FDI Spillovers with Product Differentiation

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Abstract

Based on Symeonidis (2003)'s duopoly model with product differentiation, this paper discusses how FDI spillovers that decreases the quality difference between vertically differentiated products of the home and foreign firms affects the home firm's decision on plant location and how endogenizing spillovers makes difference from the exogenous spillovers. This paper shows that endogenizing spillovers with a quadratic spillover-prevention cost function makes FDI more likely. Related with intellectual property right of the home firm, this paper focus on the role of the two exogenous variables, (1) parameter of spillover-prevention cost function and (2) degree of spillovers when no prevention effort is made, both of which may be lower when the foreign government enforces stricter intellectual property protection. In the model, the welfare of the foreign country is always higher with FDI than with exports. This paper shows that the second exogenous variable mentioned above is positively related to the unit trade cost, and that so is the level of spillovers in the endogenous case. About this relationship, some evidence from cross-country data is provided.

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