tendency to lose out in terms of jobs and profitability. The tendency of financial difficulties to mitigate the impact of product market reforms on investment may also suggest that the effects of product market reforms materialize more slowly in times when the economy is depressed and credit is hard to get by.

These insights can be used to enhance the design of product market reforms and to motivate the need for complementary measures to promote aggregate demand, restore bank balance sheets and to alleviate the social cost of adjustment (IMF, 2016; OECD, 2016).

References

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