

1 Introduction

Multinational enterprises (MNEs) play a dominant role in an increasingly globalized world. In 1999, the domestic operations of the approximately 2,400 U.S. multinational enterprises accounted for approximately 26 percent of U.S. GDP, 63 percent of U.S. exports, 37 percent of U.S. imports, and 68 percent of U.S. R&D expenditures (Mataloni and Yorgason, 2002). That year, nearly half of all U.S. manufacturing workers were employed by U.S. multinationals.

Despite their economic importance, the investment decisions of multinationals are not yet well understood. With few exceptions, the trade literature has not distinguished between the two modes in which a multinational enterprise can engage in foreign direct investment (FDI): cross-border acquisition (entering a foreign market by buying an existing enterprise) and greenfield FDI (entering a foreign market by building a new enterprise). Consequently, the literature has been preoccupied with understanding the volume of FDI, neglecting its composition across modes.

To the extent that MNEs do not view cross-border acquisitions and greenfield FDI as perfect substitutes, economists and policy makers should care not only about the volume of FDI, but also about its composition. Indeed, governments of many host countries perceive cross-border acquisitions as being rather different from greenfield FDI.¹ Any change in policies towards FDI and any variation in country characteristics is likely to affect cross-border acquisitions and greenfield FDI differently. Therefore, the volume of FDI cannot fully be understood without first understanding its composition.

If our hypothesis that cross-border acquisitions and greenfield FDI are not perfect substitutes is correct, then this should show up in the data: there should be systematic differences in FDI mode choice across MNEs. Indeed, if the two FDI modes were perfect substitutes, then all firms would be indifferent between the two modes, and so there should be no systematic variation in mode choice across firms within the same industry. In figure 1, we explore the relationship between a U.S. multinational's efficiency and its propensity to favor cross-border acquisitions over greenfield FDI. This figure is constructed using data from the Bureau of Economic Analysis (BEA) on outward FDI of U.S. multinational enterprises over the period 1994-1998. From this dataset, we construct two measures of a U.S. multinational's efficiency: (i) the parent company's sales in the U.S. (relative to its industry mean),² and (ii) the parent company's value added per worker in the U.S. (relative to its industry mean). Based on each measure of firm efficiency, we sort MNE's into three equally-sized bins: "low", "medium", and "high" efficiency. The figure reveals that firms are less likely to choose cross-border acquisitions over greenfield FDI the more efficient they are.³ The fact that FDI mode choice varies systematically with firm characteristics shows that cross-border acquisitions and greenfield FDI are not perfect substitutes.

FDI mode choice varies not only across firms, but also across host countries with different

¹See, for example, United Nations Center for Transnational Corporations (2000, p. xxiii).

²Most models of firm heterogeneity predict a monotonic relationship between firm efficiency and sales.

³As the econometric analysis in the appendix shows, this relationship is robust to including various control variables that might affect FDI mode choice. Additional information concerning the construction of the data is also provided in the appendix.

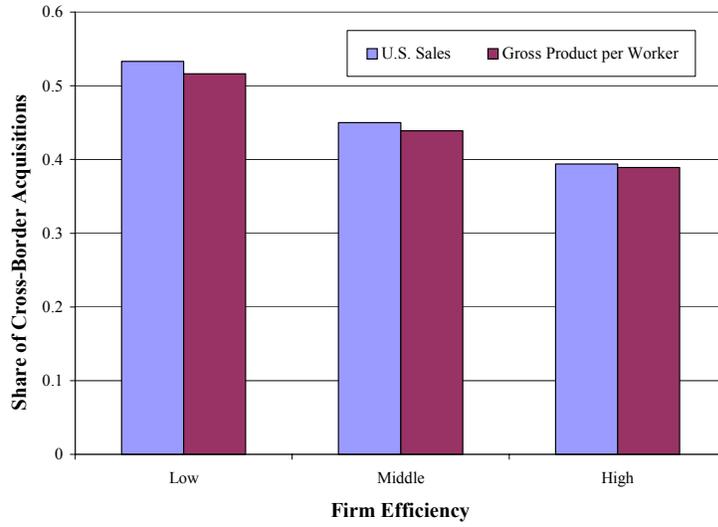


Figure 1: The Share of Cross-Border Acquisitions in Total U.S. Outward FDI by Firm Efficiency

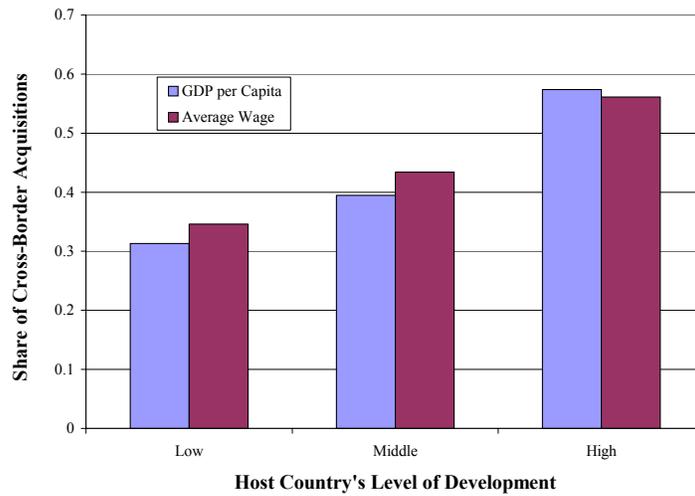


Figure 2: The Share of Cross-Border Acquisitions in Total U.S. Outward FDI by the Host Country's Level of Development

levels of development. In figure 2, we explore the relationship between a host country's level of development, as measured by GDP per capita and the average wage rate, and the fraction of U.S. multinationals that enter this country through cross-border acquisition rather than greenfield FDI. As the figure reveals, U.S. multinationals are more likely to favor cross-border acquisition over greenfield FDI, the more developed is the host country. Interestingly, more than sixty percent of U.S. outward FDI is directed towards the group of countries with the highest level of development, which is also the group with the highest fraction of cross-border acquisition in total FDI. This suggests that an understanding of the composition of FDI across modes will provide us with a deeper understanding of the volume of FDI.⁴

In this paper, we develop an assignment theory of foreign direct investment to explain multinationals' FDI mode choice. According to much of the business literature, acquisitions allow firms to exploit complementarities in their firm-specific assets. This view of mergers and acquisitions is in line with the fact that approximately half of all mergers and acquisitions in the U.S. involve trade in individual plants and divisions rather than entire corporations; see Maksimovic and Phillips (2001).⁵ These observations show that firms are in the business of buying and selling corporate assets, and that these assets are heterogeneous and complementary. Indeed, as Caves (1998; p. 1963) points out:

“For the reshuffling of plants (or lines of business) among firms to be productive, there must be sources of heterogeneity. [...] These heterogeneities cause assets' productivities to vary substantially depending on the other business assets with which they collaborate within the firm.”

We therefore model the merger market as a market in which heterogeneous firms buy and sell heterogeneous firm-specific assets to exploit complementarities. The equilibrium of the merger market is the solution of the associated assignment problem: which firm-specific assets should optimally be combined?

In our model, a cross-border acquisition involves purchasing foreign corporate assets that the acquirer lacks. Greenfield FDI, on the other hand, involves building production capacity in the foreign country to allow the firm to deploy its corporate assets abroad. There are two countries that can freely trade with one another. Motivated by our empirical finding that the host country's level of development is an important determinant of FDI mode choice, we assume that countries differ in wage levels, labor productivity, and in the distributions of entrepreneurial abilities (or some other corporate assets). Wage and productivity differences give rise to greenfield FDI (from the high-cost to the low-cost country) and to cross-border acquisitions (from each country to the other). Cross-country differences in entrepreneurial abilities, however, give rise only to cross-border acquisitions (from each country to the other). Our model thus generates (potentially large) two-way FDI flows even in the absence of transport costs and production cost differences between countries.

In our model, greenfield FDI and cross-border acquisitions co-exist. However, as production-cost differences become small, almost all FDI takes the form of cross-border acquisitions. This

⁴See the appendix for an econometric analysis and a description of the data.

⁵As Bernard, Redding, and Schott (2004) document, more than sixty percent of U.S. manufacturing firms add or delete entire four-digit product lines within five years.

prediction is consistent with figure 2 since production cost differences between the U.S. and rich, developed countries are arguably much smaller than between the U.S. and poor, developing countries. We also show that the propensity of firms in the high-cost country to engage in cross-border acquisitions rather than greenfield FDI is decreasing in the relative supply of corporate assets in the low-cost country. To the extent that poor, developing countries have fewer attractive corporate assets than rich, developed countries, this result is also consistent with figure 2.

Another prediction of our model is that firms engaging in greenfield FDI are, on average, more efficient than those engaging in cross-border acquisitions. This is consistent with the data summarized in figure 1. The intuition for this result may be summarized as follows. Greenfield FDI necessitates the expense of building a new plant in the foreign country, and such an expense is worthwhile only if the gains from relocating production are sufficiently large. Hence, only sufficiently productive firms will engage in greenfield FDI. In contrast, the market for corporate assets allows even relatively inefficient firms to exploit complementarities.

Related literature. Our paper is mainly related to two strands in the theoretical trade literature. A feature common to both strands, and shared by our paper, is the assumption that contracting problems prevent arm's-length relationships.⁶

In our model, FDI arises because of underlying differences across countries, not because of transport costs, and there is a tendency for each firm to locate production in only one country. It is this feature that our paper shares with the literature on "vertical FDI" (e.g., Helpman, 1984, and Neary, 2004). Indeed, recent empirical work by Hanson, Mataloni, and Slaughter (2003) documents a tendency for multinationals to concentrate production in low-wage countries. None of the papers on vertical FDI consider FDI mode choice. In Helpman (1984), there is only greenfield FDI, while in Neary (2004), there are only cross-border acquisitions (motivated by market power).

Our paper is also related to the recent and growing literature on firm heterogeneity which is concerned with the selection of heterogeneous firms into different modes of serving global markets. We extend this literature by introducing an international merger market. Within this literature, the two papers that are most closely related to ours are Helpman, Melitz, and Yeaple (2004), and Nocke and Yeaple (2004).⁷ However, in Helpman, Melitz, and Yeaple (2004) there is no motive for firms to engage in cross-border acquisitions, and so greenfield is the only mode of FDI. On the other hand, Nocke and Yeaple (2004) consider cross-border acquisitions but analyze the interaction between trade costs (which are absent in the present model) and the source of firm heterogeneity (mobile versus non-mobile capabilities). In the present paper, we are able to analyze general heterogeneity in all corporate assets, which is precluded by the presence of trade costs in Nocke and Yeaple (2004). Another benefit of abstracting from trade costs in the present paper is that it allows us to analyze large country differences.⁸

⁶There is, however, an interesting recent (but so far empirically untested) literature that explores the trade-offs between in-house production and outsourcing; see Antras (2003), Antras and Helpman (2004), and Grossman and Helpman (2004).

⁷Other papers in the literature on firm heterogeneity include Melitz (2003), Bernard, Eaton, Jensen, and Kortum (2003), and Eaton, Kortum, and Kramarz (2004).

⁸While not concerned with FDI, Antras, Garicano and Rossi-Hansberg (2004) analyze a model of the assign-

Plan of the paper. In the next section, we present the model. Then, in section 3, we derive the equilibrium assignment of corporate assets and the equilibrium location of production. Further, we explore the implications of the assignment for the distribution of firm efficiencies across countries. In section 4, we solve for the FDI flows implied by the equilibrium assignment and location decisions. We show that greenfield FDI and cross-border acquisitions co-exist but that, in the limit as production cost differences vanish, all FDI takes the form of cross-border acquisitions. Next, in section 5, we analyze the link between firm characteristics and FDI mode choice. We show that firms engaging in greenfield FDI are systematically more efficient than those engaging in cross-border acquisitions. Then, in section 6, we investigate the relationship between country and industry characteristics on the one hand, and the composition of foreign direct investment on the other. In section 7, we show that our predictions are robust across a wide range of alternative assumptions. Finally, we conclude in section 8.

2 The Model

We consider a general-equilibrium model of the world economy. There are two countries, 1 and 2, indexed by i , that can freely trade with one another. There are no transport costs or tariffs, and so arbitrage implies that the price of each good is the same in both countries.

Consumers. The world is populated by a unit mass of consumers with identical CES preferences. The representative consumer's utility function is given by

$$U = \sum_j \beta_j \ln \left[\int_{\Psi_j} m(\psi)^{1/\sigma_j} x(\psi)^{(\sigma_j-1)/\sigma_j} d\psi \right]^{\sigma_j/(\sigma_j-1)} + y, \quad (1)$$

where $\beta_j > 0$ is a preference parameter for the goods produced in industry j , $x(\psi)$ is consumption of good $\psi \in \Psi_j$, $m(\psi)$ is "market size" of good ψ , $\sigma_j > 1$ is the elasticity of substitution between goods in industry j , and y is the consumption of the outside good. We assume that consumer income is sufficiently large so that the representative consumer spends a positive fraction of her income on the outside good.

Firms. A firm in industry j is defined as a triplet $(\tilde{a}, m, i)_j$, consisting of one (unique) entrepreneur of ability \tilde{a} , property rights over the production of a good in industry j with market size m , and a plant to produce that good in country i . Each firm can produce (at most) one good, using entrepreneurial ability \tilde{a} and labor. An entrepreneur's ability \tilde{a} may be thought of as productivity-enhancing headquarter services that can be provided independently of the location of production but only within the firm. In particular, firm $(\tilde{a}, m, i)_j$ can produce any one unit of its good using $(\eta_{ij}\tilde{a})^{-1}$ units of labor in country i , where η_{ij} is labor productivity in country i and industry j . Hence, the firm's unit cost of production is given by $\omega_i (\eta_{ij}\tilde{a})^{-1}$, where ω_i denotes the wage rate in country i . For notational convenience, it will be helpful to use the following (monotone) transform of the entrepreneur's ability: $a \equiv \tilde{a}^{\sigma-1}$.

A plant is good-specific in the sense that it must be designed for a specific good; it has zero value in any other usage. Building a (good-specific) plant in country i and industry j requires

ment of heterogeneous agents into international teams.

ϕ_j/η_{ij} units of labor from country i .

Countries. In each country, firms face a perfectly elastic supply of labor. In country i , there is a mass E_{ij} of atomless producers that are capable of managing production in industry j . Each firm in country i and industry j is endowed with (i) an entrepreneur, (ii) property rights over the production of a unique good, and (iii) a plant to produce that good in country i . Entrepreneurs and goods are in fixed supply.

In each industry j , goods differ in their market sizes. In each country, $H_j(m)$ denotes the fraction of goods with market size less than or equal to m . We allow for cross-country differences in the distribution of endowments with entrepreneurial abilities. In country i , $G_{ij}(a)$ denotes the fraction of entrepreneurs of ability less than or equal to a . The distribution function of entrepreneurial abilities in the world is then $G_j(\cdot) \equiv (E_{1j}G_{1j}(\cdot) + E_{2j}G_{2j}(\cdot))/(E_{1j} + E_{2j})$. All distribution functions are continuously differentiable and strictly increasing on $[0, \infty)$. The associated density functions are denoted by h_j , g_{ij} , and g_j , respectively. Our formulation does not require us to make any further assumption on the joint distribution of m and a across firms.

Merger market. There exists a perfectly competitive global market for corporate assets in which entrepreneurs (firms) can buy and sell property rights over the production of goods and the associated good-specific plants. Indeed, as discussed in the introduction, about half of all mergers and acquisitions in the U.S. involve partial firm sales and divestitures. Let $W_{ij}(m)$ denote the market price of an industry- j good with market size m originating in country i (and its associated plant in country i), and $V_j(a)$ the shadow value of an industry- j entrepreneur with ability a .

Foreign direct investment. There are two modes of foreign direct investment: greenfield FDI and cross-border acquisition. A firm (or entrepreneur) from country i engages in *greenfield FDI* if (i) it manages production of a good that originated in country i , and (ii) builds a new plant for that good in country $k \neq i$.⁹ Note, however, that a firm engaging in greenfield FDI may not necessarily produce the good with which it was initially endowed (as the firm may have acquired property rights over the good from some other domestic firm). A firm (or entrepreneur) from country i engages in a *cross-border acquisition* if it acquires property rights over the production of a good (and its associated plant) in the other country k .

3 Equilibrium Assignment

In this section, we turn to the equilibrium analysis of our model. We consider a particular industry j in which country 2 is the low-cost location of production, and so $\omega_2/\eta_{2j} < \omega_1/\eta_{1j}$, where ω_i is the *equilibrium* wage rate in country i . For notational simplicity, we set $\omega_2/\eta_{2j} \equiv 1$ and drop all industry indices. We now derive a firm's equilibrium profit as a function of its assets. We then study (1) the merger market equilibrium, which implies an assignment of abilities to goods, and (2) the equilibrium location of production.

⁹A firm that has conducted greenfield FDI will have a good-specific plant in both countries, but – since product markets are perfectly integrated – will only produce in one of them, namely in the plant located in the low-cost country for that industry.

Preliminaries. Solving the representative consumer's utility maximization problem, we obtain the following demand for good ψ :

$$x(\psi) = \frac{\beta m(\psi) p(\psi)^{-\sigma}}{\int_{\Psi} m(\psi') p(\psi')^{1-\sigma} d\psi'},$$

where $p(\psi)$ is the price of good ψ . Profit maximization implies that each firm charges a fixed markup, and so the consumer price of good ψ , when produced in country i , is given by $p(\psi) = c_i(\psi)\sigma/(\sigma-1)$, where $c_i(\psi)$ is the unit cost of production. Note that the consumer price of good ψ is independent of $m(\psi)$, while demand is increasing in $m(\psi)$, holding the consumer price fixed. This shows that the preference parameter $m(\psi)$ should indeed be interpreted as the good's "market size" rather than quality: some goods are consumed more frequently or in larger quantities than others, and such differences are intrinsic to the goods rather than the producers.

The gross profit of a firm producing good ψ in country i is given by

$$Sm(\psi)c_i(\psi)^{1-\sigma},$$

where the markup-adjusted residual demand level S is given by

$$S = \beta \left[\sigma \int_{\Psi} m(\psi) c_i(\psi)^{1-\sigma} d\psi \right]^{-1}. \quad (2)$$

Writing gross profits as a function of entrepreneurial ability a , market size m , demand level S , and location of production i , we have:

$$\Pi_i(a, m) = \begin{cases} \theta Sam & \text{for } i = 1, \\ Sam & \text{for } i = 2, \end{cases} \quad (3)$$

where $\theta \equiv (\omega_1/\eta_1)^{1-\sigma}$. The parameter $\theta < 1$ captures the cost disadvantage of producing in country 1. Observe that the profit function is supermodular in a and m , reflecting that entrepreneurial ability and the good's market size are complementary in generating profits. Note also that a firm with an entrepreneur of ability a could generate the same profit when producing a good with market size m in country 1 and when producing a good with market size θm in country 2.

Equilibrium assignment and location of production. Equilibrium in the merger market induces an assignment of entrepreneurs to goods. We now investigate this equilibrium assignment, and the equilibrium location of production, *holding fixed the markup-adjusted residual demand level S* . For the equilibrium assignment, the country of origin of an entrepreneur is irrelevant: an entrepreneur can manage production (provide headquarter services) equally well in both countries, independently of his country of origin. Since firms are profit-maximizers and the merger market is perfectly competitive, equilibrium must have the property that the assignment of entrepreneurs to goods and the location of production maximize firms' joint profits, holding S fixed.

We first consider the equilibrium location of production of a good with market size m . (We will often refer to such a good as a *type- m good*.) Two immediate observations can be made.

First, no good that originated in country 2 will be produced in country 1. To see this, note that no firm would want to move production from a low-cost location to a high-cost location, given that an entrepreneur of ability a can manage production equally well in either country. Second, there must exist a threshold $\bar{m} \leq \infty$ such that a type- m good that originated in country 1 will be produced in country 2 (incurring a fixed cost ϕ of building a new good-specific plant) if $m > \bar{m}$, and in country 1 if $m < \bar{m}$.¹⁰

We now turn to the equilibrium assignment of entrepreneurs to goods. Let $a_i(m)$ denote the set of abilities of entrepreneurs who will manage a type- m good originating in country i , for any given (endogenous) threshold \bar{m} . It is straightforward to show that $a_2(\cdot)$ is a strictly increasing function: there is positive assortative matching between entrepreneurial ability and the market size of a good. This follows from three observations. First, the profit function $\Pi_2(a, m)$ is supermodular in a and m . Second, G_i and H are strictly increasing and continuous distribution functions. Third, all goods originating in country 2 will be produced in country 2.

From the profit function (3) and the location of production, we obtain two no-arbitrage conditions that link $a_1(\cdot)$ and $a_2(\cdot)$. All goods of type $m < \bar{m}$ will be produced in their country of origin, and an entrepreneur of ability a makes the same profit when managing a type- m good in country 1 and when managing a type- θm good in country 2. Hence,

$$a_1(m) = a_2(\theta m) \text{ for all } m < \bar{m}. \quad (4)$$

All goods of type $m > \bar{m}$ will be produced in country 2, independently of their country of origin. Hence,

$$a_1(m) = a_2(m) \text{ for all } m > \bar{m}. \quad (5)$$

An immediate implication of equation (4) is that the threshold \bar{m} must be finite.¹¹ From the no-arbitrage conditions (4) and (5), it follows that $a_1(m)$ is single-valued and strictly increasing in m for $m < \bar{m}$ and for $m > \bar{m}$. Further, $a_1(\bar{m})$ has two elements, namely $a_2(\theta\bar{m})$ and $a_2(\bar{m})$. Since $a_2(\theta\bar{m}) < a_2(\bar{m})$, it follows that $a_1(\cdot)$ has an upward jump at \bar{m} in the sense that $\lim_{m \uparrow \bar{m}} a_1(m) < \lim_{m \downarrow \bar{m}} a_1(m)$.

We are now in the position to derive $a_i(\cdot)$. In light of the no-arbitrage conditions (4) and (5), which link $a_1(\cdot)$ and $a_2(\cdot)$, we will focus on $a_2(\cdot)$. First, we derive $a_2(m)$ for $m > \bar{m}$. Since all goods of type $m > \bar{m}$ will be produced in country 2, independently of their country of origin, and since there is positive assortative matching between a and m , we have

$$(E_1 + E_2) [1 - G(a_2(m))] = (E_1 + E_2) [1 - H(m)] \text{ for } m \geq \bar{m},$$

¹⁰To see this, suppose otherwise that, in equilibrium, there exist two firms, (a', m') and (a'', m'') , whose goods of types m' and $m'' < m'$ originated in country 1, and firm (a', m') locates production in country 1, while firm (a'', m'') locates in country 2. The resulting joint profits of the two firms are $S[\theta a' m' + a'' m''] - \phi$. However, this allocation does not maximize joint profits. If the better of the two entrepreneurs, $\max\{a', a''\}$, purchases the type- m' good and locates production in country 2, while the other entrepreneur purchases the type- m'' and locates production in country 1, then the two firms' joint profits are given by $S[\theta \min\{a', a''\} m'' + \max\{a', a''\} m'] - \phi$, which is greater than the joint profit in the candidate equilibrium.

¹¹To see this, suppose otherwise that no firm from country 1 builds a new plant in country 2, $\bar{m} = \infty$. However, for m sufficiently large, firm $(a_1(m), m, 1)$ could then make a larger profit by building a new plant in country 2: $\Pi_1(a_1(m), m) = \Pi_1(a_2(\theta m), m) < \Pi_2(a_2(\theta m), m) - \phi$. A contradiction.

where $G(\cdot) \equiv [E_1 G_1(\cdot) + E_2 G_2(\cdot)] / (E_1 + E_2)$ is the global distribution function of entrepreneurial abilities. The term on the l.h.s. represents the mass of entrepreneurs with ability of at least $a_2(m)$, while on the r.h.s. is the mass of goods with market size m and greater. Solving for $a_2(m)$, yields

$$a_2(m) = G^{-1}(H(m)) \text{ for } m \geq \bar{m}. \quad (6)$$

Next, we derive $a_2(m)$ for $\theta\bar{m} \leq m \leq \bar{m}$. From the no-arbitrage condition (4), $a_1(m) = a_2(\theta m)$ for $m < \bar{m}$. Hence, all entrepreneurs of ability $a_2(\theta\bar{m}) \leq a \leq a_2(\bar{m})$ will manage production in country 2, independently of their country of origin. We thus have

$$(E_1 + E_2) [G(a_2(\bar{m})) - G(a_2(m))] = E_2 [H(\bar{m}) - H(m)] \text{ for } m \in [\theta\bar{m}, \bar{m}].$$

Since (6) implies $G(a_2(\bar{m})) = H(\bar{m})$, we obtain

$$a_2(m) = G^{-1} \left(\frac{E_1 H(\bar{m}) + E_2 H(m)}{E_1 + E_2} \right) \text{ for } m \in [\theta\bar{m}, \bar{m}]. \quad (7)$$

Finally, we derive $a_2(m)$ for $m < \theta\bar{m}$. We have

$$(E_1 + E_2)G(a_2(m)) = E_1 H(m/\theta) + E_2 H(m) \text{ for } m < \theta\bar{m}.$$

The term on the l.h.s. represents the mass of entrepreneurs from both countries who have ability less than or equal to $a_2(m)$. The second term on the r.h.s. is the mass of goods with market size m or less that locate (and originate) in country 2. Since $a_2(m) = a_1(m/\theta)$, the first term on the r.h.s. represents the mass of goods that are produced (and originate) in country 1 and that are managed, in equilibrium, by entrepreneurs of ability $a_2(m)$ or less. Solving the equation for $a_2(m)$ yields

$$a_2(m) = G^{-1} \left(\frac{E_1 H(m/\theta) + E_2 H(m)}{E_1 + E_2} \right) \text{ for } m \leq \theta\bar{m}. \quad (8)$$

Summarizing, the function $a_2(\cdot)$ is defined, over the relevant domains, by equations (6), (7), and (8). The function is strictly increasing, continuous, and differentiable except at $\theta\bar{m}$ and \bar{m} . Observe also that $a_2(\cdot)$ depends on \bar{m} ; we will later analyze how this function changes with \bar{m} .

The equilibrium assignment of entrepreneurs to goods originating in country 1, summarized by $a_1(\cdot)$, follows immediately from $a_2(\cdot)$ and the no-arbitrage conditions (4) and (5):

$$a_1(m) = \begin{cases} G^{-1} \left(\frac{E_1 H(m) + E_2 H(\theta m)}{E_1 + E_2} \right) & \text{for } m < \bar{m}, \\ G^{-1}(H(m)) & \text{for } m > \bar{m}. \end{cases} \quad (9)$$

Hence, $a_1(\cdot)$ is a strictly increasing and differentiable function, except at \bar{m} , where it exhibits an upward jump.

Equilibrium price schedules. Having analyzed the equilibrium assignment and location of production (as a function of S), we can now determine (i) the equilibrium price schedule on

the international merger market for property rights over the production of goods and (ii) the shadow values of entrepreneurs, for any given markup-adjusted residual demand level S .

The return of an entrepreneur of ability $a_2(m)$ is the difference between the firm's gross profit and the equilibrium price of a type- m good (and its associated plant) on the merger market, i.e.,

$$V(a_2(m)) = \Pi_2(a_2(m), m) - W_2(m). \quad (10)$$

In a competitive equilibrium of the market for corporate assets, an entrepreneur of type $a_2(m)$ maximizes his value by purchasing a good of type m in country 2, i.e.,

$$V(a_2(m)) = \max_{m'} \Pi_2(a_2(m), m') - W_2(m'). \quad (11)$$

The first-order condition yields

$$W_2'(m) = \frac{\partial \Pi_2(a_2(m), m)}{\partial m}. \quad (12)$$

Next, note that the market values of the worst goods and entrepreneurs must be zero, i.e., $W_2(0) = 0$ and $V(a_2(0)) = V(0) = 0$, since $\Pi_2(a_2(0), 0) = 0$. Integrating equation (12), we obtain the equilibrium price schedule for goods in country 2:

$$\begin{aligned} W_2(m) &= W_2(0) + \int_0^m W_2'(z) dz = \int_0^m \frac{\partial \Pi_2(a_2(z), z)}{\partial z} dz \\ &= S \int_0^m a_2(z) dz, \end{aligned} \quad (13)$$

where the last equality follows from $\Pi_2(a_2(m), m) = S a_2(m) m$. Observe that the second-order condition of the profit-maximization problem (11) is satisfied since $a_2(\cdot)$ is strictly increasing and so $W_2(\cdot)$ is strictly convex. Using (10), we can write the (shadow) value of an entrepreneur of ability $a_2(m)$ as

$$V(a_2(m)) = S \left[a_2(m) m - \int_0^m a_2(z) dz \right].$$

Consider now the equilibrium price schedule for goods created in country 1. From the no-arbitrage condition (4), a good of type $m < \bar{m}$ from country 1 generates the same profit as a good of type θm from country 2. Hence,

$$W_1(m) = W_2(\theta m) \text{ for } m \leq \bar{m}. \quad (14)$$

Furthermore, we obtain

$$W_1(m) = W_2(m) - \phi \text{ for } m \geq \bar{m} \quad (15)$$

since, in equilibrium, the production of all goods of type $m > \bar{m}$ will be located in country 2, which requires incurring the fixed cost ϕ .

From equations (14) and (15), it follows that

$$W_2(\theta \bar{m}) = W_2(\bar{m}) - \phi. \quad (16)$$

Consider a type- \bar{m} good originating in country 1. If this good is produced in country 1, it will be managed by an entrepreneur of ability $a_2(\theta\bar{m})$, and its value is thus $W_2(\theta\bar{m})$. On the other hand, if this good is produced in country 2, a new good-specific plant needs to be built in that country (at cost ϕ), and production will be managed by an entrepreneur of ability $a_2(\bar{m})$. Hence, in this case, the value of the good is $W_2(\bar{m}) - \phi$. By definition of \bar{m} , the two usages of the good must generate the same value, $W_2(\theta\bar{m}) = W_2(\bar{m}) - \phi$.

Using (13), the indifference condition (16) can be rewritten as

$$S \int_{\theta\bar{m}}^{\bar{m}} a_2(m) dm = \phi. \quad (17)$$

The l.h.s. of this equation is the profit increase from a relocation of production of a type- \bar{m} good (originating in country 1) to country 2, taking into account that the equilibrium assignment of entrepreneurs to goods depends on the location of production. From the viewpoint of maximizing profits (holding S fixed), moving production of a type- \bar{m} good from country 1 to country 2 implies that an entrepreneur of ability $a_2(\theta\bar{m})$ is freed up in country 1 to manage production of type- $\theta\bar{m}$ good in country 2, which in turn allows a re-assignment of entrepreneurs to goods in country 2: all goods with market size between $\theta\bar{m}$ and \bar{m} will now be managed by more able entrepreneurs, which generates additional profit. On the r.h.s. of equation (17) is the cost of such a relocation of production.

The markup-adjusted residual demand level. So far, we have derived the equilibrium assignment and location of production for a given markup-adjust residual demand level S . However, S is endogenous and determined jointly with the (endogenous) threshold \bar{m} . From equation (2) and the equilibrium assignment of entrepreneurs to goods derived above, the markup-adjusted residual demand level is given by

$$S = \beta\sigma^{-1} \left[E_1\theta \int_0^{\bar{m}} ma_1(m)dH(m) + E_2 \int_0^{\bar{m}} ma_2(m)dH(m) + (E_1 + E_2) \int_{\bar{m}}^{\infty} ma_2(m)dH(m) \right]^{-1}. \quad (18)$$

Combining equations (17) and (18), we obtain the following result.

Lemma 1 *The markup-adjusted residual demand level S is strictly increasing in the market size threshold \bar{m} .*

Proof. See appendix. ■

Equilibrium. We are now in the position to define equilibrium in this assignment model and prove existence and uniqueness.

Definition 1 *An equilibrium is a collection $\{a_1(\cdot), a_2(\cdot), \bar{m}, S\}$ satisfying equations (6) to (9), (17) and (18).*

Proposition 1 *There exists a unique equilibrium.*

Proof. See appendix. ■

Endogenous cross-country differences in the distribution of firm efficiencies. Holding fixed entrepreneurial ability, a firm producing in country 2 has, by assumption, lower unit costs than a firm producing in country 1. This cost advantage of country 2 will be magnified by the endogenous re-assignment of entrepreneurs to goods through the market for corporate assets.

Proposition 2 *In equilibrium, the endogenous distribution of entrepreneurial abilities associated with firms producing in country 2 first-order stochastically dominates that in country 1.*

Proof. See appendix. ■

This result follows from two observations. First, in equilibrium, all of the best entrepreneurs, namely those with ability $a > a_2(\bar{m})$, will manage production in country 2. Second, in equilibrium, the production of any good of type $m < \bar{m}$ will be managed by a more able entrepreneur in country 2 than in country 1, $a_2(m) > a_1(m)$ for $m < \bar{m}$. That is, even conditioning on ability $a < a_2(\bar{m})$, country 2 will attract on average better entrepreneurs than country 1. The proposition shows that the empirical research on the sources of comparative advantage needs to take the “selection effect” of FDI into account.

4 Foreign Direct Investment

In the previous section, we derived the equilibrium assignment of entrepreneurs to goods and the equilibrium location of production for an industry in which country 2 has a comparative cost advantage. What still needs to be analyzed is the implied equilibrium pattern of trade and FDI. In this section, we interpret the assignment of entrepreneurs to goods and the location of production in terms of choice of FDI mode. We then present two key results. First, all greenfield FDI is one-way within the same industry: from the high-cost to the low-cost country, while cross-border acquisitions occur in both directions. Second, in the limit as production cost differences between countries vanish, all FDI takes the form of cross-border acquisitions.

Types of FDI. In our model, the identity of a firm is linked to its entrepreneur. In this sense, it will be the entrepreneurs that buy or sell property rights over the production of goods, rather than the reverse. Greenfield FDI from country i to country k occurs whenever an entrepreneur from country i relocates production of a good from country i to country k by building a new plant in country k . Cross-border acquisition from country i to country j occurs whenever an entrepreneur from country i purchases a good from country k , independently of where this good will be produced. Two types of cross-border acquisitions are possible, dependent on whether the acquired good will be produced in its country of origin, or whether local production will be closed down and transferred to the entrepreneur’s home country.

Equilibrium selection. Both the assignment of entrepreneurial types to types of goods and the location of production by market size of the good are uniquely pinned down in equilibrium. However, in the absence of any mobility costs for entrepreneurs, entrepreneurs of any given ability but originating in different countries are perfect substitutes. Consequently, there is indeterminacy in the equilibrium gross flows of FDI. Since the assumption of no frictions in

the market for cross-border acquisitions may be viewed as a limiting case where such frictions become small, we henceforth confine attention to the equilibrium pattern of FDI that minimizes the volume of cross-border acquisitions.

Composition of international commerce. We are now in the position to provide a first characterization of FDI flows. Since all goods originating in country 2 are produced in that country, any greenfield FDI must be one-way, namely from country 1 to country 2. Any good of type $m > \bar{m}$ that originated in country 1 will be produced in country 2. This relocation of production may be accomplished in two ways: (i) an entrepreneur from country 1 may engage in greenfield FDI in country 2 by building a new plant in that country, or (ii) an entrepreneur from country 2 may purchase that good, close down production in country 1, and build a new plant in country 2. Since we restrict attention to the equilibrium pattern of FDI that minimizes the volume of cross-border acquisitions, the latter will occur only if there is an insufficient number of entrepreneurs of ability $a_1(m)$ originating in country 1 to manage production of goods of type m from their home country. In contrast, all goods of type $m < \bar{m}$ from country 1, and all goods from country 2, will be locally produced. Property rights over the production of these goods will be acquired by a local entrepreneur of ability $a_i(m)$, or else if the local supply of such entrepreneurs is too small, by a foreign entrepreneur.

More formally, let $\psi_i(m)$ denote the ratio between the number of entrepreneurs, originating in country i , who in equilibrium will be assigned to a type- m good, and the number of such type- m goods originating in the same country. If $\psi_i(m) < 1$, then a fraction $1 - \psi_i(m)$ of these goods must be acquired by foreign firms (entrepreneurs). A type- m good from country i will be managed by an entrepreneur of ability $a_i(m)$, and so

$$\begin{aligned}\psi_i(m) &= \lim_{\Delta \rightarrow 0} \frac{E_i [G_i(a_i(m + \Delta)) - G_i(a_i(m))]}{E_i [H(m + \Delta) - H(m)]} \\ &= \frac{g_i(a_i(m))}{h(m)} a_i'(m).\end{aligned}$$

Hence, using equations (6) through (9),

$$\psi_1(m) = \begin{cases} \frac{g_1(a_1(m))}{g(a_1(m))} \left[\frac{E_1}{E_1 + E_2} + \frac{\theta E_2}{E_1 + E_2} \frac{h(\theta m)}{h(m)} \right] & \text{if } m \leq \bar{m}, \\ \frac{g_1(a_1(m))}{g(a_1(m))} & \text{otherwise,} \end{cases} \quad (19)$$

and

$$\psi_2(m) = \begin{cases} \frac{g_2(a_2(m))}{g(a_2(m))} \left[\frac{E_2}{E_1 + E_2} + \frac{E_1/\theta}{E_1 + E_2} \frac{h(m/\theta)}{h(m)} \right] & \text{if } m \leq \theta \bar{m}, \\ \frac{g_2(a_2(m))}{g(a_2(m))} \left[\frac{E_2}{E_1 + E_2} \right] & \text{if } m \in (\theta \bar{m}, \bar{m}], \\ \frac{g_2(a_2(m))}{g(a_2(m))} & \text{if } m > \bar{m}. \end{cases} \quad (20)$$

Observe that both functions ψ_1 and ψ_2 are continuous, except that ψ_1 has a discontinuity at \bar{m} , while ψ_2 exhibits discontinuities at $\theta \bar{m}$ and \bar{m} . Note also that the value of $\psi_i(m)$ depends directly on the relative supply of firms in country i , $E_i/(E_1 + E_2)$, production-cost differences, as summarized by θ , and the relative supply of managerial abilities in country i , $g_i(a_i(m))/g(a_i(m))$; it also depends on the assignment function $a_i(m)$, provided there are cross-country differences in the distributions of entrepreneurial abilities, i.e., $g_i \neq g$.

Using the functions ψ_1 and ψ_2 , we can derive industry-level statistics of FDI flows. Let γ_i and μ_i denote the fractions of entrepreneurs (firms) from country i who will engage in greenfield FDI and cross-border acquisitions, respectively. Since all greenfield FDI is directed toward the country with the comparative advantage in production in that industry, $\gamma_2 = 0$. On the other hand,

$$\gamma_1 = \int_{\bar{m}}^{\infty} \min\{\psi_1(m), 1\} dH(m) \quad (21)$$

since a fraction $\min\{\psi_1(m), 1\}$ of a good of type $m > \bar{m}$ originating in country 1 will be produced in country 2 as part of greenfield FDI (while the remaining fraction $\max\{1 - \psi_1(m), 0\}$ will be acquired and relocated by entrepreneurs from country 2).

As regards cross-border acquisitions, we have

$$\mu_1 = \frac{E_2}{E_1} \int_0^{\infty} \max\{1 - \psi_2(m), 0\} dH(m). \quad (22)$$

To see this, note that if $\psi_2(m) < 1$, there is an insufficient number of entrepreneurs from country 2 that have the “right” ability to manage production of type- m goods in country 2, and so a fraction $1 - \psi_2(m)$ will be acquired by entrepreneurs from country 1. Similarly, we have

$$\mu_2 = \frac{E_1}{E_2} \int_0^{\infty} \max\{1 - \psi_1(m), 0\} dH(m). \quad (23)$$

We can now make two important observations. First, the flows of cross-border acquisitions will be balanced in equilibrium,

$$E_1\mu_1 = E_2\mu_2.$$

Balancedness obtains since, in each country, the mass of entrepreneurs is equal to the mass of goods, both before the merger market opens as well as after the merger market closes. Moreover, each greenfield investment involves one entrepreneur and one good from the same country. Second, all entrepreneurs from country 1 who are of ability $a \in (a_2(\theta\bar{m}), a_2(\bar{m}))$ will be engaged in cross-border acquisitions in country 2, and so $\mu_1 = (E_2/E_1)\mu_2 > 0$.

We summarize our results in the following proposition.

Proposition 3 *In equilibrium, greenfield FDI and cross-border acquisitions co-exist in the same industry. All greenfield FDI is one-way: from country 1 to country 2, but not in the reverse direction. In contrast, cross-border acquisitions are two-way: from country 1 to country 2, and from country 2 to country 1.*

Existing models of vertical FDI (e.g., Helpman, 1984) predict that, at any given production stage, all FDI flows are one-way: the only receiving country is the one that has a comparative advantage in that stage of production. Yet, there is overwhelming empirical evidence showing that FDI flows are generally two-way. In light of this stylized fact, trade theorists have relied on models with transport costs to generate two-way FDI. As proposition 3 shows, transport costs are not necessary to generate this stylized fact. To the extent that the U.S. may be viewed as the high production-cost country in most manufacturing industries vis-à-vis most countries, the

model would predict that the greenfield share of U.S. inward FDI is smaller than the greenfield share of U.S. outward FDI. This is indeed consistent with the data on U.S. manufacturing: the greenfield share of outward FDI over the period 1990-1998 is about 40% while that of inward FDI is only about 20%.

There is ample evidence that many governments are wary of foreign acquisitions of domestic establishments that result in the closure of local production. Our model can indeed generate such FDI. The measure of firms involved in such FDI is

$$E_1 \int_{\bar{m}}^{\infty} \max \{1 - \psi_1(m), 0\} dH(m),$$

which is positive if and only if $g_1(a) < g_2(a)$ for some $a > a_2(\bar{m})$. Interestingly, if foreign acquisitions result in the closure of local production, they involve the goods commanding a large market (of size $m > \bar{m}$) from country 1.

Vanishing cross-country cost differences. As figure 2 has revealed, cross-border acquisitions are the dominant mode of FDI between the richest and most developed countries (where, arguably, production-cost differences are not very large). In contrast, a much larger fraction of FDI flows from the rich and developed countries to the poor and developing countries (where, arguably, production-cost differences play an important role) involve greenfield.

To explain these findings within our model, we analyze the composition of FDI in the limit as production-cost differences become small, i.e., as $\theta \rightarrow 1$. An immediate observation is that the market size threshold $\bar{m} \rightarrow \infty$ as $\theta \rightarrow 1$.¹² Consequently, greenfield FDI disappears as production-cost differences become small: $\gamma_1 \rightarrow 0$ as $\theta \rightarrow 1$. Next, as can be seen from equation (20), for any m ,

$$\psi_2(m) \rightarrow \frac{g_2(a_2(m))}{g(a_2(m))} \text{ as } \theta \rightarrow 1.$$

However, generically, we have $g_2(a) \neq g(a)$ for (almost) any a . Hence, μ_1 and μ_2 are bounded away from zero, even as $\theta \rightarrow 1$. We therefore obtain the following key result.

Proposition 4 *There always exist cross-border acquisitions in both directions, independently of production-cost differences between countries. In contrast, greenfield FDI disappears in the limit as production-cost differences vanish. Hence, as $\theta \rightarrow 1$, all FDI takes the form of cross-border acquisitions.*

What this proposition highlights is that there are two reasons for cross-border acquisitions, but only one reason for the existence of greenfield FDI. In our model, greenfield FDI occurs only because firms want to exploit cost differences by relocating production from a high-cost to a low-cost location. In contrast, cross-border acquisitions not only exist because of cost differences, but also because the distribution of entrepreneurial abilities (or, more generally, of firm-specific assets) varies from one country to another.¹³

¹²To see this, suppose otherwise that \bar{m} is bounded from above, independently of θ . But then, (observing that S is bounded; see equation (18)) the l.h.s. of equation (17) goes to zero as θ goes to one, while the r.h.s. is equal to ϕ , and so bounded away from zero; a contradiction.

¹³This may be reminiscent of Grossman and Maggi (2000), where trade between countries occurs because of differences in the distributions of workers' talent.

More generally, the following features of our model are necessary to obtain two-way cross-border acquisitions in the absence of production-cost differences between countries: there must be heterogeneity in both types of corporate assets (entrepreneurial abilities and the market sizes of goods), and these corporate assets must be complementary, and there must be distributional differences across countries in at least one of the two types of corporate assets. This highlights the importance of “two-sided” heterogeneity in our assignment model.

5 Firm Efficiency and Choice of FDI Mode

In this section, we further explore the mapping from a firm’s efficiency (as measured by a) to its choice of FDI mode for an industry in which country 2 has the comparative advantage in production. For this purpose, we impose additional structure on the distributions of entrepreneurial abilities. We then obtain another key result: firms that engage in greenfield FDI are systematically more efficient than those that engage in cross-border acquisitions. Moreover, we show that, under some modest regularity condition on the distribution of goods’ market sizes, the probability that an entrepreneur from country 1 engages in FDI is weakly increasing in the entrepreneur’s ability.

Efficiency differences: greenfield FDI vs. cross-border acquisitions. As figure 1 has revealed, U.S. firms engaging in greenfield FDI are systematically more efficient than U.S. firms engaging in cross-border acquisitions. Our model generates this result under a variety of distributional assumptions. A natural restriction on the distribution of entrepreneurial abilities that allows us to obtain this result is the following symmetry condition.

(C1) The distributions of entrepreneurial abilities are the same in both countries: $G_1 \equiv G_2$.

Given this symmetry in entrepreneurial abilities across countries, all FDI is motivated by production-cost differences. As can be seen from equations (19) and (20), (C1) implies that $\psi_1(m) = \psi_2(m) = 1$ for all $m \geq \bar{m}$. Hence, all cross-border acquisitions involve goods of type $m < \bar{m}$, while all greenfield FDI still involves only goods of type $m > \bar{m}$. Positive assortative matching between a and m in each country then implies the following proposition.

Proposition 5 *Firm engaging in greenfield FDI are more efficient than firms engaging in cross-border acquisitions.*

If we were to relax the symmetry condition (C1), we would still obtain that firms engaging in greenfield FDI are, *on average*, more efficient than firms engaging in cross-border acquisitions. To see this, note that, even in the absence of (C1) greenfield FDI involves only entrepreneurs of abilities exceeding $a_2(\bar{m})$ and goods with market size exceeding \bar{m} , while cross-border acquisitions are the only FDI mode associated with less able entrepreneurs and goods commanding a smaller market size. To violate our weaker prediction, one would thus need a very strong departure from symmetry, namely that one country has a much larger supply of the very best entrepreneurs than another.

Through the lens of this proposition, it may become apparent why the governments of many host countries appear to favor greenfield FDI over cross-border acquisitions. Policymakers may

perceive two important differences between the two FDI modes. First, greenfield FDI involves the creation of new plants. Second, greenfield FDI involves the best foreign firms, and therefore a large number of workers.

Efficiency differences: cross-border acquisitions vs. domestic production. To further tighten our predictions on the efficiency differences between firms engaging in different modes of serving the world market, we impose a mild regularity condition on the distribution of goods' market sizes.

(C2) The elasticity of the density function h ,

$$\frac{mh'(m)}{h(m)}$$

is strictly decreasing in m .

It can easily be verified that condition (C2) is satisfied by a number of standard distributions, e.g., by the two-parameter family of Weibull distributions, $H(m) = 1 - e^{-(m/\beta)^\alpha}$, $\alpha > 0$, $\beta > 0$ (which includes the exponential distribution as a special case with $\alpha = 1$) and the two-parameter family of Gamma distributions (which includes the chi-squared distribution as a special case). Henceforth, we will assume that both distributional conditions, (C1) and (C2), hold.

(C1) implies that $\psi_1(0) < 1 < \psi_2(0)$. Moreover, (C1) and (C2) imply that $\psi_1(\cdot)$ is strictly increasing on $[0, \bar{m}]$, and $\psi_2(\cdot)$ is strictly decreasing on $[0, \theta\bar{m}]$, has a downward jump at $\theta\bar{m}$, and is constant on $[\theta\bar{m}, \bar{m}]$. It will prove useful to define a second threshold market size, \hat{m} . If $\lim_{m \uparrow \bar{m}} \psi_1(m) > 1$, the threshold \hat{m} is such that $\psi_1(\hat{m}) = 1$; otherwise, $\hat{m} = \bar{m}$. Hence,

$$\hat{m} = \begin{cases} \psi_1^{-1}(1) & \text{if } \lim_{m \uparrow \bar{m}} \psi_1(m) > 1, \\ \bar{m} & \text{otherwise.} \end{cases} \quad (24)$$

Using this threshold \hat{m} and equations (21) to (23), we can summarize the relationship between firm efficiency and FDI mode choice as follows.

Proposition 6 *Consider the mapping from entrepreneurial ability to mode of FDI. For entrepreneurs of ability $a < a_2(\theta\hat{m}) = a_1(\hat{m})$, all FDI involves cross-border acquisitions in country 1. For entrepreneurs of ability $a \in (a_2(\theta\hat{m}), a_2(\bar{m}))$, all FDI involves cross-border acquisitions in country 2. For entrepreneurs of ability $a > a_2(\bar{m})$, all FDI involves greenfield FDI in country 2.*

Consider an entrepreneur of ability a from country 1. (i) If $a \leq a_1(\hat{m}) = a_2(\theta\hat{m})$, he will not engage in FDI. (ii) If $a \in (a_2(\theta\hat{m}), a_2(\theta\bar{m}))$, the entrepreneur will, with positive probability, acquire a good in country 2. The probability that a country-2 good of type $m \in (\theta\hat{m}, \theta\bar{m})$ will be acquired by a foreign entrepreneur is $1 - \psi_2(m) \geq 0$, and is strictly increasing in m . Positive assortative matching between a and m then implies that the probability that a country-1 entrepreneur of ability $a \in (a_2(\theta\hat{m}), a_2(\theta\bar{m}))$ engages in cross-border acquisitions is strictly increasing in a . (iii) If $a > a_1(\bar{m}) = a_2(\theta\bar{m})$, the entrepreneur will engage in FDI with probability one, namely in cross-border acquisitions if $a \in (a_2(\theta\bar{m}), a_2(\bar{m}))$, and in greenfield FDI if $a > a_2(\bar{m})$. We thus obtain the following monotonicity result.

Proposition 7 *The probability that an entrepreneur from country 1 engages in FDI is weakly increasing in his ability a .*

Proposition 7 implies, in particular, that in the high-cost country, firms engaging in cross-border acquisitions are, on average, more efficient than firms producing domestically.

6 Comparative Statics

In this section, we further explore the workings of our model, again focussing on an industry in which country 2 is the low-cost location of production. We generate a number of additional predictions by analyzing the effects of changing various exogenous variables on the equilibrium assignment and location of production, and the industry-level statistics of FDI.

Throughout this section, we assume that conditions (C1) and (C2) hold. Using equations (19) and (24), the industry-level statistics of FDI, (21) to (23), then simplify to

$$\mu_1 = \frac{E_2}{E_1} \mu_2 = \frac{E_2}{E_1 + E_2} [H(\hat{m}) - H(\theta\hat{m})], \quad (25)$$

and

$$\gamma_1 = 1 - H(\bar{m}). \quad (26)$$

The fixed cost of building a plant. We now want to explore the effects of changing the fixed cost ϕ of building a new plant in country 2. Intuitively, one would expect that an increase in ϕ raises the threshold \bar{m} , and hence reduces the share γ_1 of entrepreneurs from country 1 engaging in greenfield FDI in country 2. Indeed, this can easily be established using equations (17) and (18). Further, $\bar{m} \rightarrow 0$ as ϕ becomes small, and $\bar{m} \rightarrow \infty$ as ϕ becomes large. Next, note that if $\hat{m} < \bar{m}$, \hat{m} is implicitly defined by $\theta h(\theta\hat{m})/h(\hat{m}) = 1$, and hence (locally) independent of ϕ ; otherwise $\hat{m} = \bar{m}$, and so \hat{m} is strictly increasing in ϕ . We thus have the following lemma.

Lemma 2 *The threshold \bar{m} is strictly increasing in ϕ , $\bar{m} \rightarrow 0$ as $\phi \rightarrow 0$, and $\bar{m} \rightarrow \infty$ as $\phi \rightarrow \infty$. Further, if $\hat{m} < \bar{m}$, then \hat{m} is (locally) independent of ϕ . Hence, there exists a unique $\hat{\phi} > 0$ such that $\hat{m} < \bar{m}$ for all $\phi > \hat{\phi}$, and $\hat{m} = \bar{m}$ for all $\phi \leq \hat{\phi}$.*

Since \bar{m} is strictly increasing in ϕ , it follows immediately from equation (26) that the fraction γ_1 of entrepreneurs from country 1 engaging in greenfield FDI is decreasing in ϕ . The effect of ϕ on the cross-border acquisition volume, however, depends on whether or not $\phi > \hat{\phi}$, as the following proposition shows.

Proposition 8 *A small increase in the fixed cost ϕ of building a plant, $d\phi > 0$, has the following effects:*

$$d\gamma_1 < 0, \quad d\mu_1 = \frac{E_2}{E_1} d\mu_2 \begin{cases} > 0 & \text{if } \phi < \hat{\phi} \\ = 0 & \text{otherwise.} \end{cases}$$

Proof. See appendix. ■

This proposition shows that the total number of cross-border acquisitions can be independent of the cost and volume of greenfield FDI, namely whenever the fixed cost ϕ is sufficiently large (and the volume of greenfield FDI small). However, even in this case, the composition of cross-border acquisitions from country 1 to country 2 is not independent of ϕ in the sense that a change in ϕ affects the set of entrepreneurs from country 1 who will engage in cross-border mergers.

Country characteristics. We now want to investigate the effects on the equilibrium of varying country characteristics: the production-cost differential, as measured by θ , and the numbers of entrepreneurs in each country, E_1 and E_2 . For simplicity, we will confine attention to the case $\phi > \widehat{\phi}$.

Consider first an increase in θ , i.e., a reduction in the production-cost difference between the two countries. Under condition (C1), FDI is ultimately driven by cost differences. Hence, one would expect the volume of FDI to decrease as the countries become more similar. Indeed, this intuition is correct, as the following proposition shows.

Proposition 9 *A reduction in the production-cost difference between the two countries, $d\theta > 0$, has the following effects:*

$$d\gamma_1 < 0 \text{ and } d\mu_1 = \frac{E_2}{E_1}d\mu_2 < 0.$$

Proof. See appendix. ■

Consider now a small decrease in the number of entrants in country 2, E_2 , holding the total number of entrants in the two countries, $E_1 + E_2$, fixed. That is, the aggregate mass of goods and entrepreneurs is held constant, while goods and entrepreneurs from country 2 are becoming relatively more scarce. We obtain the following proposition.

Proposition 10 *A small decrease in the number of entrants in country 2, E_2 , holding the total number of entrants, $E_1 + E_2$, fixed, has the following effects:*

$$d\gamma_1 > 0 \text{ and } d\mu_1 = -d\mu_2 < 0.$$

Proof. See appendix. ■

Intuitively, a relative decrease in the number of entrants in country 2 implies that there are fewer attractive corporate assets in country 2 that entrepreneurs from country 1 can acquire. Hence, as $E_2/(E_1 + E_2)$ decreases, entrepreneurs from country 1 will substitute away from cross-border acquisitions in favor of greenfield FDI. This effect is reinforced by the indirect effect through the markup-adjusted residual demand level: the shift in endowments in favor of the high-cost country raises S , which further increases the incentive for firms from the high-cost country to engage in greenfield FDI. In the limit as the relative number of entrants from country 2 goes to zero, all FDI from country 1 to country 2 will be in the form of greenfield FDI, i.e., $\mu_1 \rightarrow 0$, while γ_1 is bounded away from zero. This is an alternative explanation for the observation (summarized by figure 2) that U.S. MNEs are much more likely to choose greenfield FDI when engaging in FDI in poor, developing countries (where, arguably, there are fewer attractive target firms) than when engaging in FDI in rich, developed countries.

A small decrease in the fraction of entrants who originate in country 2 makes the countries “more similar” if $E_1 < E_2$, and “more dissimilar” if the reverse inequality holds. An interesting question is whether the industry-level number of cross-border acquisitions, $E_1\mu_1 + E_2\mu_2$, increases or decreases as the two countries become more similar. From equations (22) and (23), we have

$$E_1\mu_1 + E_2\mu_2 = \frac{2E_1E_2}{E_1 + E_2} [H(\hat{m}) - H(\theta\hat{m})].$$

Recall that \hat{m} is independent of the number of entrants. Hence, the industry-level volume of cross-border acquisitions follows a gravity-type equation: it increases as the two countries become more similar in terms of their populations of entrants.

Corollary 1 *Consider a small increase in the number of entrants in country 1, E_1 , holding the total number of entrants, $E_1 + E_2$, fixed. Then, the industry-level number of cross-border mergers, $E_1\mu_1 + E_2\mu_2$, increases if $E_1 < E_2$, and decreases if $E_1 > E_2$. Hence, the industry-level number of cross-border mergers is maximized when $E_1 = E_2$.*

Does the industry-level volume of cross-border acquisitions increase or decrease as the two countries become more similar in that industry? As proposition 9 and corollary 1 show, the answer depends on which set of country characteristics one considers. As countries become more similar in terms of production costs, the aggregate two-way volume of cross-border acquisitions decreases, whereas the opposite result obtains as countries become more similar in terms of their populations of entrants.

7 Discussion

In this section, we show that our predictions are robust across a wide range of alternative assumptions.

Closing the model. In the main text, we considered the equilibrium in an industry for given wage levels ω_1 and ω_2 . We remained agnostic about (i) how the wage levels are determined, and (ii) the technology and market structure of the outside-good industry. There are two ways in which we could close the model. (a) We could assume that firms in the outside good industry have a constant-return-to-scale technology and behave as price takers. Assuming that the outside good is tradeable and produced in both countries, the wages ω_1 and ω_2 would then be pinned down by the labor productivity in the outside good sector in the two countries. (b) We could consider alternative technologies and market structures in the outside good industry and close the model by explicitly writing down a labor market clearing condition.

All of our characterization results, i.e., all of the results from sections 3 to 5, remain valid under both (a) and (b) as long as there exists some industry j such that, in equilibrium, $\omega_1/\eta_{1j} \neq \omega_2/\eta_{2j}$. (If there did not exist such an industry j , there would be no greenfield FDI in equilibrium. If, in addition, (C1) were to hold, there would also be no cross-border acquisitions in equilibrium.) Indeed, if there are underlying Ricardian differences between countries, $\omega_1/\eta_{1j} \neq \omega_2/\eta_{2j}$ generically for almost all industries. As regards our comparative statics results in section 6, they are valid under assumption (a) since FDI flows do not affect

wage levels in this case. However, even under assumption (b), our comparative statics results are valid as long as they are interpreted as cross-industry comparisons (between those industries in which one country has a comparative advantage) in a given world equilibrium. This shows that our results are very robust to the particular way in which the model is closed.

Cost of building a new plant. We assumed that building a new plant in country i requires ϕ/η_i units of labor from country i , independently of the market size of the good. As we will now discuss, our results are robust to assuming that the labor requirement for a new plant to produce a type- m good in country i is $\phi \cdot \chi(m)/\eta_i$, where $\chi(0) > 0$ and $\chi''(m) \leq 0$ for all m . Indeed, conditional on the market size threshold \bar{m} , the equilibrium assignment of entrepreneurs to goods remains unchanged, while \bar{m} is now given by

$$W_2(\theta\bar{m}) = W_2(\bar{m}) - \phi \cdot \chi(\bar{m}),$$

or

$$S \int_{\theta\bar{m}}^{\bar{m}} a_2(m) dm = \phi \cdot \chi(\bar{m}). \quad (27)$$

Proposition 11 *Suppose the labor requirement for a new plant to produce a type- m good in country i is $\phi \cdot \chi(m)/\eta_i$, where $\chi(0) > 0$ and $\chi''(m) \leq 0$ for all m . Then, there exists a unique equilibrium $\{a_1(\cdot), a_2(\cdot), \bar{m}, S\}$ satisfying equations (6) to (9), (18) and (27).*

Proof. See appendix. ■

As can be seen from the proof, the result continues to hold even if $\chi(\cdot)$ is strictly convex as long as it is not “too convex”. This follows from the induced positive assortative matching between entrepreneurial abilities and types of goods. It is straightforward to verify that all of our predictions (propositions 2 to 10) continue to hold under the conditions of proposition 11.¹⁴

Multiproduct firms. In the analysis above, we assumed that each firm/entrepreneur can manage at most one good. As we now discuss, most of our results would remain unchanged if instead each entrepreneur of ability a could manage at most $n(a) \geq 1$ goods. To see this, note that in this case there exists a unique threshold $\underline{a} > 0$, defined by

$$\int_{\underline{a}}^{\infty} n(a)g(a)da = 1,$$

such that all entrepreneurs of ability $a < \underline{a}$ are “unemployed”, while each entrepreneur of ability $a > \underline{a}$ manages production of exactly $n(a)$ goods. The resulting equilibrium assignment of entrepreneurial types to goods would then be the same as in the limiting case of our single-product model, namely where the density of entrepreneurial ability takes the form

$$\tilde{g}(a) \equiv \begin{cases} n(a)g(a) & \text{if } a > \underline{a} \\ 0 & \text{otherwise.} \end{cases}$$

¹⁴The comparative statics results regarding a change in the cost of building a new plant, lemma 2 and proposition 8, are to be interpreted as involving a change in ϕ , holding the function $\chi(\cdot)$ fixed.

The only results that are potentially affected by this reformulation are those that rely on the balancedness condition, $E_1\mu_1 = E_2\mu_2$, which – in the presence of multiproduct firms – may not hold unless assumption (C.1) is satisfied. Indeed, if the share of entrepreneurs of ability $a < \underline{a}$ is much higher in country 2 than in country 1, all FDI would be one-way from the high-cost to the low-cost country.

Fixed costs. If firms had to pay a fixed cost of being in business, there would exist thresholds $\underline{a} > 0$ and $\underline{m} > 0$ such that all entrepreneurs of ability $a < \underline{a}$ and all goods of type $m < \underline{m}$ in country 1 and $m < \theta\underline{m}$ in country 2 would be “unemployed”. The assignment of entrepreneurial abilities to goods would be unaffected by the existence of fixed costs. However, if the fixed cost were sufficiently large, then there might not be FDI flowing from country 2 to country 1, not even under assumption (C.1), because the mass of unproduced goods in country 1 would be larger than that in country 2.

Foreign direct investment over time. It is straightforward to embed our model in a stochastic dynamic setting where goods become obsolete at some constant rate (independently of their type), while new goods arrive at the same rate in each country (and their types are drawn from the distribution function $H(\cdot)$). The dynamic equilibrium of this economy will then have the same features as the equilibrium derived in our static model.

8 Conclusion

In this paper, we have developed an assignment theory to analyze both the volume of foreign direct investment and its composition between cross-border acquisitions and greenfield investment. In our model, a firm consists of a bundle of heterogeneous and complementary corporate assets. The merger market allows firms to trade these corporate assets to exploit complementarities. A cross-border acquisition involves purchasing foreign corporate assets, while greenfield FDI involves building production capacity in the foreign country to allow the firm to deploy its corporate assets abroad. Equilibrium in the merger market is the solution to the associated assignment problem.

There are two countries that can freely trade with one another. Production cost differences between countries give rise to greenfield FDI and to cross-border acquisitions, while cross-country differences in entrepreneurial abilities give rise only to cross-border acquisitions. In equilibrium, greenfield FDI is always one way: from the high-cost to the low-cost country, while cross-border acquisitions are always two-way. Hence, our model can generate two-way FDI flows even in the absence of transport costs and production cost differences. Firms’ choice between the two modes of FDI, and the re-assignment of corporate assets on the international merger market have an important impact on aggregate productivity by magnifying underlying Ricardian differences between countries.

We have derived the following key predictions. (1) Firms engaging in greenfield FDI are systematically more efficient than those engaging in cross-border acquisition. As we have shown, this is consistent with the data. (2) As production cost differences between countries vanish, all FDI takes the form of cross-border acquisitions. To the extent that production cost differences reflect underlying wage differentials, this prediction is consistent with our observation that U.S. multinationals are more likely to favor cross-border acquisitions over greenfield FDI in

high-wage rather than low-wage countries. (3) As the relative supply of corporate assets in the low-cost country decreases, firms in the high-cost country substitute away from cross-border acquisitions in favor of greenfield FDI. Again, this is consistent with our observation that the share of cross-border acquisition in total U.S. FDI is decreasing in the host country's level of development.

While outside the scope of this paper, our model may also fruitfully be used as a framework for policy analysis. For instance, it would be interesting to compute the welfare implications of various policy experiments, such as restrictions on cross-border acquisitions or greenfield FDI. From the host country's point of view, cross-border acquisitions involve a change in ownership of local production (and may even lead to the closure of local production), while greenfield FDI involves the opening of a new establishment. In this sense, cross-border acquisitions bring "less" to the host country's economy than greenfield FDI. Moreover, greenfield FDI involves better foreign firms than cross-border acquisitions. Hence, the optimal government policy toward foreign direct investment should be tailored to the particular mode of FDI: greenfield FDI vs. cross-border acquisitions. We believe this to be an exciting avenue for future research.

Appendix: Empirics

This appendix serves two purposes. First, we explain the data used to construct figures 1 and 2. Second, we present an econometric analysis of the composition of a U.S. multinational's mode choice as a function of firm and country characteristics.

Our firm-level data come from the Bureau of Economic Analysis (BEA), which each year conducts a mandatory survey of all U.S. firms with foreign affiliates above a certain size threshold. (The size threshold ensures that the dataset does not contain “empty shells”, i.e., legal entities without employees.) Firms that come to own a new enterprise abroad are required to report (i) whether that enterprise was obtained through cross-border acquisition or greenfield FDI, (ii) in which industry that enterprise produces, and (iii) in which country that enterprise is located. From this database, we collected every recorded investment by those multinationals whose mainline of business is a traded good over the five-year period 1994-1998. The BEA dataset also contains a wide range of data on the characteristics of the parent firms that are conducting FDI abroad, which are used as explanatory variables in our analysis.

Construction of figures 1 and 2. Our two measures of a firm's efficiency are (i) the logarithm of sales of the U.S. parent firm in the United States (*USSALE*), and by (ii) the logarithm of the parent firm's value-added per employee (*VADDPW*). In order to sort firms in different industries into efficiency groups, we must make efficiency data comparable across industries. Using data for 1994, we calculate the difference between the efficiency of firm i in industry k and the industry k average, and normalize this difference by the standard deviation in efficiency across firms in industry k . On the basis of relative efficiency, we sort firms into the three equally-sized groups, aggregate investment counts over firms within a group, and calculate the share of investments taking the form of cross-border acquisitions by efficiency group.

To construct the data in figure 2, countries are sorted into three equally-sized groups on the basis of their real GDP per capita in 1994, and on the basis of the average wage paid by multinationals in that country in 1994. These data come from the Summers and Heston dataset and the Bureau of Economic Analysis, respectively.

Econometric model. To assess the robustness of the relationships shown in figures 1 and 2, we estimate a logit model that relates a firm's mode choice across countries and industries to a variety of firm and country characteristics. The dependent variable takes the value of one if the firm chooses cross-border acquisition, and zero otherwise. The key explanatory variables are the two measures of firm efficiency described above (*USSALES* and *VADDPW*) and the host country's level of development. In addition to including a variety of firm and country control variables, we also control for fixed effects by parent industry.

In the construction of our sample, we classified investments to facilitate interpretation of the results. In particular, we aggregated a firm's investments over the sample period 1994-1998 so that, for each firm, a country-industry pair appears at most once. For firms that made more than one investment in a particular country and industry, a country-industry observation for a firm was coded as a cross-border acquisition only if all investments made over the five-year period in that country-industry cell were cross-border acquisitions, and was coded as a greenfield investment otherwise.¹⁵ To ensure comparability across firms, the 1994 value of each

¹⁵ Almost all industry-country pairs were either entirely characterized by cross-border acquisition or greenfield.

Table 1: Descriptive Statistics.

Variable	Mean	Std. Dev.	Description
<i>ACQ</i>	0.435	0.496	Indicator for Acquisition
<i>USSALE</i>	15.2	1.61	Sales in U.S.
<i>VADDPW</i>	4.45	0.523	(Gross Product)/Employees
<i>EMP</i>	10.0	1.44	Employees
<i>DIV</i>	-1.01	0.658	Herfindahl Index for Parent Firm Sales
<i>R&D</i>	-.389	1.32	(R&D Expenditure)/Sales
<i>EXP</i>	0.696	0.460	Indicator for Previous Country Experience
<i>INTRAIM</i>	0.610	0.336	(Intra-Firm Imports)/(Total Imports)
<i>RGDPPC</i>	9.81	0.723	Real GDP per Capita
<i>AVWAGE</i>	3.1	0.75	Average Wage
<i>POP</i>	16.7	1.38	Population
<i>OPEN</i>	3.94	0.648	(Exports plus Imports)/GDP

All continuous variables (except *INTRAIM*) in logarithms.

All firm data is from the BEA's confidential dataset.

Country level data is from the Penn World Tables.

parent firm's characteristic is used to predict that firm's investment behavior over the whole five-year period.

We consider six specifications. In three of these specifications, our measure of firm efficiency is *USSALES*. In the other three, we measure firm efficiency using *VADDPW* and control for firm size using *EMP*, the number of workers employed by the parent.¹⁶ We include four firm-level controls. First, we include *RDSALE*, which is the logarithm of a firm's R&D expenditures to its total sales. Second, we include *DIV*, which is a measure of a firm's diversification across industries.¹⁷ Third, to quantify a parent firm's previous experience in a foreign country, we include an indicator variable, *EXP*, which is equal to one if the parent firm owned an enterprise in that country prior to the sample period, and is zero otherwise. Fourth, we include the variable *INTRAIM*, which is the ratio of a parent firm's intra-firm imports to total imports so as to measure the extent of the firm's international vertical integration. In all six specifications, we include measures of three country characteristics: a host country's level of development, its market size, and its degree of openness to international trade. To gauge a host country's level

Only a handful of country-industry pairs in the sample involved both cross-border acquisitions and greenfield FDI. The results that obtain from estimating the same model on the raw data offer very similar results.

¹⁶The correlation between *USSALES* and *VADDPW* is 0.46.

¹⁷*DIV* is defined as:

$$\log \left(\sum_j s_{pj}^2 \right)^{-1},$$

where s_{pj} is the share of the parent firm's sales in industry j , and the sum is over the eight largest industries in which the parent firm sells.

of development in a parsimonious fashion, we include *RGDPPC*, which is the logarithm of real GDP per capita. A country's market size is captured by *POP*, which is the logarithm of the country's population. Finally, we include *OPEN*, which is a measure of a country's openness to international trade (the sum of exports and imports, divided by GDP). Descriptive statistics are presented in table 1.

The results are shown in table 2, where the heading of each column indicates the measure of productivity used in that specification. The columns are organized by the number of controls included in the analysis with the first two corresponding to the most parsimonious specifications, the next two corresponding to specifications including the firm level controls, and the last two corresponding to specification that also include fixed effects by affiliate industry. All six specifications include parent industry fixed effects. Standard errors (shown in parentheses) are robust to heteroskedasticity and clustering by firm.

The results provide evidence that the relationships reported in figures 1 and 2 are robust to a wide range of firm and industry controls. In all six specifications, the coefficient on the efficiency measure is negative and statistically significant, indicating that the more efficient firms enter foreign markets through greenfield FDI rather than through cross-border acquisition. Firms do not perceive cross-border acquisitions and greenfield FDI as perfect substitutes.¹⁸ Further, in all six specifications the coefficient on *RGDPPW* is positive and statistically significant, indicating that firms tend to enter rich, developed countries through cross-border acquisition rather than through greenfield FDI.

¹⁸Our empirical results complement those of Blonigen (1997), who provides indirect evidence suggesting that greenfield FDI and cross-border acquisitions are different in nature.

Table 2: Greenfield FDI vs. Cross-Border Acquisitions as a Function of Firm and Country Characteristics.

	(1)	(2)	(3)	(4)	(5)	(6)
	<i>USSALE</i>	<i>VADDPW</i>	<i>USSALE</i>	<i>VADDPW</i>	<i>USSALE</i>	<i>VADDPW</i>
Efficiency	-0.211 (0.074)	-0.932 (0.308)	-0.280 (0.103)	-1.128 (0.374)	-0.301 (0.122)	-1.287 (0.504)
<i>EMP</i>		-0.141 (0.076)		-0.111 (0.115)		-0.077 (0.167)
<i>DIV</i>			-0.026 (0.317)	-0.298 (0.317)	-0.431 (0.412)	-0.766 (0.437)
<i>R&D</i>			0.038 (0.127)	0.099 (0.143)	0.009 (0.170)	0.068 (0.196)
<i>EXP</i>			0.187 (0.243)	0.190 (0.244)	0.539 (0.282)	0.542 (0.281)
<i>INTRAIM</i>			-0.306 (0.459)	-0.569 (0.487)	-0.783 (0.617)	-1.062 (0.663)
<i>RGDPPC</i>	0.662 (0.156)	0.613 (0.154)	0.564 (0.175)	0.533 (0.173)	0.550 (0.214)	0.502 (0.219)
<i>POP</i>	0.037 (0.092)	0.057 (0.097)	0.004 (0.100)	0.015 (0.103)	-0.134 (0.124)	-0.120 (0.124)
<i>OPEN</i>	-0.626 (0.185)	-0.551 (0.189)	-0.591 (0.202)	-0.573 (0.207)	-0.947 (0.280)	-0.918 (0.284)
FE: Parent Industry	YES	YES	YES	YES	YES	YES
FE: Affiliate Industry	NO	NO	NO	NO	YES	YES
Obs.	856	849	724	725	641	642
Log-likelihood	-488	-480	-412	-407	-305	-302

Standard errors (shown in parenthesis) are robust to heteroskedasticity and allow for clustering by parent firm.

The correlation between *USSALE* and *VADDPW* is 0.46.

The efficiency measure corresponding to each specification is shown under the column number.

Appendix: Proofs

Proof of lemma 1. Equation (18) is of the form $S = \beta\sigma^{-1} [D(\bar{m})]^{-1}$, where

$$D(\bar{m}) = E_1\theta \int_0^{\bar{m}} ma_2(\theta m)dH(m) + E_2 \int_0^{\bar{m}} ma_2(m)dH(m) + (E_1 + E_2) \int_{\bar{m}}^{\infty} ma_2(m)dH(m).$$

Hence, $dS/d\bar{m} > 0$ if and only if $D'(\bar{m}) < 0$. We have

$$\begin{aligned} D'(\bar{m}) &= E_1h(\bar{m}) \left\{ \bar{m} [\theta a_2(\theta\bar{m}) - a_2(\bar{m})] + \int_{\theta\bar{m}}^{\bar{m}} \left(\frac{E_2}{E_1 + E_2} \right) \frac{mh(m)}{g(a_2(m))} dm \right\} \\ &= E_1h(\bar{m}) \left\{ \bar{m} [\theta a_2(\theta\bar{m}) - a_2(\bar{m})] + \int_{\theta\bar{m}}^{\bar{m}} ma_2'(m) dm \right\}. \end{aligned}$$

Integrating by parts, yields

$$\begin{aligned} D'(\bar{m}) &= E_1h(\bar{m}) \left\{ \bar{m} [\theta a_2(\theta\bar{m}) - a_2(\bar{m})] + [\bar{m}a_2(\bar{m}) - \theta\bar{m}a_2(\theta\bar{m})] - \int_{\theta\bar{m}}^{\bar{m}} a_2(m) dm \right\} \\ &= -E_1h(\bar{m}) \int_{\theta\bar{m}}^{\bar{m}} a_2(m) dm < 0. \end{aligned}$$

■

Proof of proposition 1. First, note that, conditional on \bar{m} and S , $a_1(\cdot)$ and $a_2(\cdot)$ are uniquely determined by equations (6) to (9). Second, note that, conditional on \bar{m} (and $a_1(\cdot)$ and $a_2(\cdot)$), S is uniquely determined by (18). It thus remains to be shown that there exists a unique \bar{m} satisfying equations (17) and (18). Let

$$\Phi(\bar{m}) \equiv S \int_{\theta\bar{m}}^{\bar{m}} a_2(m) dm - \phi,$$

where S is a function of \bar{m} and given by (18). We need to show that there exists a unique \bar{m} such that $\Phi(\bar{m}) = 0$. Differentiating, we obtain

$$\Phi'(\bar{m}) = S \left\{ a_2(\bar{m}) - \theta a_2(\theta\bar{m}) + \left(\frac{E_1}{E_1 + E_2} \right) \int_{\theta\bar{m}}^{\bar{m}} \frac{h(\bar{m})}{g(a_2(m))} dm \right\} + \frac{dS}{d\bar{m}} \int_{\theta\bar{m}}^{\bar{m}} a_2(m) dm.$$

Since $a_2(\bar{m}) > \theta a_2(\theta\bar{m})$ and, from lemma 1, $dS/d\bar{m} > 0$, $\Phi'(\bar{m}) > 0$. Next, note that $\Phi(0) = -\phi < 0$. Finally, observe that $a_2(\bar{m}) - \theta a_2(\theta\bar{m}) \geq (1 - \theta)a_2(\bar{m})$ and so $\Phi'(\bar{m}) \rightarrow \infty$ as $\bar{m} \rightarrow \infty$, which implies that $\lim_{\bar{m} \rightarrow \infty} \Phi(\bar{m}) = \infty$. Hence, there exists a unique $\bar{m} > 0$ such that $\Phi(\bar{m}) = 0$. ■

Proof of proposition 2. Let $\lambda_i(a)$ denote the fraction of firms producing in country i with entrepreneurial ability less than or equal to a . We need to show that $\lambda_1(a) > \lambda_2(a)$ for all $a > 0$.

For $a \geq a_1(\bar{m})$, we have

$$\lambda_1(a) = 1 > \lambda_2(a).$$

Consider now $0 < a < a_1(\bar{m})$, and let $m_i(a)$ be such that $a = a_i(m_i(a))$, i.e., $m_i(a)$ is the market size of the good that will, in equilibrium, be produced by a firm with entrepreneurial ability a in country i . We have

$$\begin{aligned}\lambda_1(a) &\equiv \frac{E_1 H(m_1(a))}{E_1 H(\bar{m})} \\ &> \frac{H(m_1(a))}{1 + (E_1/E_2)[1 - H(\bar{m})]} \\ &> \frac{E_2 H(m_2(a))}{E_2 + E_1[1 - H(\bar{m})]} \equiv \lambda_2(a),\end{aligned}$$

where the second inequality follows from the observation that $m_1(a) > m_2(a)$. ■

Proof of proposition 8. An increase in ϕ induces an increase in the threshold \bar{m} (see lemma 2), which in turn leads to an increase in γ_1 (see equation (26)).

Consider now the effect of an increase of ϕ on μ_i . Let $\varphi(m) \equiv h(m) - \theta h(\theta m)$. Further, let \tilde{m} be defined by $\varphi(\tilde{m}) = 0$. To see that \tilde{m} is unique, note that

$$\varphi'(\tilde{m}) = h'(\tilde{m}) - \theta^2 h'(\theta \tilde{m}).$$

Further,

$$h'(\tilde{m}) < \theta^2 h'(\theta \tilde{m})$$

if and only if

$$\frac{\tilde{m} h'(\tilde{m})}{h(\tilde{m})} < \frac{\tilde{m} \theta h'(\theta \tilde{m})}{h(\theta \tilde{m})}$$

since $h(\tilde{m}) = \theta h(\theta \tilde{m})$. However, the last inequality must hold by condition (C2). Hence, $\varphi'(\tilde{m}) < 0$, and so $\varphi(m) > 0$ for any $m < \tilde{m}$, and $\varphi(m) < 0$ for any $m > \tilde{m}$.

From (19) and (24), we have $\hat{m} = \min\{\tilde{m}, \bar{m}\}$. If $\phi \geq \hat{\phi}$, then $\hat{m} = \tilde{m}$, and so an increase in ϕ has no effect on \hat{m} , and hence (by equation (25)) no effect on μ_i . If $\phi < \hat{\phi}$, then $\hat{m} = \bar{m} < \tilde{m}$. From lemma 2, it follows that a small increase in ϕ leads to an increase in \bar{m} . Using equation (25) and the implicit function theorem, an increase in \bar{m} induces an increase in μ_i if $\varphi(\bar{m}) \equiv h(\bar{m}) - \theta h(\theta \bar{m}) > 0$. However, since $\bar{m} < \tilde{m}$ if $\phi < \hat{\phi}$, it follows indeed that $\varphi(\bar{m}) > 0$. ■

Proof of proposition 9. We first want to show that \bar{m} is increasing in θ . From equation (17), \bar{m} is given by

$$\varphi(\theta, \bar{m}) \equiv \frac{\phi}{S} - \int_{\theta \bar{m}}^{\bar{m}} a_2(m) dm = 0,$$

where S is a function of θ and \bar{m} and given by (18). Since $\partial \varphi(\theta, \bar{m}) / \partial \bar{m} < 0$ (see the proof of

proposition 1), we need to show that $\partial\varphi(\theta, \bar{m})/\partial\theta > 0$. We obtain

$$\begin{aligned} \frac{\partial\varphi(\theta, \bar{m})}{\partial\theta} &= \beta^{-1}\sigma\phi \left[E_1 \int_0^{\bar{m}} ma_1(m)dH(m) + E_1\theta \int_0^{\bar{m}} m \frac{\partial a_1(m)}{\partial\theta} dH(m) \right. \\ &\quad \left. + E_2 \int_0^{\theta\bar{m}} m \frac{\partial a_2(m)}{\partial\theta} dH(m) \right] + a_2(\theta\bar{m})\bar{m} \\ &= \beta^{-1}\sigma\phi \left[E_1 \int_0^{\bar{m}} ma_1(m)dH(m) + E_1\theta \int_0^{\bar{m}} m^2 \frac{E_2 h(\theta m)h(m)}{[E_1 + E_2]g(a_2(\theta m))} dm \right. \\ &\quad \left. - E_2 \int_0^{\theta\bar{m}} (m/\theta)^2 \frac{E_1 h(m/\theta)h(m)}{[E_1 + E_2]g(a_2(m))} dm \right] + a_2(\theta\bar{m})\bar{m}. \end{aligned}$$

Changing variables, this expression can be rewritten as

$$\frac{\partial\varphi(\theta, \bar{m})}{\partial\theta} = \beta^{-1}\sigma\phi E_1 \int_0^{\bar{m}} ma_1(m)dH(m) + a_2(\theta\bar{m})\bar{m} > 0.$$

Hence, $d\bar{m}/d\theta > 0$. From (26), it then follows immediately that $d\gamma_1/d\theta < 0$.

Consider now the share μ_1 of entrepreneurs from country 1 who engage in cross-border mergers in country 2. From equation (25), we obtain

$$\frac{d\mu_1}{d\theta} = \frac{E_2}{E_1 + E_2} \left\{ -\hat{m}h(\theta\hat{m}) + [h(\hat{m}) - \theta h(\theta\hat{m})] \frac{d\hat{m}}{d\theta} \right\}.$$

Since $\phi > \hat{\phi}$ by assumption, \hat{m} is defined by $h(\hat{m}) - \theta h(\theta\hat{m}) = 0$. Hence, the above expression simplifies to

$$\frac{d\mu_1}{d\theta} = -\frac{E_2}{E_1 + E_2} \hat{m}h(\theta\hat{m}) < 0.$$

Similarly,

$$\frac{d\mu_2}{d\theta} = -\frac{E_1}{E_1 + E_2} \hat{m}h(\theta\hat{m}) < 0.$$

■

Proof of proposition 10. Observe that the effect of an decrease in E_2 , holding $E_1 + E_2$ fixed, is equivalent to the effect of increasing E_1 , holding $E_1 + E_2$ fixed. Hence, we need to prove that $d\gamma_1/dE_1 - d\gamma_1/dE_2 > 0$ and $d\mu_1/dE_1 - d\mu_1/dE_2 < 0$. To this end, we first show that \bar{m} is decreasing in E_1 , holding $E_1 + E_2$ fixed. From equation (17), \bar{m} is given by

$$\varphi(E_1, E_2, \bar{m}) \equiv \frac{\phi}{S} - \int_{\theta\bar{m}}^{\bar{m}} a_2(m)dm = 0,$$

where S is a function of E_1, E_2 , and \bar{m} and given by (18). Since $\partial\varphi(E_1, E_2, \bar{m})/\partial\bar{m} < 0$ (see the proof of proposition 1), we need to show that $\partial\varphi(E_1, E_2, \bar{m})/\partial E_1 - \partial\varphi(E_1, E_2, \bar{m})/\partial E_2 > 0$.

We obtain

$$\begin{aligned}
& \frac{\partial \varphi(E_1, E_2, \bar{m})}{\partial E_1} - \frac{\partial \varphi(E_1, E_2, \bar{m})}{\partial E_2} \\
= & \beta^{-1} \sigma \phi \left[\theta \int_0^{\bar{m}} m a_1(m) dH(m) - \int_0^{\bar{m}} m a_2(m) dH(m) \right. \\
& + E_1 \theta \int_0^{\bar{m}} m \left. \frac{\partial a_1(m)}{\partial E_1} \right|_{E_1+E_2=const.} dH(m) \\
& + E_2 \int_0^{\bar{m}} m \left. \frac{\partial a_2(m)}{\partial E_1} \right|_{E_1+E_2=const.} dH(m) \left. \right] \\
& - \int_{\theta \bar{m}}^{\bar{m}} \left. \frac{\partial a_2(m)}{\partial E_1} \right|_{E_1+E_2=const.} dm.
\end{aligned} \tag{28}$$

The sum of the third and fourth terms in brackets can be rewritten as

$$\begin{aligned}
& E_1 \theta \int_0^{\bar{m}} m \frac{H(m) - H(\theta m)}{[E_1 + E_2] g(a_2(\theta m))} dH(m) + E_2 \int_0^{\theta \bar{m}} m \frac{H(m/\theta) - H(m)}{[E_1 + E_2] g(a_2(m))} dH(m) \\
& + E_2 \int_{\theta \bar{m}}^{\bar{m}} m \frac{H(\bar{m}) - H(m)}{[E_1 + E_2] g(a_2(m))} dH(m).
\end{aligned}$$

Changing variables, we obtain

$$\theta \int_0^{\bar{m}} m [H(m) - H(\theta m)] \frac{E_1 h(m) + \theta E_2 h(\theta m)}{[E_1 + E_2] g(a_2(\theta m))} dm + E_2 \int_{\theta \bar{m}}^{\bar{m}} m \frac{H(\bar{m}) - H(m)}{[E_1 + E_2] g(a_2(m))} dH(m).$$

Integrating by parts yields

$$\begin{aligned}
& \theta \bar{m} [H(\bar{m}) - H(\theta \bar{m})] a_2(\theta \bar{m}) - \theta \int_0^{\bar{m}} a_2(\theta m) \{ [H(m) - H(\theta m)] + m [h(m) - \theta h(\theta m)] \} dm \\
& - \theta \bar{m} [H(\bar{m}) - H(\theta \bar{m})] a_2(\theta \bar{m}) - \int_{\theta \bar{m}}^{\bar{m}} a_2(m) \{ [H(\bar{m}) - H(m)] - m h(m) \} dm \\
= & -\theta \int_0^{\bar{m}} a_1(m) [H(m) - H(\theta m)] dm - \theta \int_0^{\bar{m}} m a_1(m) dH(m) + \int_0^{\theta \bar{m}} m a_2(m) dH(m) \\
& - \int_{\theta \bar{m}}^{\bar{m}} a_2(m) [H(\bar{m}) - H(m)] dm + \int_{\theta \bar{m}}^{\bar{m}} m a_2(m) dH(m),
\end{aligned}$$

where the equality follows again from integrating by parts. Substituting this expression for the

third and fourth terms in brackets in equation (28), we obtain that

$$\begin{aligned}
& \frac{\partial \varphi(E_1, E_2, \bar{m})}{\partial E_1} - \frac{\partial \varphi(E_1, E_2, \bar{m})}{\partial E_2} \\
&= \beta^{-1} \sigma \phi \left[-\theta \int_0^{\bar{m}} a_1(m) [H(m) - H(\theta m)] dm \right. \\
&\quad \left. - \int_{\theta \bar{m}}^{\bar{m}} a_2(m) [H(\bar{m}) - H(m)] dm \right] - \int_{\theta \bar{m}}^{\bar{m}} \frac{\partial a_2(m)}{\partial E_1} \Big|_{E_1 + E_2 = \text{const.}} dm \\
&= -\beta^{-1} \sigma \phi \theta \left\{ \int_0^{\bar{m}} a_1(m) [H(m) - H(\theta m)] dm \right. \\
&\quad \left. - \int_{\theta \bar{m}}^{\bar{m}} a_2(m) [H(\bar{m}) - H(m)] dm \right\} - \int_{\theta \bar{m}}^{\bar{m}} \frac{H(\bar{m}) - H(m)}{[E_1 + E_2] g(a_2(m))} dm,
\end{aligned}$$

which is clearly negative. From (26), it then follows that γ_1 is increasing in E_1 , holding $E_1 + E_2$ fixed.

Observing that \hat{m} is independent of E_1 (since $\phi > \hat{\phi}$ by assumption, we obtain from (25) that

$$\frac{d\mu_1}{\partial E_1} - \frac{d\mu_1}{\partial E_2} = -\frac{H(\hat{m}) - H(\theta \hat{m})}{E_1 + E_2} < 0,$$

and

$$\frac{d\mu_2}{\partial E_1} - \frac{d\mu_2}{\partial E_2} = \frac{H(\hat{m}) - H(\theta \hat{m})}{E_1 + E_2} > 0.$$

■

Proof of proposition 11. First, note that, conditional on \bar{m} and S , $a_1(\cdot)$ and $a_2(\cdot)$ are uniquely determined by equations (6) to (9). Second, note that, conditional on \bar{m} (and $a_1(\cdot)$ and $a_2(\cdot)$), S is uniquely determined by (18). It thus remains to be shown that there exists a unique \bar{m} satisfying equations (27) and (18). Let

$$\Phi(\bar{m}) \equiv S \int_{\theta \bar{m}}^{\bar{m}} a_2(m) dm - \phi \cdot \chi(\bar{m}),$$

where S is a function of \bar{m} and given by (18). We need to show that there exists a unique \bar{m} such that $\Phi(\bar{m}) = 0$. Differentiating, we obtain

$$\begin{aligned}
\Phi'(\bar{m}) &= S \left\{ a_2(\bar{m}) - \theta a_2(\theta \bar{m}) + \left(\frac{E_1}{E_1 + E_2} \right) \int_{\theta \bar{m}}^{\bar{m}} \frac{h(\bar{m})}{g(a_2(m))} dm \right\} \\
&\quad + \frac{dS}{d\bar{m}} \int_{\theta \bar{m}}^{\bar{m}} a_2(m) dm - \phi \cdot \chi'(\bar{m}).
\end{aligned}$$

Since $dS/d\bar{m} > 0$ from lemma 1 and since $h(\bar{m})/g(a_2(m)) > 0$, we have $\Phi'(\bar{m}) > 0$ if

$$a_2(\bar{m}) - \theta a_2(\theta \bar{m}) \geq \frac{\phi \cdot \chi'(\bar{m})}{S}.$$

Since $\chi''(m) \leq 0$ for all m and $\chi(0) > 0$, $\chi'(\bar{m}) < \chi(\bar{m})/\bar{m}$. Further, since $\Phi(\bar{m}) = 0$, $\phi \cdot \chi(\bar{m})/S = \int_{\theta\bar{m}}^{\bar{m}} a_2(m)dm$. Hence, $\Phi'(\bar{m}) > 0$ if

$$\bar{m} [a_2(\bar{m}) - \theta a_2(\theta\bar{m})] \geq \int_{\theta\bar{m}}^{\bar{m}} a_2(m)dm.$$

But this inequality must hold since $a_2'(m) > 0$, and so $\int_{\theta\bar{m}}^{\bar{m}} a_2(m)dm \leq \bar{m}a_2(\bar{m}) [1 - \theta] \leq \bar{m} [a_2(\bar{m}) - \theta a_2(\theta\bar{m})]$. It follows that $\Phi'(\bar{m}) > 0$.

Next, note that $\Phi(0) = -\phi \cdot \chi(0)$, which is negative by assumption. Finally, observe that $a_2(\bar{m}) - \theta a_2(\theta\bar{m}) \geq (1 - \theta)a_2(\bar{m})$ and $\chi'(\bar{m}) \leq \chi'(0)$, and so $\Phi'(\bar{m}) \rightarrow \infty$ as $\bar{m} \rightarrow \infty$, which implies that $\lim_{\bar{m} \rightarrow \infty} \Phi(\bar{m}) = \infty$. Hence, there exists a unique $\bar{m} > 0$ such that $\Phi(\bar{m}) = 0$. ■

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