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# Foreign Direct Investment Spillovers and Productivity Growth in Indonesian Garment and Electronics Manufacturing

SUYANTO*, HARRY BLOCH** & RUHUL A. SALIM**
*Faculty of Business and Economics, University of Surabaya, Surabaya, Indonesia, **School of Economics and Finance, Curtin University, WA, Australia

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ABSTRACT *Inflows of foreign direct investment generate externalities that spill over to domestic firms and raise their productivity. This article examines the extent of spillover effects of foreign direct investment for firms in the highly disaggregated garment (ISIC 3221) and electronics industries (ISIC 3832) in Indonesia. Both are export-intensive industries, but differ greatly in technological sophistication and labour intensity. Changes in both the productivity level and rate of growth in each industry are decomposed into the effects of technological change, technical efficiency change and scale efficiency change and then the impacts of spillovers on each component and on total productivity are estimated. The findings suggest that foreign direct investment generates a positive effect on total productivity change, technical efficiency change, technological change, and scale efficiency change in the garment industry. In contrast, foreign direct investment contributes significantly negatively to total productivity, technological change and scale efficiency change, but has no significant effect on technical efficiency change in the electronics industry.*

## I. Introduction

Over the past two decades, many developing countries have sought to attract foreign direct investment (FDI) by providing preferential fiscal and financial incentives. According to a report by UNCTAD (2009), the net FDI inflows to developing countries increased more than 30 times between 1986 and 2007, rising from US$16 billion to US$499 billion. South-Eastern Asian developing countries experienced an increase in the net FDI inflows from US$2.9 billion in 1986 to US$60.5 billion in 2007. Indonesia, which is one of the successful South-Eastern Asian countries in attracting FDI, recorded an increase of more than 34 times in net FDI inflows, jumping from a meagre US$0.2 billion in 1986 to US$6.9 billion in 2007.

Inflows of FDI are widely believed to be beneficial to host countries in terms of providing additional capital, generating new employment, financing budget deficits, and complementing a saving gap. However, preferential policies toward FDI rely to a large extent on the argument that FDI generates externalities in the form of new knowledge, including modern technology, advanced managerial expertise, and scale-efficiency knowledge (Blomström, 1986; Blomström

*Correspondence Address*: Ruhul A. Salim, A/Professor of Economics, School of Economics & Finance, Curtin Business School, Curtin University, WA 6845, Australia. Email: ruhul.salim@cbs.curtin.edu.au
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