Knowledge Spillovers and FDI Ownership

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Abstract

We model knowledge spillovers as a function of absorptive ability, ownership and the number of host country firms. In contrast to earlier studies, we assume a concave relationship between ownership and knowledge spillovers, which we use to derive the levels of ownership at which MNEs are willing to participate in FDI ventures. We find that MNEs typically choose for either high or low degrees of ownership (integration) when knowledge spillovers matter. Only when their activities are sufficiently subsidized, or when the absorptive ability of local firms is very low, will MNEs opt for more equally owned foreign ventures. Utilizing a dataset of firms in 22 transition countries, we then test these propositions. The empirical evidence indeed largely supports our theoretical results. Our findings also imply that ownership requirements imposed by governments in transition countries may have adverse effects on inward FDI.

Key-Words: Knowledge spillovers, multinationals, ownership, transition countries
JEL-Codes: F23, L23, O33

1 Introduction

Recent surveys of the literature regarding knowledge spillovers from FDI have concluded that there exists little consensus about the magnitude, direction or even the existence of knowledge spillovers (Görg and Greenaway, 2004; Barba Navaretti and Venables, 2004). This may in part be caused by econometric problems. Specifically, it has been argued that results depend crucially on the use of cross-section versus time-series data, or on the way in which multinational presence is measured (Görg and Strobl, 2001). Additionally, the intangible nature of knowledge spillovers impedes proper measurement and accordingly, precise empirical estimation.

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Although measurement and methodological problems are potentially valid reasons for the lack of consistency in empirical results, in this paper we put forward a theoretical explanation, that deals with the relationship between knowledge spillovers on the one hand, and different types of FDI on the other. Specifically, we argue that differing degrees of FDI ownership give rise to different amounts of knowledge spillovers. This observation is based on the fact that some knowledge spillover channels are relevant for some types of FDI, whereas they are irrelevant for others. Moreover, the large tacit component in knowledge spillovers will cause differences in spillovers between various types of FDI.

Some earlier studies have also taken into account the relationship between knowledge spillovers and FDI ownership. Müller and Schnitzer (2006) develop a theoretical model in which they consider a Joint Venture (JV) between a Multinational Enterprise (MNE) and a Host Country (HC). They study the effects of spillovers and ownership on the amount of technology transfer (by MNE) and on the profits for both MNE and HC. They show, *inter alia*, that MNE’s profits strictly increase in ownership and strictly decrease in spillovers but that HC, by engaging in active tax or investment policy, can change MNE’s incentives to the advantage of HC. Specifically, although spillovers increase when the MNE decreases its share of ownership, it may become optimal for MNE to share ownership with HC, thus providing a rationale for a joint venture. Accordingly, HC can benefit from increased spillovers through active policy.

Empirically, the relationship between knowledge spillovers and ownership has been studied as well, but the results vary. Blomström and Sjöholm (1999) do not find any evidence of a relationship, whereas Dimelis and Louri (2002) find evidence of minority ownership inducing intra-industry spillovers, in contrast to majority foreign-owned firms. At the other end of the spectrum, Javorcik and Spatareanu (2003) and Javorcik (2004) find evidence of fully foreign-owned firms inducing intra-industry spillovers, whereas partial ownership induces inter-industry spillovers.

A common element in all these studies is that initially a linear relationship between foreign ownership and (intra industry) knowledge spillovers is assumed, i.e. either increased ownership increases spillovers due to an increase in technology transfer by the MNE, or it decreases spillovers due to an increase in MNE control (*cf.* Javorcik, 2006).¹ Our analysis deviates from these studies in that we argue that the relationship between ownership and spillovers is not linear, but curvilinear (concave). Moreover, we also incorporate absorptive ability as a determinant of knowledge spillovers in our model, which has been shown to be relevant (Cohen and Levinthal, 1989; Grünfeld, 2003; Keller, 2004). Additionally, the number of host country firms will be of some importance, as this influences MNE profits.

Our theoretical model shows that MNEs will typically choose rather extreme degrees of integration when engaging in a foreign venture. That is, they will typically require fairly high or fairly low degrees of ownership. Only when sunk

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¹In fact, this dichotomy in the relationship is the reason for Blomström and Sjöholm (1999) to have no *ex ante* expectation regarding the sign of the relationship.
costs or absorptive ability are sufficiently low will the MNE be willing to invest at more equal degrees of ownership. All this is due to the perceived spillover threat of engaging in equally owned joint ventures. In accordance with Müller and Schnitzer (2006), we also find that FDI policy in the host country can (partly) align the interests of the MNE and its foreign partner, but that there exists a trade-off between such FDI policy and host country policy aimed at increasing the absorptive ability of local firms.

Since many transition countries have functioned as important hosts of FDI in recent years, as well as the fact that governments of some of these countries have been known to impose ownership requirements on foreign investors, they provide an interesting setting to empirically test our model. Employing a dataset of approximately 400 firms in 22 transition countries, the empirical results point out that the relationship between FDI ownership and knowledge spillovers may be concave, implying that more equally owned types of FDI potentially create the largest spillover gains for the local partner. However, requiring shared ownership may have adverse effects, leading the MNE to invest in another country since the original investment may no longer be profitable. Instead, subsidizing the FDI project or investing in local absorptive ability may sort larger gains for the transition country.

The remainder of this paper is structured as follows. In section 2 we introduce the theoretical model. Section 3 discusses policy implications and derives three testable propositions. Section 4 presents the empirical analysis and a discussion of the results. Section 5 concludes.

2 The model

This section describes the model that derives the relationship between knowledge spillovers and FDI ownership. Unlike earlier models in this vein (cf. Blomström and Sjöholm, 1999; Dimelis and Louri, 2002; Javorcik and Spatareanu, 2003; Javorcik, 2004; Müller and Schnitzer, 2006) we deviate from the assertion that this relationship is linear and instead propose a curvilinear, concave relationship. Before explaining the rationale for this approach, we first discuss the model setup.

When faced with the choice of investing abroad, the MNE essentially makes two decisions: It decides whether or not to engage in FDI and (provided that it decides to invest) at what degree of integration (i.e. ownership) to do so. In our model, the integration decision is only determined by knowledge spillover considerations and, as we will discuss below, follows directly from the investment decision. As a starting point, we consider technological space in the host country in which the MNE is considering to invest. The location of both the MNE and its potential partner firm in technological space is modeled in a Hotelling-like fashion (Hotelling, 1929). Specifically, we assume that all the host country-firms are located at equal distances from each other and that their location is fixed along a line. Without loss of generality we normalize the length of this line
to 1 so that the distance between two local firms becomes $1/n$. Accordingly, for $n \geq 2$ (an assumption that we will make throughout the paper), the MNE will always locate in between two local firms. Technological distance $x$ is then defined as the distance between the MNE and the local firm that it is closest to, i.e. $0 \leq x \leq 1/2n$. Given that the MNE decides to invest (which it will only if net profits are nonnegative, an issue that we will return to later) the problem it faces is to choose the degree of integration that maximizes profits net of knowledge spillovers. This calls for a relationship between knowledge spillovers and the degree of integration.

The linear relationship that is hypothesized in much of the earlier literature is based on the view that either higher integration gives the MNE more control over the transferred knowledge and consequently leads to less knowledge spillovers, or that higher integration will induce the MNE to transfer more of its own technology to the foreign JV and hence lead to higher spillovers. Accordingly, the sign of the relationship has been left as an empirical matter, but the evidence - as was mentioned before - is ambiguous.

In this paper we argue that the linearity assumption (either positive or negative) may be wrong for two reasons. The first one hinges on the fact that the linearity assumption fully disregards the different channels through which knowledge spillovers from FDI occur. The three main channels that have been distinguished in previous literature are labor turnover, vertical linkages and demonstration effects (Djankov and Hoekman, 2000; Saggi, 2002). Taking these into account, it can be argued that different types of FDI (in terms of integration) lead to the (unintended) employment of different combinations of spillover channels. In fact, under the plausible assumption that, ceteris paribus, the degree of effective knowledge spillovers is positively related to the number of relevant knowledge spillover channels, we argue that intermediate integrated types of FDI potentially lead to the highest spillovers. The reason is that such types of FDI possibly employ all three distinguished knowledge spillover channels. Minority types of FDI on the other hand only lead to demonstration effects and vertical linkages, whereas majority types of FDI only trigger labor turnover as a spillover channel (Smeets and de Vaal, 2006). Accordingly, we expect a curvilinear, concave relationship to appear between integration and knowledge spillovers due to the related number of spillover channels.

The second reason for such a relationship relies on the tacit component of knowledge, as opposed to its codified component. The tacit component of knowledge is embodied in people, routines and practices and requires informal and flexible mechanisms to spill over, such as personal interaction or communication. The codified component on the other hand is embodied in tangibles, such

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2We ignore endpoint problems because our focus is on the MNE’s location decision between two host firms, and not on modeling competition between host firms.

3Note that there is an explicit distinction between a knowledge transfer and a knowledge spillover. The former is a purposeful transmission of knowledge, either from the parent to the JV or between the JV partners. The latter is an externality, i.e. an unconscious diffusion of knowledge from one JV partner to the other. Accordingly, a knowledge spillover may be the result of a knowledge transfer.
as blueprints and products and more easily allows for spillovers through for instance reverse engineering or imitation (Makhija and Ganesh, 1997). Given that codified knowledge spillovers can largely be prevented by means of patenting, this implies that a large part of spillovers are bound to be tacit. Hence those types of FDI that require intensive (and informal) communication and cooperation between all parties involved will potentially create the largest spillovers. Such a situation will arise when the venture is more or less equally shared, giving another reason to expect a concave relationship between the degree of integration and knowledge spillovers. Moreover, since such alliances are often aimed at creating synergies through learning (Makhija and Ganesh, 1997) they require some minimum amount of knowledge transfer (that is, *purposeful* knowledge transmission between the parties involved - see footnote 3). This knowledge transfer allows both parties to integrate the other’s knowledge base and thereby further strengthens spillover potential by adding to the absorptive capacity of the local partner (Lane *et al.*, 2001).

Indeed, the local partner’s ability to absorb external knowledge may be another determinant of knowledge spillovers through partly-owned FDI (Cohen and Levintthal, 1989; Lane *et al.*, 2001; Keller, 2004). We split absorptive capacity into two components: absorptive ability and absorption potential. Both these components are related to the degree of technological similarity between the MNE and its partner: If both firms are technologically very similar absorptive ability is high because the partner firm is technologically able enough to absorb the MNE’s knowledge. However, absorption potential is low in this case, due to the absence of a large technological gap (and thus learning potential) between the MNE and its partner. Conversely, if both firms are technologically very dissimilar, absorptive capacity is low because the partner firm does not have the technological requirements to absorb the MNE’s knowledge. But now, because of the presence of a large technological gap, absorption potential is high. Both effects combined therefore imply a curvilinear, concave relationship between technological distance and the amount of knowledge spillovers through absorptive capacity.

We can summarize this discussion by expressing knowledge spillovers $S$ as an additive function of the degree of integration $I$ and technological distance $x$:

$$S = F [g(I), h(x)]$$

where $g(I)$ denotes the concave relationship between the degree of integration and knowledge spillovers and $h(x)$ denotes the concave relationship between technological distance and knowledge spillovers. In line with the discussion above we assume:

$$g(I) = -I^2 + I$$

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4 A related argument put forward by, *inter alia*, Beamish and Banks (1987) and Blodgett (1992) is that International Joint Ventures (IJVs) with more equal ownership structures promote higher levels of trust between partners and hence lead to increased knowledge exchange.

5 Indeed, Lyles and Salk (1996) found evidence that IJVs with 50/50 ownership control had significantly higher levels of knowledge acquisition than majority controlled IJVs.
and

\[ h(x) = x\left(\frac{1}{n} - ax\right) \text{ s.t. } a \geq 2 \]  

(3)

where \( a \) is the inverse of absorptive ability. The \( x \) in front of the parentheses represents absorption potential, whereas the term within parentheses represents absorptive ability. The inclusion of the term \( 1/n \) guarantees that \( h(x) \) reaches its optimum within the domain of the model.\(^6\) To see this, recall that technological distance \( x \) is defined with respect to the local firm that is closest to the MNE, so that \( 0 \leq x \leq 1/2n \). Given our discussion of the curvilinearity between \( S \) and \( x \), this implies that \( h(x) \) should reach its optimum within this interval: This is indeed guaranteed by the inclusion of the term \( 1/n \), given the restriction \( a \geq 2 \).

To add \( g(I) \) and \( h(x) \) together into the spillover function \( S \), we need to specify a relationship between the degree of integration and technological distance. On the one hand, we could model a positive relationship between \( I \) and technological distance \( x \). The view that underlies such a relationship perceives technological proximity as an opportunity. This implies that the MNE values a partnership more when the partner is technologically more similar to the MNE. Accordingly, it will lower its degree of integration. Alternatively, one could argue that the MNE will consider technological proximity as a threat and thus increases its degree of integration when its partner is technologically more similar. This view is in line with more established theories of the MNE such as the OLI-paradigm (Dunning, 1977) and the knowledge-capital model of FDI (Markusen, 2001). Moreover, it also accords with the argument put forward by Makhija and Ganesh (1997) that asymmetry in capabilities between JV partners is one of the key motivations to form a JV in the first place. Therefore we specify a positive relationship between technological proximity and integration, or equivalently, a negative relationship between integration and technological distance (asymmetry):

\[ I = 1 - 2xn \text{ s.t. } 0 \leq x \leq 1/2n \]  

(4)

Note that this formulation ensures that \( I \) is bounded on the domain \([0,1]\). Now, if we put this formulation of \( I \) back into \( g(I) \) in (2) and then add both \( g(I) \) and \( h(x) \) we obtain an explicit formulation for the spillover function in (1):\(^7\)

\[ S = -x^2(a + 1) + \frac{3x}{2n} \]  

(5)

Of course, the MNE’s integration decision is not solely dependent on the amount of spillovers it faces. Therefore, we also introduce a simple profit function. We assume that JV profits (i.e. the profits of both the MNE and its

\(^6\)This formulation also implies that absorptive capacity \( h(x) \) decreases as the number of local firms \( n \) increase. An intuition for this is that for a given amount of absorptive capacity, for instance in terms of skilled labor present in the host economy, an increase in \( n \) will lead to a decrease in absorptive capacity per firm, due to a reallocation of skilled labor over the extended set of local firms.

\(^7\)While adding \( g(I) \) and \( h(x) \) we scale down the former by \( 4n^2 \). The reason for doing so is that we have no \textit{ex ante} motivation to expect a relationship between \( S \) and \( n \) through \( I \). Indeed, the only reason for \( 2n \) to appear in (4) is to assure that \( I \) is bounded on \([0,1]\). Hence by dividing \( g(x) \) by \( 4n^2 \) we get rid of the unwanted concave transformation on \( 2n \) in (4).
partner firm) are positively related to technological distance $x$ (again in line with the need for asymmetry assumption) and negatively related to the total number of local firms (which represents a market stealing effect):

$$\pi_{JV} = \frac{x}{n}$$

(6)

The MNE’s share of these profits is then proportional to its degree of ownership $I$, minus some amount of sunk costs $c$ that it has to incur when investing in the host country:

$$\pi_{MNE} = I \left( \frac{x}{n} \right) - c = -2x^2 + \frac{x}{n} - c$$

(7)

Note that the MNE profit function thus becomes a concave function of technological distance (and also of the degree of integration by virtue of (4)). This implies that increased technological distance first leads to increased MNE profits (at a decreasing rate), then reaches a maximum and thereafter lowers MNE profits (at an increasing rate). This relationship is caused by two opposing effects following from an increase in $x$: On the one hand, an increase in $x$ induces an increase in $\pi_{JV}$ (and thus an increase in $\pi_{MNE}$) due to an increase in asymmetry between the MNE and its partner. On the other hand, an increase in $x$ also induces a decrease in $I$ and thus lowers MNE’s share of $\pi_{JV}$. As long as the former effect outweighs the latter, MNE profits will increase.

An important implication from the concavity of MNE profits and knowledge spillovers with respect to $x/I$ is that we obtain potentially two MNE participation constraints. Without the presence of knowledge spillovers, the participation constraints could simply be derived from the condition that $\pi_{MNE} \geq 0$. However, since we explicitly allow for knowledge spillovers, this condition becomes $\pi_{MNE} - S \geq 0$. Note that when this condition is satisfied, not only do we know that the MNE will engage in FDI, but we can also immediately derive the degree(s) of integration at which it will do so. We illustrate this graphically by means of Figure 1 below.

![Figure 1: MNE Participation Constraints](image-url)
The solid curve in the figure denotes spillovers $S$ and the dashed curve denotes MNE profits $\pi_{MNE}$, both as a function of technological distance. The participation constraint is determined at the point where knowledge spillovers are equal to profits. Hence the participation constraint can be expressed in terms of technological distance $x$, and therefore also in terms of the degree of integration $I$ according to (4). From the figure it follows that there are potentially two participation constraints: One lower constraint $\hat{x}_L$ and one upper constraint $\hat{x}_U$. In between these two constraints, knowledge spillovers are larger than MNE profits and the MNE will not invest in the host country. Consequently, only for degrees of integration lower than $\hat{x}_L$ (which correspond to relatively high degrees of integration) or above $\hat{x}_U$ (which correspond to relatively low degrees of integration) will the MNE invest in the host country.

More formally, we can derive the participation constraints by letting $S$ in (5) equal $\pi_{MNE}$ in (7). This yields:

$$\hat{x}_L = \frac{\Lambda^-}{2(a-1)}, \quad \hat{x}_U = \frac{\Lambda^+}{2(a-1)}$$

where

$$\Lambda = \frac{1}{2n} \pm \sqrt{\frac{1}{4n^2} + 4c(a-1)}$$

Note that the existence of either participation constraint is not guaranteed. In the Appendix we derive specific cost conditions to assure the existence of one or both of the participation constraints. Furthermore, we would like to note that the condition $\pi_{MNE} - S \geq 0$ is more restrictive than $\pi_{MNE} \geq 0$ if $S \geq 0$. Indeed, in our model we only allow for positive knowledge spillovers. Negative spillovers would effectively imply knowledge spilling over from the partner firm to the MNE; although earlier literature has identified conditions under which this may happen (Fosfuri and Motta, 1999; Driffield and Love, 2003) it is not our present focus, since we assume that the MNE is technologically more advanced than its local partner.8

3 Model implications

Albeit relatively simple, the model developed in the previous section already yields some interesting implications, both from a policy perspective as well as from an empirical point of view. In this section we will first present some intuition regarding the policy implications of the model. Second, we will discuss the comparative static properties of the model. Deriving the marginal effects of our model parameters on the participation constraints serves a double purpose: We obtain additional insight in the workings of the model and at the same time it allows us to derive some propositions that we use for our empirical investigation in Section 4.

8Looking ahead a bit already, this seems an acceptable assumption in the case of most IJV s in transition countries.
3.1 Policy implications

In our model, two parameters play a crucial role in determining the participation constraints: Sunk costs $c$ and absorptive ability $1/a$. First consider the effect of varying sunk costs in our model. Obviously, sunk costs affect the participation constraints only through MNE profits in (7). Suppose that sunk costs decrease: In terms of Figure 1 this implies that, ceteris paribus, the MNE profit curve will shift upward, shifting the two participation constraints inward and consequently inducing the MNE to consider investing at more equal degrees of integration. For the local partner firm, this is a favorable development since knowledge spillovers increase as well. Consequently, according to our model, host country policies subsidizing inward FDI (or more accurately: inward JV activity) can align the incentives of both the MNE and its local partner, leading to more equally owned JVs in which spillovers are higher.10

Second, consider the effect of absorptive ability $1/a$. Absorptive ability affects the participation constraints through the absorptive capacity function in (3). A decrease in absorptive ability (i.e. and increase in $a$) decreases effective spillovers $S$ in two ways: It makes spillovers peter out more quickly (in terms of Figure 1, the upper participation constraint shifts towards the origin of the figure) and it causes the maximum amount of effective spillovers to decrease (in terms of Figure 1, the optimum of $S$ shifts down). These two effects combined can cause the upper participation constraint to vanish altogether, implying that the MNE will find it profitable to invest for the entire range of $I$ below $\bar{x}_L$ (recall that $\bar{x}_L$ corresponds to $\bar{I}_U$). However, although this will thus again lead the MNE to consider more equally owned types of FDI, this is no longer in the best interest of the local partner, since the spillover optimum has shifted as a result of decreased absorptive capacity as well. Accordingly, from the local partner’s point of view, a favorable policy strategy of the host country government is to stimulate the creation of sufficient absorptive capacity, causing both the extent of spillovers as well as the maximum amount of effective spillovers to increase.

Given that the government is budget constrained, there thus arises a policy trade-off in this model: The government budget can be directed either toward subsidizing inward FDI and thus lowering sunk costs for the investing MNE, or it can be used in order to provide e.g. high quality education and training to the economy’s labor force so that absorptive capacity is increased (cf. Wang and Blomström, 1992: pp. 151-152). Although from a normative point of view it may be tempting to conclude that investing in absorptive capacity would be first-best, it has to be noted that the benefits of such a policy strategy may take several years to take effect. Indeed, a one-shot subsidy granted to a potential foreign investor will yield gains that are almost instantaneous. Accordingly, the optimal policy strategy will depend on the context in the host economy and be

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9 Of course, the number of local firms $n$ is also of some importance, but since this number cannot be directly influenced by any of the JV partners or the government of the host country, we will only discuss its comparative static properties later on.

10 Surely, such FDI subsidizing policies are often observed empirically (cf. Blomstrom and Sjöholm, 2003; Davies, 2005).
influenced by issues such as rates of time preference, the extent to which the local
government is budget constrained and the composition of the local labor force.

Moreover, an additional implication from the model in Section 2 is that im-
posing ownership requirements on foreign investors may have adverse effects on
inward FDI. From Figure 1 it is clear immediately that requiring JV ownership
to be shared relatively equally with local firms may lead to negative net profits
for the MNE and hence deter the FDI project altogether. On the other hand,
in view of the discussion above, combining such requirements with additional
FDI subsidizing policies could have the intended effect if the combination of
ownership requirements and granted subsidies is properly balanced.

Finally, although the above intuition regarding the policy implications of our
model is rather straightforward, an important remark has to be made, which
is that the existence of the participation constraints is not guaranteed, at least
not within the domain of the model. For instance, technically both constraints
could also be located outside the domain of the model, which makes a discussion
of participation constraints irrelevant. In the Appendix, we derive four cost
conditions that together assure the existence of one or both the participation
constraints. The results there leave the general intuition derived here intact, but
introduce an additional qualification: Only when the host country government
subsidizes the FDI project by an amount that matches or exceeds the sunk costs
incurred by MNE will both participation constraints exist simultaneously.

3.2 Comparative Statics

In the previous subsection we have discussed the policy implications of our
model. Now we turn to a close inspection of how the participation constraints
change when either of the key parameters changes, i.e. we consider the com-
parative statics of our model. Apart from generating additional insight into the
workings of our model, the comparative statics will also yield propositions on
which we will base our empirical investigation in the next section.

In our model three parameters determine the decision of MNEs to engage
in FDI and their choice of ownership \((n, a, c)\). Since we have potentially
two participation constraints, we also have to check the comparative statics for
both. Table 1 below summarizes all the comparative static effects in our model,
evaluated at the two participation constraints, both in terms of technological
distance \(x\) and the degree of integration \(I\) (which follows from the relationship
in (4)). What follows is a largely intuitive discussion of these effects in terms
of \(I\). A more formal derivation of the comparative statics is relegated to the
Appendix.

<table>
<thead>
<tr>
<th>Parameter</th>
<th>(\frac{\partial x_L}{\partial I})</th>
<th>(\frac{\partial I(x_U)}{\partial I})</th>
<th>(\frac{\partial x_L}{\partial (\cdot)})</th>
<th>(\frac{\partial I(x_L)}{\partial (\cdot)})</th>
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Notes: (a) Negative if \(c > 0\), positive otherwise
First consider the influence of a change in the number of local firms \( n \) on the two participation constraints. As long as both the \( I \) participation constraints exist (i.e. as long as \( c \leq 0 \) - see the previous subsection and the Appendix), an increase in the number of local (competitor) firms will induce the MNE to invest at more equal degrees of integration. The reason for this is that an increase in \( n \) will lead both JV profits and spillovers to decrease, but the latter decreases faster than the former.\(^{11}\) Accordingly, given that net profits are thus increasing over the entire range of ownership structures, the MNE will thus be able to opt for more equal degrees of ownership while still obtaining nonnegative net profits. However, as soon as \( \hat{I}(\hat{x}_L) \) disappears (i.e. as soon as \( c > 0 \) ), an increase in \( n \) will cause the MNE to lower its degree of integration unambiguously. The reason is that due to positive sunk costs, net profits are negative for high degrees of integration. Although the increase in \( n \) will still decrease both profits and spillovers, this decrease is not sufficient to make net profits positive for high degrees of integration. Since the only participation constraint that is left is located at relatively low degrees of integration, the MNE will opt for increasingly lower degrees of integration after an increase in \( n \) to compensate the profit loss by a cut in spillover costs.\(^{12}\)

Second, consider the influence of a change in absorptive ability \( 1/a \) on the participation constraints. From the table it follows that a decrease in absorptive ability (i.e. an increase in \( a \) ) will cause the MNE to invest at more equal degrees of ownership. More equal ownership structures become more attractive, since now there is less potential of knowledge spilling over to the partner. Consequently, the cooperative gains motivation in favor of cooperation tends to dominate the spillover-hazard argument against cooperation as absorptive ability weakens.

Finally, consider the effect of a change in sunk costs. The table indicates that an increase in sunk costs will lead the MNE to invest at more extreme degrees of ownership. If the MNE is already highly integrated, increasing sunk costs will lead it to further increase its degree of ownership in order to recoup the increased sunk costs by capturing a larger part of JV profits. On the other hand, if the MNE has only a small degree of ownership to begin with, it will not choose to increase its degree of integration because in that case, knowledge spillovers will increase as well. Therefore it will further decrease ownership, thereby decreasing its spillover costs and thus compensating for the increased sunk costs.

Assuming that our assumptions regarding the concavity of the relationship between ownership and spillovers on the one hand, and profits and ownership (technological distance) on the other hand are correct, and consequently that our model implications hold up as well, we can derive three testable propositions from these comparative static results:

\(^{11}\)From (7) and (5) it can be derived that, \textit{ceteris paribus}, spillovers decrease by a fraction of 3/2 of JV profits.

\(^{12}\)Recall from Figure 1 that \( \hat{I}(\hat{x}_L) \) is locate to the right of the spillover maximum. Accordingly, increasing integration (given that net profits are negative to the left of \( \hat{I}(\hat{x}_L) \) ) would serve to increase spillover costs.
Proposition 1 An increase in the number of local (competitor) firms will have an ambiguous effect on the observed degree of MNE ownership in a JV between a MNE and a local firm.

Proposition 2 An increase in the absorptive ability of the local partner firm(s) will cause the MNE to choose more extreme (i.e. less equal) degrees of ownership in a JV between a MNE and a local firm.

Proposition 3 An increase in the sunk costs incurred by the MNE will cause the MNE to choose more extreme (i.e. less equal) degrees of ownership in a JV between a MNE and a local firm.

Equipped with these three empirically testable propositions, we are now ready to test our theoretical model empirically in the next section.

4 Empirical evidence

As we already noted before, earlier papers have modeled or assumed a linear relationship between knowledge spillovers and ownership (Blomström and Sjöholm, 1999; Dimelis and Louri, 2001; Javorcik and Spatareanu, 2003; Javorcik, 2004). Although the evidence in favor of this linear relationship has been rather mixed, nonetheless it has been confirmed to some extent. Therefore, in order to give support to the model proposed here, we will present some empirical evidence in an attempt to strengthen our argument in favor of a concave relationship between knowledge spillovers and FDI ownership.

4.1 Data and method

From an empirical point of view, the countries in Central and Eastern Europe make an interesting set of testcases for our present purposes. First of all, the flow of FDI into many of these countries has increased heavily during the past years due to their transition from a centrally planned to a market economy. Second, the governments in these countries have been known to restrict foreign ownership in particular cases, thus conveying their suspicion regarding the relationship between ownership structure and the extent to which this may benefit the local economy (Lyles and Salk, 1996; Hoekman and Javorcik, 2006).

Because we have no command over any firm-level dataset, pertaining to transition countries, that allows for the simultaneous calculation of productivity measures as well as degrees of MNE ownership, we will investigate the indirect (comparative static) propositions of Section 3. The data for our empirical analysis are derived from the World Bank’s Business Environment and Enterprise Performance Survey (BEEPS). This survey contains data on 4104 firms in 22 transition countries over the period 1999-2000. The questions in the survey mainly address issues regarding the (institutional) business environment and its influence on the firm’s functioning and performance. Yet some of these
variables may be interpreted as proxies for sunk investment costs, number of competitor firms and absorptive ability.

In the original database, only 500 firms are (partly) foreign owned. Since our model does not concern purely domestically owned firms, we limit our sample to these 500 firms. However, in matching the observations of the different variables included in the regressions we lose another 110 observations, so that 390 firms remain.

As our dependent, we compute a dummy variable, taking the value of 1 for equally owned subsidiaries, and 0 for minority, majority of fully owned firms. Determining the boundaries in degree of ownership for which a firm is marked as "equally owned" is of course somewhat arbitrary. Therefore, we experiment with different intervals ranging from 33%-66% to 45%-55% as the ranges for which we interpret ownership as equally shared.

The first explanatory variable, competitors measures the perceived number of competitors in the domestic market and thus is a measure for n. The variables state investment, credit obstacles and state employment intervention measure the amount of fixed investment that is financed through the state government (as a % of total fixed investment), the firm’s perceived obstruction of receiving (information on) credit (on a 1-4 scale) and the regularity with which the government intervenes in the firm’s employment decisions (on a 1-6 scale) respectively. These three variables may thus be regarded as being somewhat related to sunk/fixed costs c of investment. Finally, skilled workers measures the actual level of skilled workers in the firm relative to the desired level. The final variable interacts this variable with a dummy that takes the value 1 for those transition countries that have recently become a member of the European Union, since it may be expected that the general skill level of these countries is higher (and thus of more relevance to MNEs) than those of the other transition countries. These variables hence relate to absorptive ability 1/a. Table 2 below provides some summary statistics and cross-correlation coefficients.

| Table 2: Summary Statistics and Correlation Coefficients |
|-----------------|-----------------|-----------------|-----------------|-----------------|-----------------|-----------------|-----------------|-----------------|-----------------|-----------------|-----------------|
|                  | Mean | SD  | 1    | 2    | 3    | 4    | 5    | 6    | 7    | 8    | 9    |
|__________________________________________________________|
| 1. Invert: 33-66|     |     | 0.22 | 0.42 | 1.00 |     |     |     |     |     |     |
| 1. Invert: 40-60|     |     | 0.27 | 0.45 | 0.89 | 1.00 |     |     |     |     |     |
| 1. Invert: 45-55|     |     | 0.16 | 0.37 | 0.64 | 0.73 | 1.00 |     |     |     |     |
| 1. Compet.    | 2.63 | 0.66 | 0.05 | 0.06 | -0.01 | 1.00 |     |     |     |     |     |
| 1. State Inv. | 1.02 | 7.15 | 0.14 | 0.11 | 0.08 | -0.01 | 1.00 |     |     |     |     |
| 1. Credit Obs.| 2.29 | 1.13 | 0.02 | 0.02 | -0.02 | -0.09 | 0.11 | 1.00 |     |     |     |
| 1. State Empl.| 5.47 | 1.05 | 0.11 | 0.10 | 0.04 | 0.08 | -0.09 | -0.10 | 1.00 |     |     |
| 1. Skilled    | 3.81 | 1.02 | 0.00 | -0.03 | -0.09 | 0.10 | 0.01 | -0.01 | 0.07 | 1.00 |     |
| 1. EU Skilled | 1.57 | 2.03 | -0.10 | -0.12 | -0.02 | 0.01 | -0.11 | -0.09 | -0.03 | 0.29 | 1.00 |

Notes: Number of Observations = 390

Given that our dependent variable is a binary variable that takes the value of 1 when the firm JV is equally owned and 0 otherwise (i.e. minority, majority or fully foreign owned), the appropriate econometric method is probit analysis. Accordingly, the following model will be tested empirically:

\[ I_{equal} = \Phi(x_i' \beta) + \epsilon_i \quad \text{s.t.} \quad \epsilon_i \sim N(\mu, \sigma^2) \] (10)

where \( \Phi(\cdot) \) denotes the standard normal distribution function and \( x_i' \) is a vector containing the explanatory variables that were discussed before. As an addi-
tional remark, we would like to note that the specification of this model is in fact conditional on an earlier decision by the MNE, i.e., the decision to engage in FDI in the first place. A solution to this problem would be to estimate a bivariate probit, in which the first equation describes the probability that a firm engages in FDI and the second then estimates the ownership decision. However, in the database we have no information regarding the factors that have been shown to influence the FDI decision (Markusen, 2001) so that this two-step procedure is not feasible. However, Javorcik (2006) shows that estimating such a two-step procedure leads to very similar results as those obtained in the one-step probit. Moreover, in our theoretical model, the ownership decision directly follows from the investment decision, so that also from a theoretical point of view, the one-step approach is somewhat warranted.

### 4.2 Results and discussion

Table 3 below presents the estimation results from the model in (10). For three out of four regressions, the coefficient on *number of competitors* is positive, which is partly in accordance with our expectations. However, it is never significant. It should be noted however, that this variable takes on only three values: 1 if there are no competitors, 2 if there are 1-3 competitors and 3 if there are more than 3 competitors. Hence, this variable does not allow for a great deal of variability and this may explain its insignificance in Table 3.

<table>
<thead>
<tr>
<th>Table 3: Probit analysis of ownership</th>
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<tbody>
<tr>
<td></td>
</tr>
<tr>
<td><strong>33% ≤ I ≤ 66%</strong></td>
</tr>
<tr>
<td>----------------------</td>
</tr>
<tr>
<td><strong>Constant</strong></td>
</tr>
<tr>
<td></td>
</tr>
<tr>
<td><strong>Competitors</strong></td>
</tr>
<tr>
<td></td>
</tr>
<tr>
<td><strong>State Investment</strong></td>
</tr>
<tr>
<td></td>
</tr>
<tr>
<td><strong>Credit Obstacles</strong></td>
</tr>
<tr>
<td></td>
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<tr>
<td><strong>State Employment Interv.</strong></td>
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<tr>
<td></td>
</tr>
<tr>
<td><strong>Skilled Workers</strong></td>
</tr>
<tr>
<td></td>
</tr>
<tr>
<td><strong>Skilled Workers x EU-dum</strong></td>
</tr>
<tr>
<td></td>
</tr>
<tr>
<td><strong>McFadden R^2</strong></td>
</tr>
<tr>
<td><strong>Log-Likelihood</strong></td>
</tr>
<tr>
<td><strong>N</strong></td>
</tr>
</tbody>
</table>

Notes: Huber/White-robust standard errors within parentheses. *=0.1sig. **=0.05 sig. ***=0.01 sig.

The coefficient on *state investment* is positive and significant in three out of four regressions. This variable may be interpreted as a form of government...
subsidy to attract new business by providing easy capital for financing sunk investment. Accordingly, more state investment implies lower relative sunk costs. In our model, this in turn implies more equally shared FDI types, which is in accordance with these empirical results. The coefficient on credit obstacles is negative, as we expected given that higher credit obstacles potentially increase sunk investment costs. However, it is insignificant in all regressions. The coefficient on state employment intervention is positive and significant in three out of four regressions. This variable measures in reverse scale, i.e. an increase in its value means less government intervention. Given that state employment intervention such as dismissal-protection increases operating costs, again this result is in line with our expectations. Finally, the coefficient on skilled workers is negative, and significant when interacted with the EU-dummy. The interpretation of this variable is less clear: It implies that when we move from too many skilled workers compared to the desired level, towards too few skilled workers, the probability of observing equally shared FDI increases. The connotation is that companies with too few workers compared to the desired level are more likely to be equally shared, which appears in line with our theoretical model’s prediction on the relationship between absorptive ability and integration.\footnote{Still, it seems a bit strange that the firm would want to employ more knowledge workers in this case, since this would only increase knowledge spillovers. Nonetheless, if a local staff-member were to answer this question (which is not unlikely given the nature of the survey from which these variables were taken) it is not surprising to find that they would want to employ more knowledge workers in order to capture knowledge spillovers from the foreign partner.}

Another fact that stands out from Table 3 is that whereas the first three regressions perform reasonably well in terms of the significance of the explanatory variables, the fourth clearly underperforms. An obvious reason for this is that the interval in which firms are considered "equally shared" in the final model is relatively small compared to the intervals of the other models. In fact, for $33\% \leq I \leq 66\%$ there are 125 equally shared firms, for $40\% \leq I \leq 60\%$ this number is 106 and for $45\% \leq I \leq 55\%$ there are 64. Thus this number decreases relatively strongly in the last model, indicating that this interval could very well be too small.

As we already discussed before, some transition countries impose(d) legal requirements regarding the extent of ownership that a foreign firm is allowed to control in domestic firms (cf. Golub, 2003; Javorcik, 2006). Rationales for such requirements are often along the lines of the desire to maintain the sovereignty of specific industries (such as defense) or the belief that restricting foreign ownership allows more easy access to foreign technology. Whichever the reason, such restrictions effectively imply that FDI is less than fully owned simply because this is imposed by law. Accordingly, observing equally owned types of FDI and relating this to spillover considerations in such countries would be false. In order to correct for this, we re-estimate the model in (10) now including country-dummies to correct for \textit{inter alia} legal ownership restrictions. Table 4 below presents the results.

The results in the table indicate that the estimates are quite robust to the
Table 4: Robustness analysis of ownership

<table>
<thead>
<tr>
<th></th>
<th>33%≤f≤66%</th>
<th>33%≤f≤66%</th>
<th>40%≤f≤60%</th>
<th>45%≤f≤55%</th>
</tr>
</thead>
<tbody>
<tr>
<td>Constant</td>
<td>-1.98 (0.63)</td>
<td>-0.98 (0.69)</td>
<td>-1.00 (0.21)</td>
<td>-0.36 (0.22)</td>
</tr>
<tr>
<td>Competitors</td>
<td>0.12 (0.12)</td>
<td>0.12 (0.12)</td>
<td>(0.12) (0.12)</td>
<td>0.04 (0.12)</td>
</tr>
<tr>
<td>State Investment</td>
<td>0.03** (0.01)</td>
<td>0.03** (0.01)</td>
<td>0.02** (0.01)</td>
<td>0.02* (0.01)</td>
</tr>
<tr>
<td>Credit Obstacles</td>
<td>-0.04 (0.07)</td>
<td>-0.03 (0.07)</td>
<td>-0.03 (0.07)</td>
<td>0.00 (0.07)</td>
</tr>
<tr>
<td>State Employment Interv.</td>
<td>0.17** (0.08)</td>
<td>0.18** (0.08)</td>
<td>0.14* (0.08)</td>
<td>0.11 (0.08)</td>
</tr>
<tr>
<td>Skilled Workers</td>
<td>0.06 (0.08)</td>
<td>0.24** (0.11)</td>
<td>0.23** (0.11)</td>
<td>0.14 (0.12)</td>
</tr>
<tr>
<td>Skilled Workers x EU-dum</td>
<td>-0.44*** (0.17)</td>
<td>-0.49*** (0.17)</td>
<td>-0.43** (0.17)</td>
<td>0.00 (0.17)</td>
</tr>
<tr>
<td>Country Dummies</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>McFadden $R^2$</td>
<td>0.134</td>
<td>0.145</td>
<td>0.035</td>
<td>0.017</td>
</tr>
<tr>
<td>Log-Likelihood</td>
<td>-211.0</td>
<td>-209.0</td>
<td>-220.2</td>
<td>-171.2</td>
</tr>
<tr>
<td>N</td>
<td>390</td>
<td>390</td>
<td>390</td>
<td>390</td>
</tr>
</tbody>
</table>

Notes: Huber/White-robust standard errors within parentheses. * = 0.1 sig. **= 0.05 sig. ***= 0.01 sig.

Inclusion of country dummies. A notable change is the effect of absorptive ability on the probability of observing equally owned types of FDI. In this case we observe a positive and significant effect of "skilled workers" individually, and a notably stronger and negative effect of this variable interacted with the EU dummy. This indicates that increased absorptive ability actually increases the probability of observing equally owned FDI in non-EU accession members, whereas it decreases this probability for the new EU-accession members. One explanation for this result is that below some threshold level of worker skill, an increase actually promotes equal ownership because of its dominant effect on joint profits through technological complementarity. However, once this threshold is reached, the spillover threat begins to dominate and we again observe a decrease in equally owned types of FDI. Indeed, it seems plausible that the non-EU transition countries are yet to reach this threshold skill level.

Summarizing these results in terms of our three propositions in Section 3, we find that proposition one has neither been confirmed nor rejected, whereas propositions two and three have been largely confirmed by the empirical results. Accordingly, the evidence for transition countries seems to be supportive of our theoretical model, hypothesizing a curvilinear relationship between knowledge spillovers and ownership. However, it is noted that they should be interpreted with caution, since they do not test the direct relationship between knowledge spillovers and FDI ownership. Testing this direct relationship as proposed by our model (i.e. a curvilinear, concave one) seems an interesting area of future research.
5 Conclusion

In this paper, we have proposed an alternative explanation for the diverse findings in the FDI-spillover literature that is based on the FDI ownership structures. Specifically, we have deviated from earlier literature by positing a concave relationship between FDI ownership and knowledge spillovers instead of a linear one. We also include absorptive capacity and the number of local (competitor firms) in our model in order to derive participation constraints that determine the range of ownership degrees at which the MNE will be willing to invest abroad, despite the fact that spillovers exist.

The results of our theoretical model show that the MNE will typically choose rather extreme degrees of integration when investing abroad. However, the range of ownership degrees over which the MNE is willing to setup a foreign production facility will increase due to either a decrease in absorptive ability of the local firm and a decrease in sunk costs. As a result, the MNE will then be more willing to engage in equally shared ventures with foreign partners, which benefits the partner firm (and therefore also the host country) in terms of higher knowledge spillovers. The effect of an increase in the number of local (competitor) firms is ambiguous.

We then used these proposed marginal effects to conduct an empirical investigation in order to give some support to our hypothesized concave relationship between FDI ownership and spillovers. Employing a dataset of approximately 400 firms in 22 transition countries we indeed empirical evidence of the proposed marginal relationships, indicating that our assumption regarding the relationship between spillovers and ownership is appropriate. Moreover, including fixed country effects in order to correct for inter alia ownership requirements imposed by host governments in transition countries leaves our initial results largely intact.

Policy implications from our analysis mainly follow from our discussion in Section 3. There we discussed that an implication of our model is that if knowledge spillovers arise from MNE activity, government policy subsidizing inward FDI may indeed be valid to some extent. However, in assessing the amount of money spent on subsidizing foreign activities, policy makers should also recognize the positive effect of increasing absorptive ability. Specifically, spending more money on FDI-policy through subsidies may lead to less investment in absorptive ability, implying a trade-off between these two policy strategies. Context specific factors such as the extent to which the government is budget constrained and the general rate of time preference in the economy will eventually determine the optimal policy. Additionally, from our model it also follows that imposing ownership requirements without any additional policy measures may serve to deter inward FDI. Only by finding a balanced combination of FDI subsidies and ownership requirements can such policies have beneficial effects.

All in all, we believe to have shown that FDI ownership may indeed affect knowledge spillovers in a non-trivial manner. In empirical economic modeling this relationship has been largely absent. Those studies that do take account of the relationship have assumed it to be linear instead of concave. Indeed, the
literature’s broad neglect of the relationship between FDI ownership structures and knowledge spillovers could provide a possible explanation for the apparent lack of consensus in empirical results. Accordingly, more empirical research, specifically investigating a potential concave relationship between knowledge spillovers and ownership, is warranted.

References


Appendix

Participation Constraint Existence

In order to see why the existence of either one of the participation constraints in (8) is not guaranteed, if suffices to recall that $x$ is bounded between 0 and $1/2n$. Accordingly, the participation constraint $\tilde{x}$ should also be located somewhere in between these two values in order to be defined. Since we know the exact domain on which $x$ is defined, it is fairly straightforward to derive some conditions that guarantee their existence.

In order for the lower constraint to exist, it has to be located at or above the lower bound of the domain of our model, i.e. it has to be larger than or equal to 0. From this it follows that:

$$\frac{1}{2n} \geq \sqrt{\frac{1}{4n^2} + 4c(a - 1)} \quad c[1]$$

$$\Rightarrow c \leq 0$$

We can derive the cost condition that guarantees the existence of the upper participation constraint in a similar way:

$$\sqrt{\frac{1}{4n^2} + 4c(a - 1)} \leq \frac{2a - 3}{2n} \quad c[2]$$

$$\Rightarrow c \leq \frac{4a - 8}{16n^2}$$

From Figure 1 and our formulation of knowledge spillovers in (5) and profits in (7), it follows that a situation may arise at which MNE profits are larger.
than knowledge spillovers over the entire domain of $I$.

In this situation, both participation constraints obviously do not exist. In order to determine under what condition this situation will arise, we note that in the limit (i.e. in the situation just before profits become strictly larger than knowledge spillovers over the entire domain) the upper and lower participation constraint will coincide ($\hat{x}_L = \hat{x}_U$). From this we can derive a "lower bound" cost condition that guarantees the existence of the participation constraint(s):

$$c \geq -\frac{1}{16n^2(a - 1)} \quad \text{c[3]}$$

If c[3] is not satisfied, MNE profits will thus be strictly higher than knowledge spillovers over the entire domain and no participation constraint will exist. This can also be seen by noting that allowing $c \leq 0$ introduces the possibility of a negative square root in (8). As it turns out, the condition that ensures this square root to be nonnegative is the same as c[3] which indeed implies that if c[3] is not satisfied, the participation constraints are not defined.

As mentioned in Section 2 we already established that since we only allow for nonnegative knowledge spillovers, $\pi_{MNE} - S \geq 0$ directly implies $\pi_{MNE} \geq S$. Accordingly, if we establish a condition under which spillovers are positive and relate this to the participation constraints, we can establish a condition under which net profits will be nonnegative. From (5) it is easily derive that $S \geq 0$ requires $x \leq 3/2n(a + 1)$. Accordingly, we also require our participation constraint to be less than or equal to this value. Rewriting this requirement of nonnegative net profits in terms of sunk costs c yields:

$$c \leq \frac{3}{2} \frac{a - 2}{n^2(a + 1)^2} \quad \text{c[4]}$$

We have now established four cost conditions. The question arises how they compare to each other. To this end, consider Figure A.1 below. The figure plots the four different cost conditions against different values of $a$ on the horizontal axis (the origin thus takes a value of $a = 2$). While interpreting the figure, note that conditions c[1], c[2] and c[4] are of the $\leq$ kind, while c[3] is of the $\geq$ kind.

14In fact, given that the curvature of the spillover function is tighter than that of the MNE profit function (i.e. $|\partial^2\pi/\partial x^2| < |\partial^2 S/\partial x^2|$), profits can be strictly larger than knowledge spillovers even beyond the domain of the model.

15Obviously, the other value is $x \geq 0$ but since our model is bounded by 0 from below, this condition is automatically satisfied in our model.
Figure A.1: Cost Conditions

The area in between $c[3]$ and the $a$-axis is the area in which both participation constraints exist. Note that this area lies entirely below $c[4]$, so that we can conclude that MNE net profits are indeed nonnegative in this area. In the area between the $a$-axis and $c[4]$ only the upper participation constraint exists while MNE net profits are still nonnegative. In the area above $c[4]$ but below $c[2]$, the upper participation constraint exists as well, but here MNE net profits are negative, so that the MNE will not invest in this area. For the area below $c[3]$, MNE profits are strictly larger than knowledge spillovers over the entire domain of the model, so that there are no participation constraints. Note that as $a \to \infty$ (i.e. absorptive ability goes to zero) the limit of $c[3]$ is 0 whereas the limit of $c[4]$ is 0 as well (by l’Hôpital’s rule). This implies that the region in which the participation constraints exist for positive MNE profits gradually disappears. Instead, the region in which MNE profits that are strictly larger than knowledge spillovers increases gradually. This is of course due to the steady decrease in absorptive ability: In terms of Figure 1, this implies that the spillover function will reach its optimum for lower values of $x$. At the same time, the value of knowledge spillovers at this optimum will decrease as well. These two effects combined make knowledge spillovers peter out rather quickly.

Comparative Statics

Recall the formulation of the participation constraints from (8):

$$
\bar{x}_L = \frac{\Lambda^-}{2(a-1)} ; \quad \bar{x}_U = \frac{\Lambda^+}{2(a-1)}
$$
For all derivatives we will need the partial derivatives of $\Lambda$ with respect to the different parameters as well:

\[
\frac{\partial \Lambda}{\partial n} = -\frac{1}{2n^2} \pm \left( -\frac{1}{4n^3} \right) \left( \frac{1}{4n^2} + 4c(a-1) \right)^{-\frac{1}{2}}
\]

\[
\frac{\partial \Lambda}{\partial a} = \pm \frac{2c}{\sqrt{\frac{1}{4n^2} + 4c(a-1)}}
\]

\[
\frac{\partial \Lambda}{\partial c} = \pm \frac{2(a-1)}{\sqrt{\frac{1}{4n^2} + 4c(a-1)}}
\]

Using this in the derivatives of (8) we get:

<table>
<thead>
<tr>
<th>Table 5: Comparative Static Derivatives</th>
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<tbody>
<tr>
<td>$\frac{\partial \hat{x}_U}{\partial n}$</td>
</tr>
<tr>
<td>$\frac{\partial \hat{x}_U}{\partial a}$</td>
</tr>
<tr>
<td>$\frac{\partial \hat{x}_U}{\partial c}$</td>
</tr>
</tbody>
</table>

In order to determine the sign of the derivatives, we check under which conditions (if any) they are larger than zero.

\[
\frac{\partial \hat{x}_U}{\partial n} = \left[ -\frac{1}{2n^2} - \frac{1}{4n^3} \left( \frac{1}{4n^2} + 4c(a-1) \right)^{-\frac{1}{2}} \right] \geq 0
\]

\[
-2n \geq \left( \frac{1}{4n^2} + 4c(a-1) \right)^{-\frac{1}{2}}
\]

\[
4n^2 \leq \frac{1}{\frac{1}{4n^2} + 4c(a-1)}
\]

\[
16n^2c(a-1) \leq 0 \Rightarrow c \leq 0
\]

Where the last inequality follows from our assumptions that $n, a \geq 2$. Hence $\frac{\partial \hat{x}_U}{\partial n} \geq 0$ iff $c \leq 0$.

\[
\frac{\partial \hat{x}_L}{\partial n} = \left[ -\frac{1}{2n^2} + \frac{1}{4n^3} \left( \frac{1}{4n^2} + 4c(a-1) \right)^{-\frac{1}{2}} \right] \geq 0
\]

\[
2n \geq \left( \frac{1}{4n^2} + 4c(a-1) \right)^{-\frac{1}{2}}
\]

\[
4n^2 \geq \frac{1}{\frac{1}{4n^2} + 4c(a-1)}
\]

\[
16n^2c(a-1) \geq 0 \Rightarrow c \geq 0
\]
Where the last inequality again follows from $n,a \geq 2$. Hence $\partial \hat{x}_L / \partial n \geq 0$ if $c \geq 0$. However, since according to $c[1]$ $\hat{x}_L$ does not exist for $c \geq 0$ it follows that in our model setup it always holds that $\partial \hat{x}_L / \partial n \leq 0$

\[
\frac{\partial \hat{x}_U}{\partial a} = \frac{4c(a-1) \left( \frac{1}{4n^2} + 4c(a-1) \right)^{-\frac{1}{2}} - 2 \left( \frac{1}{2n} + \sqrt{\frac{1}{4n^2} + 4c(a-1)} \right)}{4(a-1)^2} \geq 0
\]

\[
2c(a-1) \left( \frac{1}{4n^2} + 4c(a-1) \right)^{-\frac{1}{2}} \geq \frac{1}{2n} + \sqrt{\frac{1}{4n^2} + 4c(a-1)}
\]

\[
\frac{-2c(a-1) - \frac{1}{2n}}{\sqrt{\frac{1}{4n^2} + 4c(a-1)}} \geq \frac{1}{2n}
\]

\[
-4nc(a-1) - \frac{1}{2n} \geq \sqrt{\frac{1}{4n^2} + 4c(a-1)}
\]

\[
16n^2c^2(a-1) + 4c(a-1) + \frac{1}{4n^2} \leq \frac{1}{4n^2} + 4c(a-1)
\]

\[
16n^2c^2(a-1) \leq 0
\]

Given that $a,n \geq 2$ it follows that the last inequality can never hold, which implies that $\partial \hat{x}_U / \partial a < 0$.

\[
\frac{\partial \hat{x}_L}{\partial a} = \frac{-4c(a-1) \left( \frac{1}{4n^2} + 4c(a-1) \right)^{-\frac{1}{2}} - 2 \left( \frac{1}{2n} - \sqrt{\frac{1}{4n^2} + 4c(a-1)} \right)}{4(a-1)^2} \geq 0
\]

\[
-2c(a-1) \left( \frac{1}{4n^2} + 4c(a-1) \right)^{-\frac{1}{2}} \geq \frac{1}{2n} - \sqrt{\frac{1}{4n^2} + 4c(a-1)}
\]

\[
\frac{2c(a-1) + \frac{1}{4n^2}}{\sqrt{\frac{1}{4n^2} + 4c(a-1)}} \geq \frac{1}{2n}
\]

\[
4nc(a-1) + \frac{1}{2n} \geq \sqrt{\frac{1}{4n^2} + 4c(a-1)}
\]

\[
16n^2c^2(a-1) + 4c(a-1) + \frac{1}{4n^2} \geq \frac{1}{4n^2} + 4c(a-1)
\]

\[
16n^2c^2(a-1) \geq 0
\]

Again, given that $a,n \geq 2$ the last inequality will always hold, which implies that $\partial \hat{x}_L / \partial a > 0$.

\[
\frac{\partial \hat{x}_U}{\partial c} = \frac{2(a-1) \left( \frac{1}{4n^2} + 4c(a-1) \right)^{-\frac{1}{2}}}{2(a-1)} \geq 0
\]

\[
\frac{1}{\frac{1}{4n^2} + 4c(a-1)} \geq 0
\]

24
Given our discussion regarding cost condition \( c[3] \) in the previous part of the Appendix, this inequality most always hold. Accordingly, in our model setup it will always hold that \( \partial \hat{x}_U / \partial c \geq 0 \).

\[
\frac{\partial \hat{x}_L}{\partial c} = -2(a - 1) \left( \frac{1}{4n^2} + 4c(a - 1) \right)^{-\frac{1}{2}} \geq 0
\]

\[
- \frac{1}{4n^2} + 4c(a - 1) \geq 0
\]

For the same reason as before, this inequality will never hold. Thus in our model setup it will always hold that \( \partial \hat{x}_L / \partial c \leq 0 \).

From (4) we can derive that \( \hat{I} = 1 - 2\hat{x}n \) and accordingly that \( \hat{I}(\hat{x}_U) = 1 - 2\hat{x}_Un \) and \( \hat{I}(\hat{x}_L) = 1 - 2\hat{x}_Ln \). Consequently, we obtain the following:

\[
\frac{\partial \hat{I}(\hat{x}_U)}{\partial n} = - \left[ \Lambda^+ + n(\partial \Lambda^+ / \partial n) \right] / (a - 1)
\]

\[
= - \left[ \sqrt{\frac{1}{4n^2} + 4c(a - 1) - \frac{1}{4n^2} \left( \frac{1}{4n^2} + 4c(a - 1) \right)^{-\frac{1}{2}}} \right] / (a - 1) \geq 0
\]

\[
\frac{1}{4n^2} \geq \frac{1}{4n^2} + 4c(a - 1)
\]

\[
0 \geq 4c(a - 1) \Rightarrow c \leq 0
\]

Where the last inequality follows from the fact that \( a \geq 2 \). Hence \( \partial \hat{I}(\hat{x}_U) / \partial n \geq 0 \) iff \( c \leq 0 \).

\[
\frac{\partial \hat{I}(\hat{x}_L)}{\partial n} = - \left[ \Lambda^- + n(\partial \Lambda^- / \partial n) \right] / (a - 1)
\]

\[
= - \left[ - \sqrt{\frac{1}{4n^2} + 4c(a - 1) + \frac{1}{4n^2} \left( \frac{1}{4n^2} + 4c(a - 1) \right)^{-\frac{1}{2}}} \right] / (a - 1) \geq 0
\]

\[
\frac{1}{4n^2} + 4c(a - 1) \geq \frac{1}{4n^2}
\]

\[
4c(a - 1) \geq 0 \Rightarrow c \geq 0
\]

Where the last inequality follows from the fact that \( a \geq 2 \). Hence \( \partial \hat{I}(\hat{x}_L) / \partial n \geq 0 \) iff \( c \geq 0 \). However, since according to c[1] \( \hat{x}_L \) does not exist for \( c \geq 0 \) it follows that in our model setup it always holds that \( \partial \hat{I}(\hat{x}_L) / \partial n \leq 0 \).

\[
\frac{\partial \hat{I}(\hat{x}_U)}{\partial a} = -2 \frac{\partial \hat{x}_U}{\partial a} > 0
\]

\[
\frac{\partial \hat{I}(\hat{x}_L)}{\partial a} = -2 \frac{\partial \hat{x}_L}{\partial a} < 0
\]
This follows directly from our discussion of $\partial \dot{x}_U / \partial a$ and $\partial \dot{x}_L / \partial a$ above.

\[
\frac{\partial I(\dot{x}_U)}{\partial c} = -2 \frac{\partial \dot{x}_U}{\partial c} \leq 0
\]

\[
\frac{\partial I(\dot{x}_L)}{\partial c} = -2 \frac{\partial \dot{x}_L}{\partial c} \geq 0
\]

Again this follows immediately from our discussion of $\partial \dot{x}_U / \partial c$ and $\partial \dot{x}_L / \partial c$ above.