2 The determinants of host country spillovers from foreign direct investment: a review and synthesis of the literature
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INTRODUCTION

The existence of spillover efficiency benefits to host country economies from inward foreign direct investment (FDI) is well documented in the literature.¹ The determinants of the size and scope of the spillover benefits have also been studied, but they are not as clearly and consistently documented as the existence and magnitude of the relevant externalities.

There are many factors that are thought to affect the size and nature of productivity spillovers from inward investment, including host country characteristics such as industrial market structure, technological sophistication and overall economic size. Attributes of the nature of the inward investment have also been considered, such as whether the dominant mode of international business is a wholly owned affiliate, a minority-owned affiliate, or a strategic alliance. Some attention has also been paid to the motives and attributes of the foreign investor. Nevertheless we would argue that theoretical consideration of the determinants of FDI spillovers has been relatively ad hoc and limited. Perhaps as a consequence, there is no well-established theoretical paradigm for the determinants of spillover efficiency benefits to guide empirical research. Indeed a casual reading of the relevant literature conveys a sense of conflicting or inconclusive theoretical, as well as empirical evidence.²

A good understanding of the determinants of the nature and magnitude of FDI efficiency spillovers is of crucial importance to policymakers. Sectoral and related restrictions on inward FDI continue to keep
capital markets segmented. The ability to leverage spillover efficiency benefits from inward FDI is an important stimulant to a host government’s willingness to reduce or eliminate the relevant restrictions. Moreover many government policies not directly related to FDI would be seen as even more (or less) in the public interest if they had substantive positive (or negative) impacts on the benefits that the economy derived from inward FDI.

The primary purpose of this chapter is to review and synthesise the available literature, focusing on the determinants of efficiency spillovers from inward FDI. In particular, we attempt to identify points of agreement and to reconcile, if possible, points of disagreement. We also identify issues that merit additional study for the potential light they might shed upon the FDI spillover process. In order to do so, we outline a theoretical framework for understanding the underlying ‘supply’ and ‘demand’ forces determining the scope and magnitude of FDI spillovers to host economies.

The chapter proceeds as follows. In the next section, we present and discuss a theoretical framework for identifying determinants of FDI spillovers. We also discuss the main empirical hypotheses linking FDI spillovers to their underlying determinants. The third section summarises and assesses the available empirical evidence bearing upon these hypotheses. Finally, we address policy implications and areas for future research.

DETERMINANTS OF FDI SPILLOVERS

In a stylised fashion, one can think of spillovers in a traditional market supply and demand context. In the case of FDI, foreign investors make available (directly or indirectly) appropriable technology to host country businesses. Appropriable technology should be viewed broadly as any tangible or intangible resource that can generate economic rent for host country firms, for example by improving technical efficiency and total factor productivity. However for convenience we shall discuss the concept in its more narrow and traditional meaning, that is, embodied or disembodied knowledge about production and distribution.

Foreign investors presumably recognise that host country firms may be able to benefit from spillovers. They also presumably recognise that they can expend resources to mitigate spillovers if it is a profit-maximising strategy to do so. For example, if conveying trade secrets to the