Response to the comments and suggestions for "Economics-2556"; DP-2018-19.

I am grateful for your helpful comments and suggestions to which you will find below my responses. In particular, all your comments and suggestions are well taken and the paper will be revised accordingly.

Reviewer 2's comments:

1. *The author argues that the subject of the paper (i.e. the implications of incorporating a consumer welfare standard into foreign market entry regulations through minimum output requirements) have been overlooked by the previous literature. However, he does not provide any empirical or anecdotal evidence that would explicate the relevance of his research questions. Given that the author argues that his is the first study on this question, I would expect this.*

   You are right; the revised version of the paper should (and will) put some more effort to make clear the empirical/anecdotal evidence that motivates this specific research question.

2. *It remains unclear what to learn from Proposition 2. The author wants to frame his results of foreign acquisition of the local firm as a prisoner's dilemma game. However, this notion is inadequate given that only the situation is discussed where one foreign firm can acquire the local firm. For the model to fit the action set of a prisoner's dilemma it would be necessary that both foreign firms can acquire the local firm simultaneously. This situation is however not discussed at all in the paper.*

   Thanks for this comment. It is mainly the outcome that qualitatively resembles the outcome of a prisoner's dilemma game. What I had in mind was firms' strategy space, *compete for acquisition of the local firm* vs. *do not*. The wording can be different. If only one firm chooses to compete, then the outcome will be one firm acquiring the local firm at a price equal to its takeover valuation. If both firms choose to compete, then the outcome will be a preemptive acquisition by an ex-post more efficient firm. If neither firm chooses to compete, then they will have

independent foreign sales in the host country. The outcome of all three firms merging to monopoly is not available as this will be most likely not approved by a competition authority. That said, you are right a revised version of the paper should make this clear.

3. *As the author correctly infers from Helpman et al. (2004) on page 4, more productive firms are more likely to access foreign markets (through either exports or FDI). Given this observation, the author assumes that the entrants are more cost-efficient than the incumbent firm. This may be correct; however, the argument is not entirely consistent with the reference. Helpman et al. also predict, that very productive local firms are also active in the local market and therefore the present analysis is one of a very special case. I would expect this to be made clear in the paper. It would also be interesting to extend the analysis to the set of all possible marginal cost constellations and to see whether and how the welfare results extend to the alternative settings. This would strengthen the contribution of the paper as it then would not only be concerned with a very particular scenario.*

   Thanks for this comment. The idea is that the literature on firm heterogeneity has shown that productivity differences among firms are mostly attributed to multinationality; see, for example, Castellani and Zanfei (2007) for evidence from Italian firms. It will be made clear in a revised version of the paper that the model assumes a local firm (without capacity anywhere but the host country) and two foreign firms that have already maintained capacity in different countries and they owe their superior productivity to their large R&D investments and intensive use of professional and technical workers generating proprietary knowledge. Moreover, the model assumes that local assets together with more efficient foreign assets generate synergies; if they are combined with some assets of an equal partner, then such synergies are not possible, and thus will not fulfill the minimum output requirement. Also, as is already discussed in the paper that, if foreign entrants are not sufficiently productive compared to the local firm, then independent foreign sales decrease welfare, which calls for a restrictive foreign market entry regulation. In such a case, the local firm can appropriate almost all surplus from acquisition by a foreign firm, leading to no further insights.

4. *In the Introduction, reference to "traditional models of FDI" is made but no paper is cited. I would expect citations of the most relevant papers here. Moreover, the summary of this literature in the first paragraph is not accurate: Papers on exporting vs. FDI with heterogeneous firms such as Melitz, Helpman, and Yeaple (2004) document that some firms may prefer FDI over exporting also in situations where trade is liberalized (e.g. transport costs still may exist).*

   A revised version of the paper will include the most relevant references and will make the statement consistent with the finding documented in the literature on firm heterogeneity.

5. *The author should improve the readability of the paper. The summary of the paper's contribution on page 2 consists of extremely long sentences and the paper would benefit from using simpler language here.*

   I am sorry that some parts of the paper was a hard read; a revised version of the manuscript certainly will do a better job.

6. *On page 6, the optimal output level $q*_i$ remains undefined. Moreover, the partial derivative of the inverse demand function with respect to q_i should be denoted accurately (denoting it by $p'(Q)$ suggests that the derivative is taken w.r.t. aggregate output).*

   You are right; this will be corrected.

References:

1. Castellani, D., Zanfei, A. 2007. Internationalisation, innovation and productivity: how do firms differ in Italy? *World Economy* 30, 156-176.