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The Effects of the European Single Market on Attractiveness to Foreign Direct Investment

KEY MESSAGES

- **The European Single Market has been a major driver of enhanced attractiveness of EU countries to foreign direct investment (FDI)**
- **Higher FDI by multinational firms in EU countries has fostered productivity and employment growth and has also generated wider benefits to host economies via knowledge spillovers on the productivity and trade performance of domestic firms**
- **The completion of the Single Market, especially in the areas of services and capital markets, could further increase trade and investment in EU countries**
- **Removing regulatory barriers at both the EU and member states levels in the areas of services could strengthen the integration of business services in key manufacturing sectors and could result in a more efficient integration of firms in European and global value chains**
- **An integrated Single Market for capital would improve financing and investment opportunities for European firms**

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The European Single Market Program introduced on January 1, 1993, comprised a range of measures to reduce and eliminate non-tariff barriers (administrative and regulatory barriers) between member states with the aim to foster intra-EU trade and increase competition, productivity, and ultimately welfare gains in the long run.

One of the most significant achievements of the European Single Market is that it has enhanced the attractiveness of EU countries to foreign direct investment (FDI), in particular market-seeking FDI from outside the EU. This is consistent with predictions of the early literature on FDI known as the Ownership-Location-Internalization (OLI) framework (Caves 1974; Dunning 1977; Vernon 1966), formalized in seminal papers by Helpman (1984), Helpman and Krugman (1985), Markusen (1984, 1995 and 2002), Markusen and Venables (1997 and 1998), as well as more recent theoretical models of international trade with firm heterogeneity (Helpman et al. 2004), and supported by empirical evidence on the location choice of foreign affiliates in EU countries by multinational firms (Head and Mayer 2004; Davies et al. 2018; Siedschlag et al. 2021) and evidence on the impact of the EU Single Market on inward FDI flows to EU countries (Dunning 1997; Neary 2002; Bruno et al. 2021). In addition to these expected effects of the Eurpean Single Market on FDI, recent evidence suggests that the quality of the Single Market institutions, in the sense of a timely and correct transposition of the Single Market legislation, has been a source of comparative advantages and increased production linkages via FDI between EU countries (Wolfmayr et al. 2019).

A large body of international evidence has established that FDI by multinational firms is associated with new technologies and managerial know-how, which boost productivity and competitiveness in host countries (Bloom et al. 2012; Schiffbauer et al. 2017). There is growing evidence showing that FDI in EU countries has contributed to direct economic gains in terms of productivity, exporting, and employment growth (Barrell and Pain 1998; Driffield and Taylor 2000) and has also generated wider benefits to the host economies via knowledge spillovers on the productivity and trade performance of domestic firms (Jude 2016; Haller 2014; Di Ubaldo et al. 2018; Ciani and Imbruno 2017; Bajgar and Javorcik 2020; Di Ubaldo and Siedschlag 2022).

EUROPEAN SINGLE MARKET AS A DRIVER OF FOREIGN DIRECT INVESTMENT

Bruno et al. (2021) provide evidence showing that the European Single Market has been the main driver of higher FDI in EU countries. Using a structural gravity model and data on bilateral FDI for the 1985–2018 period, they estimate that EU membership resulted in 60 percent higher FDI inflows from outside the EU and around 50 percent higher intra-EU FDI. This effect appears positive and statistically significant only after 1993, and it is larger than the impact of economic integration on FDI in the European Economic Area (EEA), North Atlantic Free Trade Agreement (NAFTA), and Mercosur. The authors estimate that 93 percent of the EU membership premium is due to the European Single Market.

Davies et al. (2018) find that access to the European Single Market has been a key driver of the location choice of new foreign affiliates by multinationals in EU countries. Using data on 18,110 new foreign affiliates established in EU countries between 2002 and 2013, they find that countries with a greater EU market potential,[1] are particularly attractive to FDI from multinationals with headquarters outside the EU. The results also indicate that investing in EU countries is more attractive the farther away from the EU investors are. This suggests that FDI in EU countries by investors from outside the EU is market-seeking, in particular seeking access to the EU Single Market. Further results indicate that intra-EU FDI is mainly efficiency-seeking. While EU investors are less likely to invest in countries with a greater access to the Single EU Market (large core countries), greater access to the EU Single Market substantially increases the attractiveness for investment from non-EU investors in both manufacturing and services, with a larger effect in the case of FDI in services. Taken together, these results are consistent with economies of scale and lower transaction costs as the main motivation for market-seeking FDI from outside the EU (Head and Mayer 2004; Fontagné and Mayer 2005), while labor cost differentials appear to drive efficiency-seeking intra-EU FDI (Bevan and Estrin 2004).

Using data on 60,743 new greenfield FDI projects[2] (2003–2020) from the Financial Times fDi Markets database, Siedschlag et al. (2021) estimate that the EU market potential has been more important than domestic market potential for FDI attractiveness in high-value knowledge-intensive sectors[3] across EU regions and countries.

COMPLETING THE EUROPEAN SINGLE MARKET: THE NEED FOR FURTHER INTEGRATION IN THE AREAS OF SERVICES AND CAPITAL MARKETS

Notwithstanding the substantial progress made in the implementation of the Single Market and the associated economic gains in terms of welfare, productivity, employment, and trade (as highlighted in many research papers and reports), the Single Market is still incomplete, which is why the anticipated potential benefits have yet to fully materialize (Wolfmayr et al. 2019; European Commission 2023). The main reasons for the incomplete implementation of the Single Market identified include incorrect, incomplete, or late transposition and application of EU harmonized rules, fragmented regulation, and inconsistences between EU and national laws, as well as incomplete administrative cooperation and lack of information about rights and their application in practice.

Recent evidence on the performance of the Single Market for goods after 25 years provided by Wolfmayr et al. (2019) indicates that a timely and correct transposition of the Single Market legislation has fostered export specialization in contract-intensive industries and international production linkages via FDI between EU countries. This evidence is consistent, on the one hand, with a growing body of empirical literature on the quality of institutions as a source of comparative advantage and export specialization (Nunn 2007; Levchenko 2007; Chor 2010; Cuñat and Melitz 2012; Nunn and Treffler 2014) and, on the other hand, with another literature strand highlighting that institutional characteristics across countries, in particular with respect to contract enforcement, affect firms' organizational choices in the context of their international production operations (Antràs and Chor 2013; Antràs and Yeaple 2014). To the extent that export specialization is linked to higher long-term productivity (Quah and Rauch 1990), this evidence suggests that improving the quality of the Single Market institutions in the sense of a timely and correct transposition of existing Single Market rules could be an important driver of welfare gains in EU countries. Furthermore, recent research results have shown that international sourcing choices are associated with relationship-specific investments that are linked to productivity growth and welfare (Antràs et al. 2017; Constantinescu et al. 2017).

In addition to enforcing the existing Single Market rules, further integration in the area of services has a large potential for increased cross-border trade and investment. As highlighted in a recent research paper (Vandermeer 2022), a significant proportion of barriers to trade and investment in the area of services, such as regulatory and administrative burdens, lack of skilled workers, shortage of supply of product inputs and low labor mobility, appear to be persistent: 60 percent of the barriers in the area of services businesses reported in 2022 are of the same type as those reported in 2002, 20 years ago. While many of these barriers are related to national regulation and administrative practices, there is also a role for EU policy to facilitate the removal of regulatory and administrative barriers. Removing regulatory barriers at both the EU and member states levels would allow a more efficient allocation of resources across firms and sectors and a more efficient integration of firms in European and global value chains by strengthening the integration of business services in key manufacturing sectors (Di Ubaldo and Siedschlag 2018).

Another area of further Single Market integration where progress is needed is the completion of the Capital Markets Union. An integrated Single Market for capital would diversify funding sources and improve investment opportunities for European firms (European Commission 2023). In addition, as highlighted by

[1] Market potential is a measure of market access calculated as the sum of the economic size of each of the EU countries other than the host country discounted by the bilateral distance between the host country and each of the other EU countries.

[2] New greenfield FDI projects are new operations established by foreign companies at a new site. The foreign company may or may not already be present in the country, but the FDI project is in a new location within the country. It can also include relocation from one country to another.

[3] The knowledge-intensive sectors considered in the analysis are: aerospace; biotechnology; pharmaceuticals; medical devices; semiconductors; business machines and equipment; electronic components; consumer electronics; communications; software and IT services; financial services; business servicers; and space and defense. These sectors have been identified following the Eurostat classification for knowledge-intensive sectors matched with the sectoral classification used by the Financial Times fDi Markets.

Demertzis et al. (2021), deeper and more integrated capital markets in the EU would facilitate increased equity-based financing, which is better suited than banks to finance investment in high-growth sectors such as digital and high-tech (sectors high in intangible capital that cannot be used as collateral) as well as green technologies in carbon-intensive sectors.

POLICY CONCLUSION

The European Single Market has been a major driver of enhanced attractiveness of EU countries for foreign direct investment (FDI), in particular for market-seeking FDI from outside the EU. Higher FDI from multinational firms in EU countries has fostered productivity and employment growth and has also generated wider benefits to host economies via knowledge spillovers on the productivity and trade performance of domestic firms. A timely and correct transposition of the Single Market could foster export specialization and production linkages between EU countries. In addition to enforcing the existing Single Market rules, the completion of the Single Market especially in the areas of services and capital markets could further increase trade and investment in EU countries. Removing regulatory barriers at both the EU and member states levels in services could strengthen the integration of business services in key manufacturing sectors and could result in a more efficient integration of firms in European and global value chains. An integrated Single Market for capital would provide more diversified funding sources and improve investment opportunities for European firms.

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