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Determinant Factors of Pecuniary Externalities

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Abstract:

This paper relates to the literature on pecuniary externalities from FDI. Their transmission mechanism is complex, because pecuniary externalities may cause knowledge externalities and inversely. Moreover, each type of externality, or a combination of both, may increase firm productivity. Thus, so far, the factors determining pecuniary externalities are not fully exploited. As a result, all the potential effects of FDI on firm productivity remain to explain. We contribute to the literature by providing a broader picture of the determinant factors of pecuniary externalities; through their classification along the lines of theory of heterogeneous firms, and by relating their effects.

Keywords: Foreign direct investmet, vertical externalities, multinational corporations, productivity

1. Introduction

Foreign Direct Investment (FDI) is generally considered as a key generator of economic growth (Mencinger, 2003). This is due to the fact that FDI exerts direct and indirect effects on host economies. The first includes capital formation, job creation, increased tax revenue and shifts in the production and exports of host countries, while the latter mainly involves the access to Multinational Corporations (MNCs) technology (Crespo and Fontoura, 2006). According to the Theory of Industrial Organization, the access to foreign technology is important because MNCs possess advanced technology (in the broad sense, i.e. including marketing and organizational knowledge) that makes them more efficient than their domestic counterparts (Dunning and Rugman, 1985).

Technology can be transferred voluntarily through agreements or unintentionally through FDI. As a result, there may be an increase in domestic firms' productivity (Leshner and Miroudot, 2008). Empirical studies (e.g., Eaton and Kortum 1999, Keller, 2001) show that, in OECD countries, the main sources of technological change leading to increases in the total factor productivity (TFP) comes from abroad. The reason is that R&D is highly concentrated in a small number of Developed Countries (Archibugia and Pietrobelli, 2003). As a consequence, the income convergence across countries depends on the international technology diffusion (Keller, 2001). Thus, the main motivation for policies aiming to attract FDI is the potential increase of domestic firms' productivity via technology diffusion (Buckley et al., 2003).

FDI externalities may be horizontal or vertical. Horizontal externalities occur when the entry of the MNC generates positive externalities for domestic competitors; while vertical externalities arise from the linkages between MNCs and their domestic suppliers/customers (backward/forward linkages).

The empirical evidence suggests that vertical externalities are more likely to occur than horizontal externalities (Jindra, 2005; Damijan et al, 2008). In particular, backward linkages seem to facilitate technology spillovers (Javorcik, 2004; Damijan et al, 2008). This occurs for several reasons. First, the entry of the MNCs generates information flows to the local suppliers and customers. Second, generic knowledge provides little incentive for trade secrecy and requires less absorptive capacity. Finally, vertical spillovers are less likely to generate a loss of MNCs profits than horizontal spillovers. Vertical (pecuniary) externalities are typically related to non-technological (organizational and marketing) innovations. In developed countries these types of innovations occur in a significant number of manufacturing firms (Warwick, 2010). However, as de Mello (1997) highlighted, the role of FDI as a catalyst for output growth is a less controversial assumption in theory than in practice. This is of particular concern since there is a lack of empirical research focusing on DCs, especially on small open economies facing restrictions due to the economic crisis. Empirical studies report a large amount of heterogeneity in the productivity of firms within sectors which suggests that firm characteristics are important in terms of whether externalities can be internalized by the domestic firms. Nevertheless, the analysis of the determinant factors of externalities from FDI has been relatively limited and ad hoc (Blomström et al, 1999).

Thus, this paper is an attempt to fill the identified gap in the literature. To the best of our knowledge, we are the first to discuss and relate the determinant factors of pecuniary externalities. In addition, we present a new classification of such determinant factors along the lines of the Theory of Heterogeneous Firms. We also suggest new determinant factors such as age of firms and age of employees/managers. Hence, this paper imparts a broader picture of the determinant

factors of pecuniary externalities and provides support for empirical research on the identification of variables to be included in the estimating equations.

In what follows, section 2 describes the nature of FDI externalities and their transmission mechanisms. Section 3 discusses, classifies and relates the determinant factors of pecuniary externalities in the light of Theory of Heterogeneous Firms. Section 4 reviews a set of 20 empirical studies regarding the determinant factors, and section 5 concludes.

2. FDI as Channel of International Technology Diffusion

The literature on International Technology Diffusion has emphasized three channels for technology transfer: international trade of intermediate goods, international dissemination of the results of research and development (R&D) and FDI (see e.g. Keller, 2004). However, international trade of intermediate goods is considered a weak source of international technological diffusion since the technology is not directly incorporated in the imported intermediate inputs (Keller, 2004). Thus, the larger the volume of tacit knowledge involved in the production of the intermediate goods, the greater the limitation because tacit knowledge is subjective and, thus, not measurable.

Moreover, according to Coe and Helpman (1995), the majority of high technological content goods are imported by the MNCs. Therefore, the empirical results about the importance of international trade on the technological diffusion can be misleading if there is no distinction between the effect of the activities of MNCs and International Trade. The second channel seems to be a stronger source of international technological diffusion. The reason is that the disclosure of R&D results suggests a complete domain of the technology as opposed to the ability to use only the incorporated technology. However, since in this second case, the technology is not tied to any particular form, externalities seem to be more difficult to measure. As a result, FDI is considered the main channel of international technological diffusion and contributes to the creation of new knowledge or the adaptation of foreign technology (Lim, 2001).

According to the literature, technology diffusion occurs in two stages. Firstly, MNCs transfer technology to their subsidiaries in the host country. In the next stage, technology diffusion to local firms may occur via externalities, through different channels. The occurrence of externalities depends on the assumptions of the early 1990's Endogenous Growth Theory (Aghion and Howitt 1992, Grossman and Helpman 1991 a,b, Romer 1990, Segerstrom et al., 1990). According to this theory, technology has, to some extent, the nature of a public non-rival good. A key assumption is that the production of knowledge does not take the form of a physical device, being instead usually incorporated (a patent, a software program, etc.). Therefore, the marginal cost of its exploitation by an additional agent is negligible and its returns cannot be fully appropriated by the owner and, thus, knowledge externalities arise.

However, because technology cannot be transferred at zero cost, the technological diffusion is likely to be incomplete and vary geographically. Indeed, the high cost of coding the technology motivates innovative firms to ensure that only its contours are encoded, leaving the rest as "tacit" (Polanyi, 1958). Part of that tacit knowledge is often transferred through contacts and personal instructions (David, 1992). Since FDI provides contacts between local and foreign individuals, then technology diffusion may inadvertently occur. In addition to this involuntary transmission of knowledge, recent literature has focused on the possible voluntary transmission of knowledge from MNCs to local customers and suppliers. In this case, the diffusion of knowledge may assume the form of acquisition of skills, training and the introduction of management practices that are likely to increase the TFP of local firms (Borensztein et al, 1998; Mastromarco and Ghosh, 2009).

2.1. Transmission Mechanisms of Externalities

We describe the channels by which domestic firms can appropriate knowledge from foreign firms operating in the host economy. This appropriation may take the form of utilization of foreign knowledge or the recombination of foreign and internal knowledge into a new kind of knowledge. This process may require absorptive capacity, which according to Narula and Marin (2003) "includes the ability to internalize knowledge created by others and modifying it to fit their own specific applications, processes and routines" [Narula and Marin (2003), p 23].

The theoretical literature on technology transfer (e.g., Görg and Greenaway, 2004) considers that technology diffusion from MNCs to local firms may occur at two levels: the horizontal technology transfer that occurs through contacts with local competitors (via demonstration/imitation, labour mobility, exports, competition, consulting and specialized services and coordination with local institutions); and the vertical technology transfer that occurs through linkages with local suppliers (backward linkages) or local customers (forward linkages).

Regarding the horizontal level, the entry of the MNCs may provide externalities to the local competitors through various channels. The demonstration / imitation (for local firms) is probably the most obvious channel (Das, 1987, Wang and Blomström, 1992).

Concerning demonstration, the introduction of a new technology in a given market may be costly and risky for local firms to perform due to the uncertainty of the results. However, if the technology is successfully used by a MNC, it encourages local firms to adopt it, if the goods produced are similar (Barrios and Ströbl, 2002).

Geographical proximity can lead to externalities through imitation or demonstration effects, especially in industrial clusters. Domestic firms may be able to learn and copy by simply observing, or through reverse engineering, personal contacts and industrial espionage. Additionally, when subsidiaries introduce innovations, they may be demonstrating to their competitors how to deal with the technology and thus the efficiency of the later may increase.

Labour mobility occurs if local firms hire former MNCs' employees and are able to learn from them in order to implement their technology, or if MNCs' former employees create their own firms and apply the acquired knowledge for their own benefit (Glass and Saggi 2002; and Pesola, 2006). However, the effects of labour mobility on the productivity of local firms

are difficult to measure because it involves the monitoring of workers and estimating the impact on the productivity of other workers (Saggi, 2001).

Exports are viewed by some authors as another channel through which knowledge externalities to local firms can take place (Kokko et al, 2001; Greenaway et al, 2004). According to those authors, the export activity involves costs of studying foreign markets, establishing distribution networks and transport infrastructure. MNCs can meet these costs in an easier way due to their greater experience in foreign markets and financial capacity (Greenaway et al., 2004). Imitation or collaboration with MNCs in order to learn the export process allows local firms to reduce the costs of internationalization and have a positive impact on their productivity. However, in our opinion, this is a particular case of the imitation/demonstration channel.

The increased competition induced by the entry of MNCs is another channel of externalities from FDI (Wang and Blomström, 1992; Markusen and Venables, 1999). The higher competitive pressure, particularly in highly competitive sectors with low barriers to entry, induces technological change and learning. Indeed, competition may lead to the rationalization of resources, the adoption of new technologies and the introduction of new products by local firms to protect their market share (Blomstrom and Kokko, 1998).

However, at an early stage, the presence of the MNCs may imply significant losses of market shares for the local firms, forcing them to operate on a less efficient scale and, thus, increasing their average costs (Aitken and Harrison, 1991; Harrison, 1994). In the next stage, however, the entry of an MNC creates a selection effect, where the competitive pressure drives the least efficient firms out of the market, increasing the average productivity of the surviving local firms.

The entry of the MNCs may also be accompanied by foreign consulting and specialized services (trade brokers, accounting firms and consulting, etc.) that may be available for local firms and hence may contribute to the increase of their performance.

Regarding the coordination with local institutions, the diffusion of knowledge is possible in two ways: partnerships between firms, universities and institutes, and the leakage of technological content from the original recipient to his local rivals.

Concerning vertical technology transfer, the use of more specialized inputs generates a positive social value in the form of increased productivity for the local firm, which is not appropriated by the MNCs. In certain circumstances (i.e., increased returns in the production of inputs, transportation costs and benefits of specialization), backward externalities occur when an MNC, by increasing its demand for inputs, leads to the introduction of new varieties of inputs. The introduction of these specialized inputs reduces the cost of production of the final goods, making the production more profitable. This mechanism is modelled, for example, in Rodriguez-Clare (1996), Markusen and Venables (1999) and Lin and Saggi (2005).

Relating to the backward linkages, the presence of the MNCs may benefit local suppliers if they are interested in guaranteeing a certain quality standard. In this context, MNCs can provide technical support to local suppliers in order to improve the quality of inputs or to assist their suppliers in the introduction of innovations, training, creation of productive infrastructure, procurement of raw materials, as well as the introduction of new management techniques, among others (Lall, 1980).

Several case studies (see Moran, 2001) show that MNCs often provide technical assistance to its suppliers in order to raise the quality of its products and facilitate innovation. As a result, FDI in downstream sectors induces greater competition, lower prices and increased production and value added in upstream sectors. Moreover, while the technological gap between local and foreign firms may limit the transfer of technology in the sector, MNCs purchase less sophisticated inputs in order to narrow the gap. The competition among local firms to supply MNCs is also likely to generate an increase in their efficiency.

Regarding forward linkages, externalities arise when MNCs provide higher quality and /or cheaper inputs to local producers of final goods (Markusen and Venables, 1999). Meyer (2004) argues that 'FDI in infrastructure and business services directly influences productivity of its customers if services required by businesses improve, or are newly introduced.' (Op cit, p. 11).

Downstream effects of FDI are generally more beneficial than the upstream effects (Blomström and Kokko, 1998). Indeed, local firms may be able to compete in world markets with technical expertise based on the industrial application of the MNCs' technology. This provides opportunities for countries to remain competitive in various "niches" of high technology (Blomström, 1991). However, there are few studies addressing the importance of forward linkages. Aitken and Harrison (1991) is one of these studies. Another example is Zysman et al. (1996). The authors find that, in the 1980s, US electronics firms gradually deepened the technological capacity and autonomy of their Asian subsidiaries, largely in response to the competitive challenge represented by their Japanese competitors. The transfer of higher value-added production from the U.S. to Asia allowed subsidiaries to produce more sophisticated electronic parts.

3. Determinant Factors of Vertical Externalities

While most Endogenous Growth Models focus on the role of R&D in the technological diffusion, in the early 2000s, a new approach, triggered by Bernard and Jensen (1995) has introduced firm heterogeneity in the analysis of how technology diffusion influences economic growth. Similarly, the more recent empirical studies take into account the heterogeneity of subsidiaries' performance, in addition to domestic firms' characteristics, in the analysis of the determinants of FD for example, Görg et al. (2009) conclude that the larger, more productive and more experienced firms are more likely to invest in the Czech Republic. Hence, in spite of sharing many characteristics of the monopolistic

competition models from New Trade Theory, this approach assumes differences in firms' characteristics within a sector, especially with regard to productivity (Ciuriak et al, 2011).

This trend of incorporating heterogeneity into the analysis have also influenced the most recent theoretical models of technology transfer (Driffield and Love, 2007; Marin and Sasidharan, 2010). A key assumption of this new approach is that the decisions on where MNCs locate the production and the extent of control over these activities is part of their global sourcing strategies (Antràs and Helpman, 2008) and cannot be analysed in a framework of International Trade theories (Coase, 1937; Williamson, 1975; Grossman and Hart, 1986). Hence, the core model of Melitz (2003), based on Krugman (1980), is being developed in several ways. One dimension of this literature is using the interaction of sunk costs and heterogeneous firm level productivity to determine the reason why some firms invest abroad while others stay in the domestic market (Helpman et al., 2004). Other extensions include models of firm decision on: how many products to produce and in which international markets to sell (Bernard et al., 2010); imports of inputs (Kasahara and Lapham, 2013); and international outsourcing (Antràs and Helpman, 2008; Caliendo and Rossi-Hansberg, 2012). Hence, along the lines of the Theory of Heterogeneous Firms, we identify and classify the determinant factors of vertical externalities.

3.1. Determinant Factors

We focus on vertical externalities because empirical studies (for example, Crespo et al., 2010; Kugler, 2005) suggest they are more likely to occur than horizontal externalities. In particular, downstream effects of FDI provide opportunities for countries to remain competitive in various "niches" of high technology, as domestic firms may be able to compete in world markets with technical expertise based on the industrial application of the MNCs' technology (Blomström, 1991). Crespo and Fontoura (2007) remark that there has been an effort to research the factors that determine the existence, sign and magnitude of externalities from FDI. Yet, the literature does not present clear-cut evidence on which factors impact on their existence and/or magnitude. Thus, along the lines of the Theory of Heterogeneous Firms we suggest the following classification into 'internal' and 'external' factors in Table 1.

Internal	Domestic Firms	Firm size
		Financial capacity
		Age of firms
		Age of managers
		Age of workers
		absorptive capacity
	Foreign Firms	Origin of FDI
		Politics on the value of the technology
		Intensive use of intermediate inputs
		FDI motive
		Entry mode (Greenfield/ M&As)
		Age of the subsidiary
		Level of autonomy of the subsidiary
		Size of the subsidiary
External	Industry Specific	Specialization
		Agglomeration economies
		Characteristics of the industry (export-oriented/ local market-oriented, market concentration, capital intensity)
	Symbiotic	Technological Gap
		Geographical proximity
		Cooperation

Table 1: Determinant Factors of Externalities from FDI

Source: Own Analysis

The 'internal' determinant factors are those related to firms' characteristics; whether they are domestic (size, financial capacity, age of firms and employees including managers, and the absorptive capacity) or foreign (home Country, value of the technology, intensive use of intermediate inputs, FDI motive; entry mode, and age, level of autonomy and size of the subsidiary); whereas the 'external' determinant factors are those that firms cannot control through their behaviour, and are specific of a certain industry (level of specialization, existence of agglomeration economies; export or domestic market-orientation, market concentration and capital intensity); or is an outcome of the interaction between domestic and

foreign firms (symbiotic), such as the technological gap, the geographical proximity or cooperation between domestic and foreign firms.

We now describe the mechanism through which those determinants impact on the existence of linkages, and therefore, on the occurrence of vertical externalities.

3.1.1. Individual -Domestic Firms

The size of domestic firms is important for benefits associated with the presence of MNCs to occur, because small firms may not operate on a large enough scale to deal with some of the technologies introduced by the MNCs (Ngo and Conklin, 1996).

Similarly, the lack of financial capability makes it very hard to achieve a production scale large enough to deal with some of the technologies introduced by the MNCs (Cline, 1987).

The age of the firms is likely to determine the occurrence of externalities from FDI to domestic firms (Suyanto and Salim, 2010). Older firms that have served the market for a longer time and may have a larger network of contacts and information on the markets. Therefore, the probability of vertical externalities to occur is higher.

Regarding the age of managers, youth brings energy to innovate and to overcome the difficulties, but it may also mean less experience. Therefore, the age of managers should be such as to allow for market experience and the establishment of a network of contacts with suppliers and local clients for vertical externalities to occur.

Concerning the age of the employees, FDI flows are sensitive to the health of the workforce (Globerman and Shapiro, 2002). Since, *coeteris paribus*, younger workers are healthier than older workers, and firms with younger employees attract more foreign investors, then firms with younger employees are more likely to benefit from vertical externalities (Liu and Zou, 2008; Stancik, 2009).

The absorptive capacity is often proxied by the human capital which have an impact on FDI flows. Indeed, MNCs tend to acquire firms with a higher level of human capital (Teixeira and Tavares-Lemhann, 2007) and M&As are more likely to generate vertical externalities.

3.1.2. Individual- Foreign Firms

The origin of the FDI is a determinant factor of externalities from FDI (Karpaty and Lundberg, 2004; Javorcik et al. 2004; Takii, 2011). In fact, the origin of the FDI may be expressed by many factors such as culture, language, the level of economic development of the country, among others. Foreign investors coming from countries with a culture characterized by multiculturalism, are more likely to mingle with the locals and make efforts to learn the local language, and thus, to establish contacts with local suppliers and customers. Moreover, if the language of investing and host countries is the same or similar, the probability of contacts between suppliers/customers may be higher. Also, the degree of development of the country of origin may influence the type of FDI and, therefore, it may influence the occurrence of vertical externalities.

The technological strategy of MNCs is also a determinant factor of vertical externalities. Indeed, the degree of technological expertise of the subsidiaries determines the existence of externalities from FDI (Marin and Sasidharan, 2010; Narula and Dunning, 2010). Subsidiaries that are an important source of technological knowledge and perform their own R&D and innovation are more prone to establish linkages with domestic firms (Jindra et al., 2009). If subsidiaries have superior technology comparing to their domestic counterparts, they will require more specialized and complex inputs and may not be able to get them in the host country. However, this problem can be solved by providing technical assistance to their potential suppliers. On the other hand, If MNCs have much more sophisticated technology than their domestic clients, and they are the leading suppliers of those domestic firms, then it is likely that forward linkages occur.

An additional determinant factor is the intensive use of intermediate inputs by MNCs. Local sourcing depends positively on the transport costs (and therefore on distance) between the MNCs home country and the host country (Rodriguez-Clare, 1996). If transport costs are high enough, the MNCs may have an incentive to buy inputs locally. Then, the occurrence of backward linkages is likely.

The motivation of FDI is another determinant factor of vertical externalities (Driffield and Love 2006). Local market-oriented MNCs, measured in terms of share of domestic sales in total sales, are likely to establish backward linkages (Jordaan, 2011 and Giroud et al., 2012). Indeed, in this case, MNCs will need to tailor products to local market specific needs. Engaging with domestic suppliers will facilitate the process of adapting the products to local taste and may provide MNCs with reliable information about domestic customer preferences. If MNCs are export-oriented and domestic firms produce for the domestic market, the potential for externalities increases if the requests imposed by the MNCs, by serving foreign markets, are largely dependent on local suppliers to make the necessary adjustments (Moran, 2001). If the FDI is motivated by the access to specific items which are not available in the country of origin and are not easy to transfer, the probability for backward externalities is high. If FDI is related to the existence of tariffs and other trade barriers that prevent MNCs to export to the host country, MNCs try to jump barriers by establishing a subsidiary in the host economy to gain access to the local market (Chrysochoidis et al., 1997). The local presence need only be enough to circumvent the trade barriers, since the MNC wants to keep the maximum added value in its domestic economy. Therefore, in this case, the probability of occurrence of backward linkages is low. The internationalization strategies allow MNCs to increase their potential for absorbing external knowledge; and influence their supply mode (Figueiredo, 2011). Externalities from FDI are expected to be higher when the FDI is technology sourcing because the entry of the MNCs can lead to the process of technological development and competition that can generate externalities for domestic firms (Driffield and Love 2003). In addition, scale economies and transaction costs of outsourcing seem to be forcing MNCs to consolidate their supply

relationships with a smaller number of major suppliers, for example in the automotive and electronics industries (Ernst, 2002).

The entry mode also influences the existence of externalities (Javorcik, 2004 and Merlevede and Schoors, 2005; Jabbour and Mucchielli, 2007). Subsidiaries with higher degree of local participation (M&As) facilitate access to foreign technology by local firms and are expected to create more vertical linkages with the host economy (Crespo and Fontoura, 2007; Liu and Zou, 2008 and Stancik 2009). In contrast, wholly-owned foreign projects are unlikely to generate positive vertical externalities. Also, in greenfield projects, we expect that foreign wholly-owned subsidiaries rely more on imported inputs.

The age of subsidiaries also may influence the sourcing decisions (Zhang et al, 2010; Suyanto and Salim, 2010) as older subsidiaries are likely to be more independent from the headquarters and may take their own decisions about local sourcing.

Indeed, strategic decisions by MNCs in terms of supply and linkages are related to their degree of autonomy and have an impact on the existence of externalities from FDI (Jordaan, 2011). A subsidiary with a high degree of autonomy is more likely to supply locally; while less autonomy means that the subsidiary may rely more on imports (Holm and Pedersen, 2000).

The size of the subsidiaries determines the occurrence and magnitude of externalities from FD. Smaller subsidiaries are probably more adaptable to the external environment than larger firms. Therefore, smaller subsidiaries are more likely to establish linkages with domestic firms (McCann, 1997). Furthermore, it is probable that smaller subsidiaries need more local support because of their organization fragilities (Chen and Chen, 1998). In contrast, larger subsidiaries are probably more able to find niches in the highly internationalized networks and therefore source on a global basis (Barkely and McNamara, 1994). In addition, smaller subsidiaries with little international experience will less likely choose Greenfield projects because of the lack of knowledge about the host market; and many smaller subsidiaries assign less weight to the disadvantages associated with any strategic incoherence resulting from the acquisition (Mendes, 2002). Thus, there is more likelihood of vertical externalities to occur.

3.1.3. External- Industry Specific

Regarding specialization, an initially high level of expertise in certain activities may attract more investments and generate agglomeration economies (Barrell and Pain, 1999). Since physical proximity facilitates the flow of knowledge, agglomeration economies may facilitate the occurrence of vertical externalities. As a result, areas of high productivity tend to be geographically clustered, creating strong linkages (Anselin, 2001).

Firms in export-oriented industries are already accustomed to meeting the superior quality required in export markets and adapt more easily to foreign firms demand in downstream sectors. This mechanism is especially effective when there is high sectoral competition. In fact, it is claimed that the industries that export a significant part of their production face greater competition than those market-oriented (Barrios and Strobl, 2002; Bekes et al., 2006), hence, it is more likely that vertical externalities occur.

In our view, firms in concentrated markets are likely to have market power that can facilitate linkages with foreign clients/suppliers, and thus vertical externalities may arise. For example, domestic firms with market power can beat their rivals (if there are any, since, in these markets, competition is low) more easily, when competing to become suppliers of an MNC. Moreover, stronger industry concentration generates larger profits that can be re-invested, for example, in new technologies or in the production of more sophisticated products that can be more appealing to foreign firms.

Capital intensity represents a firm's commitment to modernization and upgrading of its productive capacity. In the long run, capital expenditures typically has a positive impact on firms' performance (Lee & Blevins, 1990; Lee and Xiao, 2011). Thus, more productive firms can lower the price of the goods sold. If this is the case, then, it is our opinion that firms in capital intensive industries are more prone to establish linkages, for example, with foreign clients, and vertical externalities are more likely to arise.

3.1.4. External- Symbiotic

It is argued that there must be some difference between the technologies of the two types of firms (foreign and domestic) for externalities from FDI to occur. Hence, the higher the technological gap the greater the potential magnitude of vertical externalities. If the technology gap is large, it implies that MNCs have much more sophisticated technology than their domestic counterparts; and if they establish linkages with domestic firms, then it is likely that vertical externalities occur.

The geographical proximity facilitates relationships between foreign and domestic firms and the flow of knowledge from the first to the latter. Therefore, it favors the occurrence of vertical externalities.

Finally, the propensity to establish technological cooperation is a key determinant of the existence of externalities from FDI (Dunning and Lundan, 2008; Narula and Dunning, 2010). This propensity for establishing technological cooperation will be greater if the FDI is technology sourcing since MNCs opt for less stringent appropriability strategies in order to facilitate the exchange of knowledge in the host country, demonstrating reciprocity (Faria and Sofka, 2008). The higher this propensity the greater the potential for the occurrence of vertical externalities.

Crespo and Fontoura (2007) remark that empirical studies do not specify the mechanisms by which the determinant factors of vertical externalities neither are effective nor distinguish between factors of occurrence and factors of magnitude. The first are factors that cause the externalities and the second are factors susceptible to intensify the extent

of externalities. Hence, based on the several authors referred above in this section, Table 2 shows the possible connections between the several determinant factors of occurrence.


Primary	Secondary	Tertiary	Fuse
Specialization	Geographical Proximity	Agglomeration	Cooperation
	Age of Managers		
	Origin of FDI		
	Market concentration		
	Capital intensity		
Absorptive capacity	FDI motive/ Entry Mode		Intensive Use of Inputs
Size of the			
Age of Workers			
	Politics on Technology		
	Level of autonomy of the Subsidiary		
	Age of the Subsidiary		
	Age of firms		

Table 2: Factors of Occurrence of Externalities from FDI
Source: Own Analysis

According to our analysis, factors of occurrence are classified into primary, secondary and tertiary, and emerge respectively in the first, second and third column. The primary factors are those that do not depend on other factors; the secondary factors depend, at least at some level, on the primary factors, and the tertiary factors depend on secondary and, ultimately, on the primary factors. In our opinion, because 'FDI motive' and 'entry mode' are related to both factors on the fourth column, the propensity to establish cooperation and the intensive use of local inputs, we label it 'factors of liaison'.

The fourth column contains what we label 'fuse factors', i.e., factors that trigger externalities from FD in other words, 'cooperation' between domestic and foreign firms, and the 'intensive use of local inputs' by foreign firms most probably lead to external economies and, ultimately, vertical externalities arise.

We will now describe how primary, secondary, tertiary and liaison determinant factors are related and contribute to the occurrence of 'fuse factors'.

Technological specialization promotes the learning effect between firms. Cantner and Graf (2004) provide empirical evidence concerning specialization and cooperation. The higher a region's specialization, the more cooperatives are formed between partners outside that region. Taking cooperatives as a proxy for knowledge externalities, this result may show that the exchange of knowledge is highest in a specialized cluster (Dawid and Wersching, 2007). In addition, the geographical proximity may lead to agglomeration (industrial clusters) which is important for establishing contacts, cooperate and supply locally. As a result, cooperation between MNCs and local firms may occur when a high level of expertise (specialization) in some activities attract more investments to a certain location, creating geographical proximity between firms (Anselin, 2001).

The age of the managers can also influence the propensity to establish technological cooperation. In our opinion, the youth of managers may imply propensity to innovate, but it also means less experience. Therefore, linkages are more likely to occur if the managers are not too young, to allow for market experience and a network of contacts with foreign firms.

Foreign investors coming from multicultural countries probably are more prone to establish contacts with local suppliers and customers. Also, the degree of development of the country of origin may influence the type of FDI projects and, thus, have an influence on the occurrence of vertical externalities.

The propensity to establish technological cooperation is a key ingredient for the existence of linkages (Jindra, 2010) and depends on the origin of the FDI (Javorcik et al, 2004; Wei and Liu, 2004; Takii, 2011).

Both market concentration and capital intensity contribute to provide market power and resources to domestic firms and, thus, the probability of cooperation between these firms and foreign firms is higher, in our view.

Assuming that human capital (as proxy for the absorptive capacity) is important to attract FDI inflows (Teixeira and Tavares-Lemhann, 2007), then the greater the level of human capital, the greater the likelihood of MNCs chose Mergers and Acquisitions (M & A) and source locally.

The size of the subsidiary may also impact on local sourcing. Small firms with less experience of international markets are likely to enter the domestic market through M&As to minimize the risks associated with the lack of knowledge about local tastes and overcome the weaknesses of their organization (Chen and Chen, 1998). In our opinion, FDI projects via M&As are more likely to source locally than Greenfield projects because in the former type of firms the sourcing decisions may be attributed to nationals as they be included in the board of directors. In contrast, larger firms are probably more capable to find niches in the highly internationalized networks and therefore usually supply in the international markets (Barkely and McNamara, 1994).

Regarding the age of workers, because younger employees are probably healthier than the older ones, and MNCs are sensitive to the health of the workforce regarding their M&A projects (Globerman and Shapiro, 2002), the age of employees impacts on the entry mode. In addition, in foreign projects via M&As, the sourcing decisions are more likely to

be established by the previous firm owners. In this case, the subsidiary management team is more likely to be an advocate of local sourcing (Tavares and Young, 2002)

The FDI motive may contribute to cooperation and to the intensive use of local inputs (Driffield and Love, 2006). According to Belderbos et al. (2001) if the subsidiaries are market driven, then they will adapt their products to local tastes, which may involve local supply and probably will cooperate with local firms. In addition, local sourcing of components and parts is a priority for international subcontractors that place great emphasis on flexibility (Chen et al, 2004).

On the other hand, high levels of investment on incorporated technology by the MNCs require more specialized and complex inputs that can be more expensive through imports. The solution would be to provide technical assistance to potential domestic suppliers (Driffield and Love, 2007; Marin and Sasidharan, 2010).

The sourcing decisions are also related to the level of autonomy of the subsidiary. The higher the autonomy, the more likely is local sourcing (Holm and Pedersen, 2000; Jordaán, 2011). For example, McAleese and McDonald (1978) have shown that purchases of local inputs tend to increase as the subsidiaries become more mature.

In this context, the age of subsidiaries may also have an impact on sourcing decisions (Zhang et al, 2010; Suyanto and Salim, 2010). In our opinion, older firms are likely to have gained more autonomy over time, and thus the likelihood of local sourcing is higher. On the other hand, we hypothesise that older domestic firms are more likely to be more integrated in the market and, thus, have more probabilities to have sourcing contracts with MNCs.

The intensive use of local inputs is related to FDI motive. If the MNC is motivated by the access to specific items that are either not available or not easy to transfer from the host country, the probability of local sourcing is higher. On the contrary, if the FDI motive is to overcome tariffs or other trade barriers that prevent MNCs to export to the host country, the probability of local sourcing is low (Chrysochoidis et al., 1997). The entry mode also influences the local supply (Jabbour and Mucchielli, 2007). Greenfield projects are expected to rely more on imported inputs. However, when the FDI is via M&As, it is expected that domestic suppliers of the acquired firm will continue to supply the firm (Stancik 2009).

In our view, both determinant factors of occurrence and magnitude depend on firm behaviour (foreign and domestic). However, foreign firms' behaviour is crucial for vertical externalities to occur, in the sense that it is ultimately their choice whether to establish cooperation and/or source locally; that can cause vertical externalities. In other words, the determinant factors related to foreign firms are relatively more important for the occurrence of vertical externalities than those factors related to domestic firms' characteristics. In Table 2 we present 5 primary internal factors related to foreign firms (origin of FDI, size, politics on the value of the technology, level of autonomy and age of the subsidiary) and 2 factors of liaison (FDI motive and entry mode) also related to foreign firm's characteristics, while internal factors related to domestic firms are only 4 and all are primary (age of managers, absorptive capacity, age of workers and the age of firms). Conversely, the determinant factors related to domestic firms' characteristics are relatively more important for the magnitude of vertical externalities. In other words, depending on domestic firms' characteristics, the intensity of vertical externalities can be higher or lower. Table 3 shows the determinant factors of magnitude of vertical externalities.

Vertical Externalities		
FDI motive		depend
Entry Mode		-
Absorptive capacity		+
Age of Workers		-
Age of firms	Financial Capacity	+
Firm size		+
Characteristics of the sector (Export-oriented/domestic market)		(-/+)
Technological Gap		depend

Table 3: Factors of Magnitude of Externalities from FDI

Notes: +Positive; - Negative

Source: Own Analysis

Indeed, Table 3 shows 5 domestic firms characteristics as internal determinant factors of magnitude (absorptive capacity, age of workers, age of firms, firm size, and financial capacity) and just 2 related to foreign firm's characteristics (FDI motive and entry mode).

The joint analysis of tables 2 and 3 shows that the determinant factors of occurrence related to domestic firms' characteristics (absorptive capacity, age of workers and age of firms) are also determinant factors of magnitude. The magnitude of vertical externalities will be higher if the absorptive capacity is higher too. The same reasoning applies for the age of workers and the age and size of firms. Younger workers, in principle are more receptive to foreign ideas, older and larger firms are likely to possess more resources to implement foreign knowledge. In addition, small firms may not be able to operate on a scale large enough to handle some of the foreign technology (Ngo and Conklin, 1996). However, we do not find convincing evidence that support the idea that the remaining determinant factors, domestic firms' size and financial capacity, can generate vertical externalities. In our view, these characteristics can only impact on the intensity of vertical externalities, once they occur.

Regarding foreign firms' characteristics as determinant factors of magnitude, as Moran (2001) stresses, the magnitude of linkages increases if the MNCs are largely dependent on local suppliers and impose high quality inputs. On

the other hand, the share of foreign capital can be regarded as a proxy of the entry mode, and several studies (Javorcik, and Spatareanu, 2003; Javorcik, 2004b; Merlevede and Schoors, 2005) report the influence of the share of foreign capital on externalities from FD. Indeed, MNCs with higher local participation will not only facilitate access to foreign technology to local firms but also will probably create more linkages (Merlevede and Schoors, 2005). On the other hand, local producers of final products in export-oriented sectors usually face greater competition when compared to firms that supply the local market (Blomström and Sjöholm, 1999). Hence, these firms probably are familiar with the imposition of high quality to their products and were already forced to import inputs if the local inputs do not meet the quality requirements. Thus, these firms can at best benefit marginally from the improved quality of local inputs and therefore, the magnitude of vertical externalities will be lower. However, if these firms produce for the local market, then the magnitude of vertical externalities will be greater. Finally, we find that benefits arising from linkages will be greater if the technological gap is not too low, because in this case local firms will have (potentially) more to learn with the MNCs. However, if the technological gap is too high, local firms may not have the necessary absorptive capacity to implement foreign innovations.

4. Empirical Studies

We will now analyse a set of empirical studies for DCs regarding the determinant factors and results, to draw some conclusions regarding the direction of future empirical research on externalities from FDI for DCs. Previous literature reviews had focused only in the Least Developed Countries (LDCs); or in a mix of countries with different levels of development; or just in one country (DC or LDC).

4.1. The Selected Studies

We analyse 20 empirical studies (see table 4) that test the effects of FDI on the productivity of domestic manufacturing firms for 5 countries of Western Europe, with panel data at firm level.

Study	Pubdate	Country	Period	Methodology	Dependent Variable	Proxy for FDI	Horizontal	Backward	Forward
Ruane and Ugur	2005	Ireland	1991-1998	OLS	Labour Productivity	Employment	Ns +		
Barry et al	2005	Ireland	1990-1998	Fixed Effects	Labour Productivity	Employment	-		
Barrios et al.	2012	Ireland	1990-1995	2SLS	TFP	R&D	+		
Imbriani and Reganati	2004	Italy	1994-1996	Fixed Effects	Value Added	Employment	Ns -		
Reganati and Sica	2007	Italy	1997-2002	Fixed Effects	Value Added	Employment	Ns +	+	+
Albanese et al	2008	Italy	1999-2005	Fixed Effects	TFP	No. of Firms	+		
Farinha and Mata	1996	Portugal	1986-1992	Random effects	Labour Productivity	Employment	Ns		
Proenca et al.	2002	Portugal	1996-1998	GMM	Labour Productivity	Capital Stock	Ns		
Crespo et al. ^a	2009	Portugal	1996-2000	GMM	Labour Productivity	Employment	-	+	Ns +
Crespo et al. ^a	2012	Portugal	1996-2001	GMM	Labour Productivity	Employment	Ns-	+	Ns +
Barrios and Ströbl	2002	Spain	1990-1994	Fixed Effects	Output	Capital Stock	Ns		
Alvarez and Molero	2005	Spain	1991-1999	GMM	Growth of Productivity	Capital Stock	+		
Jabbour and Mucchielli	2007	Spain	1990-2000	OLS	Output	Capital Stock	-	+	+
Girma	2005	U.K.	1989-1999	GLS	TFP	Employment	Ns +		
Girma and Wakelin	2002	U.K.	1988-1996	GMM	Output	Employment	+		
Driffield	2004	U.K.	1983-1997	GMM	Value Added	Capital Stock	-		
Harris and Robinson	2004	U.K.	1974-1995	GMM	Value Added	Capital Stock	+	Und.	Und.
De Propis and Driffield	2006	U.K.	1993-1998	3SLS	Value Added	Capital Stock	-		
Haskel et al.	2007	U.K.	1973-1992	OLS	Output	Employment	+	+	+
Girma et al.	2008	U.K.	1992-1999	OLS	Output	Output	+	+	-

Table 4: Empirical Studies on FDI Externalities

Notes: ^a Results at regional level. Pubdate- Date of Publication, +Positive, - Negative, Ns- Non Significant, Und- Undetermined, OLS- Ordinary Least Squares; 2SLS- Two-stage Least Squares, 3SLS- Three-stage Least Squares, GMM-Generalized

Method of Moments
Source: Own Analysis

The sample contains only DCs because the extent to which externalities occur is not the same for DCs and LDCs (Roording and Vaal, 2010). In fact, studies on DCs document positive productivity externalities even after controlling for industry and regional fixed effects (Hale and Long, 2006).ⁱ This occurs for several reasons. First, FDI projects in DCs are mainly market-driven (Roording and Vaal, 2010). Thus, according to what was said in section 3.2, market-oriented MNCs are likely to establish backward linkages; and the potential for vertical externalities is increased. Second, because labour market is more restrictive in LDCs, it does not work as well, and it is not as regulated as in DCs, the potential for vertical externalities is lower. Third, in countries with developed financial markets, the access to credit for investment is facilitated, favouring the occurrence of linkages (Alfaro et al. 2004).

However, while all our selected studies investigate the existence of horizontal externalities, only 35% investigate the existence of vertical externalities. The choice of the countries is related to the number of studies produced for comparison purposes. Nevertheless, despite the research on vertical externalities, the number of such studies for DCs is still scarce. Most of the studies (35%) are for the UK, 20% refer to Portugal and the other countries represent a share of 15 % each. As Figure 1 shows, in all countries, except for Ireland, the growth rate of the manufacturing Gross Value Added has been relatively constant over the period 1995-2007.

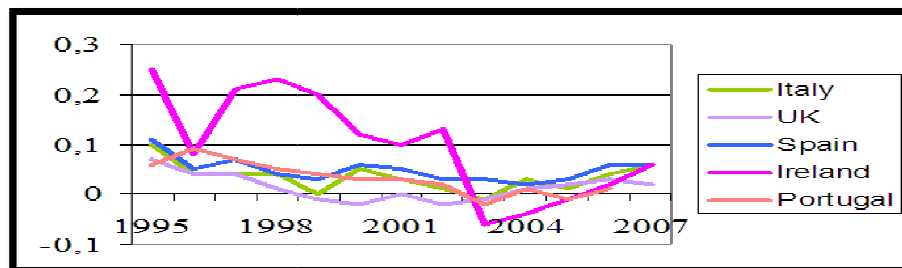


Figure 1: Growth Rate of Manufacturing Gross Value Added (%)
Source: Author's Calculations Based on Euklems Database

According to Inklaar and Timmer (2008), these countries shared the average weight of manufacturing in the overall economy of approximately 22%, in 1997. We focus on the manufacturing sector because, being a major producer of tradables, it potentially generates high rates of innovation and drag capabilities to other sectors of the economy. In other words, the manufacturing sector is a driver of technological change (Andreoni and Gregory, 2013).

4.2. Determinant Factors in the Selected Studies

Considering our classification of the determinant factors in section 3, we now analyse how the authors of the selected studies have tested the determinant factors of externalities from FD

For the UK, while De Propis and Driffield (2006) and Driffield (2004) find negative horizontal externalities, due to agglomeration economies and government policies, Girma and Wakelin (2002) and Haskel et al. (2007) find positive horizontal externalities via competition and the level of development, respectively. The effect of the agglomeration economies on vertical externalities is indeterminate in Harris and Robinson (2004); whilst Haskel et al. (2007) and Girma et al. (2008) find that the level of development and the FDI motive gives rise to positive externalities via backward linkages. In contrast, externalities via forward linkages are positively affected by the level of development; while the impact of the FDI motive is negative.

For Portugal, Farinha and Mata (1996) and Proença et al. (2002) find non-significant horizontal externalities, due to firm size and technological gap; while Crespo et al. (2009, 2012) find a negative effect on horizontal externalities. Crespo et al. (2012) find positive externalities via backward linkages and positive but non-significant externalities via forward linkages, due to geographic proximity.

For Ireland, Barrios et al. (2012) and Ruane and Uğur (2005) test the absorptive capacity and find non-significant and positive results, respectively. Barry et al (2005) find that firm size and the capitalistic intensity impact negatively on horizontal externalities.

For Italy, Imbriani & Reganati (1999) and Reganati and Sica (2007) test the impact of the geographical proximity and the absorptive capacity on horizontal externalities and find non-significant results; while Albanese et al (2008) find a positive influence of geographical proximity on horizontal externalities. Reganati and Sica (2007) also find a non-significant impact of the absorptive capacity on externalities via backward linkages, but positive for externalities via forward linkages.

Finally, for Spain, Jabbour and Mucchielli (2007) find that technological gap impact negatively on horizontal externalities and positively on vertical externalities. Barrios and Ströbl (2002) test the absorptive capacity and find a non-significant effect on horizontal externalities; whilst Alvarez and Molero (2005) conclude that the share of foreign capital has a positive effect on horizontal externalities.

Thus, while the absorptive capacity is tested in 24% of studies, the share of foreign capital and the geographical proximity are tested in 15% of studies, and the firm size and the FDI motive are tested only in 9% of the studies, followed by the agglomeration economies, export capacity and technological gap (6%). Finally, the level of development of the host country, the FDI policies adopted, the market size and the competition are analysed in 3 % of the studies.

The meta-analysis of Havranec and Irsova (2010) includes 4 of our 20 studies. However, our analysis provides different insights. We focus on findings for five developed Western European countries and we focus on the determinants factors of externalities from FDI, included in these studies. Comparing our analysis with the findings of Havranec and Irsova (2010) and the study of Javorcik (2002), we conclude the following. Our analysis of the determinant factors confirms to some extent the study of Havranec and Irsova (2010). The authors claim that the most used determinants of horizontal externalities are the technological gap, trade openness, IPR protection, human capital and FDI penetration (measured by the ratio of inward FDI stock to GDP). Moreover, our results confirm the findings of Javorcik (2002) that the determinants used to explain vertical externalities are mostly competition, FDI motive, the share of foreign capital and technological gap.

5. Results

Table 5 compares the results of Havranec and Irsova (2010) with the results of our selected studies. The sample of Havranec and Irsova (2010) contains 4 studies, 1 for each of the selected countries, except for Ireland. In what follows, our results are shown in parentheses. The results analysed by Havranec and Irsova (2010) include 75% (55%) of studies with positive horizontal externalities, 100% (100%) show positive externalities via backward linkages; and 33% (67%) show positive externalities via forward linkages.

	Havranec and Irsova (2010)			Our Group of Studies		
	sample =4			sample =20		
	Positive	Negative	N.S.	Positive	Negative	N.S.
Horizontal	3	1		11	6	3
Backward	4			6		
Forward	1	2		4	2	

Table 5: Results of Empirical Studies of Externalities from FDI

Notes- N.S. Is Non-Significant

Source: Own Elaboration Based on Table A1 from Havranec E Irsova (2010)

The results are mixed and sometimes indeterminate. In fact, the years of 1993-1996 showed controversial results for the UK and Ireland; as well as the years 1995 and 2000 for Portugal; and 1998 for Spain. In contrast, it seems consistent to assume that, according to the sample of studies, the results are positive for horizontal externalities in the UK for 1974-1988; and negative for 1997. However, for Portugal, horizontal externalities appear to be non-significant for 1989-1992; positive in 1999; and negative in 2001; while in Spain, horizontal externalities seem to be non-significant in 1991-1992; positive in 1999; and negative in 2000. Regarding Ireland, horizontal externalities appear to be non-significant in 1991 and 1998-1999; while in Italy, horizontal externalities seem to be non-significant in 1994-1998; and positive in 2003-2005. Though mixed results may be a consequence of different data sources and methodologies, positive and negative results may also be affected by business cycles, and, the amount of inward FDI flows targeting the manufacturing sector in those periods.

Comparing the results for each country, considering the methodologies and variables used, we highlight the following aspects. For Ireland, the 3 studies analyse the period 1991-1995, where both studies of Ruane and Ugur (2005) and Barry et al. (2005) use the same dependent variables and proxies for the foreign presence; and Barrios et al (2012) use the TFP as dependent variable, and the R&D stocks of foreign firms as a proxy for foreign presence. While Ruane and Ugur (2005) find positive but non-significant results for horizontal externalities, Barry et al. (2005) find negative results and Barrios et al (2012) find positive results. The explanation for different results, especially between the studies of Ruane and Ugur (2005) and Barry et al. (2005), since they have several common characteristics, may be attributed to different econometric techniques. Indeed, while the first use OLS, the second use fixed effects and Barrios et al. (2012) use 2SLS.

In the case of Italy, studies by Reganati and Sica (2007) and Albanese et al. (2008) analyse the common period of 1999-2002; and the studies of Imbriani and Reganati (2004) and Reganati and Sica (2007) use the same dependent variable and the same proxy for foreign presence. However, Imbriani and Reganati (2004) find negative but non-significant results and Reganati and Sica (2007) find positive but non-significant results. Albanese et al. (2008) share the same econometric technique with the other two studies, but the authors use the TFP as the dependent variable and the number of firms as proxy for foreign presence and find positive horizontal externalities.

Regarding Portugal, Farinha and Mata (1996) analyse the 1986-1992 period while Proença et al. (2002) focus their analysis between 1996 and 1998 and Crespo et al. (2009, 2012) analyse the period 1996-2001. The common period is 1996-1998 for the last 3 studies. Except for Farinha and Mata (1996), that use a random effects model, all authors use the system GMM to estimate an equation where the dependent variable is the labour productivity which depends on variables of foreign presence in level (whose proxy is the employment in foreign firms, except Proença et al. that use the capital stock). Results for horizontal externalities are controversial. Indeed, while Crespo et al. (2009, 2012) find negative results; Farinha and Mata (1996) and Proença et al. (2002) find non-significant results. Regarding Vertical externalities, Crespo et al (2009, 2012) find positive and positive but non-significant results via backward and forward linkages, respectively. One

possible cause for these controversial results may be the underestimation of the real externality effects due to econometric problems associated with traditional panel data estimation methods.

Concerning Spain, Barrios and Strobl (2002), Jabbour and Mucchielli (2007) and Alvarez and Molero (2005) analyse the common time span of 1991-1994 and the authors use the capital stock as a proxy for foreign presence. However, even though both Barrios and Strobl (2002) and Jabbour and Mucchielli (2007) use the output as the dependent variable; the first use fixed effects; while the second use OLS, and find non-significant and negative horizontal externalities, respectively. Alvarez and Molero (2005) find positive results by regressing the labour productivity using the GMM estimator.

In the case of the UK, studies that found positive results use the output or value added as the dependent variable; while studies with negative results use the capital stock as a proxy for foreign presence. It is interesting to note that the studies of Driffield (2004) and Harris and Robinson (2004) share the date of publication and the same period of analysis of 1983-1995. They also use the capital stock as a proxy for foreign presence and the output as the dependent variable and find opposite results (negative and positive, respectively) for horizontal externalities. In this case, we believe that the methodology and the fact that the data source is not the same may have influenced the results. Indeed, while Driffield (2004) apply the econometric approach of Griliches and Lichtenberg (1984) to ONS, ANBERD (Analytical Business Enterprise Research and Development) and STAN OECD data; Harris and Robinson (2004) use weighted panels with DPD algorithm in PcGive with data from ARD (Annual Census of Production Respondents). Regarding the results for vertical externalities, externalities via backward linkages are positive using output as dependent variable and Levhinson and Petrin (2003) econometric procedure; and are undetermined in the studies where the proxy of foreign presence is the capital stock and the methodology is the weighted panels in the DPD algorithm. We cannot arrive to a conclusion about the presence of forward externalities in the UK since the result is positive, undetermined or negative depending on the use of employment, capital stock or output as the proxy for foreign presence.

6. Conclusion

According to some authors (see, for example, Kugler, 2006) externalities are more likely to occur at vertical level. Vertical externalities (especially via forward linkages) seem to exert a significant influence on the competitiveness of countries and stimulate economic growth via increased exports (Freund and Moran, 2017). Overall, internal characteristics of firms (local and foreign) appear to be more important for the occurrence and magnitude of vertical externalities than external factors.

In this context, empirical studies at firm level report that firms are strongly heterogeneous in various performance measures, namely size and productivity (Melitz, 2003). Thus, domestic firms' characteristics that enhance the absorptive capacity (such as firm size) may be key contributors to the magnitude of externalities from FD Hence, there is scope for further analysis on the transmission mechanisms of externalities from FDI considering firms' heterogeneity. Two major conclusions can be drawn from the analysis of the empirical studies on Western European Countries. First, the impact of the FDI motive has not been fully exploited perhaps due to the difficulty to disentangle all possible effects; second, the share of statistically non-significant results is high. Hence, up to now, the empirical literature has not contributed to an unambiguous explanation of the transmission mechanism of externalities from FDI, and, therefore, the link between theoretical and empirical literature is missing (Lautier and Moreau, 2012).

We expect to contribute ~~for~~ to the existing literature in two ways. Firstly, we present a new classification on the determinant factors of vertical externalities; secondly, we are the first to review the literature focusing on a set of developed European countries. This is of crucial importance regarding the choice of variables to include in empirical models to evaluate the existence of externalities from FDI in Developed Countries.

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¹ See for example, Girma, et al. (2001) and Haskel et al. (2007).