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The Effects of Foreign Direct Investment on Host Country Firms

International Business

Bachelor's thesis

Turku School of Economics

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☐ I have not used any AI-based tools.

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Abstract

Foreign Direct Investment (FDI) is generally regarded as a driver of economic development due to its potential to generate productivity spillovers to domestic firms in host countries. However, empirical evidence shows that such spillovers are not automatic and can be positive, negative, or non-existent depending on local conditions.

This thesis examines the effects of FDI spillovers on host country firms. Through bringing together theoretical and empirical literature, the purpose is to identify which factors enable or prevent spillovers. This thesis aims to answer two sub-questions: (1) What types of effects do FDI spillovers generate on domestic firms, and (2) what determines whether domestic firms can absorb them.

The main findings are that a moderate technology gap maximizes spillovers, while a gap that is too large or too small limits them. Absorptive capacity must meet a minimum threshold for horizontal spillovers to occur, after which benefits eventually decline. Vertical backward linkages generate positive spillovers reliably, and joint ventures generally produce more frequent spillovers than wholly owned subsidiaries.

Keywords: FDI spillovers, absorptive capacity, technology gap, joint ventures, backward linkages

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Tiivistelmä

Ulkomaiset suorat sijoitukset (FDI) nähdään yleisesti talouskehityksen edistäjinä, koska ne voivat synnyttää tuottavuusvaikutuksia (spillover) kohdemaiden kotimaisille yrityksille. Empiirinen tutkimus osoittaa kuitenkin, että nämä vaikutukset synny automaattisesti, vaan ne voivat olla positiivisia, negatiivisia tai jäädä kokonaan toteutumatta paikallisista olosuhteista riippuen.

Tässä tutkielmassa tarkastellaan FDI:n spillover-vaikutuksia isäntämaiden yrityksiin. Teoreettista ja empiiristä kirjallisuutta käyttämällä tavoitteena on tunnistaa tekijät, jotka mahdollistavat tai estävät näiden vaikutusten syntymisen. Tutkielman tarkoituksena on vastata kahteen alakysymykseen: (1) millaisia vaikutuksia ulkomaiset suorat sijoitukset aiheuttavat kotimaisille yrityksille ja (2) mitkä tekijät vaikuttavat siihen, kykenevätkö kotimaiset yritykset absorboida niitä.

Tutkielman keskeiset havainnot osoittavat, että maltillinen teknologinen kuilu maksimoi spillover-vaikutukset, kun taas liian suuri tai liian pieni kuilu heikentää niitä. Lisäksi yritysten absorptiokyvyn on ylitettävä tietty vähimmäistaso, jotta horisontaalisia spillover-vaikutuksia voi syntyä, minkä jälkeen niiden hyödyt alkavat vähitellen vähentyä. Vertikaaliset taaksepäin suuntautuneet yhteydet (backward linkages) synnyttävät luotettavammin positiivisia spillover-vaikutuksia, ja yhteisyritykset tuottavat niitä yleensä useammin kuin kokonaan ulkomaisomisteiset tytäryhtiöt.

Avainsanat: FDI spillovers, absorptive capacity, technology gap, joint ventures, backward linkages

Contents

1	Introduction	7
2	Positive effects of FDI spillovers: channels and mechanisms	8
	2.1 Demonstration effects	8
	2.2 Labor mobility	8
	2.3 Competition effects	9
3	Negative effects of FDI spillovers	10
	3.1 Crowding out	10
	3.2 Negative effects of labor mobility	10
4	Horizontal and vertical spillover channels	12
5	Determinants of FDI spillover absorption	13
	5.1 Absorptive capacity	13
	5.1.1 How firms build absorptive capacity	14
	5.1.2 The role of absorptive capacity in channel selection	14
	5.2 Technology gap	15
	5.3 Ownership Structure: joint ventures vs. wholly owned subsidiaries	15
6	Conclusions	17
	References	18

FIGURES

Figure 1. A model of absorptive capacity (adapted from Zahra & George, 2002) 13

1 Introduction

Foreign Direct Investment (FDI) is generally regarded as an important driver of economic development, because of its potential to generate spillovers in host countries. FDI spillovers refer to effects on local firms from Multinational enterprises (MNEs) that MNEs cannot charge for. This means that even when foreign companies enter the market and increase competition, this can also be a spillover if it pushes local firms to adopt new technologies or become more efficient. Spillovers that lead to such improvements are referred to as positive spillovers. (Blomström & Kokko, 1998, 1-3).

Even when MNEs operate with full ownership and attempt to protect their competitive advantages, complete isolation of knowledge is difficult in practice. Keller (2010, 795) notes that technology is "not fully codifiable", meaning it cannot be completely written down or explained. This makes communication about technological knowledge difficult and can lead to market failures such as disagreements over contracts and asymmetric information. These market imperfections mean that technology transfers often occur outside formal market transactions, generating technology spillovers. (Keller, 2010, 795-796.)

Spillovers are not always positive. The increased competitive pressure from foreign firms may also negatively affect less productive domestic firms, which can lead to reduced market share, lower profits, or even exit from the market. These effects are referred to as negative spillovers. As a result, the overall impact of FDI on domestic firms varies across industries and depends on the ability of domestic firms to respond to foreign competition. (Blomström and Kokko, 1998, 4)

This thesis examines the effects of FDI spillovers on host country firms, and it seeks to answer two sub-questions: (1) What types of effects do FDI spillovers generate on domestic firms, and (2) What factors determine whether domestic firms are able to absorb FDI spillovers?

2 Positive effects of FDI spillovers: channels and mechanisms

Positive technology spillover occurs when knowledge or technology developed by one firm spreads to other firms without full compensation. As Blomström & Kokko (1998, 1-2) explain, technology has characteristics of a public good, meaning it can be used by others without being used up. Even when MNEs keep full ownership of their operations, meaning they do not form joint ventures with local firms, local firms can still benefit from their technology because the MNE cannot fully prevent its technology from leaking. This leakage can happen through labor mobility, reverse engineering, or demonstration effects (Blomström & Kokko, 1998, 1-2).

2.1 Demonstration effects

Even if a local firm is allowed to buy or license foreign technology, it still faces a problem: it does not know which technology is worth buying. The demonstration effect provides free information for local firms. When a local firm sees an MNE using a technology in the same local market it operates in, it learns three things: the technology works in this market, it appears profitable or viable under local conditions, and the risks are manageable. Blomström & Kokko (1998, 4) further argue that demonstration effects are more important in developing countries because local firms lack the skills and information to evaluate new technologies on their own.

More recent evidence confirms that demonstration effects remain a relevant channel for FDI spillovers. Sugiharti et al. (2022, 1) find that firms with medium-high and medium-low technology levels raise their productivity through demonstration and by adopting new technologies. High-technology firms, however, gain from FDI mostly because they have a strong ability to absorb new knowledge, not directly from watching foreign firms.

Low-technology firms, which rely heavily on unskilled workers, remain highly inefficient and struggle to benefit from demonstration unless they improve their absorptive capacity. Their workers have limited skills and their management practices are less advanced than those of multinationals. Because the knowledge gap between domestic low-tech firms and foreign firms is so wide, local companies in these sectors cannot imitate new technologies or raise their productivity. (Sugiharti et al., 2022, 10-11).

2.2 Labor mobility

Labor mobility refers to the movement of workers from MNEs to domestic firms, or entrepreneurship, while bringing with them knowledge and skills acquired in their previous place of employment. (Fosfuri et al., 2001) Workers employed by MNEs are often trained in technologies and practices that local firms do not yet possess, since MNEs often possess more advanced technology, which is what gives it a competitive advantage in the foreign market. Once trained, these employees become potential carriers of that technology

to local competitors, who can get access to the technology by hiring that trained employee. (Fosfuri et al., 2001)

Fosfuri et al. (2001) argue that MNE's technology can only be passed on by speaking directly to the worker or by having them learn on the job. This means the knowledge lives inside the worker. Once trained, that worker takes the knowledge with them wherever they go. Firms have no real way to stop this knowledge from spreading when the worker leaves. Therefore, when trained workers move to domestic companies, they naturally carry productivity benefits with them. (Fosfuri et al. 2001)

Sokhanvar (2025, 929) argues that flexible labor markets facilitate knowledge spillovers by allowing skilled workers and managers to move between domestic and foreign firms, carrying their knowledge with them. This directly supports the theoretical mechanism described by Fosfuri et al. (2001), who argued that when trained workers change jobs freely, the knowledge they possess transfers to their new employers, creating positive spillovers for the local firms that hire them.

2.3 Competition effects

One way in which positive FDI technology spillover may occur is through the positive competition effect, in which MNE practices create competitive pressure on local firms and to remain competitive, local firms must improve their operations through management style reform and upgrading their production technologies. (Tian 2010).

Keller & Yeaple (2009) found a strong positive spillover effect from FDI to domestic firms. The spillovers were concentrated in high-technology industries, and the paper suggests that positive spillover effect in lower technology industries and low-income countries the effect will be weak or non-existent. Using data from Lithuanian manufacturing firms, Javorcik (2004) finds evidence of positive spillovers taking place through backward linkages, which means that local suppliers benefitted from working with foreign firms. A typical increase in FDI led to a 15% increase in output for local suppliers. These benefits came only from partially owned foreign projects (such as joint ventures or minority stake acquisitions) and not fully foreign-owned firms.

3 Negative effects of FDI spillovers

3.1 Crowding out

Empirical research from Venezuela has shown that an increase in FDI can decrease the productivity of domestic firms within the area. This is explained through the market-stealing effect, also known as crowding out. The crowding out effect occurs when foreign firms take demand away from domestic firms, forcing them to cut production. As a result, domestic firms would still pay fixed costs for a smaller output, lowering productivity. (Aitken & Harrison, 1999)

Crowding out is defined as occurring when FDI displaces investments that would otherwise have been made by domestic firms (Agosin, 2009, 21). The crowding out effect is generally short-term phenomenon. After an MNE joins the market there is often a jump in the exit rates of domestic firms, but this is often followed by positive spillovers that benefit the surviving domestic firms. (Kosová, 2010)

The crowding out effect of FDI is not uniform across all domestic firms. Small and medium firms are more negatively impacted by FDI than large firms. (Goel & Saunoris, 2021, 1162). Larger firms compete more effectively through economies of scale, making them less sensitive to negative effects of FDI. Smaller firms, already hindered by innovation barriers, face tighter constraints or intimidation from foreign competitors. (Goel and Saunoris 2021, 1174)

3.2 Negative effects of labor mobility

Transferring technology to a foreign subsidiary requires training a local worker, which makes the MNE vulnerable to poaching by local competitors (Fosfuri, Motta & Rønde, 2001, 205). Poaching reduces the benefit of training and leads to underinvestment in workforce development. If the required wage premium becomes too high, the MNE may find it more profitable to export to the host country instead of investing there, thereby avoiding both the dissipation of its intangible assets and the cost of higher wages. To reduce the risk of losing trained workers to local competitors, multinational enterprises may adopt defensive strategies using higher wages (Fosfuri, Motta & Rønde, 2001).

Recent evidence from the Netherlands by Roesch et al. (2025) supports this theoretical mechanism. Their analysis finds that the wage gap between foreign-acquired and domestic firms rises from 1% to 5% after acquisition, with roughly three-quarters of this gap explained by higher wages paid directly by the firm rather than by hiring better-educated workers. Workers who leave acquired firms also earn significantly higher wages in their next jobs than those leaving comparable domestic firms.

Several factors influence whether poaching and spillovers occur. Labour mobility is higher when the training provided by the MNE is general rather than specific. Technological spillovers are more likely when the local firm is not a direct competitor of the MNE. This is the case when the local firm sells products that are different from or work well alongside the MNE's products. (Roesch et al. 2025, 207).

4 Horizontal and vertical spillover channels

FDI spillovers are generally classified into two categories based on linkage: horizontal and vertical.

Horizontal spillovers happen when local firms learn from MNEs operating in the same market. Vertical spillovers happen through different industries in the same supply chain. Vertical spillovers are further divided into two subtypes, backward and forward spillovers based on direction of the spillover. Backward vertical spillover goes downstream in the supply chain from FDI to local suppliers, whereas forward vertical spillover upstream from FDI to local buyers. (Javorcik, 2004) According to a large-scale meta-analysis across 45 countries the average horizontal FDI spillover is close to zero. But this does not mean horizontal spillovers never happen. Some countries benefit from them, while others are harmed by them. (Iršová & Havránek 2013, 3-4).

MNCs try to avoid leaking information that would improve local competitors, but they may still benefit from sharing knowledge with local suppliers. For this reason, vertical spillovers generally happen more often than horizontal spillovers (Javorcik 2004). Keller (2010, p. 809) explains this by noting that multinational affiliates have a direct financial incentive to transfer knowledge to their local suppliers. Improving supplier performance benefits the MNE's own production. Because the MNE actively assists its suppliers, backward linkages function as a channel that requires lower absorptive capacity from domestic firms than horizontal spillovers do. Iršová & Havránek, (2011) argue that joint ventures generate larger spillovers than fully owned foreign subsidiaries. Investors from distant countries with only a slight technological edge over local firms create the most beneficial linkages. Firms in manufacturing benefit more than those in services.

5 Determinants of FDI spillover absorption

5.1 Absorptive capacity

In Blomström and Kokko (2003), it is concluded that FDI inflow into a country does not automatically lead to positive spillovers, but depends on local conditions. The potential benefits of FDI occur only when domestic firms are both capable and willing to put effort into learning and adopting new technologies and skills. This capability is known as absorptive capacity (ACAP), which Cohen and Levinthal (1990) defined as the firm's ability to identify, understand, and integrate knowledge from outside the firm.

Building on this idea, Zahra and George (2002, 185) suggested four dimensions of absorptive capacity, which can be categorized into two groups. The first group, comprising acquisition and assimilation, which are labeled potential absorptive capacity (PACAP), while the other group consists of transformation and exploitation, which are labeled realized absorptive capacity (RACAP). PACAP alone does not generate benefits. While PACAP allows firms to access knowledge, but only RACAP allows firms to use this knowledge in ways that improve the firm's performance. (Zahra and George, 2002, 189-190.)

Zahra and George (2002, 194) propose that transforming PACAP into RACAP depends on social integration mechanisms, which are informal and formal ways between employees to share knowledge. These mechanisms would reduce the gap between PACAP and RACAP, by allowing knowledge to flow across the organization more freely, without it being trapped in individuals.

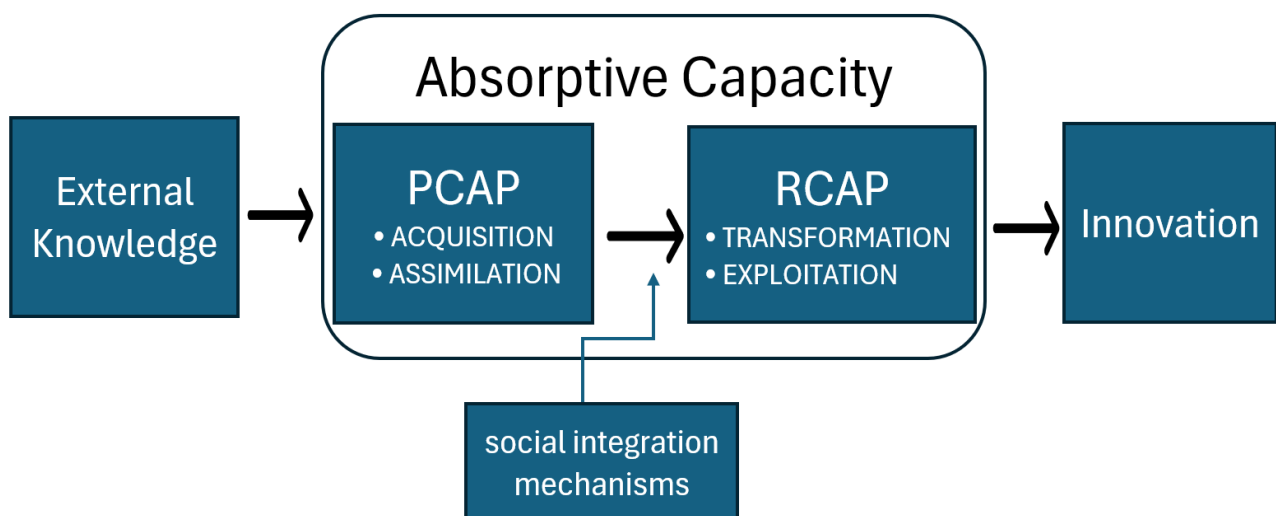


Figure 1. A model of absorptive capacity (adapted from Zahra & George, 2002)

Figure 1 illustrates the absorptive capacity model developed by Zahra and George (2002). The process begins with external knowledge entering the firm. PACAP enables the firm to acquire and assimilate this external knowledge. However, acquiring knowledge alone is insufficient to generate value. The knowledge must also be transformed and exploited through realised RACAP. Through these processes, firms are able to apply external knowledge commercially, resulting in innovation. Arrows between the two blocks represent social integration mechanisms, which link PACAP to RACAP.

5.1.1 How firms build absorptive capacity

A firm's absorptive capacity depends on its existing knowledge. According to Cohen and Levinthal (1990) explain that firms need to have prior knowledge to effectively identify valuable new information from outside, understand it, and put it into effective business practice. This prior knowledge comes from several sources. One important factor is human capital. Employees bring skills, experience, and understanding that help the firm interpret new ideas and technologies. If employees lack the right skills, external knowledge may not be properly understood or used. (Cohen and Levinthal, 1990). Another important factor is investment in research and development (R&D). R&D not only helps firms create new products and processes, but also improves their ability to learn from others. According to Cohen and Levinthal (1990) absorptive capacity is often a byproduct of a firm's research and development investment

Not all successful firms have strong absorptive capacity. Sokhanvar (2025, 920, 926, 928) defines the top 10% of job creators as high-growth firms but finds that high-growth status has no significant impact on productivity and that there is no significant difference in productivity between these firms and others. It is also noted that growth can come from political ties, lack of competition in the market, or temporary increases in customer demand rather than efficiency. In other words, high growth is not a reliable sign that a firm possesses high absorptive capacity.

5.1.2 The role of absorptive capacity in channel selection

To absorb and utilize FDI spillovers, domestic firms must first assess their absorptive capacity, as some channels require high capacity while others do not. Whether horizontal FDI helps or hurts domestic firms depends on their level of absorptive capacity, meaning that the relationship between absorptive capacity and productivity spillovers from FDI is not a straight line and there are specific thresholds that determine the outcome (Girma, 2005, 303-304). These threshold effects apply to horizontal spillovers. Backward linkages follow a different pattern, as Duong (2020, 52) finds that domestic firms benefit from them regardless of their absorptive capacity.

Using UK manufacturing data, Girma (2005, 299) finds that as absorptive capacity increases, the productivity gains from horizontal FDI also increase up to a point. Once a firm's absorptive capacity reaches

about 66.5% of the industry frontier, the benefits begin to shrink. Firms that are already very close to the technological frontier gain the least from foreign competitors because they have little left to learn. At the other end of the scale, firms with very low absorptive capacity experience no benefits or even negative effects from FDI spillovers. (Girma, 2005, 299-303.)

5.2 Technology gap

Several factors determine whether a domestic firm possesses sufficient absorptive capacity to benefit from FDI spillovers. Iršová & Havránek (2013) conducted a large-scale meta-analysis of 1,205 spillover estimates from 45 countries and concluded that the technology gap between domestic and foreign firms matters more than anything.

The technology gap has a nonlinear relationship with spillovers. When the gap is too large, domestic firms lack the capacity to absorb foreign knowledge. When it is too small, there is too little to learn from MNEs. A one standard deviation increase in the gap reduces the spillover coefficient by 0.158, more than any other factor they examined. (Iršová & Havránek, 2013, 10). This is supported by Ahn, Kim, Li and Manera (2026). Using patent data from 60 countries over 20 years, they find that countries with more innovation benefit more from FDI. The top 10 percent of countries get spillovers up to eight times larger than the bottom 90 percent.

The authors also show that technological proximity between the investor and the host country significantly increases spillovers. When technological proximity is low, spillovers become negligible. When proximity is high, spillovers increase substantially. This finding directly supports the argument that a large technology gap prevents absorption, while a modest gap enables learning. The authors also note that FDI may reinforce existing innovation disparities rather than reduce them. Countries with higher absorptive capacity benefit disproportionately more. This means that without enough prior knowledge and a suitable technology gap, domestic firms struggle to benefit from FDI spillovers.

5.3 Ownership Structure: joint ventures vs. wholly owned subsidiaries

Iršová & Havránek (2013) identify the second major determinant of productivity spillovers from FDI as the organizational structure of the foreign entry, specifically whether it takes the form of a joint venture with domestic partners or a wholly owned subsidiary. Wholly owned subsidiaries tend to generate negative spillover effects, while joint ventures are significantly more likely to produce positive knowledge transfers to domestic firms (Iršová & Havránek, 2013, 10). There are two main reasons why this happens

First, a MNE that enters through a joint venture may find it easier to identify and work with local suppliers, since their partner can provide knowledge of the local market networks. This makes it cheaper and easier for them to buy materials and parts from local businesses. In contrast, a fully foreign-owned company often lacks this local knowledge, so it is more likely to import materials from abroad instead of buying locally. When joint ventures buy from local suppliers, those suppliers learn and improve, creating positive spillovers for the local economy, which local firms can then absorb. (Javorcik & Spatareanu, 2008)

Second, MNEs usually reserve their more advanced technologies for factories they fully own. They tend to give relatively simpler technologies to joint ventures that share ownership with local partners. Because these technologies are easier to understand and because a local partner is actively involved in running the business, other local companies in the same industry may find it easier to observe and learn from these practices. This can increase knowledge diffusion to local competitors (Javorcik & Spatareanu, 2008). This mechanism is consistent with the idea of absorptive capacity, which suggests that knowledge is more easily transmitted when it is closer to the existing capabilities of local firms (Cohen & Levinthal, 1990). This logic implies that the effect should be weaker in more advanced economies, where local firms possess higher absorptive capacity and benefit from alternative spillover channels.

6 Conclusions

This thesis set out to answer two sub-questions: (1) what types of effects FDI spillovers generate on domestic firms, and (2) what factors determine whether domestic firms are able to absorb those spillovers. The overall findings show that FDI does not automatically generate positive effects for domestic firms, but instead produces a mixed set of outcomes that depend strongly on firm-level and country-level conditions.

The findings for the first question reveal that FDI spillovers are not a single phenomenon but a bundle of different mechanisms, each operating through different channels. Demonstration effects, labor mobility, and competition effects can generate positive spillovers, but labor mobility and crowding out can just as easily produce negative ones. In labor mobility, workers leaving MNEs carry valuable knowledge to domestic firms, yet the threat of this poaching reduces MNE incentives to train workers in the first place. This means that it should not be assumed that more FDI or more labor movement will generate net benefits.

This thesis examined which factors determine whether domestic firms can absorb productivity spillovers from foreign direct investment. It was found that the technology gap between domestic and foreign firms is the most influential determinant. The relationship is non-linear: a too large gap prevents knowledge absorption, while a small gap offers no meaningful learning opportunity. This factor exerts a stronger effect than any other single variable examined in this thesis.

Absorptive capacity is critical when domestic firms face horizontal spillovers from MNEs operating in the same industry. It has two parts: potential absorptive capacity, which allows a firm to acquire and assimilate external knowledge, and realized absorptive capacity, which allows it to transform and exploit that knowledge. A firm can get access to foreign knowledge but still gain nothing if it cannot transform that knowledge into better products or processes. The relationship between absorptive capacity and horizontal spillovers follows a threshold, where benefits appear only above a minimum capacity level, rise with capacity, but the additional gains decline once a firm reaches about two-thirds of the industry frontier. Firms with very low capacity get no benefit or experience negative spillovers.

Joint ventures generate larger spillovers than wholly owned subsidiaries. MNEs reserve their most advanced technologies for fully owned facilities and give simpler technology to joint ventures, but the simpler technology is easier for domestic firms to absorb. Vertical linkages are more reliable spillover channels than horizontal ones, though this holds mainly for partially owned foreign projects. An exception is that backward linkages benefit domestic suppliers even when their absorptive capacity is low.

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Statement on the Use of Artificial Intelligence

AI was used to assist in the making of this thesis. AI usage is described below. The AI tool used in this thesis was ChatGPT, using GPT-5.5 model.

At the beginning of the research process, generative AI was used to assist in brainstorming the research topic.

Example prompt: “How should I narrow my topic? I want to make it about FDI.”

At the beginning of the research process, generative AI was used to generate suggestions for potential sources. The suggested sources were then searched using Volter and evaluated for relevance.

Example prompt: “What are some famous peer-reviewed articles about FDI spillovers?”

During the writing process, Generative AI was used to proofread parts of the text for inaccuracies or grammar mistakes. The feedback was then reviewed.

Example prompt: “Proofread this sentence for any grammatical mistakes and make sure it makes logical sense.”