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To share or not to share: Does local participation matter for spillovers from foreign direct investment?[☆]

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Abstract

This study hypothesizes that the ownership structure in foreign investment projects affects the extent of vertical and horizontal spillovers from foreign direct investment (FDI) for two reasons. First, affiliates with joint domestic and foreign ownership may face lower costs of finding local suppliers of intermediates and thus may be more likely to engage in local sourcing than wholly owned foreign subsidiaries. This in turn may lead to higher productivity spillovers to local producers in the supplying sectors (vertical spillovers). Second, the fact that multinationals tend to transfer less sophisticated technologies to their partially owned affiliates than to wholly owned subsidiaries, combined with the better access to knowledge through the participation of the local shareholder in partially owned projects, may facilitate more knowledge absorption by local firms in the same sector (horizontal spillovers). The analysis based on a Romanian firm-level data set produces evidence consistent with these hypotheses. The results suggest that vertical spillovers are associated with projects with shared domestic and foreign ownership but not with fully owned foreign subsidiaries. They also indicate that the negative competition effect of FDI inflows is lower

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in the case of partially owned foreign investments as it is mitigated by larger knowledge dissipation within the sector.
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1. Introduction

Although domestic equity ownership requirements used to be extensively utilized by governments in developing countries,[2] their incidence has sharply declined in recent years (UNCTAD, 2003). Increasingly competitive environment for foreign direct investment (FDI) and the need to comply with international commitments have put pressure on governments to relax restrictions on foreign entrants.

One of the original motivations for the existence of ownership sharing conditions was the belief that local participation in foreign investment projects reveals their proprietary technology and thus benefits domestic firms by facilitating technology diffusion (see Beamish, 1988; Blomström and Sjöholm, 1999). As writing a contract specifying all aspects of the rights to use intangible assets is difficult, if not impossible, joint domestic and foreign ownership of an investment project is more likely to lead to knowledge dissipation. A local partner may use the knowledge acquired from the foreign investor in its other operations not involving the foreign shareholders or being in charge of hiring policies, as is often the case, the local partner may have less incentive to limit employee turnover.[3] This problem is reduced when the multinational is the sole owner of its affiliate.[4] As a consequence, multinationals may be more likely to transfer sophisticated technologies and management techniques to their wholly owned subsidiaries than to partially owned affiliates.[5]

This in turn has implications for knowledge spillovers to local producers in a host country. Less sophisticated technologies being transferred to jointly owned FDI projects may be easier to absorb by local competitors, which combined with a better access to knowledge through the actions of the local shareholder may lead to greater intra-industry (or horizontal) knowledge spillovers being associated with the shared ownership structure than with wholly owned foreign affiliates. Moreover, lower sophistication of inputs needed by jointly owned FDI projects and the familiarity of the local partner with local suppliers of intermediates may result in greater reliance on locally produced inputs and thus greater vertical spillovers accruing to local producers in upstream sectors. While a lot of research effort has been put into looking for the evidence of FDI

[2] In the 1980s restrictions on foreign ownership were present in China, India, Indonesia, Malaysia, Mexico, Nigeria, Pakistan, the Republic of Korea, Sri Lanka and others (UNCTC, 1987).

[3] Both channels of knowledge dissipation find confirmation in anecdotal evidence. For instance, Unilever's joint venture partner in China began to manufacture a washing detergent that had a similar formula and was packaged in a strikingly similar box as the Omo brand produced by the joint venture (The Economist, April 19, 1997). As for knowledge dissipation through movement of labor, the Bulgarian Commission for the Protection of Competition investigated multiple cases of violation of business secrets by former employees. Some of these cases were brought by foreign companies operating in the country (Djankov and Hoekman, 1997).

[4] This argument is in line with the property rights approach developed by Grossman and Hart (1986) and Hart and Moore (1990).

[5] For empirical evidence see Mansfield and Romeo (1980), Ramachandaram (1993) and Javorcik and Saggi (2004).

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