



Catching-up to foreign technology? Evidence on the “Veblen–Gerschenkron” effect of foreign investments

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Abstract

The presence of foreign multinational enterprises may benefit local economies. In particular, highly productive foreign-owned firms may promote the technological catch-up of local firms. This channel of spillovers is defined as the “Veblen–Gerschenkron” effect of foreign direct investment and is analyzed in this article. Rather than the overall concentration of foreign-owned plants in a region or sector, it is their productivity advantage that determines the positive effect on domestic firms in geographical and technological proximity. We test this hypothesis using new firm-level data for German and Italian manufacturing firms during the 1990s. These two countries are particularly interesting due to the low productivity of domestic firms in some regions of East Germany and the Mezzogiorno. We find evidence of a significant (statistically and economically) Veblen–Gerschenkron effect which is robust to various ways of measuring the total factor productivity (TFP) of firms and to different empirical specifications.

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1. Introduction

Does foreign direct investment (FDI) benefit the domestic firms of the host country? And if so, through which channels are these benefits received? These long standing and important

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questions have attracted much interest among economists. Strictly from a theoretical perspective, the answer remains unclear: FDI can either help or harm domestic firms, depending on the intensity levels of various effects. Ultimately the net effects of FDI have to be evaluated empirically, but recent empirical studies have found both positive to negative effects, depending on the focus, the data and the method used.¹ This article contributes another piece of evidence to this issue by focusing on a potentially important (but largely neglected) determinant of spillovers from FDI to domestic firms,² namely the productive advantage foreign firms have over domestic firms within a sector and region.

According to [Blomström et al. \(2001\)](#), “foreign investors make available (directly or indirectly) appropriable technology to host country businesses. Appropriable technology should be viewed broadly as any tangible or intangible resource that can generate economic rent for host country firms, . . . by improving total factor productivity.” By this we should believe that technological spillovers will depend both on the technological edge foreign firms have over domestic firms, and on the geographical proximity of foreign firms to domestic firms. Hence, our variable of interest will be the productivity of foreign-owned firms, and in particular the difference in productivity between foreign and domestic firms in a sector-region. Since the work of [Caves \(1974\)](#), economists have honed their attention on the concentration of foreign-owned firms (measured as the share of FDI capital or share of FDI workers) within a sector and/or a region as the source (and proxy) of potential spillovers.³ In an influential paper, however, [Aitken and Harrison \(1999\)](#) have shown that properly controlling for unobserved region-specific effects eliminates most of the effect of FDI density on domestic firms’ productivity. This may occur because certain local characteristics that attract FDI⁴ (such as the presence of a high-quality labor force, large local markets, good infrastructures and good administration) also enhance the productivity of domestic firms, generating a spurious correlation between these two variables. Once these factors are properly controlled for, no correlation survives.

This result, however, does not necessarily imply that there are no spillovers from FDI. The density of FDI may simply not be the right source of (and proxy for) spillovers. Rather the productivity advantage enjoyed by foreign firms may potentially be a more important source of spillovers. While the largest concentration of foreign firms normally occurs in regions and sectors where domestic firms are already highly productive, the largest effect of foreign firms on domestic ones could be in backward regions, where FDI concentration is small but their productivity effects are large due to the scope for technological catch-up. The effects of this mechanism are labeled the “Veblen–Gerschenkron” effect (or VG effect for brevity) in acknowledgement of the early intuitions of [Veblen \(1915\)](#) and [Gerschenkron \(1952\)](#).

¹ Advocates of a positive role of FDI through technological transfer are [Findlay \(1978\)](#), [Das \(1987\)](#), and [Wang and Blomström \(1992\)](#). [Rodríguez-Clare \(1993\)](#) and [Markusen and Venables \(1999\)](#) argue that they benefit local suppliers and local consumers. [Fosfuri et al. \(2001\)](#) and [Glass and Saggi \(1998, 2002\)](#) document that they could increase the human capital of the local labor force. On the other hand, FDI could out-compete local firms forcing them out of production without employing local labor because of skill mismatch. This is argued in [Aitken and Harrison \(1999\)](#). A combination is [Barrios et al. \(2005\)](#).

² For a survey of the literature, see [Blomström and Kokko \(1998\)](#). An interesting meta-analysis of the different research results is [Görg and Strobl \(2001\)](#).

³ There have been some studies aimed at quantifying some important channels of knowledge diffusion via FDI. [Branstetter \(2001\)](#) uses patent citation data while [Cassiman and Veugelers \(2002\)](#) rely on survey data. These studies, however, address specific channels of spillovers rather than their overall impact on productivity.

⁴ See, for example, [Shannon and Zeile \(1999\)](#) for the US and [Stirböck \(2001\)](#) for Europe.

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