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SOURCES OF PRODUCTIVITY GAINS FROM FDI IN INDONESIA: IS IT EFFICIENCY IMPROVEMENT OR TECHNOLOGICAL PROGRESS?

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This article investigates the spillover effects of foreign direct investment (FDI) on productivity growth in the Indonesian food-processing (ISIC 311) and electrical machinery industries (ISIC 383). Total factor productivity (TFP) growth is decomposed into efficiency change and technological change by using the Malmquist productivity index. The empirical results show that efficiency improvement is the major driver of TFP growth in the food-processing industry, whereas technological progress is the dominant contributor in the electrical machinery industry. There are positive spillovers on efficiency change but negative spillovers on technological change in the food-processing industry. However, FDI spillovers turn out to be negative in efficiency change while positive in technological progress in the electrical machinery industry. These findings demonstrate that different industries experience different sources of productivity gains, which are dependent on the characteristics of firms in the industry.

Keywords: FDI; TFP growth; Efficiency change; Technological change
JEL classification: D24, F21

I. INTRODUCTION

Policy makers in developing countries compete actively for foreign direct investment (FDI). A range of incentive packages are provided, such as tax exemptions, investment allowances, and permission to repatriate profits, among other benefits. Competition arises partly because of externalities generated from the presence of multinational companies (MNCs) in the recipient economies (Blomström and Kokko 2003). MNCs, which are believed to be among the most knowledge-advanced firms, establish subsidiaries in the host countries and transfer

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