

Firm-embedded productivity and cross-country income differences*

Vanessa Alviarez
IADB

Javier Cravino
University of Michigan
and NBER

Natalia Ramondo
Boston University
and NBER

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Abstract

We measure the contribution of firm-embedded productivity to cross-country income differences. By firm-embedded productivity we refer to the components of productivity that are firm-specific and internationally transferable. Using micro-level data for multinational enterprises (MNEs), we compare market shares of the same MNE in different countries and document that they are systematically larger in less-developed countries. This indicates that MNEs face less competition and that firm-embedded productivity is scarce in these countries. We implement a measure of firm-embedded productivity based on this observation. Differences in firm-embedded productivity account for a third of the cross-country variance in output per-worker in our sample.

Keywords: Development Accounting, TFP, Multinational Enterprises

JEL Codes: O4, O1, F2

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1 Introduction

Differences in Total Factor Productivity (TFP) account for about half of the cross-country differences in income per-capita.¹ Understanding TFP differences is thus at the center of Development Economics. A common view is that aggregate productivity is partly determined by knowledge and expertise that is embedded in individual firms in the form of blue-prints, management practices, and other intangible capital.² This view has motivated a wide array of policies that promote firm-embedded productivity around the world, ranging from tax-incentives for R&D to incubator programs for startups.³ More recently, randomized control trials have shown that micro-level interventions fostering different aspects of firm-embedded productivity can improve firm outcomes.⁴ Nonetheless, the Macro Development literature has been mostly silent on the aggregate contribution of firm-embedded productivity to cross-country income differences.⁵

This paper introduces and implements a framework for measuring the contribution of firm-embedded productivity to cross-country income differences. By ‘firm-embedded productivity’ we refer to the components of productivity that are specific to the firm and that can be transferred internationally. We contrast these components with ‘country-embedded factors’, which are available to all firms producing in a country and are internationally immobile, such as natural amenities, infrastructure, and workers’ quality. As noted by [Burstein and Monge-Naranjo \(2009\)](#), separating between these two components is challenging, as different combinations of firm-embedded productivity and country-embedded factors can result in the same level of output per-worker.

Our approach overcomes this challenge by bringing to bear firm-level data on the cross-border operations of multinational enterprises (MNEs). We compare the market shares of the exact same MNE in different countries and document that they are roughly four times larger in developing than in high-income countries. We propose and implement a new measure of firm-embedded productivity based on this observation. Our central idea is that MNEs should have larger market shares in countries where aggregate firm-embedded productivity is relatively scarce, as they face less competition in those coun-

¹See [Hall and Jones \(1999\)](#) and [Caselli \(2016\)](#).

²See [Prescott and Visscher \(1980\)](#), [Klette and Kortum \(2004\)](#), [Atkeson and Kehoe \(2005\)](#), [Bloom and Van Reenen \(2007\)](#), and [McGrattan and Prescott \(2009\)](#).

³See the policy report by [Atkin et al. \(2019\)](#) for a review.

⁴For example, [Giné and Yang \(2009\)](#) and [Atkin et al. \(2017a\)](#) facilitate technology adoption at the firm level; [Bloom et al. \(2013\)](#) and [Brooks et al. \(2018\)](#) improve management practices; [Cai and Szeidl \(2017\)](#) and [Atkin et al. \(2017b\)](#) provide intangible capital in the form of business networks and market access.

⁵[Burstein and Monge-Naranjo \(2009\)](#) is a notable exception that we discuss in detail below.

tries. The observed differences in MNE market shares are indicative of large differences in the firm-embedded productivity of the competitors that MNEs face in each country.

We develop this logic in a development accounting framework and measure aggregate firm-embedded productivity using data on market shares of the foreign affiliates of MNEs that simultaneously operate in multiple countries. The framework assumes that producers in a country are heterogeneous in their production efficiency and product quality (what we call 'firm-embedded productivity'), but access the same country-embedded factors and set a constant markup over their marginal cost. Thus, the market share of a MNE in a country is determined by the MNE's productivity relative to the aggregate firm-embedded productivity in the country.⁶ MNEs can transfer their productivity around the world but face different competitors in each country where they operate. Differences in market shares of the same MNE in different countries pin-down the difference in aggregate firm-embedded productivity between those countries. We attribute the residual differences in income per-capita across countries to differences in country-embedded factors.

Of course, MNEs may not be able to fully transfer their productivity across countries. We allow for imperfect technology transfers by assuming that MNEs can only use a fraction of their productivity when operating abroad. This is the standard assumption in the multinational production literature when modeling imperfect technology transfers, home-bias in preferences, and other costs and policies that imply a differential treatment of MNEs versus domestic firms. Under this assumption, the market share of a MNE can be relatively low in a country both if aggregate firm-embedded productivity in that country is high, or if the MNE faces large transfer costs.

We control for these transfer costs in two straightforward ways. First, we focus on the cross-country variation in the market shares of MNE's *foreign* affiliates (not parent firms), so we control for MNE-specific transfer costs that are common across foreign destinations. Second, we control for the country-pair specific component of the transfer costs using a gravity specification that follows [Waugh \(2010\)](#). This specification assumes that bilateral costs are a function of bilateral distance and other country-pair specific characteristics, and includes fixed effects to control for source-specific costs. In addition, we control for country-pair specific taxes for MNEs that may affect MNEs market shares across desti-

⁶If there are firm-level distortions, and if as documented by [Bento and Restuccia \(2017\)](#) and [Fattal Jaef \(Forthcoming\)](#) these are size-dependent and more prevalent in less developed countries (e.g. if larger firms are taxed more or have higher markups in developing countries), then these distortions would push *down* MNE market shares in less developed countries. In this case our procedure would provides a lower bound for the contribution of firm-embedded productivity to cross country income differences.

nations. Section 5 shows that our results are robust to using alternative controls. If it is harder for MNEs to transfer technology into less developed countries and this is not captured by our controls, this should push *down* MNE market shares. In this case, our estimates would provide a lower bound for the contribution of aggregate firm-embedded productivity to the cross-country variance of output per-worker.

We implement our framework using data on MNE revenues from ORBIS, a worldwide dataset maintained by Bureau van Dijk. The main advantage of ORBIS is the scope and accuracy of its ownership information: it details the full list of direct and indirect subsidiaries and shareholders of each company in the dataset, along with a company's global ultimate owner and other companies in the same corporate family. This information allows us to build ownership links between affiliates of the same MNE, including cases where the affiliates and the parent are in different countries. We build these links at the firm-sector level to ensure that the affiliates in our comparisons are producing similar goods and services across countries. We focus on destinations where ORBIS has the most extensive coverage, so that our sample is mainly comprised of Eastern and Western European countries.⁷ Since ORBIS does not cover the universe of firms, we take aggregate revenues at the country-sector level from KLEMS and OECD when computing market shares. We note that, while ORBIS may have limited coverage of small firms in some countries, it has very good coverage of MNEs in the countries in our sample.

We estimate the key structural equation from our model, which states that the log of a MNE market share in a country and sector can be written as the sum of: (i) a MNE-sector component; (ii) a destination-sector component; and (iii) the transfer costs. We fit a two-way fixed-effect specification to measure cross-country differences in firm-embedded productivity from the estimated destination-sector fixed effects.

The OLS estimates of the destination-sector-specific components of the market shares are unbiased if the assignment of MNEs to destination-sectors is exogenous with respect to the error term. This is the case if selection of MNEs into destinations is driven by firm characteristics (e.g. productivity) and by destination-sector characteristics (e.g. market size), as is the case in workhorse models of multinational production in the tradition of [Helpman et al. \(2004\)](#). It is also the case if selection is driven by firm-destination characteristics uncorrelated to firm revenues (e.g. firm-destination specific fixed-costs), as in [Eaton et al. \(2011\)](#). Thus, the fact that MNEs are larger and more productive than domestic firms, the fact that MNEs are more likely to enter sectors where domestic firms are

⁷Our sample of destination countries also includes Japan, Korea, and Mexico. In contrast, every country in the world is potentially a source of MNEs in our data.

relatively unproductive, and the fact that ORBIS may not cover the universe of MNEs, do not bias our estimates of the destination-sector fixed effects. These estimates are identified from variation in market shares within MNEs across countries, rather than from variation across MNEs.

In contrast, the OLS estimates would be biased if the assignment of MNEs to destination countries were driven by firm-destination characteristics that affect firm revenues. This is the case if unproductive MNEs entered unattractive locations only when they had a low firm-destination-specific transfer cost. We address this and other selection concerns in detail in Section 5.2. We show that our main results are unchanged if we focus on subsamples of large MNEs that are present in most destinations, and thus are less likely to have selected based on firm-destination-specific transfer costs.

We find that for the average country in our sample, firm-embedded productivity is 0.20 log points lower than in France, our reference country.⁸ The relative importance of the differences in firm-embedded productivity varies considerably across countries. For example, firm-embedded productivity in Italy is 0.28 log-points higher than in Greece, accounting for three quarters of the observed differences in output per-worker between these two countries. In contrast, firm-embedded productivity is similar for Greece and Bulgaria, though output per-worker in Greece is 0.5 log points higher than in Bulgaria due to the difference in country-embedded factors between these countries.

We show that there is a strong positive correlation between firm-embedded productivity and output per-worker. It is worth noting that while the development accounting literature documents a positive correlation between TFP and output per-worker, it computes TFP as a residual using data on output per-worker. In contrast, we directly measure a component of TFP (firm-embedded productivity) using data on MNE market shares, and show that this component is strongly correlated with independent measures of output per-worker. In fact, differences in firm-embedded productivity account for about one-third of the cross-country variance in output per-worker. We also show a positive correlation between firm-embedded productivity and measures of firm innovation and management practices across countries. In contrast, firm-embedded productivity is uncorrelated with a country's physical and human capital, and with measures of infrastructure and governance.

Next, we study cross-country differences in firm-embedded productivity at the sector level. The cross-country differences in firm-embedded productivity are larger in Manu-

⁸We use France as our reference country since it has the best coverage among the rich countries in ORBIS.

facturing than in Services, but so are the cross-country differences in output per-worker. Remarkably, the contribution of firm-embedded productivity to the cross-country variance in output per-worker ends up being roughly a third in these two broad sectors. We further show that the foreign output of a country's MNEs is concentrated in sectors where the country's firm-embedded productivity is relatively high. For example, Japan and Finland have a particularly large stock of firm-embedded productivity in Manufacturing, and the foreign output of the MNEs from these countries is also concentrated in the Manufacturing sector. In contrast, Latvia and Lithuania have relatively more firm-embedded productivity in Services, and the foreign output of the MNEs from these countries is concentrated in the Service sector.

Finally, we evaluate the sources of the observed cross-country differences in firm-embedded productivity along two dimensions. First, we evaluate if these differences stem from aggregate scale (or variety) effects by focusing on the component of firm-embedded productivity that is orthogonal to a country's population, thus removing scale effects from our measure. We show that there is still a very strong correlation between this residualized component of firm-embedded productivity and output per-worker. Second, we separately compute differences in firm-embedded productivity across domestic firms and across the foreign affiliates of the MNEs that operate in each country. Differences in firm-embedded productivity across domestic firms account for roughly 88 percent of the observed differences in firm-embedded productivity across countries, while differences across the foreign affiliates of MNEs account for the remaining 12 percent.

Related literature: Our paper is related to [Burstein and Monge-Naranjo \(2009\)](#), who separate firm-embedded productivity from country-embedded factors using a model of MNE location choices and aggregate data on output per-worker, capital stocks, and corporate tax-rates. Their framework is based on the Lucas 'span of control' model and assumes that firm-embedded productivity is a rival factor, so that each firm (or manager) must choose only one country where to produce. Under these assumptions, they recover firm-embedded productivity from aggregate data using an equilibrium condition that equates after-tax managerial profits across countries.⁹ In contrast, our approach recovers firm-embedded productivity directly from firm-level data on MNE market shares in multiple countries, and does not rely on specific assumptions on how MNEs make loca-

⁹The main goal of [Burstein and Monge-Naranjo \(2009\)](#) is to investigate the aggregate consequences of reallocating firm know-how across countries, in the spirit of the quantitative literature on Multinational Production cited below. To such end, they need to estimate the autarky allocation of firm-embedded productivity, which they obtain using data on Foreign Direct Investment (FDI) stocks.

tion choices. In particular, our approach treats firm-embedded productivity as a non-rival factor that can be used simultaneously in many countries, and infers aggregate firm embedded productivity from differences in market shares of the same MNE across countries.

The idea behind our approach is similar to that in [Hendricks and Schoellman \(2018\)](#), who separate the contributions of human capital from country-embedded factors exploiting the idea that workers can take their human capital with them when moving to a foreign country. Using worker-level data on wage gains upon migration, they tease out the role of aggregate human-capital in explaining cross-country income differences. In the same spirit, we use firm-level data and exploit the idea that MNEs can use their firm-specific productivity in many countries to measure cross-country differences in aggregate firm-embedded productivity.

More broadly, our paper is related to the extensive literature on development accounting, which measures the contribution of factors of production to cross-country income differences directly and computes TFP as a residual (see [Caselli 2005](#) for a survey). This literature has focused on improving measures of factor stocks to better account for differences in productivity embodied in physical and human capital (recent examples are [Hendricks and Schoellman, 2018](#), [Lagakos et al., 2018](#) and [Caunedo and Keller, 2020](#)). We contribute to this literature by proposing a measure of the productivity that is embodied in firms. In doing so, we provide a direct measure of one of the components of TFP, firm-embedded productivity, using data on MNEs.

Finally, our paper is related to the large literature studying technology transfers through MNEs. One branch of the literature uses parent-affiliate matched data to estimate how productivity and shocks are transmitted within the MNE (see e.g. [Cravino and Levchenko 2017](#) and [Bilir and Morales 2020](#)). In contrast, our focus is on measuring the contribution of firm-embedded productivity in explaining cross-country income differences. A different branch of the literature parameterizes structural models of MNE location choices to measure their contribution to welfare and TFP (see e.g. [Burstein and Monge-Naranjo 2009](#), [Ramondo and Rodriguez-Clare 2013](#), [Irrazabal et al. 2013](#), [Alviarez 2019](#) and [Arkolakis et al. 2018](#)). Our measurement strategy is based on parent-affiliate matched data rather than on the general equilibrium conditions of a structural model.

The rest of the paper is organized as follows. Section 2 presents the accounting framework. Section 3 describes the data and our empirical strategy. Section 4 presents the quantitative results. Section 5 collects robustness exercises, and Section 6 concludes.

2 Accounting framework

In this section, we first develop a stylized framework that formalizes our definition of firm-embedded productivity and shows how it can be measured using firm-level data on the cross-border operations of MNEs. Next, we present a quantitative version of this framework that allows for multiple sectors and factors of production.

2.1 A model economy

Preliminaries: We consider a world economy consisting of N countries indexed by i and n . Each country is populated by a continuum of differentiated intermediate good producers that are owned by firms from different source countries. We refer to a firm that simultaneously operates in multiple countries as a MNE. Factor markets are competitive and integrated within countries. Intermediate goods cannot be traded internationally. In each country, intermediates are aggregated into a final tradable good by a competitive producer.

Technologies: The production function for the final good in each country n is given by

$$Y_n = \left[\sum_i \int_{\omega \in \Omega_{in}} [Q_{in}(\omega) Y_{in}(\omega)]^{\frac{\rho-1}{\rho}} d\omega \right]^{\frac{\rho}{\rho-1}}, \quad (1)$$

where $Y_{in}(\omega)$ is the output of firm ω from source country i operating in country n , and $\rho \geq 1$ is the elasticity of substitution across intermediate goods. Ω_{in} denotes the set of firms from country i that are active in country n . $Q_{in}(\omega)$ is a shifter for firm ω , which we interpret as product quality. Note that the idiosyncratic quality $Q_{in}(\omega)$ can differ across production locations.

The production function for intermediate goods is

$$Y_{in}(\omega) = Z_n X_{in}(\omega) L_{in}(\omega), \quad (2)$$

where $L_{in}(\omega)$ is the number of workers employed by firm ω in country n . The productivity of the firm depends on a country-specific component, Z_n , and a firm-specific component, $X_{in}(\omega)$. Following [Burstein and Monge-Naranjo \(2009\)](#) we refer to Z_n as “country-embedded productivity”, as it captures factors that affect all firms in a country

and are not internationally mobile, such as infrastructure, institutions, workers' quality, and natural amenities. In contrast, $X_{in}(\omega)$ is idiosyncratic to firm ω , and like product quality, can differ across production locations.

It is useful to define $A_{in}(\omega) \equiv [Q_{in}(\omega) \times X_{in}(\omega)]^{\rho-1}$. In what follows, we will refer to $A_{in}(\omega)$ as "firm-embedded productivity". It captures production, managerial, and marketing know-how that is specific to the firm. In contrast to country-embedded productivity, firm-embedded productivity can be transferred internationally within the boundaries of the firm.

We assume that firm-embedded productivity can be transferred imperfectly across countries, so that the productivity of an MNE from country i when it operates in country n is

$$A_{in}(\omega) = A_i(\omega) \times \exp(-\kappa_{in}(\omega)), \quad (3)$$

with $\kappa_{ii}(\omega) = 0$. Here, $A_i(\omega)$ is the productivity embedded in MNE ω in its home country i , and $\kappa_{in}(\omega)$ is a technology transfer cost that captures the degree to which firm-embedded productivity can be moved from i to n . If $\kappa_{in}(\omega) = 0$, the MNE can use the same $A_i(\omega)$ in all the countries where it produces.

Aggregate output and TFP: Aggregate output can be written as

$$Y_n = Z_n \Phi_n^{\frac{1}{\rho-1}} L_n, \quad (4)$$

where

$$\Phi_n \equiv \sum_i \int_{\omega \in \Omega_{in}} A_{in}(\omega) d\omega \quad (5)$$

denotes *aggregate* firm-embedded productivity in country n , which is the sum of the productivity embedded in the firms that produce in country n .

In what follows, we use lowercase to denote the log of a variable, and use $y_n \equiv \ln[Y_n/L_n]$ to denote the log of output per-worker. Using Equation (4), we can thus write

$$y_n = z_n + \frac{1}{\rho-1} \phi_n. \quad (6)$$

Equation (6) states that cross-country differences in output per-worker arise from differences in country-embedded productivity, z_n , and differences in aggregate firm-embedded

productivity, ϕ_n . Clearly, the same level of y_n can be achieved with different combinations of z_n and ϕ_n , so that these two terms cannot be separated using only aggregate data. Next, we show how to use micro-level data on the cross-border operations of MNEs to separate ϕ_n from z_n .

2.2 Decomposing cross-country differences in output per-worker

We now show how cross-country differences in ϕ_n can be computed using firm-level data on market shares. From the demand functions implied by Equation (1), we can write the revenue of MNE ω from country i producing in country n , relative to the sum of the revenues of all firms producing in n , as

$$S_{in}(\omega) \equiv \frac{P_{in}(\omega) Y_{in}(\omega)}{\sum_i \int_{\omega \in \Omega_{in}} P_{in}(\omega) Y_{in}(\omega) d\omega} = \frac{A_{in}(\omega)}{\Phi_n}. \quad (7)$$

A MNE market share in a country depends on its productivity, $A_{in}(\omega)$, relative to the productivity embedded in all firms operating in that country, Φ_n . Intuitively, MNEs should have larger market shares in countries where aggregate firm-embedded productivity is relatively low, since they face less competition in those countries.

We build on this intuition to identify cross-country differences in Φ_n . Substituting Equation (3) in (7), the market share in logs is

$$s_{in}(\omega) = a_i(\omega) - \kappa_{in}(\omega) - \phi_n. \quad (8)$$

Equation (8) shows that if technology transfer costs do not vary across foreign destinations, $\kappa_{in}(\omega) = \kappa_i(\omega)$, cross-country differences in market shares across affiliates of the same MNE pin-down differences in ϕ_n . In this case, one could regress firm-level market shares on MNE- and destination-level dummies, and use the destination dummies to recover cross-country differences in ϕ_n . The MNE-level dummies would capture differences in $a_i(\omega) - \kappa_i(\omega)$ across MNEs, while the cross-country variation in shares within an MNE would identify the differences in ϕ_n . After obtaining cross-country differences in ϕ_n , differences in z_n can be computed as residuals from Equation (6). This two-way fixed-effect approach constitutes the basis of our estimation strategy described in Section 3.2.

In the more general case where technology transfer costs vary across destinations, dif-

ferences in market shares across affiliates of the same MNE are not enough to identify differences in aggregate firm-embedded productivity. As Equation (8) makes clear, this is because the market share of an affiliate can be relatively low in country n if either firm-embedded productivity is relatively large in country n , high ϕ_n , or if the costs to transfer technology are large, high $\kappa_{in}(\omega)$. Section 3.2 shows how, if we observe market shares for MNEs from multiple source countries and into multiple destinations, we can identify differences in ϕ_n by imposing assumptions on the structure of $\kappa_{in}(\omega)$ that are common in the International Trade and Multinational Production literature.

Discussion: Two remarks are in order. First, Equation (7) relies on the assumption that the allocation of resources across firms is efficient. We note that, if as documented by [Bento and Restuccia \(2017\)](#) and [Fattal Jaef \(Forthcoming\)](#), size-dependent distortions are more prevalent in less developed countries -for example if larger firms are taxed more or have higher markups in developing countries-, then these distortions would push *down* MNE market shares in less developed countries. In this case our procedure would underestimate the contribution of firm-embedded productivity to cross country income differences.

Second, country-embedded productivity, Z_n , does not affect the MNE market share $S_{in}(\omega)$ in Equation (7), since it proportionally affects all the firms producing in n . This follows from the assumption that Z_n and $X_{in}(\omega)$ enter log-linearly into the production function in Equation (2). Section 5.2 and Appendix B show that this functional form provides a good approximation of the data. Together with the assumption on transfer costs in Equation (3), the log-linearity assumption also implies that country-embedded factors that have different effect across domestic vs. foreign firms -such as regulations that apply only to foreign firms- would be captured in $\kappa_{in}(\omega)$.¹⁰

2.3 Quantitative model

We now extend our framework to incorporate additional sectors and factors of production.¹¹ We assume that in each country there are J sectors indexed by j , and that a com-

¹⁰That is, our model is isomorphic to assuming a production function given by $Y_{in}(\omega) = \tilde{Z}_{in}(\omega) X_{ij}(\omega) L_{in}(\omega)$, with $\tilde{Z}_{in}(\omega) \equiv \kappa_{in}(\omega) Z_n$.

¹¹The framework incorporates physical and human capital. Appendix C shows that our approach and results do not change if we incorporate intermediate inputs in production, and recalibrate the model's parameters accordingly.

petitive producer of final goods aggregates sectorial output according to

$$Y_n = \prod_j \left[Y_n^j \right]^{\theta_n^j}, \quad (9)$$

where Y_n^j denotes the final output from sector j and $\theta_n^j \in [0, 1]$ with $\sum_j \theta_n^j = 1$. Sectorial output is produced by aggregating intermediate goods,

$$Y_n^j = \left[\sum_i \int_{\omega \in \Omega_{in}^j} \left[Q_{in}^j(\omega) Y_{in}^j(\omega) \right]^{\frac{\rho^j-1}{\rho^j}} d\omega \right]^{\frac{\rho^j}{\rho^j-1}}, \quad (10)$$

where $Y_{in}^j(\omega)$ is the output of intermediate-good producer firm ω from country i in sector j . $Q_{in}^j(\omega)$ denotes product quality of firm ω from country i in sector j .

Intermediate goods in each sector are produced with a Cobb-Douglas technology,

$$Y_{in}^j(\omega) = Z_n^j X_{in}^j(\omega) H_{in}^j(\omega)^{1-\alpha^j} K_{in}^j(\omega)^{\alpha^j}, \quad (11)$$

where $\alpha^j \in [0, 1]$. The variables $H_{in}^j(\omega)$ and $K_{in}^j(\omega)$ denote the effective units of labor and capital employed by firm ω in country n and sector j .

As in the previous section, we define $A_{in}^j(\omega) \equiv \left[Q_{in}^j(\omega) \times X_{in}^j(\omega) \right]^{\rho^j-1}$ with

$$A_{in}^j(\omega) = A_i^j(\omega) \times \exp\left(-\kappa_{in}^j(\omega)\right). \quad (12)$$

Aggregate output in each sector satisfies

$$Y_n^j = Z_n^j \left[\Phi_n^j \right]^{\frac{1}{\rho^j-1}} \left[\bar{H}_n^j L_n^j \right]^{1-\alpha^j} \left[K_n^j \right]^{\alpha^j},$$

where $\Phi_n^j \equiv \sum_i \int_{\omega \in \Omega_{in}^j} A_{in}^j(\omega) d\omega$ is the aggregate firm-embedded productivity in sector j and country n , L_n^j denotes the number of workers employed in sector j , and $\bar{H}_n^j \equiv \left[\sum_i \int_{\omega \in \Omega_{in}^j} H_{in}^j(\omega) d\omega \right] / L_n^j$ are the units of effective labor per-worker (average human capital) in sector j , and K_n^j is the physical capital employed in sector j . Output per-worker

in sector j can be written as

$$\frac{Y_n^j}{L_n^j} = \tilde{Z}_n^j \tilde{\Phi}_n^j, \quad (13)$$

where $\tilde{Z}_n^j \equiv \left[Z_n^j \right]^{\frac{1}{1-\alpha^j}} \bar{H}_n^j \left[\frac{K_n^j}{Y_n^j} \right]^{\frac{\alpha^j}{1-\alpha^j}}$, $\tilde{\Phi}_n^j \equiv \left[\Phi_n^j \right]^{\beta^j}$, and $\beta^j \equiv \frac{1}{1-\alpha^j} \frac{1}{\rho^j-1}$. In an abuse of notation, in what follows we will refer both to $\tilde{\Phi}_n^j$ and Φ_n^j as firm-embedded productivity. We refer to \tilde{Z}_n^j as country-embedded factors, as it includes physical and human capital, in addition to the country-embedded productivity Z_n^j .

Aggregate output per worker can be written as

$$\frac{Y_n}{L_n} = \tilde{Z}_n \tilde{\Phi}_n, \quad (14)$$

with $\tilde{\Phi}_n \equiv \prod_j \left[\tilde{\Phi}_n^j \right]^{\theta_n^j \frac{\beta_n}{\beta^j} \frac{\rho_n-1}{\rho^j-1}}$, $\beta_n \equiv \frac{1}{1-\alpha_n} \frac{1}{\rho_n-1}$, $\alpha_n \equiv \sum_j \theta_n^j \alpha^j$, $\rho_n \equiv \sum_j \theta_n^j \rho^j$, and $\tilde{Z}_n \equiv \bar{\theta}_n \bar{H}_n \left[\frac{K_n}{Y_n} \right]^{\frac{\alpha_n}{1-\alpha_n}} \prod_j \left[Z_n^j \right]^{\frac{\theta_n^j}{1-\alpha_n}}$.¹² Here L_n and K_n denote the number of workers and capital stock in country n , and $\bar{H}_n \equiv \left[\sum_j \sum_i \int_{\omega \in \Omega_{in}^j} H_{in}^j(\omega) d\omega \right] / L_n$ is the average human capital in n .

Applying logs to Equation (14), we can thus write

$$y_n = \tilde{z}_n + \tilde{\phi}_n. \quad (15)$$

We can compute the terms in Equation (15) following steps analogous to those described in Section 2.2. In particular, the (log) market-share of MNE ω operating in country n and sector j is

$$s_{in}^j(\omega) = a_i^j(\omega) - \kappa_{in}^j(\omega) - \phi_n^j. \quad (16)$$

A MNE share in a sector depends on its productivity, $a_i^j(\omega)$, relative to the productivity of all firms in the sector, ϕ_n^j . As explained in the previous section, we can use differences in sectorial market shares across affiliates of the same MNE that are located in different

¹² $\bar{\theta}_n \equiv \prod_j \left[\theta_n^j \left[\frac{1-\alpha^j}{1-\alpha_n} \right]^{1-\alpha^j} \left[\frac{\alpha^j}{\alpha_n} \right]^{\alpha^j} \right]^{\frac{\theta_n^j}{1-\alpha_n}}$ is a country-specific constant.

countries to pin-down differences in ϕ_n^j . These differences can be aggregated to obtain $\tilde{\phi}_n = \sum_j \theta_n^j \frac{\beta_n}{\beta^j} \frac{\rho_n - 1}{\rho^j - 1} \phi_n^j$. Once $\tilde{\phi}_n$ is calculated, \tilde{z}_n can be computed as a residual from Equation (15).

Finally, our development-accounting exercise evaluates the contribution of firm-embedded productivity to the cross-country variance of output per-worker. We follow the variance decomposition in [Klenow and Rodriguez-Clare \(1997\)](#) and compute

$$\frac{\text{cov}(y_n, \tilde{z}_n)}{\text{var}(y_n)} + \frac{\text{cov}(y_n, \tilde{\phi}_n)}{\text{var}(y_n)} = 1. \quad (17)$$

The next section explains how we implement this variance decomposition in our data.

3 Data and empirical strategy

3.1 Data description

This section describes our data. We refer the reader to [Appendix A](#) for details.

Our firm-level data come from ORBIS, a worldwide dataset maintained by Bureau van Dijk that includes comprehensive information on firm’s revenue and employment. ORBIS includes information on both listed and unlisted firms collected from various country-specific sources, such as national registries and annual reports. The main advantage of ORBIS is the scope and accuracy of its ownership information: it details the full lists of direct and indirect subsidiaries and shareholders of each company in the dataset, along with a company’s global ultimate owner and other companies in the same corporate family. This information allows us to build links between affiliates of the same MNE, including cases in which the affiliates and the parent are in different countries. We specify that a parent should own at least 50 percent of an affiliate to identify an ownership link between two firms.

The main variable used in our analysis is the revenue (turnover) of each firm. We use data for the year 2016, which is the year with the largest coverage in ORBIS. We focus on a subset of destination countries for which aggregate revenues by foreign firms in ORBIS account for at least 20 percent of the aggregate revenues by foreign firms reported

by OECD/Eurostat.¹³ In addition, we exclude Ireland, Luxembourg, and Switzerland from our sample as MNE revenues in these countries are particularly sensitive to profit-shifting strategies. In contrast, every country in the world is a potential source country for the MNEs in ORBIS, so that our sample of source countries is much larger than our sample of destination countries.¹⁴

The original unit of observation in ORBIS is a tax-identification number. Often, affiliates or plants, located in different addresses within the same country and belonging to the same corporate group, are registered with different tax identification numbers. We aggregate revenues of all firms in ORBIS that belong to the same corporate group and that operate in the same country and 2-digit NAICS sector. Our unit of observation is then a corporate group-country-sector triplet. For example, ORBIS shows multiple tax-ids belonging to Renault in Germany in the Transportation and Equipment sector. We aggregate the revenues of those affiliates to obtain Renault's total revenues in this sector in Germany. Our procedure thus compares affiliates of the MNE Renault in the Transportation and Equipment sector located in different countries, and separately compares affiliates of Renault's in, e.g., the Retail sector across countries.

Finally, to compute market shares, we divide the revenues of each corporate group-country-sector by the aggregate revenues in each country-sector. Since ORBIS not always covers the population of firms in each country-sector pair, we use data on aggregate revenues from EU KLEMS and OECD.

We obtain aggregate output per-worker from the Penn World Tables (9.1), and measure output-per-worker in international dollars at the sector level using data on output per-worker from EU KLEMS and the PPP conversion factor from the Penn World Tables (9.1).

3.2 Empirical strategy

This section describes how we measure cross-country differences in firm-embedded productivity using firm-level data on the activity of MNEs across countries. Our strategy builds on Equation (16) and imposes structure on the technology transfer costs following

¹³OECD Activity of Multinational Enterprises (AMNE) database and the Eurostat Foreign Affiliate Statistics database. Appendix Figure A1 shows our sample of destination countries and reports, for each destination, the ratio of the foreign-firm revenues in ORBIS to the foreign-firm revenues as reported by OECD/Eurostat.

¹⁴Our sample of source countries includes the United States, China, and Canada, among others. As destinations, these countries have very low or inexistent coverage in ORBIS, and thus they are not included in our sample of destination countries.

a long tradition in International Economics that approximates trade and multinational production costs using observable variables.

We assume that technology transfer costs are given by

$$\kappa_{in}^j(\omega) = O_i^j + D_n^j + B_{in}^j + \varepsilon_{in}^j(\omega). \quad (18)$$

The assumption states that technology transfer costs in each sector can be additively decomposed into origin- and destination-specific components, O_i^j and D_n^j , a bilateral component, B_{in}^j , and a MNE-destination-sector specific component, $\varepsilon_{in}^j(\omega)$. We proxy for the bilateral component B_{in}^j with a log-linear function of bilateral distance and a dummy for common language, which we obtain from CEPIL. Section 5.4 shows that our results are unchanged if we add country-pair specific taxes for MNEs, bilateral tax treaties, and other gravity variables as additional controls for B_{in}^j .

Substituting Equation (18) into (16), we obtain the estimating equation

$$s_{in}^j(\omega) = \delta_i^j(\omega) + \mathbb{A}_n^j + B_{in}^j + \varepsilon_{in}^j(\omega). \quad (19)$$

Here, $\delta_i^j(\omega)$ are MNE-sector fixed effects. \mathbb{A}_n^j denotes a set of dummies that take the value of 1 if the destination country is n and the sector is j . We estimate Equation (19) by Ordinary Least Squared (OLS) using the sample of the MNE foreign affiliates in the ORBIS data -MNEs in their home country are not included. The regression identifies the MNE-sector fixed effect, $\delta_i^j(\omega)$, from the within-MNE average market share across destinations, in each sector j , controlling for destination characteristics and the bilateral component of the technology transfer costs. Similarly, the destination effects \mathbb{A}_n^j are identified from the average market shares of the foreign affiliates that operate in each country n and sector j , controlling for within-MNE characteristics and the bilateral component of the technology transfer costs. The residual $\varepsilon_{in}^j(\omega)$ is (the negative of) the MNE-destination-sector specific component of the technology transfer costs.

The OLS estimates of the destination-sector-specific components of the market shares, \mathbb{A}_n^j , are unbiased if the assignment of MNEs to destination countries is exogenous with respect to the error term, $\varepsilon_{in}^j(\omega)$. This is the case if selection is driven by firm characteristics (e.g. productivity) and by destination-country characteristics (e.g. market size), or by firm-destination characteristics uncorrelated to firm revenues (e.g. firm-destination specific fixed-costs).

In contrast, the OLS estimates would be biased if the assignment of MNEs to destination countries is driven by $\varepsilon_{in}^j(\omega)$. For the remainder of this section, we assume that MNEs do not select into countries based on $\varepsilon_{in}^j(\omega)$. In Section 5.2, we show that our main results are robust to reestimating Equation (19) using subsamples of MNEs that are more likely to satisfy this exogeneity assumption.

3.3 Cross-country differences in MNE market shares

In what follows, we use the notation $\Delta x_n \equiv x_n - x_r$ to express the difference of a variable in country n with respect to France, our reference country. Using data on sectorial expenditure shares in each country, θ_n^j , our OLS estimates of ΔA_n^j , and defining $\Delta x_n \equiv \sum_j \theta_n^j \Delta x_n^j$ as the aggregate across sectors, we compute the aggregate destination-country effects as

$$\Delta A_n \equiv \sum_j \theta_n^j \Delta A_n^j. \quad (20)$$

The aggregate country effect ΔA_n captures the (log of the) average MNE market share in each destination relative to France, after controlling for the MNE-sector fixed effects and the bilateral variables.

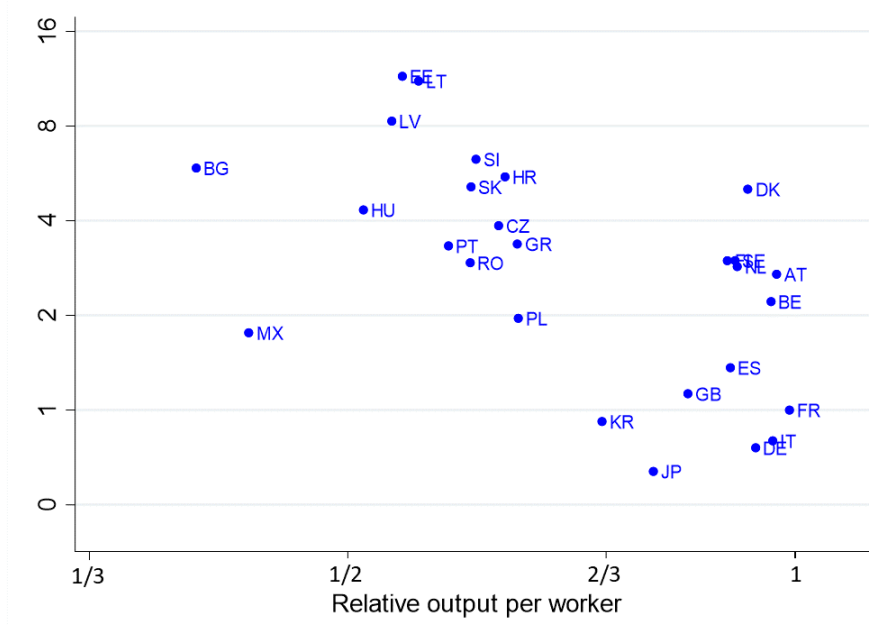
Figure 1 reports $\exp(\Delta A_n)$. On average, MNE market shares are larger in less developed countries. Differences between developed and developing countries are enormous: MNE market shares are about three and a half times larger in Greece and Portugal, and about twelve times larger in Estonia and Lithuania, compare to their market shares in France. In contrast, MNEs have similar market shares in the UK, Germany, and France.

Appendix Figure A2 reports standard errors for our estimates of ΔA_n , and shows that these dummies are tightly estimated and exhibit substantial variation across countries. The R-squared of the regression is 0.72.¹⁵ The country-sector dummies ΔA_n^j and the MNE-sector dummies $\delta_i^j(\omega)$ account respectively for 0.27 and for 0.45 of the total variance of $s_{in}^j(\omega)$ in Equation (19). Appendix Figure A2 also shows that we obtain very similar estimates if we use data on employment shares or data on value-added shares as the dependent variables in Equation (19).¹⁶

¹⁵Appendix Table A1 reports the OLS coefficients on bilateral distance and common language, ψ_d^j and ψ_l^j , for each sector. Appendix B presents additional statistics on our two-way fixed effect estimator.

¹⁶In the model, revenue shares, employment shares, and value-added shares coincide, so that in theory any of these shares can be used for our estimation. We use revenue shares for our baseline estimates since ORBIS has a more complete coverage of revenues than of employment and value-added. Using employment data alleviates concerns about profit-shifting strategies by MNEs.

Figure 1: Market shares of foreign MNE affiliates, relative to France.



Note: The figure shows $\exp(\Delta A_n)$, calculated using Equation (20) and the OLS estimates of Equation (19). The x-axis reports the output per-worker of each country, relative to France, from Penn World Tables (9.1).

3.4 Interpreting differences in MNE market shares

We calculate the differences in $\Delta \phi_n^j$ using our estimated country-sector effects, ΔA_n^j . In our model, these effects correspond to

$$\Delta A_n^j = - \left[\Delta \phi_n^j + \Delta D_n^j \right], \quad (21)$$

which conflates firm-embedded productivity $\Delta \phi_n^j$ and the destination effects of the technology transfer costs ΔD_n^j . For our baseline results, the identification strategy follows [Waugh \(2010\)](#), and assumes that costs have an origin-specific, $\Delta O_i^j \neq 0$, but not destination-specific, component, $\Delta D_n^j = 0$. In that case, the country dummies can be interpreted as $\Delta A_n^j = -\Delta \phi_n^j$, and the MNE-level dummies, $\delta_i^j(\omega)$, would absorb the origin-specific component of the technology transfer cost, ΔO_i^j . But what if this identification assumption is not satisfied, $\Delta D_n^j \neq 0$? If ΔD_n^j is high for low income countries (i.e. it is harder to transfer technology into less developed countries), then $cov(\Delta y_n, \Delta D_n^j) \leq 0$. This inequality implies that our baseline estimates of $\Delta \phi_n^j$ based on Equation (21) would understate the contribution of aggregate firm-embedded productivity to the cross-country variance

of output per-worker,

$$\text{cov}(\Delta y_n, -\Delta A_n^j) = \text{cov}(\Delta y_n, \Delta \phi_n^j + \Delta D_n^j) \leq \text{cov}(\Delta y_n, \Delta \phi_n^j). \quad (22)$$

Section 5 presents a robustness exercise that allows for $\Delta D_n^j > 0$. Those results are remarkably similar to our baseline results.

3.4.1 Parameterization

Finally, as shown in Section 2.3, to evaluate the contribution of aggregate firm-embedded productivity to cross-country income differences we need to aggregate our sectoral estimates and assign values to the model parameters. Taking logs of Equation (13), and using our baseline identification assumption so that $\Delta A_n^j = -\Delta \phi_n^j$, yields

$$\Delta y_n^j = -\beta^j \Delta A_n^j + \Delta z_n^j.$$

Here $\beta^j \equiv [[\rho^j - 1] [1 - \alpha^j]]^{-1}$ is a composite elasticity and can be estimated from an OLS regression of Δy_n^j on ΔA_n^j . Unfortunately, these estimates would not be consistent unless ΔA_n^j is orthogonal to Δz_n^j . A concern would be that policies that encourage accumulation of country-embedded factors, captured by Δz_n^j , would also improve firm-embedded productivity, $\Delta \phi_n^j$. One way to deal with this concern is to control for factors included in Δz_n^j that simultaneously affect the accumulation of firm-embedded productivity, such as human capital and the capital-output ratio, the quality of institutions, and the infrastructure in country n . In particular, we estimate

$$\Delta y_n^j = b_0^j + b_1^j \Delta A_n^j + b_2^j \Delta C_n + u_n^j, \quad (23)$$

where C_n is a vector of country-specific controls.

Table 1 reports these estimates. Columns (1), (4) and (7) respectively show the results for the pooled sample of sectors, Manufacturing sectors, and Services sectors, estimated under the restriction that b_1 is the same in all sectors (see Appendix Table A2 for results on estimating b_1^j for each sub-sector in Manufacturing and Services). The coefficients on b_1 are precisely estimated around -0.20 in the three samples. As shown in Columns (2), (5) and (8), we estimate very similar values when we control for the (log of the relative) capital-output ratio and the (log of the relative) average years of schooling, and also in

Columns (3), (6) and (9) when controlling for measures of country’s governance and infrastructure.¹⁷ Overall, we cannot reject the null hypothesis that $\beta = 0.2$ in any of these samples. For a labor share of $1 - \alpha = 2/3$, our estimate implies a value of $\rho = 8.5$, which is within the range of estimates used to match the average markup in the United States (see e.g. [Edmond et al. 2018](#) and [Baqae and Farhi 2020](#)).

Using $\beta = 0.2$ and the restriction that $\Delta D_n^j = 0$, we get our baseline estimates of aggregate firm-embedded productivity as $\Delta \tilde{\phi}_n = -\beta \Delta \mathbb{A}_n$, where $\Delta \mathbb{A}_n$ is obtained from aggregating the OLS estimates in Equation (19) according to Equation (20).¹⁸ We calculate $\Delta \tilde{z}_n$ as a residual using data on income per worker.

4 Quantitative results

This section combines the estimates from Equation (21) with our elasticity estimates from Section 3.4.1 to decompose differences in output per-worker across countries into aggregate firm-embedded productivity and country-embedded factors. Figure 2 plots the result of this decomposition (see Appendix Table A5 for the exact numbers). The x-axis shows the log-difference in output per-worker in each country relative to France, Δy_n . In the y-axis, the red circles show the difference in firm-embedded productivity in each country relative to France, $\Delta \tilde{\phi}_n$, while the blue squares show the differences in country-embedded factors relative to France, $\Delta \tilde{z}_n$.

For the average country, firm-embedded productivity is 0.20 log points lower than in France. There is, however, wide variation across countries. For some of the large developed nations in our sample, such as Germany and Korea, firm-embedded productivity is the same as in France, whereas in Japan it is somewhat larger (0.09 log-difference). In contrast, firm-embedded productivity is quite low in the Baltic Republics of Lithuania, Latvia, and Estonia.

¹⁷Our measure of infrastructure is the number of mobile cellular subscriptions per-capita, from the World Development Indicators. Our estimates are unchanged if we use alternative measures of infrastructure, such as the number of fixed broadband subscriptions per-capita or the electric power consumption per-capita.

¹⁸In a one-sector model, estimating Equation (23) without controlling for ΔC_n would yield $\beta = -\frac{\text{cov}(\Delta \mathbb{A}_n, \Delta y_n)}{\text{var}(\Delta \mathbb{A}_n)}$. Using this expression to calculate $\Delta \tilde{\phi}_n = -\beta \Delta \mathbb{A}_n$, the second term of the variance decomposition in Equation (17) would boil down to $\frac{\text{cov}(\Delta y_n, \Delta \tilde{\phi}_n)}{\text{var}(\Delta y_n)} = -\beta \frac{\text{cov}(\Delta y_n, \Delta \mathbb{A}_n)}{\text{var}(\Delta y_n)} = \frac{\text{cov}(\Delta \mathbb{A}_n, \Delta y_n) \text{cov}(\Delta y_n, \Delta \mathbb{A}_n)}{\text{var}(\Delta \mathbb{A}_n) \text{var}(\Delta y_n)}$, which corresponds to the R-squared of a regression of Δy_n on $\Delta \mathbb{A}_n$, and which does not depend on the model parameters. Rather than focusing exclusively on this R-squared, we parameterize β to evaluate the decomposition for each individual country in our sample.

Table 1: Estimating the composite elasticity β

	All sectors			Manufacturing sectors			Service sectors		
	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)
ΔA_n^i	-0.194***	-0.199***	-0.197***	-0.189***	-0.203***	-0.196***	-0.193***	-0.194***	-0.193***
	[0.0267]	[0.0261]	[0.0282]	[0.0338]	[0.0372]	[0.0340]	[0.0342]	[0.0342]	[0.0386]
$\Delta[k_n - y_n]$		0.381***	0.275*		0.496**	0.297		0.195	0.121
		[0.115]	[0.157]		[0.165]	[0.167]		[0.122]	[0.128]
Δh_n		0.244	-0.168		0.774	0.144		-0.0915	-0.456
		[0.385]	[0.522]		[0.494]	[0.751]		[0.301]	[0.423]
$\Delta Governance_n$			0.479			0.780			0.348
			[0.350]			[0.432]			[0.219]
$\Delta Infrastructure_n$			0.117			0.00421			0.197
			[0.390]			[0.385]			[0.380]
Observations	445	445	445	158	158	158	161	161	161
R-squared	0.334	0.393	0.422	0.397	0.513	0.581	0.420	0.447	0.482

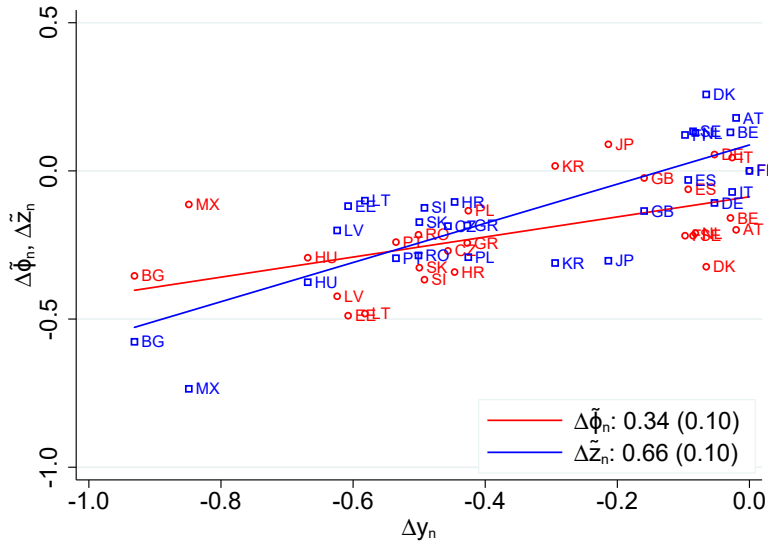
Notes: The table reports the OLS estimates from Equation (23). $\Delta[k_n - y_n]$ denotes the capital-output ratio, Δh_n denotes human capital from the Penn World Tables (9.1). $\Delta Governance_n$ is an aggregate indicator of governance averaging the six Worldwide Governance Indicators (WGI): (1) rule of law, (2) voice and accountability, (3) political stability and absence of violence, (4) government effectiveness, (5) regulatory quality, and (6) control of corruption. $\Delta Infrastructure_n$ is measured by the number of mobile cellular subscriptions per-capita. Sector fixed effects are included and standard errors are clustered by country and sector (in parentheses).

The relative importance of the differences in firm-embedded productivity and country-embedded factors also varies considerably across countries. For example, Italy and Slovenia –both EU members– have similar levels of country-embedded factors. However, Italy has more firm-embedded productivity, which generates significant differences in output per-worker between these two countries. In contrast, firm-embedded productivity is similar for Slovenia and Bulgaria, though output per-worker is much higher in Slovenia due to a large difference in country-embedded factors between these two countries. For countries such as Spain and the Netherlands, with roughly the same level of output per-worker, our decomposition indicates that while for Netherlands firm-embedded productivity is 0.15 log-point lower than for Spain, that negative difference is compensated by an advantage of equal magnitude in country-embedded factors.

Our measure of aggregate firm-embedded productivity is strongly correlated with output per-worker. As we noted in the Introduction, while the development accounting literature documents a positive correlation between TFP and output per-worker, it computes TFP as a residual using output per-worker data. In contrast, we directly measure one component of TFP (firm-embedded productivity) and show that this component is strongly correlated with independent measures of output per-worker. Furthermore, we compute the share of the cross-country variance in output per-worker accounted for aggregate firm-embedded productivity and country-embedded factors, in the spirit of [Klenow and Rodriguez-Clare \(1997\)](#). The contribution of aggregate firm-embedded productivity corresponds to the slope of a bivariate OLS regression of $\Delta\tilde{\phi}_n$ on Δy_n , which is reported in [Figure 2](#). Differences in $\Delta\tilde{\phi}_n$ account for roughly a third of the cross-country variance in output per-worker; differences in country-embedded factors account for the remaining two thirds.

Correlation with country characteristics: [Table 2](#) evaluates how our measures of firm-embedded productivity and country-embedded factors correlate with country characteristics. In particular, we regress output per-worker, firm-embedded productivity, and country-embedded factors on a country’s capital-output ratio, human capital, measures of governance and infrastructure, and the number of patent applications per capita. The table shows that differences in firm-embedded productivity are uncorrelated with physical and human capital ([Column 3](#)), and with Governance and Infrastructure ([Column 4](#)), but strongly correlated with the number of patent applications per capita ([Column 4](#)). In contrast, differences in country-embedded factors are significantly correlated with physical and human capital ([Column 5](#)), and Governance ([Column 6](#)), but they are uncor-

Figure 2: Dev. accounting: firm-embedded productivity vs country-embedded factors.



Notes: Each circle (square) represents a country’s firm-embedded productivity (country-embedded factors) relative to France. The figure plots the decomposition in Equation (15), where Δy_n is plotted in the x-axis and $\Delta \tilde{z}_n$ and $\Delta \tilde{\phi}_n$ are plotted in the y-axis. The legend reports the slopes of a bivariate OLS regression of $\Delta \tilde{\phi}_n$ on Δy_n .

related with the number of patent applications per capita (Column 6). These results are reassuring since, as explained in Section 2.3, cross-country differences in factors should be captured by our measure of country-embedded factors, and not by our measure of firm-embedded productivity.¹⁹

Finally, we relate our measure of firm-embedded productivity with an index of Management Practices from the World Management Survey. Unfortunately, this index is only available for 12 countries in our sample, and thus we cannot include it in the regressions in Table 2. Figure 3 shows the raw correlation between these two variables. The figure shows that, despite the sample size, there is a strong positive correlation between the index of management practices and our measure of firm embedded productivity. In contrast, Management Practices are not significantly correlated with our measure of $\Delta \tilde{z}_n$.

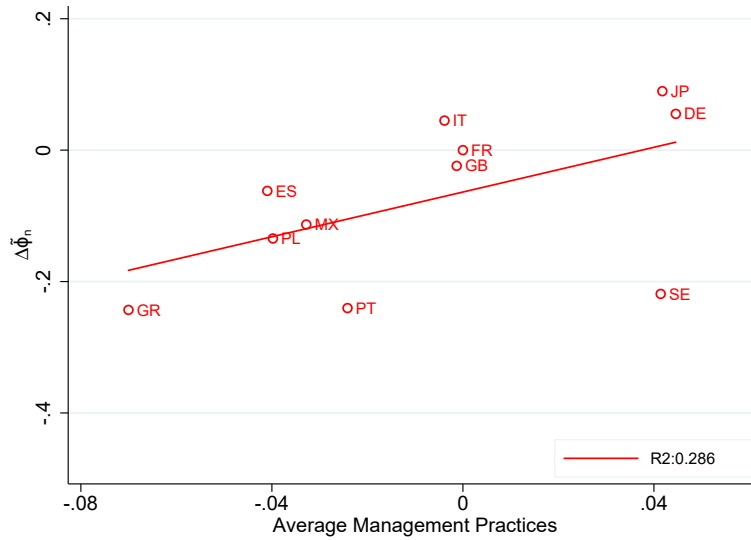
¹⁹The measures of Governance and Infrastructure are those used in Section 3.4.1. We obtain similar results with other measures.

Table 2: Correlations with country characteristics

dep. var.	Δy_n		$\Delta \tilde{\phi}_n$		$\Delta \tilde{z}_n$	
	(1)	(2)	(3)	(4)	(5)	(6)
$\Delta [k_n - y_n]$	0.379**	0.183	-0.045	-0.0496	0.428***	0.232**
	[0.179]	[0.187]	[0.094]	[0.103]	[0.127]	[0.103]
Δh_n	0.772*	-0.157	-0.019	-0.331	0.792**	0.174
	[0.424]	[0.630]	[0.274]	[0.213]	[0.350]	[0.525]
$\Delta Governance_n$		0.689*		-0.134		0.823***
		[0.385]		[0.205]		[0.235]
$\Delta Infrastructure_n$		-0.0643		-0.101		0.0365
		[0.597]		[0.338]		[0.319]
$\Delta patents(pc)_n$		0.0841**		0.110***		-0.0264
		[0.0366]		[0.0211]		[0.0262]
Obs.	27	27	27	27	27	27
R-squared	0.201	0.525	0.007	0.610	0.358	0.637

Notes: The table reports the OLS estimates from Equation (23). $\Delta [k_n - y_n]$ denotes the capital-output ratio, Δh_n denotes human capital from the Penn World Tables (9.1). $\Delta Governance_n$ is an aggregate indicator of governance averaging the six Worldwide Governance Indicators (WGI): (1) rule of law, (2) voice and accountability, (3) political stability and absence of violence, (4) government effectiveness, (5) regulatory quality, and (6) control of corruption. $\Delta Infrastructure_n$ is measured by the number of mobile cellular subscriptions per-capita. $\Delta patents(pc)_n$ denotes the total number of patent applications per capita from the World Development Indicators. Sector fixed effects are included and standard errors are clustered by country and sector (in parentheses).

Figure 3: Firm-embedded productivity and management practices.



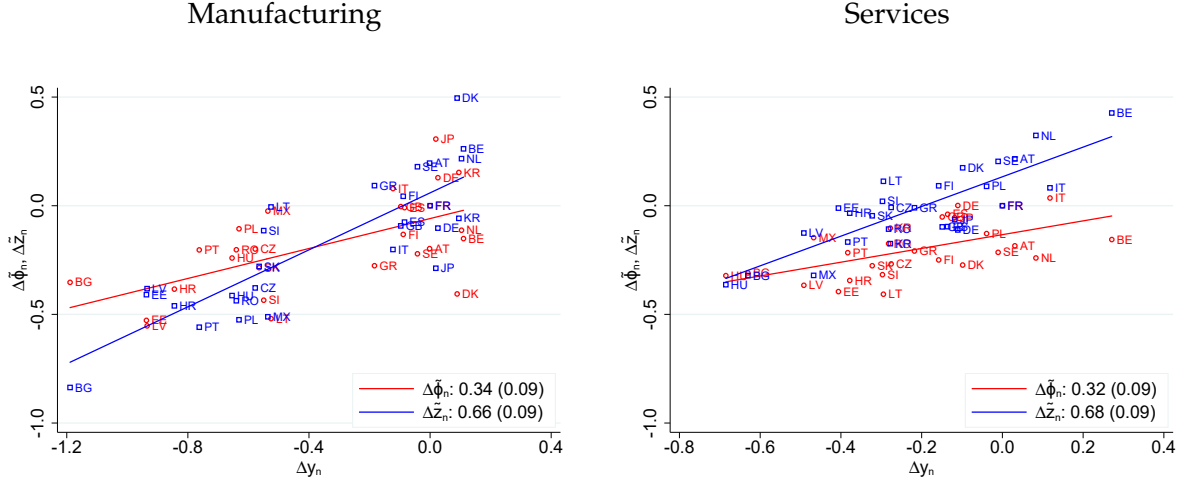
Notes: Each circle represents a country's firm-embedded productivity relative to France. The figure plots the the average management practices score from the World Management Survey in the x-axis and $\Delta\tilde{\phi}_n$ are plotted in the y-axis. The legend reports the R-squared of a bivariate OLS regression of $\Delta\tilde{\phi}_n$ and country's management practices score.

4.1 Sector-level decompositions

We now decompose differences in output per-worker in Manufacturing and Services by aggregating our sectoral estimates of the country effects into those two broad sectoral categories.

Figure 4 reports the results. Even though firm-embedded productivity for the average country (relative to France) is similar for Manufacturing and Services (-0.18 vs -0.20 log-points), the cross-country differences are larger in Manufacturing. The cross-country differences in output per-worker are also larger in Manufacturing than in Services, so the contribution of firm-embedded productivity to cross-country income differences ends up being roughly one third for both sectors. There is substantial variation across countries. For example, Japan, Korea, and Germany have relative high levels of firm-embedded productivity in Manufacturing, but their firm-embedded productivity in Services is similar to that of other developed countries. Firm-embedded productivity is lower than country-embedded factors, relative to France, in Services sectors for all countries, except for Germany, Mexico, and Hungary. Manufacturing presents much more heterogeneity than services, with less developed countries having higher firm-embedded productivity than more developed countries, and vice-versa.

Figure 4: Dev. accounting: Manufacturing and Services



Notes: Each circle (square) represents a country's firm-embedded productivity (country-embedded factors). The figures plot the decomposition in Equation (15) at the sectoral level. Δy_n^j is plotted in the x-axis and $\Delta \tilde{z}_n^j$ and $\Delta \phi_n^j$ are plotted in the y-axis for $j = \text{Manufacturing}$ (left panel) and $j = \text{services}$ (right panel).

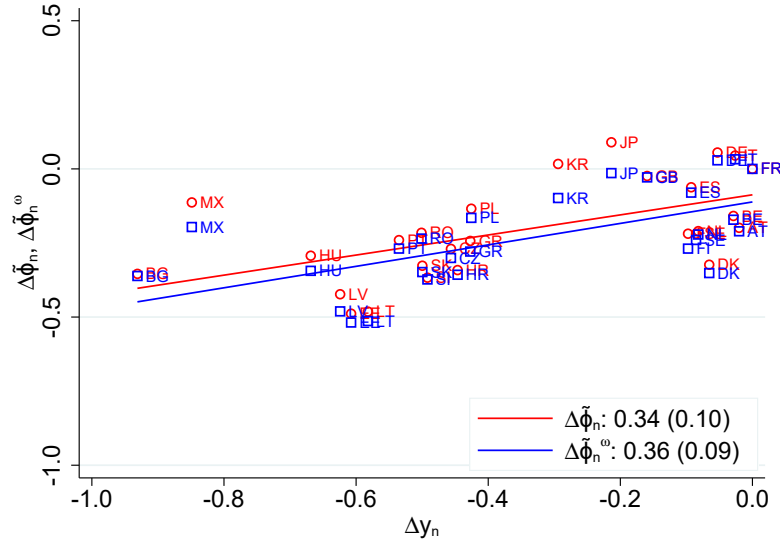
We can further decompose differences in output per-worker within each sub-sector in Manufacturing and each sub-sector in Services. Appendix Figures A3 and A4 show these results. The figures show a very strong correlation between our sectoral measures of firm-embedded productivity and output per-worker at the sector level.

Finally, we evaluate if the observed differences in aggregate firm-embedded productivity arise from differences in the sectoral composition of output across countries. With this in mind, we compute a measure of aggregate firm-embedded productivity that aggregates sectoral differences using the output shares of our reference country (France), $\Delta \tilde{\phi}_n^w \equiv \sum_j \theta_r^j \Delta \tilde{\phi}_n^j$. Figure 5 shows that this measure and our baseline measure are very close to each other, indicating that cross-country differences in aggregate firm-embedded productivity are not driven by cross-country differences in sectoral output shares. Within-sector differences in firm-embedded productivity across countries overwhelmingly create the observed aggregate differences.

4.2 Firm-embedded productivity and comparative advantage

An extensive literature in International Trade studies the sources of comparative advantage by relating the sectorial concentration of a country's exports to factor endowments,

Figure 5: Differences in firm-embedded productivity within and between sectors.



Notes: The figure plots the decomposition in Equation (15), where Δy_n is plotted in the x-axis and $\Delta \tilde{\phi}_n^\omega \equiv \sum_j \theta_j^i \Delta \tilde{\phi}_n^j$ and $\Delta \tilde{\phi}_n \equiv \sum_j \theta_n^j \Delta \tilde{\phi}_n^j$ are plotted in the y-axis. The legend reports the slopes of a bivariate OLS regression of $\Delta \tilde{\phi}_n$ (rest. $\Delta \tilde{\phi}_n^\omega$) on Δy_n . Each circle (square) represents a country.

technologies, financial conditions, or institutions.²⁰ In this section, we evaluate how sectorial differences in firm-embedded productivity and in country-embedded factors shape the sectorial concentration of the foreign output of a country's MNEs. The notion that MNEs can use their idiosyncratic productivity around the world while country-embedded factors are immobile suggests that only the former should affect the activities of MNEs when producing abroad.

With this in mind, we correlate sectorial differences in firm-embedded productivity in a country with the sectorial concentration of the foreign output of the MNEs from that country (referred to as 'outward MNE sales'). We measure this sectorial concentration using a Revealed Comparative Advantage (RCA) index for outward MNE sales. Let $R_{n,row}^j$ ($R_{r,row}^j$) denote the total revenues of MNEs from country n (reference country, r) in the

²⁰A non-exhaustive list of recent papers includes [Bernhofen and Brown \(2004\)](#), [Romalis \(2004\)](#), [Levchenko \(2007\)](#), [Nunn \(2007\)](#), [Costinot et al. \(2012\)](#), [Levchenko and Zhang \(2016\)](#), and [Hanson et al. \(2015\)](#).

rest of the world.²¹ We define the RCA index for outward MNE sales as

$$\Delta rca_n^j \equiv \ln \left(\frac{R_{n,row}^j / \sum_{j'} R_{n,row}^{j'}}{R_{r,row}^j / \sum_{j'} R_{r,row}^{j'}} \right). \quad (24)$$

Δrca_n^j is defined in logs and takes France as the reference country. Thus, $\Delta rca_n^j > 0$ when the share of sector j in outward MNE sales is larger for MNEs from country n than for MNEs from France. Note that, while $\Delta \tilde{\phi}_n^j$ is measured with data on market shares of foreign MNEs in country n , Δrca_n^j is measured with data on sales of country n 's MNEs in foreign countries, so that the two measures do not need to be correlated.

Figure 6 compares the relative differences in firm-embedded productivity in manufacturing vs. services, $\Delta \tilde{\phi}_n^{man} - \Delta \tilde{\phi}_n^{serv}$, to the differences in revealed comparative advantage in manufacturing and services for outward MNE sales, $\Delta rca_n^{man} - \Delta rca_n^{serv}$. There is a strong positive relation between differences in firm-embedded productivity and differences in the RCA index for outward MNE sales across countries. For example, Japan and Finland have a particularly large stock of firm-embedded productivity in Manufacturing, and the outward sales of the MNEs from these countries are concentrated in the Manufacturing sector. In contrast, Latvia and Lithuania have relatively more firm embedded productivity in Services, and the sales of the MNEs from these countries in the rest of the world are also concentrated in the Service sector.

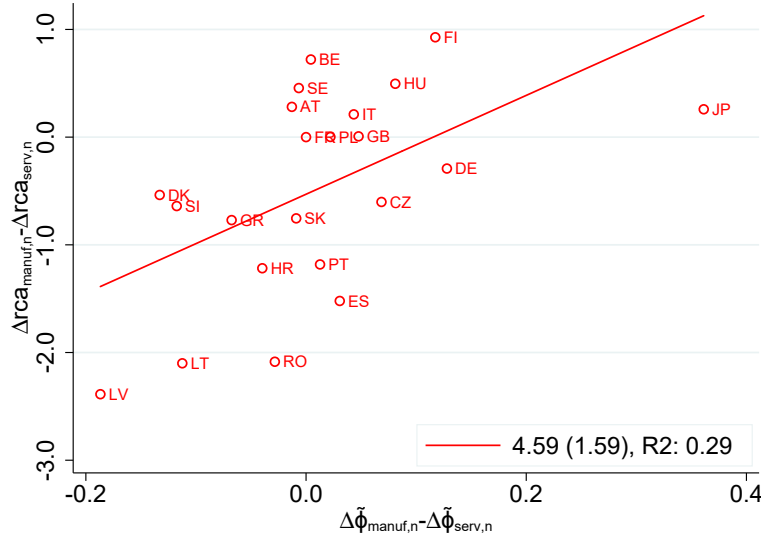
We observe similar patterns across disaggregated 2-digit sectors. Table 3 shows the results of regressing our sectorial measure of comparative advantage, Δrca_n^j , on our measures of sectorial firm-embedded productivity and country embedded factors, $\Delta \tilde{\phi}_n^j$ and Δz_n^j . Columns (1), (4) and (7) show a strong correlation between a country's sectorial firm-embedded productivity and its comparative advantage.²² In contrast, Columns (2), (5) and (8) show no correlation between sectorial country-embedded factors and a country's comparative advantage. Columns (3), (6), and (9) reports similar results when country-embedded factors and firm-embedded productivity are simultaneously included in the regression.

These results are in line with the notion that firm-embedded productivity is transferable

²¹Using the notation from Section 2 these revenues correspond to $R_{n,row}^j \equiv \sum_{n' \neq n} \int_{\omega \in \Omega_{nn'}^j} P_{nn'}^j(\omega) Y_{nn'}^j(\omega) d\omega$.

²²This result is in line with the findings in [Alvarez \(2019\)](#), who using sectoral-level data shows a positive correlation between the bilateral sales of affiliates of foreign MNEs in a sector and the RCA index for sectoral TFP in the source country of the MNE.

Figure 6: Sectorial firm-embedded productivity and outward MNE sales.



Notes: The x-axis reports the difference in our measure of firm-embedded productivity in manufacturing vs. services, relative to France. The y-axis reports the difference in the Δrca_n^j index defined in Equation (24), between $j = \text{Manufacturing}$ and $j = \text{Services}$.

across countries and a source of advantage for MNEs operating abroad. Country embedded factors, which are immobile across countries, do not appear to shape the sectorial concentration of a country's MNEs.

4.3 Contribution of domestic and foreign firms

This section further decomposes the sources of the cross-country differences in firm-embedded productivity by considering the origin of the firms in each country. In particular, differences in firm-embedded productivity may arise both from cross-country differences in the productivity embedded in all domestic firms, and from differences in the productivity embedded in the foreign affiliates operating in each country.

We write the market share of domestic firms in country n and in sector j as

$$S_{nn}^j \equiv \int_{\Omega_{nn}^j} S_{nn}^j(\omega) d\omega = \frac{\Phi_{nn}^j}{\Phi_n^j}, \quad (25)$$

where $\Phi_{nn}^j \equiv \int_{\Omega_{nn}^j} A_{nn}^j(\omega) d\omega$ is the productivity embedded in domestic firms in country

Table 3: Sectorial firm-embedded productivity and comparative advantage.

dep. var. Δrca_n^j	All sectors			Manufacturing sectors			Service sectors		
	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)
$\Delta \tilde{\phi}_n^j$	2.63*** [0.663]		3.23*** [0.836]	4.14** [1.326]		5.48*** [1.075]	3.07** [0.906]		2.84** [0.812]
$\Delta \tilde{z}_n^j$		0.17 [0.469]	0.83 [0.501]		1.51 [0.927]	2.49** [0.823]		-0.76 [0.527]	-0.19 [0.645]
Observations	313	313	313	121	121	121	132	132	132
R-squared	0.072	0.001	0.094	0.138	0.056	0.274	0.063	0.023	0.064

Notes: Each j corresponds to a NAICS 2-digit sector. 'All sectors' include sectors those in Manufacturing, Services, and others. Standard errors are clustered by country and sector (in parentheses).

n . Similarly, the market share of foreign firms in country n is given by

$$S_{Fn}^j \equiv \sum_{i \neq n} \int_{\Omega_{in}^j} S_{in}^j(\omega) d\omega = \frac{\Phi_{Fn}^j}{\Phi_n^j}, \quad (26)$$

where $\Phi_{Fn}^j \equiv \sum_{i \neq n} \int_{\Omega_{in}^j} A_{nn}^j(\omega) d\omega$ denotes the productivity embedded in foreign firms operating in country n . From the definition of Φ_n^j , and using lowercase to denote logs, we can write the first-order approximation

$$\Delta \phi_n^j = S_{rr}^j \Delta \phi_{nn}^j + [1 - S_{rr}^j] \Delta \phi_{Fn}^j, \quad (27)$$

where S_{rr}^j refers to the market share of domestic firms in the reference country r (and sector j).

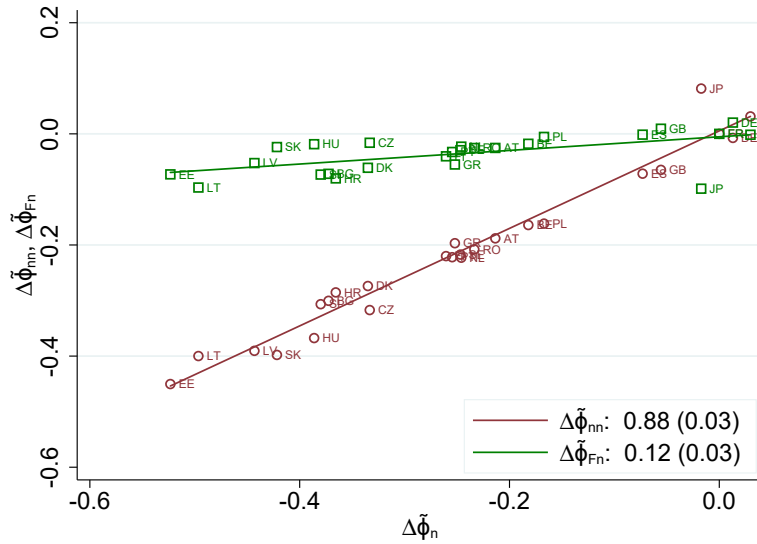
Finally, aggregating across sectors we obtain

$$\Delta \tilde{\phi}_n = \underbrace{\sum_j \theta_n^j S_{rr}^j \Delta \tilde{\phi}_{nn}^j}_{\Delta \tilde{\phi}_{nn}} + \underbrace{\sum_j \theta_n^j [1 - S_{rr}^j] \Delta \tilde{\phi}_{Fn}^j}_{\Delta \tilde{\phi}_{Fn}}, \quad (28)$$

where $\Delta \tilde{\phi}_{nn}^j \equiv \beta^j \Delta \phi_{nn}^j$ and $\Delta \tilde{\phi}_{Fn}^j \equiv \beta^j \Delta \phi_{Fn}^j$.

Equation (28) shows the contributions of domestic firms ($\Delta \tilde{\phi}_{nn}$) and foreign firms ($\Delta \tilde{\phi}_{Fn}$) to the observed differences in aggregate firm-embedded productivity ($\Delta \tilde{\phi}_n$). To measure these contributions, we first use domestic shares S_{nn}^j from the data, our estimates of Φ_n^j ,

Figure 7: Aggregate firm-embedded productivity: domestic vs foreign firms.



Notes: Brown circles and green squares, respectively, report $\Delta\tilde{\phi}_{nn}$ and $\Delta\tilde{\phi}_{Fn}$ defined in Equation (28).

and Equation (25) to compute Φ_{nn}^j . Similarly, we use the revenue share of foreign firms in country n , S_{Fn}^j , together with the estimates of Φ_{nn}^j and Equation (26), to compute Φ_{Fn}^j . We then aggregate across sectors using sectoral shares θ_n^j and the reference-country sectoral revenue share for their domestic firms, S_{rr}^j .

Figure 7 shows the two terms in the right-hand side of Equation (28). The average country has a 0.21 log-point difference relative to France regarding domestic firm-embedded productivity, while the gap for foreign firms is only 0.04. Differences in aggregate firm-embedded productivity for domestic firms account for 88 percent of the cross-country differences in aggregate firm-embedded productivity. Differences in the productivity embedded in the foreign affiliates of MNEs are very small across countries, with some developing countries having better foreign MNE affiliates than developed countries. Countries such as Latvia, Estonia, and Slovakia have less productivity embedded in domestic firms than most of the more developed countries in our sample. However, these countries foreign firms that are as productive as the ones located in Finland, the Netherlands, or Austria. Finally, this decomposition attributes, for instance, all the difference in aggregate firm-embedded productivity between France and Poland, observed in Figure 2, to domestic firms.

4.4 Firm-embedded productivity and scale effects

A recurring theme in the International Trade and Growth/Development literatures is that aggregate scale or variety effects may be important for TFP (see e.g. [Krugman 1980](#), [Jones 1995](#), and [Hsieh and Klenow 2009](#)). In this section we decompose cross-country differences in aggregate firm-embedded productivity into differences in the average productivity embedded in each firm, and differences in the number of firms across countries. In particular, we can write the differences in firm-embedded productivity as

$$\Delta\tilde{\phi}_n = \underbrace{\beta\Delta m_n}_{Scale} + \underbrace{\Delta\bar{\phi}_n}_{Average}, \quad (29)$$

where Δm_n denotes the log-difference in the aggregate number of firms across sectors, and $\Delta\bar{\phi}_n \equiv \Delta\tilde{\phi}_n - \beta\Delta m_n$ is the log-difference in the average firm-embedded productivity relative to France.

Computing the scale term in Equation (29) is not straightforward, since comparable data on the number of firms across countries are not readily available.²³ This problem is compounded by the fact that, in our framework, a firm corresponds to all the tax-identification numbers belonging to the same ultimate owner. In contrast, in most existing datasets, establishments and firms are not recorded by their ultimate owner. Notice that this challenge cannot be overcome by counting the firms in our dataset, since ORBIS does not cover the population of firms in each country and the coverage differs across countries.

With this in mind, we assume that there is a log-linear relation between the scale effect and the population in a country,

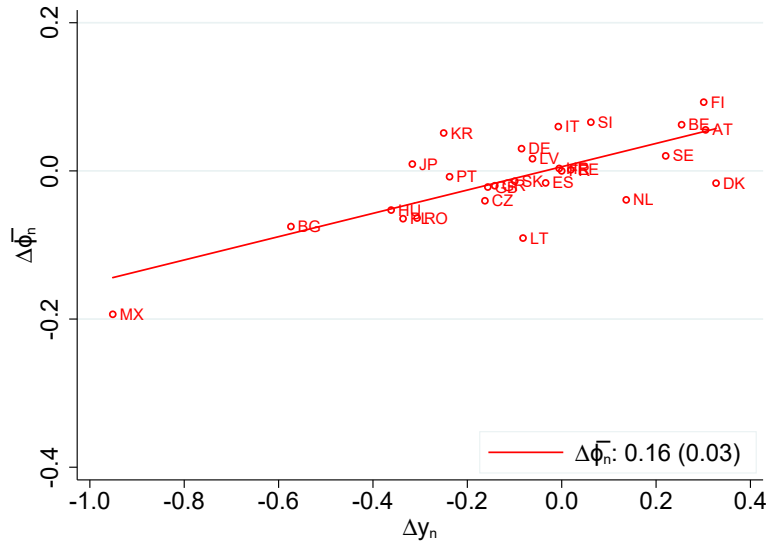
$$\Delta m_n = \lambda \times \Delta pop_n, \quad (30)$$

where we continue to use lowercase to denote logs, and where pop_n is the log of the population in country n . This relation is a standard feature of many models of scale economies, such as [Krugman \(1980\)](#). Replacing Equation (30) into (29), we fit the regression given by

$$\Delta\tilde{\phi}_n = b \times \Delta pop_n + \varepsilon_n.$$

²³The definition of what constitutes a ‘firm’ differs across country-sources. For example, the minimum number of employees for an establishment or firm to be counted in surveys varies across countries.

Figure 8: Dev. accounting: average firm-embedded productivity.



Notes: Each circle represents a country. The y-axis plots the residual of a regression of firm-embedded productivity, $\Delta \bar{\phi}_n$, on the log of population. The x-axis plots the residual of a regression of the log of income per capita, y_n , on the log of population.

Under the assumption that the average firm-embedded productivity $\Delta \bar{\phi}_n$ is orthogonal to the country's population, the error term can be interpreted as $\varepsilon_n = \Delta \bar{\phi}_n$. If the average firm-embedded productivity in a country increased with population, the residual ε_n would understate the differences in average firm-embedded productivity across countries, since it would capture only the part of average firm-embedded productivity that is orthogonal to population.

Figure 8 shows a very strong correlation between our measure of average firm-embedded productivity $\Delta \bar{\phi}_n$ and output per-worker (also residualized by population).²⁴ The slope in this figure is flatter but more precisely estimated than the slope between $\Delta \bar{\phi}_n$ and Δy_n in Figure 2. The cross-country variation in firm-embedded productivity that is not driven by the country's scale accounts for 16 percent of the cross-country variance in income per-worker, almost half of the variation accounted for our aggregate measure of firm-embedded productivity $\Delta \bar{\phi}_n$.

²⁴Thus, the slope of this relation corresponds to the slope of a regression of Δy_n on $\Delta \bar{\phi}_n$ that also controls for Δpop_n .

5 Robustness

This section presents several robustness exercises. First, we show how to estimate firm-embedded productivity under alternative assumptions on the technology transfer costs. Second, we evaluate potential selection concerns. Third, we evaluate the log-linearity assumption on the production function. Finally, we repeat our analysis using alternative samples, finer sectoral disaggregations, and other gravity controls.

5.1 Alternative assumptions on the technology transfer costs

Our baseline estimates for $\Delta\phi_n^j$ were derived under the assumption that technology transfer costs could have an origin-specific, but not a destination-specific component, $\Delta D_n^j = 0$, as specified in Equation (21). As explained in Section 3.2, if this assumption does not hold, and if it is harder to transfer technology to less developed countries, our baseline estimates would understate the contribution of firm-embedded productivity to the cross-country variance of output per-worker.

We now show how to estimate $\Delta\phi_n^j$ when $\Delta D_n^j \neq 0$. We use data on market shares of both affiliates and parent firms of MNEs, and assume that costs have a destination-specific, but no origin-specific, component, $\Delta O_n^j = 0$, as in Eaton and Kortum (2002). In particular, we estimate

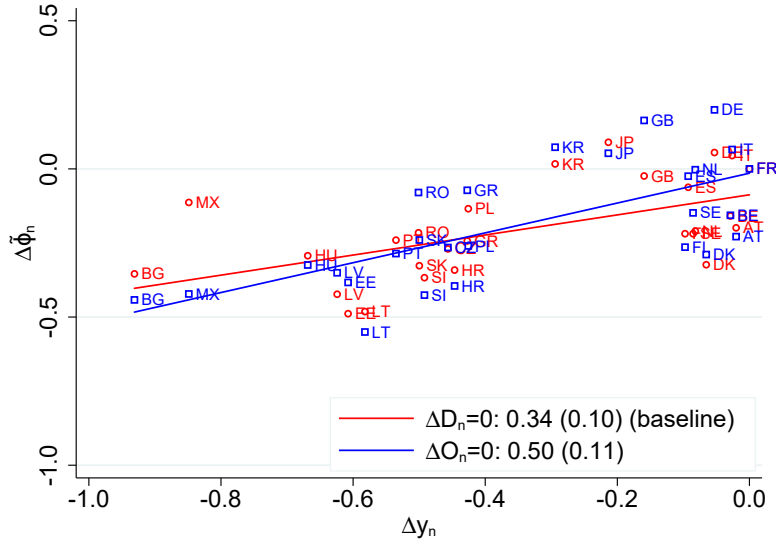
$$s_{in}^j(\omega) = \delta_i^j(\omega) + \mathbb{A}_n^j + \mathbb{P}_n^j + B_{in}^j + \epsilon_{in}^j(\omega). \quad (31)$$

Here, \mathbb{A}_n^j is a set of dummies that take the value of 1 if the destination country is n and the firm is an affiliate, $i \neq n$, in sector j , while \mathbb{P}_n^j is a set of dummies that take the value of 1 if the destination country is n and the firm is a parent, $i = n$, in sector j . In this specification, the dummies \mathbb{A}_n^j are still given by Equation (21), while the dummies \mathbb{P}_n^j are

$$\Delta\mathbb{P}_n^j = - \left[\Delta\phi_n^j - \Delta O_n^j \right]. \quad (32)$$

If $\Delta O_n^j = 0$, $\Delta\mathbb{P}_n^j$ can be interpreted as the inverse of the firm-embedded productivity in country n relative to France. If the assumption is not satisfied and the origin-specific component of the transfer cost is higher for low income countries, $cov(\Delta y_n^j, \Delta O_n^j) \leq 0$, estimates based on Equation (32) would overstate the contribution of firm-embedded pro-

Figure 9: Alternative assumptions on the technology transfer costs.



Notes: Each circle (square) represents a country. The figure plots the decomposition in Equation (15), where Δy_n is plotted in the x-axis and $\Delta \tilde{\phi}_n$ is plotted in the y-axis. The legends report the slopes of a bivariate OLS regression of $\Delta \tilde{\phi}_n$ on Δy_n under the assumption that $\Delta D_n^j = 0$ (baseline) and $\Delta O_n^j = 0$. Standard errors are in parenthesis.

ductivity to the cross-country variance of output per-worker,

$$\text{cov} \left(\Delta y_n, -\Delta \mathbb{P}_n^j \right) = \text{cov} \left(\Delta y_n, \Delta \phi_n^j - \Delta O_n^j \right) \geq \text{cov} \left(\Delta y_n, \Delta \phi_n^j \right). \quad (33)$$

Hence, while our baseline estimates yield a lower bound to the contribution of differences in firm-embedded productivity to cross-country differences in income, this alternative specification yields an upper bound to that contribution.

Figure 9 compares our baseline estimates with those based on Equations (32) and (31) and the restriction that $\Delta O_n^j = 0$. The two alternative identification assumptions on transfer costs yield similar estimates for aggregate firm-embedded productivity, relative to France, for each country. Appendix Figure A5 shows that the OLS estimates from Equation (31) are less precise than our baseline estimates, as the number of MNE foreign affiliates in our data far exceeds the number of MNE parent firms. For the average country, this alternative estimate of $\Delta \phi_n$ is -0.19 log-points, relative to France, while our baseline estimate is -0.20. One of the largest differences is observed for Mexico where aggregate firm-embedded productivity, relative to France, is estimated to be -0.42 when we assume that $\Delta O_n^j = 0$ and -0.11 when we alternative assume that $\Delta D_n^j = 0$.

5.2 Selection based on MNE-destination specific characteristics

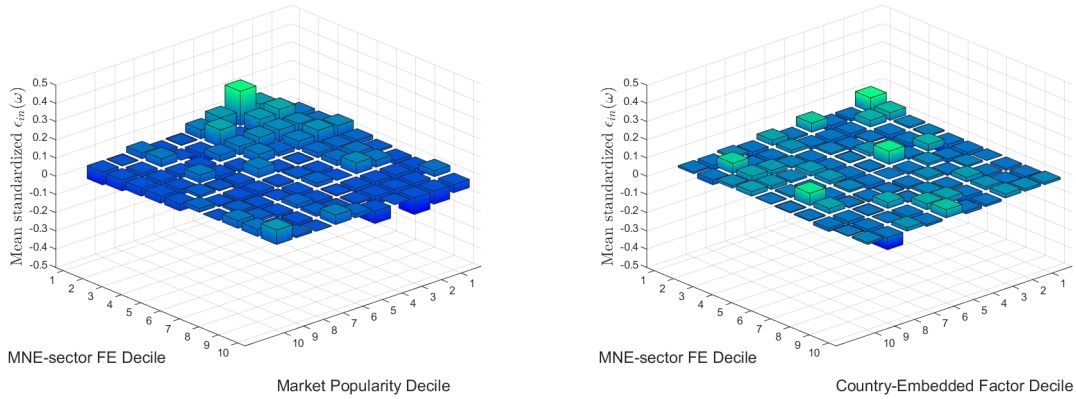
The OLS estimates of the destination-sector-specific components of the market shares are unbiased if the assignment of MNEs to destination countries is exogenous with respect to the error term in Equation (19). This is the case if selection is driven by firm characteristics and by destination-country characteristics, but not by firm-destination characteristics. In contrast, the estimates are biased if MNE-destination specific transfer costs drive the assignment of MNEs to countries -that is, if selection is based on match-specific effects-. If the relatively unproductive MNEs enter unattractive locations only when their MNE-destination specific component of the transfer cost $\varepsilon_{in}^j(\omega)$ is low, then the average of $\varepsilon_{in}^j(\omega)$ across the MNEs that choose to enter each destination would vary across n and thus it would be captured by the country effects A_n^j .

To assess the severity of this potential bias, we follow the literature on two-way matching (Abowd et al., 1999) and analyze the residuals from estimating our baseline specification in Equation (19) by OLS. If the assignment of MNEs to countries is driven by MNE-destination specific transfer costs, we should expect these costs to be on average lower -low $\varepsilon_{in}^j(\omega)$ - for low-productivity MNEs in unattractive markets. In contrast, highly productive MNEs are more likely to enter these markets irrespective of their $\varepsilon_{in}^j(\omega)$. If this is the case, our specification should underestimate market shares for low-productivity MNEs in unattractive markets, as it does not take into account that the $\varepsilon_{in}^j(\omega)$'s can systematically vary with firm productivity among the MNEs that choose to enter any given market.

We evaluate this implication in Figure 11a, which plots the mean standardized residuals, $\hat{\varepsilon}_{in}^j(\omega) = \frac{s_{in}^j(\omega) - \hat{s}_{in}^j(\omega)}{\sigma_s}$, against deciles of estimates of the MNE-sector fixed effects, $\delta^j(\omega)$, and deciles of market popularity. Our measure of market popularity is calculated using data from OECD-Eurostat on the number of foreign MNEs operating in a country-sector pair. Indeed, we tend to see positive residuals for the less productive MNEs (decile 1 of the MNE-sector fixed effect) in less popular markets (decile 1 of market popularity). In contrast, we overestimate the market shares of the most productive MNEs (decile 10 of the MNE-sector fixed effect) in these markets. The residuals are very close to zero in the remaining bins of the figure, indicating that technology transfer costs do not vary systematically across MNEs and locations in those bins.

With this concern in mind, we proceed to re-estimate Equation (19) using alternative subsamples, restricted to exclude the MNEs at the extremes of the market-share distribution.

Figure 10: OLS Residuals.



(a) By MNE-sector and market popularity.

(b) By MNE-sector and country-embedded factors.

Notes: Deciles are calculated within sectors. Market popularity refers to the number of foreign MNEs in a country-sector pair, from OECD-Eurostat. Country-embedded factor refers to estimates of \tilde{Z}_n^j .

Concretely, we restrict the sample to subsets of MNEs that lie within the 2nd to 9th, 3rd to 8th, 4th to 7th deciles, or 5th and 6th deciles, of the MNE-sector fixed effect distribution within a sector. Alternatively, we also apply our estimation procedure to subsamples of MNEs that operate in at least 3, 5, or 10 countries. These are large MNEs that are unlikely to select into destination markets due to the MNE-destination specific component of the technology transfer costs. Table 4 shows that the contribution of firm-embedded productivity to the cross-country variance in output per-worker is very similar to our baseline in all these subsamples.

5.3 Production function assumptions

A related concern with our baseline estimation pertains the separability between firm-embedded productivity and country-embedded factors. Our model assumes a production function that is log-linear in firm-embedded productivity and the country embedded factors. This separability is inherited by the aggregate production function, which is linear in \tilde{z}_n and $\tilde{\phi}_n$. But if, for instance, high productivity MNEs do relatively better in countries with high country-embedded factors, the assumption would not longer hold, and our procedure would underestimate market shares for high productivity MNEs in markets with high \tilde{z}_n .

We evaluate this implication in Figure 11b, which plots the mean standardized residuals,

Table 4: Contribution of firm-embedded productivity, restricted samples.

	$\frac{\text{cov}(\Delta y_n, \Delta \hat{\phi}_n)}{\text{var}(\Delta y_n)}$
Baseline	0.34 (0.10)
I. Keeping MNEs with MNE-sector FE belonging to:	
2nd to 9th Decile	0.32 (0.10)
3rd to 8th Decile	0.31 (0.11)
4th to 7th Decile	0.31 (0.11)
5th to 6th Decile	0.37 (0.12)
II. Keeping MNEs operating in:	
at least 3 countries	0.32 (0.10)
at least 5 countries	0.28 (0.08)
at least 10 countries	0.32 (0.08)

Notes: Slopes of a bivariate OLS regression of $\Delta \hat{\phi}_n$ on Δy_n . MNE-sector fixed effect, for each sector, estimated using Equation (19) by OLS. Standard errors are in parenthesis.

$\hat{\epsilon}_{in}^j(\omega) = \frac{\hat{s}_{in}^j(\omega) - \hat{s}_{in}^j(\omega)}{\sigma_s}$, against deciles of estimates of the MNE-sector fixed effects, $\delta^j(\omega)$, and deciles of estimates of the country-embedded factors \tilde{z}_n^j . We see positive residuals for the less productive MNEs (decile 1 of the MNE-sector fixed effect) in countries with lower \tilde{z}_n^j (decile 1 of country-embedded factors). We actually overestimate the market shares of the most productive MNEs (decile 10 of the MNE-sector fixed effect) in these countries. The residuals are very close to zero in the remaining bins of the figure, indicating that the log-linearity assumption is not systematically violated in those bins. Table 4 shows that the contribution of firm-embedded productivity to the cross-country variance in output per-worker is very similar when estimated in subsamples of MNE that are not at the extremes of the fixed-effects distribution.

A different approach to assess the additive separability assumption is to group destination countries using k-mean clustering based on the distribution of affiliates' market shares (Bonhomme et al., 2019). Each firm-destination group-pair can then be allowed to have a differential effect. This new specification replaces the additive country and MNE-sector fixed effects with an interaction between country-group and MNE-sector fixed effect. Based on this approach, Appendix B presents additional tests that support our linearity assumption.

Table 5: Contribution of firm-embedded productivity, additional robustness.

	$\frac{\text{cov}(\Delta y_n, \Delta \tilde{\phi}_n)}{\text{var}(\Delta y_n)}$
Baseline	0.34 (0.10)
Controlling for bilateral MNE-specific tax rates	0.34 (0.10)
Controlling for bilateral tax treaties (BTT)	0.35 (0.10)
Controlling for differences in GDP per-worker between source and host country	0.34 (0.10)
Excluding gravity variables	0.29 (0.11)
Aggregation at 4-digit NAICS industries	0.38 (0.11)
Excluding Real Estate, Health, and Education	0.32 (0.10)
Excluding MNEs that do not appear in ORBIS every year between 2010-2016	0.39 (0.09)

Notes: Slopes of a bivariate OLS regression of $\Delta \tilde{\phi}_n$ on Δy_n . Bilateral tax treaties data comes from UNCTAD International Investment Agreements. Standard errors are in parenthesis.

5.4 Additional robustness exercises

This section briefly describes additional robustness exercises, which are collected in Table 5. First, we use additional controls for the bilateral component of MNE costs, B_{in}^j . In particular, we add bilateral MNE-specific taxes, which we compute using data from the OECD Effective Tax Rates dataset, the UNCTAD International Investment agreements dataset, and Deloitte’s Withholding Tax Rates.²⁵ Alternatively, we include an indicator variable for the existence of a bilateral tax treaty between the source and host country, which allow foreign-owned subsidiaries to avoid or mitigate double taxation. Next, we control for the difference between the income per-capita of the source and the host country, and finally we repeat our analysis without any gravity control.

In an additional robustness, we consider sectors at the 4-digit NAICS (336 sectors), rather than the 2-digit NAICS classification. Alternatively, we exclude the Health, Education, and Real Estate sectors from our sample, as the government has a large participation in these sectors in some countries in our sample. Finally, we repeat our analysis for firms that appear in ORBIS in every year between 2010 and 2016, as these are arguably the years when the ORBIS data are of the highest quality (see Appendix Table A4 for results by year). The results of our decomposition for all these alternative specifications are remarkably close to our baseline result.

²⁵See Appendix A for details.

6 Conclusion

This paper measures cross-country differences in firm-embedded productivity and their contribution to cross-country income differences. Our key insight is that, if MNEs can use their idiosyncratic productivity around the world, but they must use the factors from the countries where they produce, differences in the market shares of the same MNE across countries can be used to measure cross-country differences in firm-embedded productivity. We implement this idea in an accounting framework and measure firm-embedded productivity using firm-level revenue data on MNEs that produce in multiple countries. While our sample of developing countries is limited to those in Eastern Europe and Mexico, our new procedure can be easily applied to more countries as new affiliate-parent matched data become available.

Our results indicate that cross-country differences in firm-embedded productivity are large, accounting for roughly one-third of the observed differences in output per-worker across the countries in our sample. This suggests that micro-level interventions and policies that foster firm-embedded productivity can play an important role in closing cross-country income differences.

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APPENDIX

Table A1: Estimates of gravity coefficients.

	Distance		Common Language	
	Coef.	S.E.	Coef.	S.E.
Other goods				
Agriculture and Mining	-0.702	0.215	-0.078	0.327
Electricity	-0.754	0.138	0.069	0.481
Construction	-0.491	0.222	0.740	0.277
Manufacturing				
Food and Beverage	-0.214	0.165	0.597	0.090
Textiles, Apparel and Wood	-0.285	0.125	-0.144	0.277
Chemicals, Petroleum and Plastic	-0.191	0.075	0.161	0.085
Basic Metals	-0.202	0.097	0.261	0.089
Electrical Equipment and Machinery	-0.030	0.074	0.272	0.112
Transport Equipment and Other Manufacturing	-0.278	0.114	0.004	0.211
Services				
Wholesale Trade and Retail Trade	-0.278	0.064	0.212	0.103
Transportation and Storage	-0.123	0.088	0.233	0.201
Information	-0.340	0.116	0.559	0.114
Financial and Insurance Services	-0.423	0.101	1.013	0.178
Support Services	-0.276	0.058	0.335	0.149
Accommodation and Recreation	-0.075	0.147	0.245	0.218
Other Sectors				
Education	0.081	0.511	0.678	0.592
Health	0.099	0.569	0.240	0.511
Real Estate	-0.296	0.129	0.279	0.176

Notes: This table reports OLS coefficients on distance, and common language, MNE taxes from estimating Equation (19).

Table A2: Estimates of sectoral elasticities β^j .

	no controls		$+k_n/y_n + h_n$	
	Coef.	S.E	Coef.	S.E
Other goods				
Agriculture and Mining	-0.08	0.04	-0.09	0.04
Construction	-0.21	0.04	-0.21	0.04
Electricity	-0.12	0.02	-0.13	0.02
Manufacturing				
Food and Beverage	-0.18	0.03	-0.19	0.03
Textiles, Apparel and Wood	-0.26	0.05	-0.29	0.05
Chemicals, Petroleum and Plastic	-0.22	0.04	-0.23	0.04
Basic Metals	-0.12	0.02	-0.12	0.03
Electrical Equipment and Machinery	-0.21	0.03	-0.21	0.03
Transport Equipment and Other Manufacturing	-0.31	0.03	-0.32	0.03
Services				
Wholesale Trade and Retail Trade	-0.18	0.05	-0.20	0.04
Transportation and Storage	-0.06	0.05	-0.07	0.05
Information	-0.28	0.05	-0.29	0.05
Financial and Insurance Services	0.05	0.03	0.04	0.02
Support Services	-0.15	0.03	-0.15	0.02
Accommodation and Recreation	-0.20	0.05	-0.22	0.04
Other Sectors				
Real Estate	-0.18	0.04	-0.19	0.04
Health	-0.16	0.04	-0.15	0.04
Education	-0.04	0.05	-0.05	0.06

Notes: OLS estimates from Equation (23) by 2-digit sector. Standard errors in parentheses.

Table A3: Number of observations, R-squared, and mean squared errors.

	<i>N</i>	<i>R</i> ²	<i>MSE</i>
Baseline	49,811	0.70	1.43
I. Other outcome variables			
Employment	41,697	0.76	1.31
Value Added	27,271	0.75	1.30
II. Alternative assumption on technology transfer costs	70,353	0.72	1.46
III. Keeping MNEs with firm-sector FE belonging to:			
2nd to 9th Decile	38,652	0.74	1.06
3rd to 8th Decile	27,275	0.81	0.80
4th to 7th Decile	16,218	0.89	0.55
5th to 6th Decile	6,120	0.97	0.28
IV. Keeping MNEs operating in:			
at least 3 countries	38,709	0.66	1.43
at least 5 countries	26,298	0.62	1.42
at least 10 countries	11,682	0.58	1.34
V. Other Robustness:			
Aggregation at 4-digit NAICS industries	59,088	0.63	1.54
Excluding Real Estate, Health, and Education	47,584	0.70	1.43
Excluding MNEs that do not appear in ORBIS every year between 2010-2016	32,396	0.72	1.34
Controlling for differences in GDP per-worker between source and host country	48,955	0.70	1.43
Controlling for bilateral tax treaties (BTT) between source and host country	49,811	0.70	1.43
Excluding gravity controls	50,649	0.70	1.44

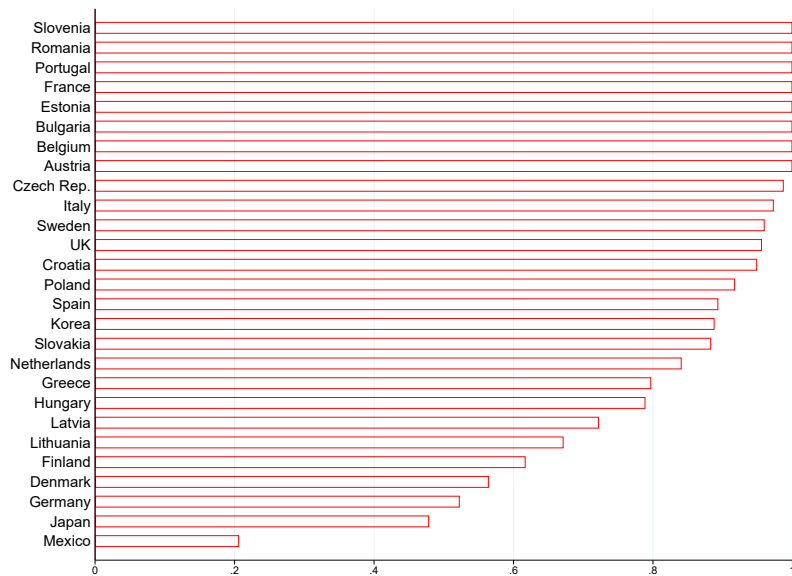
Notes: Number of observations, R^2 , and mean squared errors for the regressions presented in the paper. I. refers to alternative firm's outcome variables. II. refers to our alternative specification in Equation (31), which includes data from parent firms. III. refers to keeping firms in the specified deciles of the distribution of the MNE-sector fixed effects. IV. refers to keeping firms that have affiliates in at least as many countries as reflected by the threshold. V. refers to the additional robustness in Section 5.4.

Table A4: Contribution of aggregate firm-embedded productivity, by year.

	All firms	Countries (#)	Constant Sample	Countries (#)
	$\frac{cov(\Delta y_n, \Delta \tilde{\phi}_n)}{var(\Delta y_n)}$		$\frac{cov(\Delta y_n, \Delta \tilde{\phi}_n)}{var(\Delta y_n)}$	
2006	0.28 (0.15)	15		
2007	0.35 (0.10)	24	0.20 (0.11)	15
2008	0.32 (0.09)	25	0.24 (0.08)	24
2009	0.34 (0.08)	25	0.26 (0.08)	24
2010	0.36 (0.10)	25	0.31 (0.09)	24
2011	0.35 (0.10)	25	0.29 (0.09)	24
2012	0.38 (0.11)	25	0.31 (0.10)	24
2013	0.28 (0.11)	27	0.33 (0.09)	24
2014	0.32 (0.10)	27	0.34 (0.09)	24
2015	0.33 (0.10)	27	0.37 (0.09)	24
2016	0.34 (0.10)	27	0.39 (0.09)	24
2017	0.34 (0.10)	27	0.41 (0.09)	24

Notes: Slopes of a bivariate OLS regression of $\Delta \tilde{\phi}_n$ on Δy_n . A country is required to have estimates of firm-embedded productivity in at least 10 sectors to construct $\Delta \tilde{\phi}_n$. Each sector is required to have observations of three or more foreign affiliates. The last two columns use only firms (BVDIDs) that are available in ORBIS in every year from 2010 to 2016.

Figure A1: Data coverage: foreign-MNE revenues.



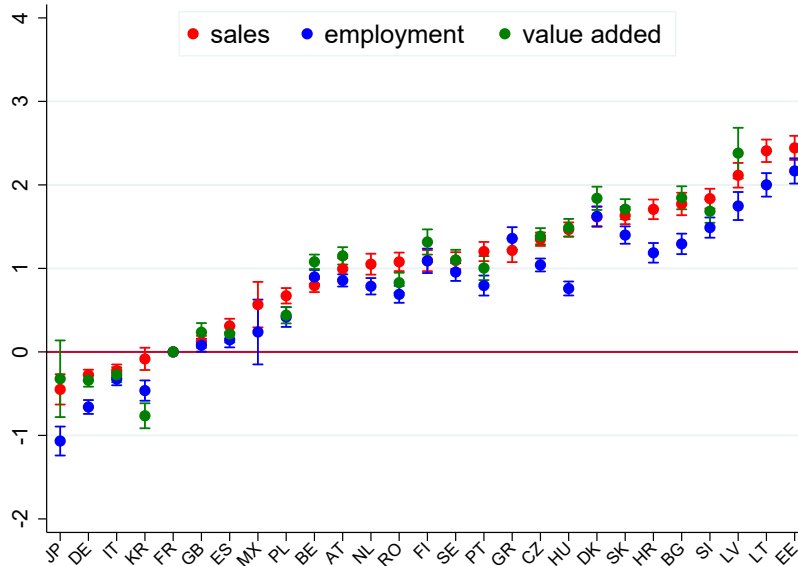
Notes: Ratio of total foreign-affiliate revenues in ORBIS to total foreign-affiliate revenues reported by OECD/Eurostat, for each country in our sample.

Table A5: Output per-worker and firm-embedded productivity, by country.

Country	ISO	Δy_n	$\Delta \tilde{\phi}_n$	$\Delta \tilde{\phi}_n^{manuf}$	$\Delta \tilde{\phi}_n^{serv}$
Austria	AT	-0.02	-0.20	-0.20	-0.18
Belgium	BE	-0.03	-0.16	-0.15	-0.16
Bulgaria	BG	-0.93	-0.35	-0.35	-0.31
Czech Rep.	CZ	-0.46	-0.27	-0.20	-0.27
Germany	DE	-0.05	0.06	0.13	0.00
Denmark	DK	-0.07	-0.32	-0.41	-0.27
Estonia	EE	-0.61	-0.49	-0.53	-0.40
Spain	ES	-0.09	-0.06	-0.01	-0.04
Finland	FI	-0.10	-0.22	-0.13	-0.25
France (ref)	FR	0.00	0.00	0.00	0.00
UK	GB	-0.16	-0.02	0.00	-0.05
Greece	GR	-0.43	-0.24	-0.28	-0.21
Croatia	HR	-0.45	-0.34	-0.38	-0.34
Hungary	HU	-0.67	-0.29	-0.24	-0.32
Italy	IT	-0.03	0.04	0.08	0.04
Japan	JP	-0.21	0.09	0.31	-0.05
Korea	KR	-0.29	0.02	0.15	-0.10
Lithuania	LT	-0.58	-0.48	-0.52	-0.41
Latvia	LV	-0.62	-0.42	-0.55	-0.37
Mexico	MX	-0.85	-0.11	-0.02	-0.15
Netherlands	NL	-0.08	-0.21	-0.11	-0.24
Poland	PL	-0.43	-0.13	-0.11	-0.13
Portugal	PT	-0.54	-0.24	-0.20	-0.22
Romania	RO	-0.50	-0.22	-0.20	-0.17
Sweden	SE	-0.09	-0.22	-0.22	-0.21
Slovenia	SI	-0.49	-0.37	-0.43	-0.32
Slovakia	SK	-0.50	-0.33	-0.29	-0.28

Notes: Numbers underling Figures 2 and 4. Column 3 shows the country's output per worker relative to France, Δy_n , Column 4 shows the country's aggregate firm-embedded productivity, $\Delta \tilde{\phi}$, and Columns 5 and 6 show the country's firm-embedded productivity for the Manufacturing and the Service sector, respectively.

Figure A2: Country effects: Alternative dependent variables.



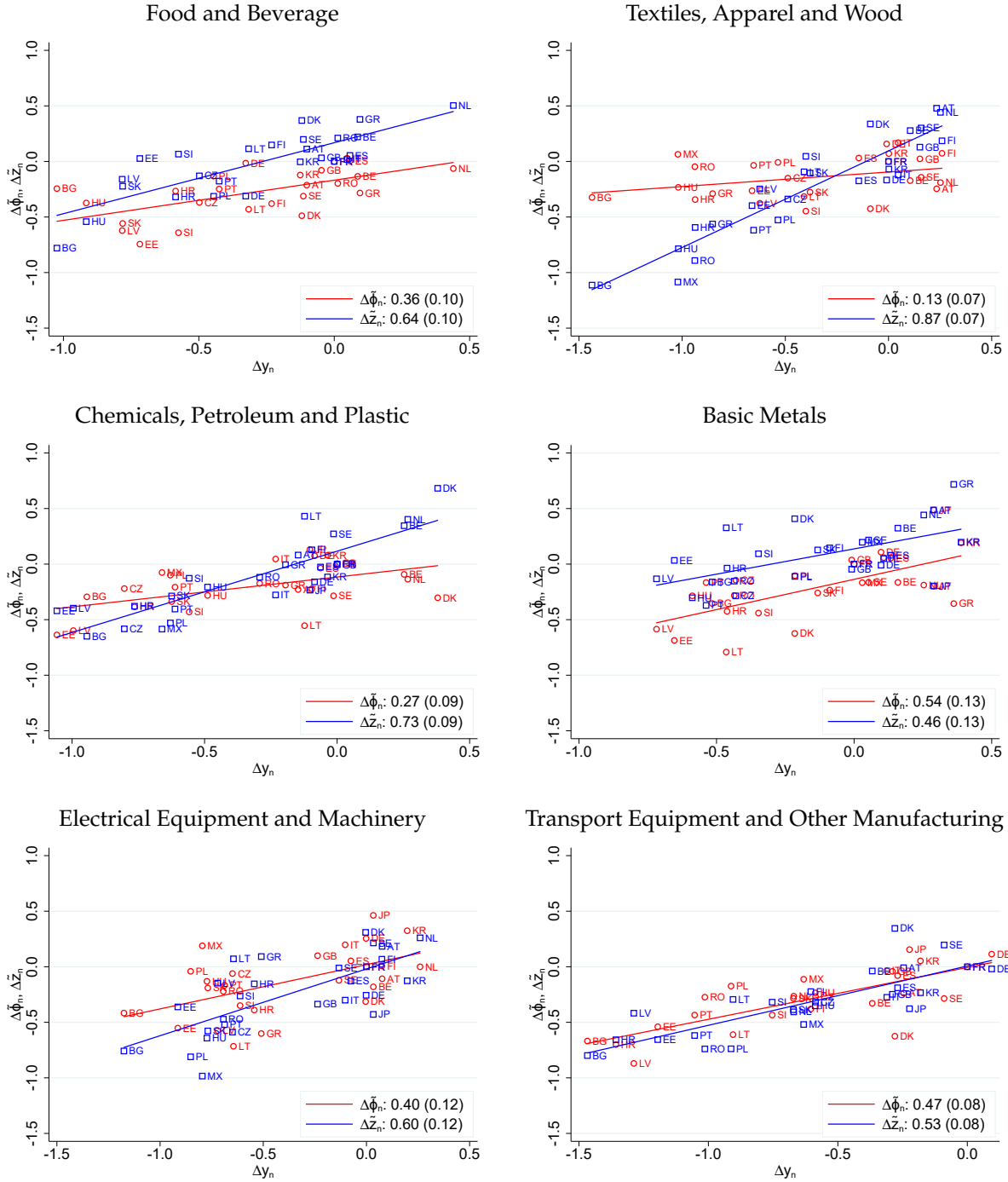
Note: Red dots are OLS estimates of ΔA_n from Equation (19) using data on revenue shares. Blue and Green dots are OLS estimates of ΔA_n using employment and value added shares, respectively. Bars reflect 95-percent confidence intervals, clustered at the country level.

A Data Appendix

Firm level data: In this section we describe the construction of our sample using ORBIS. We start by dropping those firms with revenues below 100,000 USD. We also drop firms that only report information from consolidated accounts, as well as firms with only “limited financials” (LF) information. From the remaining sample, we exclude firms operating in “Public Administration”, “Extraterritorial Organizations”, and “Activity of Households” sectors. The time span of our dataset is 2006-2017, but our baseline analysis uses information for 2016 since it is the latest year with the largest number of firms in ORBIS historical.

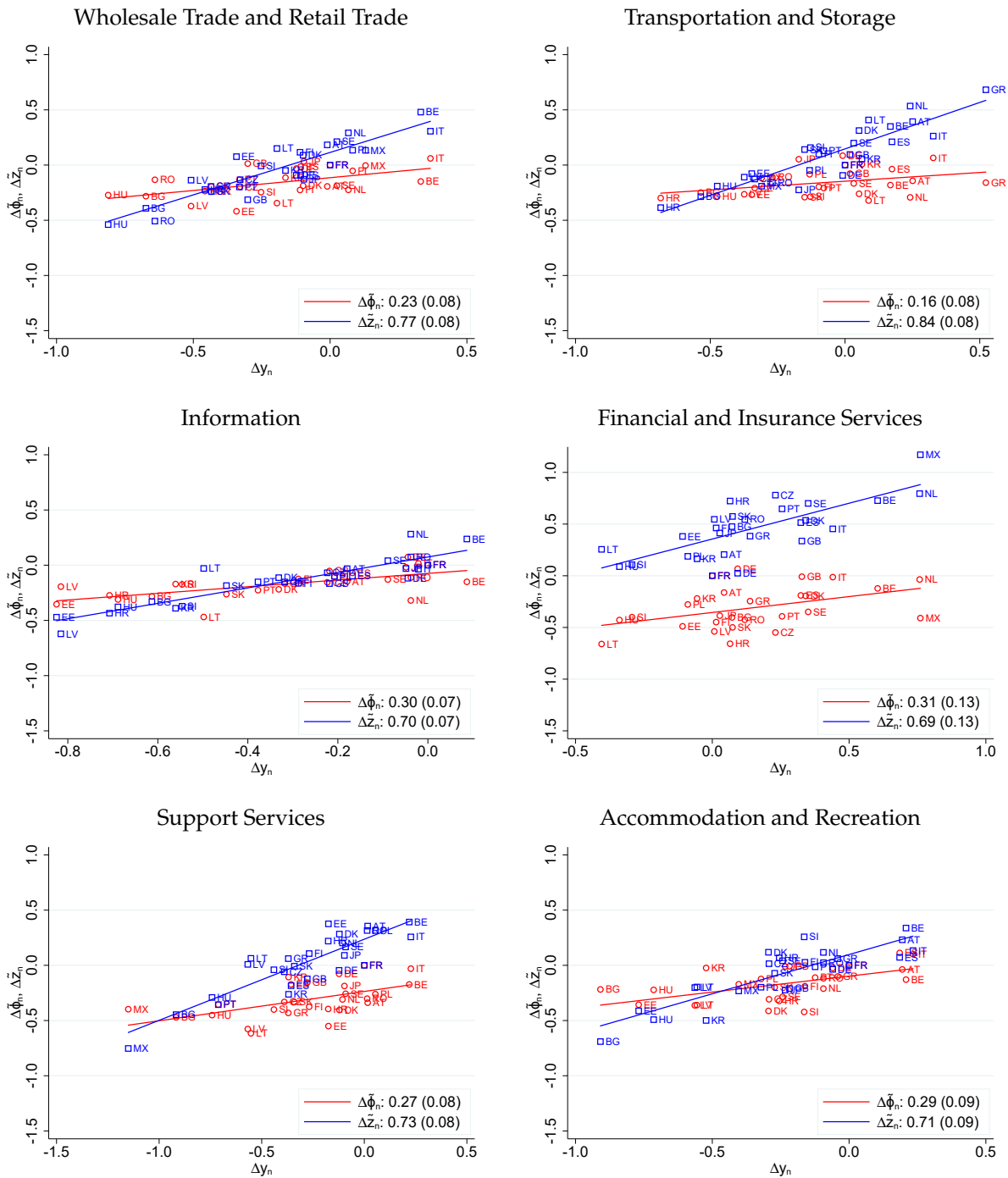
A multinational enterprise (MNE) is defined as a company exerting above 50 percent of the control rights on affiliates located in more than one country. Crucially for our analysis, a MNE is defined within a given sector. In order to define a company as a MNE, we use the NAICS sector classification at three different levels of disaggregation, NAICS2 (18 industries), NAICS3 (99 industries) and NAICS4 (336 industries). Information on revenues, employment, and value-added are aggregated for all tax identification numbers in ORBIS belonging to the same corporate group and operating in the same country and sector. Therefore, in our analysis an affiliate is defined as a corporate group-country-sector triplet in which the country of location differs from the country where the headquarter is located, whereas a parent is defined as a triplet located at the headquarter’s country. Moreover, a MNE owning affiliates in multiple countries, but each operating in a different

Figure A3: Dev. accounting: Manufacturing sectors.



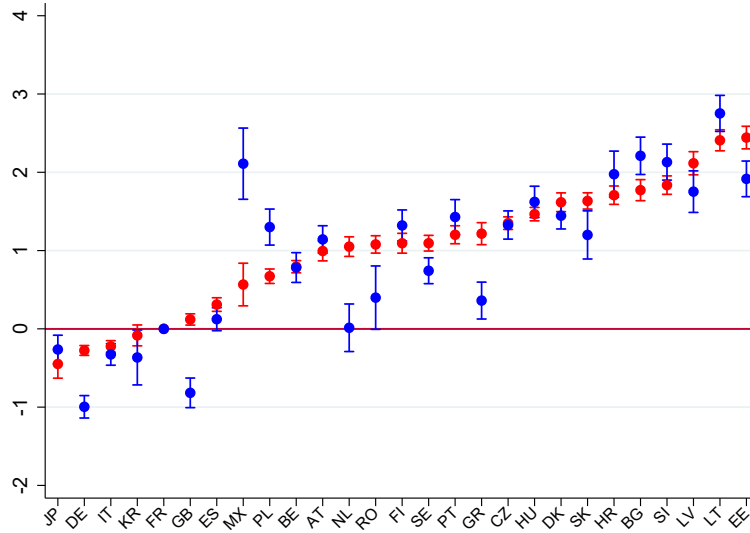
Notes: Each circle (square) represents a country. The figures plot the decomposition in Equation (15) at the sectoral level. Δy_n^j is plotted in the x-axis and $\Delta \tilde{z}_n^j$ and $\Delta \tilde{\phi}_n^j$ are plotted in the y-axis for $j =$ two-digit manufacturing sectors.

Figure A4: Dev. accounting: Service sectors.



Notes: Each circle (square) represents a country. The figures plot the decomposition in Equation (15) at the sectoral level. Δy_n^j is plotted in the x-axis and $\Delta \tilde{z}_n^j$ and $\Delta \tilde{\phi}_n^j$ are plotted in the y-axis for $j =$ two-digit service sectors.

Figure A5: Country effects: Alternative specification of the technology transfer costs.



Note: Red dots are our baseline OLS estimates of ΔA_n . Blue dots are the OLS estimates of ΔP_n from Equation (31). Bars reflect 95-percent confidence intervals, clustered at the country level.

sector, will ultimately be excluded from our sample.

Table A6 shows the number of affiliates and the number of parent firms in each NAICS2 sectors in our sample, including affiliates in “Other Goods” as well as in other sectors. Each column of Table A6 shows the number of affiliates and parents according to the availability of information on firm’s revenues, employment and value-added.

Table A7 and Table A8 report the number of affiliates and the number of parents in each country in our sample, according to the available information from sales, employment and value added. The numbers are shown for manufacturing, services, and for all sectors.

Aggregate firm-embedded productivity at the country level is constructed by calculating the weighted average of the sector level firm-embedded productivity, using country-sector level expenditure shares as weights. If a country has less than three foreign MNE affiliates in a particular sector, we exclude the country from that sector, and reweigh the remaining sectors accordingly to compute the aggregate $\Delta \tilde{\phi}_n$ for that country. Table A9 reports the country-sector pairs for which we cannot compute an estimate of $\Delta \phi_n^j$ for our baseline regression.

Aggregate data: In addition to the ORBIS data, to construct sales, employment, and value-added shares, we use information from KLEMS and OECD on gross output, gross value-added, and the number of employees at the country-sector level, in million of current dollars and thousands of employees, respectively. The KLEMS dataset corresponds to the statistical national accounts from their latest release in 2019. The OECD statistics come from the Dataset for Structural Analysis (STAN) and we convert the sectoral ISIC revision 4 to the sectoral classification used in KLEMS. To maximize the number of

Table A6: Number of affiliates and parents, by NAICS2.

	Foreign Affiliates			Parents		
	Sales	Emp.	VA	Sales	Emp.	VA
Other goods						
Agriculture and Mining	407	354	246	43	37	30
Construction	1,041	843	583	125	113	92
Electricity	557	344	273	73	65	57
Manufacturing						
Food and Beverages	1,061	964	794	118	116	99
Textiles, Apparel and Wood	965	886	699	127	126	109
Chemicals, Petroleum and Plastic	3,104	2,861	2,375	307	301	260
Basic Metals	1,550	1,401	1,178	160	158	124
Electrical Equipment and Machinery	3,019	2,828	2,195	327	321	270
Transport Equipment and Other Manufacturing	1,445	1,309	1,082	139	136	105
Services						
Wholesale Trade and Retail Trade	18,513	16,434	11,429	1,245	1,184	868
Transportation and Storage	2,265	2,004	1,417	237	231	192
Information	1,499	1,298	882	115	111	86
Financial and Insurance Services	1,402	1,104	555	147	138	80
Support Services	10,329	9,015	5,817	959	894	702
Accommodation and Recreation	1,218	1,098	774	105	99	75
Other Sectors						
Real Estate	1,969	1,132	910	192	145	112
Health	204	187	151	21	21	19
Education	96	84	49	5	4	4

Notes: A foreign affiliate is a majority-owned firm by a company with operations in multiple countries within a given sector. Sectors roughly correspond to the 2-digit NAICS classification.

Table A7: Number of foreign affiliates, by country and sector.

Country	Sales			Employment			Value Added		
	All	Mfg.	Services	All	Mfg.	Services	All	Mfg.	Services
Austria	1,510	293	1,141	1,219	271	895	956	242	661
Belgium	2,743	536	1,973	2,555	526	1,866	1,863	434	1,304
Bulgaria	737	119	536	711	119	522	596	108	437
Czech Rep.	2,507	656	1,602	2,389	652	1,555	1,492	499	866
Germany	3,680	1,046	2,378	3,620	1,040	2,337	2,795	921	1,673
Denmark	819	151	581	703	151	502	635	138	454
Estonia	659	99	502	612	94	476	-	-	-
Spain	4,099	819	2,933	3,909	817	2,825	3,995	809	2,855
Finland	1,417	258	1,045	1,143	219	848	655	139	471
France	4,659	1,075	3,267	3,638	950	2,528	3,469	969	2,337
UK	5,072	1,259	3,402	4,690	1,231	3,144	2,744	881	1,689
Greece	512	74	398	502	74	393	-	-	-
Croatia	829	102	634	776	99	609	-	-	-
Hungary	1,272	306	827	1,172	302	774	568	196	310
Italy	4,545	1,176	2,997	4,279	1,166	2,883	3,654	1,098	2,359
Japan	192	48	141	180	47	130	12	4	8
Korea	899	291	592	694	256	426	384	171	208
Lithuania	445	69	324	439	69	318	-	-	-
Latvia	679	60	543	658	60	533	28	2	24
Mexico	137	51	72	52	24	20	-	-	-
Netherlands	1,130	260	805	1,003	249	710	-	-	-
Poland	3,399	833	2,238	992	293	617	1,871	541	1,189
Portugal	1,759	278	1,304	1,651	275	1,249	1,712	275	1,268
Romania	2,040	424	1,365	1,934	416	1,329	1,266	348	788
Sweden	2,694	419	2,064	2,526	411	1,967	1,378	205	1,091
Slovenia	612	108	460	567	106	427	345	64	261
Slovakia	1,603	334	1,102	1,537	332	1,070	996	279	621

Notes: A foreign affiliate is defined as a corporate group-country-sector triplet where the country of operation differs from the country where the headquarter is located.

Table A8: Number of parents, by country and sector.

Country	Sales			Employment			Value Added		
	All	Mfg.	Services	All	Mfg.	Services	All	Mfg.	Services
Austria	246	55	149	226	54	135	212	53	125
Belgium	218	67	125	204	66	118	185	62	104
Bulgaria	2	-	2	2	-	2	2	-	2
Czech Rep.	54	5	45	53	5	45	44	4	37
Germany	629	192	379	627	192	378	508	174	288
Denmark	156	42	101	143	42	92	136	40	87
Estonia	50	5	36	45	5	33	-	-	-
Spain	248	54	156	246	54	156	243	53	154
Finland	161	45	99	145	44	89	119	34	74
France	715	170	446	639	163	398	647	167	401
UK	459	91	328	425	89	304	308	68	220
Greece	18	3	12	18	3	12	-	-	-
Croatia	8	3	4	8	3	4	-	-	-
Hungary	34	2	28	33	2	27	23	1	20
Italy	387	118	241	376	118	234	361	116	223
Japan	418	180	225	418	180	225	208	137	65
Korea	32	13	18	29	12	17	23	9	14
Lithuania	18	1	15	18	1	15	-	-	-
Latvia	10	2	5	10	2	5	2	-	-
Mexico	8	5	1	6	4	1	-	-	-
Netherlands	109	10	87	92	9	76	-	-	-
Poland	40	7	29	30	6	20	21	1	17
Portugal	36	7	20	36	7	20	35	7	19
Romania	2	-	2	2	-	2	2	-	2
Sweden	365	99	237	348	95	232	188	39	138
Slovenia	13	-	11	13	-	11	10	-	8
Slovakia	10	2	7	9	2	6	8	2	5

Notes: A parent is defined as a corporate group-country-sector triplet located in the source country of the MNE.

Table A9: Countries with less than 3 affiliates, by NAICS2.

Sector	Country
Other goods	
Agriculture and Mining	KR, MX
Construction	JP
Electricity	KR, MX
Manufacturing	
Food and Beverages	JP, MX
Textiles, Apparel and Wood	JP
Transport Equipment and Other Manufacturing	GR
Services	
Information	MX
Others	
Real Estate	JP
Health	DK, EE, GR, JP, LV, SI
Education	AT, CZ, DK, HU, KR, NL, PT, RO, SI, SK

Notes: A foreign affiliate is a majority-owned firm by a company with operations in multiple countries within a given sector. Sectors roughly correspond to the 2-digit NAICS classification.

country-sector pairs in our sample, we combine some ISIC sectors into the following categories: Agriculture and Mining; Textiles, Apparel and Woods; Chemicals, Petroleum and Plastic; Electrical Equipment and Machinery; Transport Equipment and Other Manufacturing; and Accommodation and Recreation.

We use the real GDP at chained PPPs in 2016 US dollars over total employment to measure output per-worker in each country from Penn World Tables (PWT, 9.1). To construct measures of output per-worker at the sectoral level we use gross value added per-worker from the KLEMS-OECD dataset that we convert to international dollars using the PPP conversion factor for GDP, measured in units of local currency per international dollars. We obtain the GDP PPP conversion factor and the share of employees compensation in value added from PWT (9.1).

Finally, we obtain aggregate information for the activity of foreign affiliates for each country-sector pair in our sample from the OECD Activity of Multinational Enterprises (AMNE) dataset and the Eurostat Foreign Affiliates Statistics (FATS), for which we harmonize the sectoral classification into the 18 sectors used in our dataset.

Bilateral MNE-specific taxes: Domestic firms and foreign affiliates are often subject to different tax rates. In addition to the corporate tax rate paid in the destination country, foreign affiliates are also subject to withholding taxes, the magnitude of which depends on whether the source and destination countries have signed a bilateral tax-treaty (BTT).¹

¹The withholding tax operates as a retention tax. It is an income tax to be paid to the government by the payer of the income rather than by the recipient of the income. Withholding taxes act as proxy for the

In the robustness exercises in Section 5.4 we control for tax differentials between foreign and domestic firms in two alternative ways: (1) by including a BTT dummy, and (2) by including for the ratio of tax rates paid by foreign MNEs to tax rates paid by domestic firms. To compute tax rates paid by foreign MNEs we assume their income subject both to the corporate tax rate and to the withholding tax rate that corresponds to the BTT agreement in place.² Data on BTTs comes from UNCTAD International Investment Agreements dataset; corporate tax rates are from the OECD Effective Tax Rates Statistics; and withholding taxes by BTT status are from Deloitte's Withholding Tax Rates dataset.

B Additional statistics: two-way fixed-effect estimation

Connectivity: To identify the country-sector fixed effects in Equation (19), we should perform our estimation on the largest connected set (LCS), which corresponds to the largest sample where destination countries are connected by the MNE foreign affiliates. In our case, the LCS is comprised of all 27 countries in our sample, whether using sales or employment, NAICS2 or NAICS4 sector classification.³ Nonetheless, it is still possible that countries are poorly connected, even within the LCS, if only few MNEs link them together. When only a handful of MNEs connect countries in the sample, the variance of the fixed effects will be over-estimated and spurious negative correlations can appear between country and MNE fixed effects (Andrews et al. 2008). The literature has proposed three ways in which connectivity can be improved. The first method consists in performing the estimation on the "leave-one-out" set, which is defined as the set of countries that remain connected even after any individual MNE is removed from the sample (Kline et al. 2020). We note that all countries in our sample stay connected regardless of which MNE is dropped from the set. The second method (Andrews et al., 2008) consists of restricting the sample to countries hosting MNEs that also operate elsewhere. Since we only work with MNEs, this restriction is always satisfied in our sample. The third method (Bonhomme et al., 2019) groups destination countries using k-mean clustering based on the distribution of affiliates' market shares. This method enhances connectivity by reducing the number of country fixed effect that must be estimated. Unfortunately, its application would defeat our purpose of estimating firm-embedded productivity for each country-sector pair.

Log-linearity assumption: In Section 5.3, we show that the standardized residuals are mostly flat across the MNE-sector fixed effects and country-embedded factors decile-bins. A different approach to assess the additive separability assumption comes from Bonhomme et al. (2019), where each pairing of firm and country-sector is allowed to have a differential effect. This new specification replaces the additive country and MNE-sector

income taxes shareholders would pay if they were residents of the destination country.

²This calculation assumes the income earned by majority owned affiliates is classified as "active", and therefore the dividends repatriated to the source country are tax exempt.

³By definition, all MNEs contribute to connecting the countries where they keep operations, overcoming the usual problem of "limited mobility bias" that plagues most two-way fixed effect exercises in the labor literature. In that literature, identification is achieved by workers who switch employers over their careers (Abowd et al., 1999).

Table A10: Contribution to $Var\left(s_{in}^j(\omega)\right)$.

Variance Decomp.	Baseline	k-means (linear)	Interaction
	(1)	(2)	(3)
ΔA_k^j	0.27	0.26	
$\delta^j(\omega)$	0.45	0.45	
R^2	0.72	0.70	0.76

Notes: Column 1 corresponds to the additive model using individual country-sector fixed effects (baseline). Columns 2 and 3 use country-sector-group fixed effect, with k=5. The MNE-sector and the country-sector-group enter additively in the second column, and multiplicatively in the third column.

fixed effects with an interaction between country-group and MNE-sector fixed effect. If country-MNE “match effects” are relevant in determining the assignment of MNEs to countries, then there is a potential for bias since the error term could be correlated with the country fixed effects. Table A10 shows the share of the variance explained by the country-sector fixed effects. Our results indicate that an additive model provides a very good approximation to our data: allowing interactions between MNE and country-group yields a small increase in the R-squared (Column 3) compared to an additive model that uses individual countries (Column 1) or country groups (Column 2). Also notice that the individual contributions of MNE and country effects to the variance of MNEs market shares remain almost unchanged in the additive model that uses k-country groups relative to the additive model that uses individual countries.

C Extension: Intermediate inputs

This section shows how to extend our framework to allow for intermediate inputs in production. We again focus on the one-sector case to facilitate the exposition. We assume that the final good can be used as an input, and that the production function for intermediate goods is

$$Y_{in}(\omega) = Z_{in} X_{in}(\omega) \left[H_{in}(\omega)^{1-\alpha} K_{in}(\omega)^\alpha \right]^\gamma M_{in}(\omega)^{1-\gamma}.$$

Here, the parameter γ is the value-added share and $M_{in}(\omega)$ represents the intermediate inputs used by producer ω in country n . The aggregate production function is

$$\mathcal{Y}_n = \gamma^{\frac{1}{\gamma}} Z_n^{\frac{1}{\gamma}} \Phi_n^{\frac{1}{\gamma} \frac{1}{\rho-1}} [\bar{H}_n L_n]^{1-\alpha} [K_n]^\alpha.$$

We can write cross-country differences in the log of value added per-worker as

$$\Delta y_n = \frac{1}{\gamma} \Delta \tilde{z}_n + \frac{1}{\gamma} \Delta \tilde{\phi}_n. \quad (\text{C.1})$$

We show next how to obtain the contribution of aggregate firm-embedded productivity to cross country differences in value added per-worker, $\frac{1}{\gamma} \Delta \tilde{\phi}_n$. Note that in this economy, the revenue, employment, and the value-added shares coincide and are given by Equation (16). We can thus use Equation (19) and the procedure described in Section 3.2 to estimate $\Delta \mathbb{A}_n$, which under our baseline assumption on technology transfer costs corresponds to $\Delta \mathbb{A}_n = -\Delta \phi_n$.

The last step is to reestimate $\beta \equiv [1 - \alpha] [\rho - 1]$ in a way that is consistent with Equation (C.1). With intermediate inputs, Equation (23) becomes

$$\Delta y_n = b_0 + \frac{b_1^{inp}}{\gamma} \Delta \mathbb{A}_n + b_2 C_n + u_n,$$

so that the coefficients in Table 1 should be interpreted as $b_1 = \frac{b_1^{inp}}{\gamma}$. The contribution of firm-embedded productivity to cross-country income differences is $\frac{1}{\gamma} \Delta \tilde{\phi}_n = \frac{b_1^{inp}}{\gamma} \Delta \mathbb{A}_n = b_1 \Delta \mathbb{A}_n$, which coincides with the estimate used in our baseline analysis.