PRODUCTIVITY SPILLOVERS FROM MULTINATIONAL CORPORATIONS: VULNERABILITY TO DEFICIENT ESTIMATION*

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Abstract: Evidence on productivity spillovers from FDI to domestic firms is ambiguous. Incorrect estimation procedures may be one of the sources for the contradictory results obtained in empirical studies on this subject. We observe that inadequacy of the estimation procedures leads to a severe underestimation of the spillover effect. In discussing the appropriated econometric methodology, inconsistency due to simultaneity of FDI and other explanatory variables and endogeneity related to firm unobserved heterogeneity are specially addressed. Additionally, incorrect inference and the possible lack of precision in estimation due to the availability of few periods in the panel are also analysed.

JEL Codes: F21, F23, 052

Keywords: domestic firm productivity; multinational corporations; technological spillovers; panel data; Extended GMM.

* Financial support received from Fundação para a Ciência e a Tecnologia/MCT under FCT/POCTI and under SFRH/BD/6412/2001 (also supported by the European Social Fund) is gratefully acknowledge. The authors are indebted to Eric Strobl, João Santos Silva, Renato Flôres and Richard Blundell for their helpful comments. The usual disclaimer applies. Corresponding Author: Isabel Proença, Rua do Quelhas 6, 1200-781 Lisboa, Portugal, email: isabelp@iseg.utl.pt

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1. Introduction

A substantial body of literature has been produced to analyse whether the presence of multinational corporations (MNCs) results in an increase of the productivity of domestic firms in host countries. This is related to the concept of productivity (or technology) spillovers, which embodies the fact that foreign firms own intangible assets such as technological know-how, marketing and managerial skills, international experience or reputation, which can be transmitted to domestic firms and thereby raise their productivity level.

Although theory has been identifying a wide range of possible productivity spillover's channels - they may be knowledge or technologically based and they may occur through demonstration/imitation effects, the labour market via skill enhancement, increased competitive pressure that may spur local firms to operate more efficiently and/or backward and forward linkages between local and foreign firms - robust empirical support for positive productivity spillovers is hard to find, as shown, for instance, in the surveys by Meyer (2003) and Görg and Greenaway (2004).

Heterogeneity on the spillover result has been associated to the ambiguity as regards the sign of the effect in the case of some spillover channels (Crespo and Fontoura, 2005), in addition to the fact that it may be difficult to distinguish one channel from the other as they are often interdependent (Kinoshita, 2001). Recent literature also stresses that the sign, the magnitude and the existence of productivity spillovers appear to depend on idiosyncrasies of the host country and of the foreign direct investment (FDI) project, such as the macroeconomic policies, competition and FDI laws, educational level, size and market share of domestic firms, size and age of foreign firms, degree of ownership and entry mode of the FDI, technological gap between the foreign and domestic firms, degree of geographical proximity of domestic firms to foreign ones, among others, that require further theoretical and empirical attention (Fan, 2002; Meyer, 2003). However, lack of robustness on the role of foreign presence can also be due to inadequacy of the estimation procedures used. This paper focuses this last

aspect by investigating the impact of deficient estimation on the spillover effect, with data at the firm level for the Portuguese manufacturing industry.

Görg and Strobl (2001) and Görg and Greenaway (2004), with a sample of representative papers on the subject, have shown that the results for the spillover effect appear to be affected whether the data used are cross-sectional or panel data. The sign obtained is frequently negative with a panel dataset, in contradiction with the results obtained with many cross-sectional studies. It is well known that the cross-sectional approach may induce significant bias in the estimation of the coefficients if there are unobserved time-invariant firm or specific effects on the relationship between MNCs and productivity that are correlated with the explanatory variables of the model. Together with the fact that the development of domestic firms' productivity should be analysed over a longer period of time and the improvement on panel data estimating techniques, this explains why most recent studies on the subject have opted for panel data models, while in the 1970s and 1980s predominated the cross-sectional data.

Panel data studies, nonetheless, may also not be reliable when they are based, as in the vast majority of studies on this subject, on the classical panel data methods, such as the Pooled OLS (POLS) or the Fixed Effects Estimator (FEE) and the Random Effects Estimator (REE). These methods usually do not take into account features of the data like the existence of unobserved heterogeneity dependent on the regressors (except the FEE), the existence of explanatory variables that are predetermined or even endogenous, thus requiring the use of instrumental variables, and/or statistical properties of the disturbances related to the panel nature of the data that set the need of robust inference. The consequences are inconsistency of the coefficients estimators and/or of the covariance estimators.

In this paper, we investigate whether estimation of the spillover effect with a blind application of the panel data methods suffers from severe bias. For this purpose, these classical estimates are compared with those obtained with the adequate methodology. Our findings point to possible misleading conclusions induced by invalid estimating procedures in most case studies and give directions for a correct approach.

Section 2 introduces the model used in this study to analyse the existence of productivity spillovers. Section 3 discusses the adequate econometric methodology. Section 4 presents the empirical results and section 5 concludes.

2. The empirical model

Following the approach adopted in most studies on the subject, we measure the intra-sectoral spillover effect[1] indirectly, by regressing labour productivity of domestic firms (*PROD*) on a number of covariates assumed to have an effect on productivity, including the presence of foreign firms measured at the sectoral level (*FP*).

To specify the equation that estimates the spillover effect, we have chosen a standard model, based on the pioneering work of Caves (1974) and Globerman (1979), with an extension suggested as indispensable by the empirical literature on this topic, including previous results for Portugal. With this simple model, the estimation issues that motivate this paper can be easily generalised to alternative specifications. Table 1 presents the variables used in this study.

Table 1: Definition of the variables

Variable	Definition
$PROD_{it}$	**domestic productivity** – labour productivity of firm *i* at time *t* measured by the total added value of the firm divided by the respective number of workers.
FP_{it}	**foreign presence** – share of equity capital held by foreign firms in the industrial sector of domestic firm *i*, at time *t*.
SL_{it}	**skilled labour** – total remuneration per worker in domestic firm *i*, at time *t*.
CI_{it}	**capitalistic intensity** – total fixed assets of domestic firm *i* divided by the number of workers, at time *t*.
$H_{it} = \sum_{g \in J} \left(\frac{X_{gt}}{\sum_{g \in J} X_{gt}} \right)^2 \times 100$	**degree of concentration** – Herfindhal concentration index, where X_{gt} represents the output of firm g, at time t; g is an index for the firms (domestic or foreign) belonging to sector J to which domestic firm i belongs.
SE_{it}	**scale economies** – the ratio in % of the output of domestic firm *i* to the average output of the five largest firms (in terms of output) in the industrial sector of firm *i*, at time *t*.

Besides the standard explanatory variables (*FP*, *SL*, *CI*, *H*, *SE*), we have also considered the influence of the technological gap between domestic and foreign-owned firms. In contrast with the remaining extensions provided by literature on this topic, the importance of this latter variable emerges as a solid conclusion in most studies on the

[1] Some recent studies also investigate the existence of inter-sectoral spillovers, associated to backward and forward linkages (see, for instance, Harris and Robinson, 2002, Schoors and van der Tol, 2002, and Smarzynska, 2003), but this is not the motivation of this paper.

subject (Crespo and Fontoura, 2005), including the analysis of Flôres et al. (2002) for the Portuguese case. The reasoning is that if the gap in technological capabilities between the two sets of firms is too large, domestic firms may not be able to benefit from the introduction of new technology (like for instance, copying foreign procedures or benefit from the training of local workers) but, on the other hand, if the gap is too small, domestic firms may not have much to learn from the foreign ones.

To measure the technological gap (TG), we assume, as is usually done in this literature, that higher productivity signals better technology. Therefore, TG_{it} is the ratio of the productivity of domestic firm *i* to the highest productivity level of the foreign firms in the industrial sector of firm *i*. For values below 1, the wider the gap the lower is *TG*. The corresponding model is:

$$PROD_{it} = \beta_1 FP_{it} D_{it} + \beta_2 CI_{it} + \beta_3 SE_{it} + \beta_4 SL_{it} + \beta_5 H_{it} + \lambda_t + \eta_i + \varepsilon_{it}. \quad i = 1,...,n;\ t = 1,...,T \qquad (1)$$

where D_{it} is a dummy variable that takes the value one if TG_{it} is in a specified range and zero otherwise. The choice of an adequate gap is empirically driven. A unit variation of the foreign presence in the sector induces a spillover effect equal to β_1 only if the firm has a technological gap lying in the chosen range.

The error term of this model includes the unobserved heterogeneity of firms, η_i (the permanent effect) and ε_{it}, an idiosyncratic random error which may be heteroscedastic and/or autocorrelated (the transitory effect).

We include fixed time effects[2], λ_t, in order to capture possible common aggregate shocks in production, such as technological progress or other unobserved time-varying (pro-cyclical) influences on productivity.

The unobserved permanent effect, η_i, can be related to a myriad of influences on productivity that are constant over the time period, like those related to the "software" environment for spillovers mentioned by Kokko (1994), managerial skills, environment characteristics, among others. Flôres et al (2002) suggested that, in the case of Portugal, part of this time-invariant influence is related to geographical proximity of firms in the context of agglomeration economies.

It is reasonable to assume that the spillover effect of the MNCs on productivity is lagged which would lead us to define a dynamic model if we had more waves in the

panel. Nevertheless, we can consider that present values of foreign presence are a proxy of past values given that this variable is highly correlated in time.[3]

3. Discussion of the econometric methodology

As previously mentioned, panel data methods commonly used to estimate the spillover effect may not be adequate because either they lead to inconsistent estimators for the unknown coefficients or, even if they are consistent, inference may be invalid.

Consistency in POLS and REE fail if the permanent effect (unobserved heterogeneity) is related to the regressors. We expect this situation to arise in productivity spillovers' models at the firm level, since the unobserved factors explaining firm heterogeneity in what concerns productivity (some were identified in the last section) depend in great deal from the characteristics of the firm itself. The usual alternative approach defines a transformation of the variables, like the deviations from mean (FEE) or the first differences, in order to wipe out the permanent effect of the model.

The consistency of FEE estimators depends on the strict exogeneity of the regressors whereas economic variables are usually predetermined. The estimation of the model for the first differenced variables is less demanding than FEE on the type of exogeneity required and instruments can be easily found to guarantee consistency with predetermined variables. On the other hand, in presence of heteroscedasticity, autocorrelation and strictly exogenous regressors, the GMM estimator in the first-differenced variables model (DGMME), with appropriately chosen instruments, is asymptotically more efficient than the FEE with a robust estimator for the covariance matrix for panels with few observations in time (see Arellano, 2003).

Even if POLS is consistent, inference is invalid unless a robust estimator of the covariance matrix appropriated to the pattern of autocorrelation induced by the permanent effect is used (Wooldridge, 2002).[4] REE specifically addresses this type of autocorrelation by Feasible Generalised Least Squares (FGLS) estimation, traditionally assuming homoscedasticity. However if the transitory effect is heteroscedastic, which

[2] Since time effects are fixed, in practice they are parameters to be estimated corresponding to a different intercept for each year.

[3] This is a common shortcoming as most studies use either the contemporaneous level of foreign presence or relatively short lags, usually one year (Görg and Greenaway, 2004).

[4] The popular Newey-West estimator is not adequate because it assumes that autocorrelation fades away with time, which is not the pattern of autocorrelation induced by the permanent effect. Most softwares use

frequently happens with micro data, and/or displays autocorrelation, its consistency is questionable unless FGLS is tailored to accommodate the particular patterns of the covariance matrix of the error term.

When some of the explanatory variables suffer from endogeneity due to simultaneity, instrumental variable estimation has to be performed. It is well known that high productivity sectors or firms may attract the location of MNCs in the same sector, yielding a positive relationship even without spillovers taking place, as emphasised by Aitken and Harrison (1999). Furthermore, it is highly plausible that workers' remuneration, the proxy for skilled labour, may also depend on productivity itself. Even when additional variables are not available in the data, finding suitable instruments for first-differenced variables is straightforward if observations in levels, conveniently lagged, are correlated with observations in first differences.

With dynamic models extra care has to be taken because of the properties enhanced by the presence of the lagged dependent among the regressors and instrumental variables estimation has to be performed even when the other regressors are strictly exogenous.[5] Bond (2002) addresses specifically dynamic panel data models when the number of observations in time is small.

More recently, Blundell and Bond (2000) introduced the Extended GMM Estimator (EGMME) as an alternative to the DGMME that has shown to produce better estimates for panels with small to moderate number of periods, as it is the case of the example we will consider in the next section.[6] It consists on performing GMM estimation on the set of equations for the differenced variables together with equations for the variables in levels given by model (1).

4. An empirical example

In this paper, we consider data at firm level for the Portuguese manufacturing industry, in the period 1996-1998. Data was compiled from the Dun & Bradstreet database for the period 1996-98 except for the foreign presence proxy, *FP*. The latter was collected from the Ministry of Employment.

The database comprises observations for 2133 firms (of which 1957 are domestic firms and 176 are foreign firms, i.e. MNCs) for each of the three years of our

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a robust block covariance estimator that is consistent to autocorrelation and heteroscedasticity of unknown type for panels that are short in time.

[5] See Arellano (2003) for details on this question.

[6] See Harris and Robinson (2002) for an application of this method to a productivity spillovers' model.

study. We had to reduce the number of domestic firms to 1604, due to the need to exclude sectors without any foreign presence in the whole period to obtain some of the variables we use. Sectoral disaggregation was carried out at the three digit-level of the NACE Nomenclature (Eurostat), which corresponds to 103 sectors, of which only 62 report the existence of foreign firms.

Results were obtained with TSP 4.5. Since we observe 1604 firms belonging to many different economic sectors and having dissimilar characteristics, we expect heteroscedasticity in the error term. Therefore, when possible (i.e., in all estimators but the REE), estimated standard deviations are heteroscedasticity robust. TSP considers for GMM optimal weighting matrices, ensuring asymptotic efficiency and the validity of the Sargan test.

In order to estimate our model, we first need to find an adequate range for *TG*.[7] In view of this, we analyse the correlation coefficient between *PROD* and *FP* within several arbitrarily predefined ranges for *TG*. The choice of the range was based on two criteria: the above mentioned correlation is high and it includes a relevant number of observed firms. In the case of our database, the range between 0.3 and 0.95 appears to be the most adequate, as it displays one of the highest correlations and it includes around 50 % of the observed firms. Table 2 reports the results obtained when the model was estimated considering this range for *TG*.

Evidence of positive spillovers follows from the estimation with FEE, though only at 7% level, and from EGMME. The difference Sargan test detects simultaneity of the foreign presence. Only the estimator from the last column is consistent and, in this case, the estimate of the coefficient of *FP* (significant at 2% level) is, in fact, substantially bigger (75.7 against 9.61 from EGMME with *FP* considered exogenous or 8.16 from FEE). Therefore, we may conclude that ignoring endogeneity of foreign presence severely underestimates the spillover effect.

Our findings seem sufficient clear to warn about spillover results obtained with a non-judicious application of the classical panel data methods. First, we argue that the possible endogeneity of some explanatory variables should be considered and, consequently, tested, for instance with a differenced Sargan test, to ensure that estimates are not significantly biased due to inconsistent estimation. Second, as expected, POLS and REE - which estimate directly models which keep the unobserved heterogeneity of firms depicted in the permanent effect - give systematically erroneously estimates for

the spillover effect, and should not be used. Finally, we detect that the FEE may also severely distort the results, which may be explained by inconsistency due to endogeneity of FP and/or violation of strict exogeneity. In fact, in Table 2, not only the spillover effect comes out clearly undervalued but also distortions are obvious in the case of the remaining explanatory variables.

Table 2: Estimation results for the spillover effect ($0.3 < TG < 0.95$)

Independent Variables	POLS	Fixed Effects	Random Effects	Ext. GMM (endogeneity of SL)	Ext. GMM (endogeneity of SL and FPxD)
C	108.78 (1.34)		242.36 (14.00)	110.82 (2.52)	176.24 (3.73)
FPxD	1.00 (0.07)	8.16 (1.88)	5.74 (1.36)	9.61 (2.68)	75.70 (2.37)
CI	0.88 (1.47)	-0.25 (-1.30)	-0.23 (-3.23)	12.12 (1.81)	7.62 (1.19)
SL	9.02 (4.04)	-0.02 -(0.01)	3.05 (13.75)	8.34 (7.69)	6.73 (6.50)
SE	3.10 (2.09)	5.25 (4.47)	4.15 (13.63)	1.68 (2.00)	1.95 (2.11)
H	8.08 (1.30)	1.78 (0.58)	8.13 (7.43)	1.61 (0.93)	-4.90 (-1.44)
δ96	-28.79 (-2.38)	-72.48 (-7.78)	-61.76 (-8.60)		
δ97	-18.41 (-2.06)	-29.27 (-4.26)	-25.47 (-3.58)	-7.78 (-1.30)	-3.23 (-0.46)
Sargan Test				20.22 (df =9) [P-value=.02]	12.98 (df=8) [P-value=.11]
Diff. Sargan Test					7.24 (df=1) [P-value=.01]

t-statistics (between brackets) with robust standard deviations estimates in POLS, FE and GMM estimates

5. Final remarks

This paper alerts that the traditional panel data techniques commonly used in the literature to identify productivity spillovers from FDI may be invalid. This fact suggests that incorrect estimation procedures may be one of the explanations for the ambiguous results on the evaluation of these spillovers found by the literature on the subject.

We remarked that unobserved heterogeneity has to be properly managed in order that consistency in estimation is attained. We also focussed the need to consider the

[7] See Flôres et al. (2002) for a similar exercise.

possible simultaneity of some explanatory variables (namely the foreign presence, as it is natural to expect that foreign investors might prefer to acquire shares in sectors with better firms), and to do appropriated hypothesis tests which may eventually lead to the estimation with instrumental variables. In this latter case, or with pre-determined regressors, the differenced model is preferable to the fixed effects transformation given that, when there are more than two waves in the panel, it is possible to easily find instruments suitable in most of the situations. Robust estimation of covariance matrices is also indicated to ensure valid inferences. In contrast to the classical panel data methods, GMM allows to deal with these topics as in most packages it easily implements both instrumental variables and robust covariance matrix estimation. When the panel is short in time, the Extended GMM of Blundell and Bond (2000) is specially advised.

The validity of the conclusions of existent empirical studies on this subject are, therefore, conditional upon whether the econometric methodology used controls the special issues we discuss in this paper. In the case of our empirical example, with statistical information for Portugal, we detected a severe underestimation of the spillover effect with the classical panel data methods.

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