R&D investment responses to R&D subsidies: A theoretical analysis and a microeconometric study*

by

Tor Jakob Klette‡) and Jarle Møen‡‡)

Preliminary draft presented at the NBER Summer Institute 1998

Abstract: Whereas many countries subsidize R&D in private companies through tax credits, subsidies to the Norwegian high tech industries are given as "matching grants", i.e. the subsidies are targeted, and the firms have to contribute a 50 percent own risk capital to the subsidized projects. It is, however, an open question to what extent this induces firms to increase their total R&D investments as they may reduce non-subsidized R&D activites upon receiveing an R&D grant. Our results suggest that grants do not crowd out privately financed R&D, but that subsidized firms do not increase their privately financed R&D either. Hence, the own risk capital seems to be taken from ordinary R&D budgets, and there is no "additionality" associated with matching grants subsidies. We also investigate possible long run effects of R&D subsidies, and show that conventional R&D investment models predict negative dynamic effects of subsidies. Our data, however, do not support this claim. On the contrary, there seems to be positive dynamic effects, i.e. temporary R&D subsidies seem to stimulate firms to increase their R&D investments even after the grants have expired. We propose learning-by-doing in R&D activities as a possible explanation for this, and present a theoretical analysis showing that such effects may alter the predictions of the conventional models. A structural, econometric model of R&D investments incorporating such learning effects is estimated with reasonable results.

JEL classification:
Keywords:

---

*

‡ University of Oslo, Department of Economics. E-mail: t.j.klette@econ.uio.no.

‡‡ Norwegian School of Economics and Business Administration. E-mail: jarle.moen@nhh.no.

1. Introduction

The public good nature of innovation and R&D investments has attracted economists' attention over several decades, with the most recent interests associated with so-called new growth theory. That R&D activities give products that are at least partially non-excludable and non-rivalrous was forcefully pointed out by Arrow (1962) and has recently been stressed by Romer (1990), among others. According to economic theory, there are many different options available to deal with market failure due to externalities such as tax credits, subsidies, extending property rights and public production. All these policy instruments have been actively used to promote innovation and R&D activities by most OECD governments, but both the level and the optimal mix of instruments is an open question.

While there is a growing literature with empirical studies of the working of R&D tax credits[1], less is known about the empirical performance of other policy instruments in the context of R&D investments. Our study focuses on R&D subsidies targeted at specific projects, and in particular on their impact on privately funded R&D investments. Using a panel data set for high-tech firms, we examine the investment in R&D for firms receiving R&D grants from different public sources. Our main question is whether public R&D subsidies result in a net increase or decrease in R&D expenditure, – that is; do government funds substitute for or complement private R&D expenditures? Our results suggest that R&D subsidies in the industries we study have been successfully targeted at firms that have expanded their R&D investments, and we conclude that there is little tendency to "crowding out". On the other hand, there does not seem to be any significant degree of "additionality" associated with the subsidies either, even though the government requires that firms contribute 50% own risk capital to subsidized projects. This own risk capital seems to be taken from ordinary R&D budgets.

We also pursue the issue of dynamic or longer run effects of R&D subsidies on R&D investments. Our empirical investigation suggest that such effects are positive, while conventional models of R&D-investments predict negative dynamic effects. We present a theoretical analysis of this question, where we argue that learning-by-doing effects in R&D may explain our empirical results. Such learning effects will generate positive feedback loops where temporary R&D subsidies increase the profitability of future R&D investments. We present estimates for a structural econometric model of R&D investment incorporating learning effects in line with the theoretical model.

Mowery's (1995) survey of the practice of technology policy points out that most OECD countries have grants and subsidy schemes for R&D where government funds are aimed at complementing and stimulating private R&D investments targeted at innovations with civilian industrial applications[2]. Such schemes have gained popularity among governments in the US and Europe in recent years. One such subsidy scheme has been investigated by Irwin and Klenow (1996), in a study where they consider the US government's effort to promote US semiconductor producers in the late 1980s and the 1990s through subsidies to the R&D consortium called Sematech. They found that Sematech induced members to cut their overall R&D spending which they interpreted to be the result of the firms eliminating excessive duplication of research. Earlier and broader studies of US. firms by Scott (1984) and Lichtenberg (1984, 1987), and

[1]The literature on the response of R&D investments to tax credits has been recently surveyed by Griffith, Sandler and Van Reenen (1995).

[2]See also OECD (1996), especially pp. 111-113.

of German firms by Keck (1991), have reached different conclusions. Scott (1984) concluded that federally funded R&D in private firms tend to stimulate the firms' own R&D expenditure, while Lichtenberg (1984) found no such tendency when he controlled for problems with selection bias embedded in Scott's estimate of the effect of federally funded R&D. Keck (1991) also argued that recipients of public R&D grants did not increase their overall R&D activities, suggesting that public funds substituted for private financing in the German firms he studied[3]. It is not too surprising that the effects differ across these various studies, since the public R&D schemes differ considerably in their aims. E.g. most of the federal funds studied by Scott (1984) and Lichtenberg (1984, 1987) are military contracts, while the Sematech program aimed at industrial development based on co-operative research.

2. An analytical treatment of "matching grants" R&D subsidies

A common feature of Norwegian high tech programs is the requirement that companies receiving R&D subsidies must co-finance the supported projects. Matching grants have been the most common criteria, but sometimes the own risk has been more than 50% and sometimes less. Despite the formality about own risk capital it is obviously possible that subsidies in reality crowd out private investments, or at least that some of the private investments spent on subsidized projects would be invested in R&D even without subsidies. To aid the discussion, and to prepare a model of matching grants R&D-subsidies let

$$R = R^{PP} + R^{PG} + R^{G} \tag{2.1}$$

where R are total R&D investments, R^G is the R&D-subsidy received from the government, R^{PG} is the part of the subsidized R&D projects which a firm has to finance itself, i.e. the own risk capital, and R^{PP} is the R&D investments which the firm undertakes in non-subsidized projects. Let total R&D investments financed by the firm be $R^P = R^{PP} + R^{PG}$. Matching grants imply that $R^{PG} = R^G$.

The full effect of a subsidy on the firms' R&D investments is given by

$$\begin{aligned} \frac{dR}{dR^G} &= \frac{\partial R^{PP}}{\partial R^G} + \frac{\partial R^{PP}}{\partial R^{PG}} \cdot \frac{\partial R^{PG}}{\partial R^G} + \frac{\partial R^{PG}}{\partial R^G} + \frac{\partial R^{PG}}{\partial R^{PP}} \cdot \frac{\partial R^{PP}}{\partial R^G} + 1 \\ &= \left(2 + \frac{\partial R^{PP}}{\partial R^{PG}}\right) \end{aligned} \tag{2.2}$$

since by definition of a matching grant regime $\frac{\partial R^{PG}}{\partial R^G} = 1$ and $\frac{\partial R^{PP}}{\partial R^G} = 0$ can be assumed without loss of generality[4].

Two properties of the regime is critical to the firms' investment decision. First, asymmetric information between private firms and the governmental agencies allocating the grants will affect to what extent it is possible for firms to finance the own risk capital using ordinary R&D budgets. Second, even though the firms suggest the size of the subsidized projects in their applications, we do not know whether there is an implicit constraint on the size of the projects, i.e. we do not know whether subsidized firms receive subsidies at the margin.

[3] See Vickrey (1988) and Ergas (1987) for opposing views.

[4] As $R_t^{PG} = R_t^G$, considering $\frac{\partial R_t^{PP}}{\partial R_t^G} = 0$ simply means that the total effect of the subsidies is measured by the term $\frac{\partial R_t^{PP}}{\partial R_t^{PG}}$.

Figure 1 illustrates in a simplistic way the firms' demand for R&D. The dashed rectangle with base *abc* represents a subsidized R&D-project. $\overline{w}$ is the unit cost of R&D in the market, e.g. the hourly wage of a researcher, and R^* is the level of R&D that the firm will choose if it does not receive a subsidy. If the governmental agency is perfectly informed about R^*, it will only subsidize R&D projects to the right of this level. That is the case we define as full additionality, implying $\frac{\partial R^{PP}}{\partial R^{PG}} = 0 \Leftrightarrow \frac{dR}{dR^G} = 2$. The government then induces firms to increase their total R&D by two dollars when giving them a subsidy of one dollar because of the own risk capital requirement.

Consider now a situation where the governmental agency is not perfectly informed about the firms' R^*, the optimal level of R&D investments without subsidies. The firms then want to move as much of their subsidized projects left of R^* as possible[5] in order to increase the private returns to the projects. If the firms succeed in moving the projects entirely to the left of R^*, there is full crowding out and $\frac{\partial R^{PP}}{\partial R^{PG}} = -2 \Leftrightarrow \frac{dR}{dR^G} = 0$. Subsidies are then pure transfers, and the government achieves nothing. If, on the other hand, there is some, but not full, crowding out, $\frac{\partial R^{PP}}{\partial R^{PG}} \in \langle -2, -1 \rangle \Leftrightarrow \frac{dR}{dR^G} \in \langle 0, 1 \rangle$. One dollar spent on R&D subsidies will increases total R&D investments, but by less than a dollar since the firms reduce their privately financed R&D after receiving the subsidies. If there is neither crowding out, nor additionality, $\frac{\partial R^{PP}}{\partial R^{PG}} = -1 \Leftrightarrow \frac{dR}{dR^G} = 1$. In this case a governmental R&D subsidy do not influence the firms' privately financed R&D, and the subsidies will therefore increase total R&D investments dollar by dollar. With some but not full additionality, $\frac{\partial R^{PP}}{\partial R^{PG}} \in \langle -1, 0 \rangle \Leftrightarrow \frac{dR}{dR^G} \in \langle 1, 2 \rangle$. One dollar spent on R&D subsidies then increases the firms' privately financed R&D, but not with as much as a dollar. Total R&D investments will therefore increase with less than two dollars.

In order to discuss whether the firms are free to decide the size of the subsidized projects, i.e. whether they are subsidized at the margin, we need to distinguish between the unit cost of R&D in the market, and the firms' marginal cost of R&D. Let therefore w' denote the firms' marginal cost. If there is full additionality, and firms gets to decide the size of the subsidized projects, their marginal cost is $w' = \frac{1}{2}\overline{w}$, and they will expand their R&D investments until $R = R^{**}$ in Figure 1. If there is less than full additionality and the firms get to decide the size of the subsidized projects, their marginal cost of R&D is

$$w' = \overline{w}\left(\frac{dR^P}{dR}\right) = \overline{w}\left(\frac{\frac{dR^P}{dR^G}}{1 + \frac{dR^P}{dR^G}}\right) = \overline{w}\frac{\alpha}{1+\alpha} \tag{2.3}$$

where we have renamed $\frac{dR^P}{dR^G} = \alpha$, and $\alpha \in [0, 1]$. With full additionality $\alpha = 1$. Note that as $\alpha \to 0$, the marginal cost of R&D according to the formula above approaches zero. The intuition behind this is that firms can expand their R&D activities to a very low cost if they get to decide the size of subsidized projects where most of the own risk part is privately profitable, i.e. to the left of R^*. However, the governmental agency is bound to become suspicious if firms apply for subsidized projects which are large relative to their total R&D activities. This indicates that it is unlikely that firms are subsidized at the margin unless there is a significant degree of additionality associated with the subsidies. If the firms are constrained with respect to the size of the subsidized projects, their marginal cost of R&D is $w' = \overline{w}$.

[5] In the following we disregard the possibility that the governmental agency responds to its uncertain information about R^* by being "conservative" in its grant allocation policy, so that firms may want to move their subsidized projects rightwards in Figure 1 in order to increase the probability of having the projects accepted. For the purpose of this analysis, such a situation can be considered equivalent to the case with perfect information, as there will be full additionality. The two cases will, however, not be equivalent with respect to the commercial value of the R&D undertaken.

3. The effect of high tech R&D subsidies on R&D investments: A first look

3.1. Questionnaire studies

To what extent subsidies actually stimulated R&D has been an important issue when technology programs have been evaluated. Table 2 summarizes questionnaire studies undertaken on this account. Looking at the pooled results at the rightmost column, about 18 percent of the supported projects would have been undertaken in full without subsidies, while the subsidy was not completely crowded out in 82 percent of the projects. Furthermore, according to the evaluation reports, 34 percent of the projects had full additionality. Hence, these questionnaire studies suggest that R&D subsidies as implemented by the public agencies in Norway exert a positive influence on the R&D investments in private firms. It also seems that the degree of crowding out has been decreasing over time. This trend could indicate a learning process in the public agencies implementing the subsidy schemes, but it could as well indicate reduced honesty on behalf of the firms when answering the questionnaires. One would in any case suspect that these verbal reports are biased towards not admitting crowding out, as this would reduce the likelihood of similar programs being launched in the future. A more analytic approach is therefore desirable.

3.2. The effect of changes in the level of subsidies on deviation from planned R&D

One way to shed light on the effect of subsidies, is to examine the correlation between changes in the level of subsidies and the deviation from planned R&D. Such an analysis is possible because the firms in the R&D surveys have been asked about their R&D investment plans both one and two years ahead of time. From 1982 until 1989 the investment plans were given in terms of man-years while from 1989 until 1995 the investment plans were given in nominal terms. Unfortunately, the R&D surveys were conducted annually only in the first four years of the time period examined, and the correlation between the change in R&D subsidy and the deviation between planned and performed R&D within a one year horizon can therefore not be calculated after 1985. From the first row in Table 3 we see that the one year horizon correlation coefficient based on the available years is essentially zero. This lack of correlation most likely indicates that firms know the level of subsidies they will receive one year ahead and hence that they have already included the response to the subsidies in their investment plans[6]

The two year horizon results are given in Table 3, row two and three, based on R&D measures in man-years and nominal terms respectively. The coefficients strongly indicate that the correlation between an increase or decrease in subsidies and a deviation from planned R&D, is positive and significant. Our interpretation of this is that an increase in subsidies induces the companies to undertake more research than they otherwise would have done[7]. Note, however, that this does not give us any information

[6]The firms apply about a year in advance, and the data for year t is collected early in year $t+1$, i.e. year $t+1$ has started when the firms give their expectations for that year. Many of the applications for grants have probably been answered at that time.

[7]An alternative interpretation is that those who came across a good research project after they gave the survey information both changed their plans and received subsidies. We do, however, think that the time span involved is too short for this to be a plausible explanation. Within less than two years the firms would have to come up with the idea, file a detailed application for R&D support, have the

about the strength of the effect. All that can be concluded is that there is not complete crowding out. To determine whether there is some degree of crowding out, some or full additionality, or maybe even more than full additionality, we need to frame the question within a regression analysis.

3.3. Crowding out or additionality: Regression analyses

In this section we regress the firms' R&D investments on received R&D subsidies, controlling for other factors determining R&D investments. We draw on Swenson (1992) who summarizes the theoretical R&D investment literature into three main hypotheses about what affects the level of R&D investments in private firms. First, expected sales might be important if the development costs of new products or processes are fixed. Second, technological opportunity may vary across industries and time. This will in turn affect the returns to R&D and hence the incentive to invest. Third, the degree of appropriability is important. If it is difficult to protect innovations from leaking out to competitors, less profit can be made, and the incentive to innovate is reduced accordingly.

Expected sales are in empirical studies often proxied by current sales. We have also included the square of sales to account for possible non-linearities in size. Technological opportunity and degree of appropriability can to some extent be handled by including industry and time dummies. Industry dummies are, however, not sufficient to account for the large heterogeneity in R&D investments found in microdata. Furthermore, as argued by Lichtenberg (1984), unobservable firm characteristics which positively affect the level of R&D investments are likely to be positively correlated with R&D subsidies. To exclude this bias we have included firm specific fixed effects in our regressions. Also, since R&D subsidies are partly motivated by the belief that R&D investments might be discriminated against in the capital markets, we have included the firms' cash flow as a proxy for liquidity constraints influencing the level of investments[8]. According to this, the regression equation is

$$R_{it} = \beta_0 + \beta_1 S_{it} + \beta_2 S_{it}^2 + \beta_3 CF_{it} + \beta_4 R_{it}^G + \mu_t + \mu_i + e_{it} \tag{3.1}$$

where i is a firm index, t is a time index, S_{it} is sales, CF_{it}, is cash flow before R&D investments, μ_t is a vector of time dummies, μ_i is a vector of firm dummies to account for fixed effects and e_{it} is an error term. The coefficient on subsidies, $\beta_4 = \frac{\partial R_{it}}{\partial R_{it}^G}$, is the parameter of primary interest.

Our sample covers 697 observations of business units at the three digit line of business level in the high tech industries defined as ISIC 382, 383 and 385. These have been successfully merged with the manufacturing statistics. There are at least 2 observations of every business unit, and all business units have at least 20 employers on average. The variables have been deflated, and all observations are weighted by the square root of inverse sales to correct for heteroscedasticity.

Theory does not say anything about functional form, and various specifications have been tried in the literature. A matching grants subsidy regime implies a linear relationship between R&D investments and subsidies, whereas other studies, e.g. Bound et al. (1984) suggest a loglinear relationship between R&D investments and sales. We prefer a linear relationship since the effect of subsidies is what we primarily are interested in.

application accepted and start the R&D project.

[8]We recognize that this cash flow variable also could be a proxy for investment opportunities.

The results are given in Table 4, 5, 6 and 7. Column (1) reports a linear functional form, estimated with fixed effects. We consider this to be our main regression. To test the robustness of this specification, column (2) reports a linear functional form estimated with the variables transformed to first differences between year t and $t-2$ and column (3) reports a loglog functional form estimated with fixed effects. The general impression from the tables is that the three different specifications agree on the main effects. We will base our discussion on the results in column (1) unless something else is stated.

3.3.1. Main results

From Table 4 we see that β_4 is 1.03 and highly significant. This suggest that there is no crowding out, but there does not seem to be any degree of additionality either[9]. The results of the questionnaire studies indicated that the effect of subsidies may have changed over time. In a set of regressions not reported, we have investigated this by including a dummy for observations from the 1990s in interaction with the subsidy variable. The results do not indicate that the effect of R&D subsidies have changed. We have also run regressions where the sample is extended to include all manufacturing industries[10], but the coefficient is still stable, β_4 then being 0.98.

With respect to the other variables, we see that sales squared has a significantly positive coefficient, implying that both small and large firms are more R&D intensive than medium size firms. This finding is supported by the empirical study of Bound et al. (1984), but runs contrary to previous work on the relationship between size and R&D cited in their article[11]. Finally, cash flow has a positive and significant effect on R&D investments, indicating that liquidity constraints are relevant to the R&D investment decision.

3.3.2. Differences between small and large firms

In Table 5 we report regressions studying whether there are differences between small and large firms. We do this by including a dummy variable for small and large business

[9]Since we have controlled for firm specific effects there must be a longitudinal positive correlation between subsidies and private investments. Firm specific effects, however, do not completely exclude reverse causality as an explanation for our results. As pointed out by Kauko (1996), applications for financial support are dependent on the firms intention to invest in R&D. If most applications are accepted, R&D subsidies then contain information not only on the cost of R&D but also on the intention to carry out new R&D projects. Hence, it is possible that there is a positive bias left even in the fixed effects estimates. Kauko argues that this kind of endogeneity can be controlled for using data on applications filed. This, however, is only true to the extent that the firms' own evaluation of the R&D-projects is not affected by the outcome of the application. This may not be so, and in any case, data on applications filed are presently not available. We will, therefore, have to leave this problem unresolved. Note, however, that in addition to the possible positive bias that Kauko points at, there is also a possible negative bias due to measurement errors.

[10]This sample has 2141 observations, and is constructed in the same manner as the sample based on high tech industries alone. The results are not reported.

[11]In the sample comprising all manufacturing industries, we get a significantly negative coefficient on sales squared, indicating that this relationship may vary across industries. Note however, that there is an obvious selection problem associated with the sample. Førre (1997) doing a thorough analysis of the size-R&D relationship in Norwegian manufacturing, concludes that the empirical relationship found when correcting for selection bias by conventional methods, is quite sensitive to model specification and outlying observations. There is a large international literature on the size-R&D relationship, cf. Cohen and Klepper (1996), but a more detailed investigation of the question is beyond the scope of this paper.

units in interaction with the subsidy and cash flow variables. We have defined small business units as units with average employment below the 25th percent percentile, i.e. below 58 workers. Large units are defined accordingly as those larger than the 75th percent percentile, i.e. having an average employment above 263 workers, cf. Table 1.

In an interview study of Norwegian manufacturing firms, Hervik and Waagø (1997) find support for the hypothesis that large firms, having a portfolio of projects, will seek to obtain public support for those projects they have already decided to undertake, whereas small firms, being less diversified and possibly more liquidity constrained, will find subsidies with a matching grant claim to be a stimulus making increased R&D investments possible. It is difficult to find support for this hypothesis in our data. The only business units having some degree of additionality, approximately 25 percent, associated with R&D subsidies, are the large ones. For small units there is neither crowding out, nor additionality, whereas for medium size units the point estimate indicates about 50 percent crowding out. This finding might be rationalized if we extend the hypothesis of Hervik and Waagø by taking account of monitoring costs. It is probably difficult for the governmental agencies to assess whether R&D projects which small and medium size firms apply to get subsidized, will be undertaken without support. The hypothesis of Hervik and Waagø then explains why we find crowding out for medium size firms, but not for small firms. Large firms, however, are likely to be monitored more closely by the government, as they receive large grants and are well known "regular customers". If these firms apply for projects which are obviously profitable without subsidies, the governmental agencies might see through it, and they can even lose credibility with respect to future applications. This may explain why we do not find crowding out for these firms.

When it comes to cash flow, we see a similar pattern as both small and large business units have a larger coefficient than medium size units. These results are somewhat surprising, however, and cast doubt on the cash flow variable being able to account for liquidity constraints. Two problems may be of relevance. First, a number of small and medium size business units are subsidiaries of larger firms, and the cash flow of such units do not contain information about the financial constraints they face. Second, cash flow may be considered a proxy for present success of the firm and thereby for expected future success. Expected future success increases the incentive to invest in R&D. It is, however, not clear why "success" should stimulate R&D investments more strongly in large than in small firms.

3.3.3. Differences between the effect of subsidies from various public sources

The R&D surveys have detailed information on R&D investments by source of finance, and this makes it possible to investigate whether the effect of R&D subsidies varies across different public sources. The main governmental agencies awarding R&D subsidies have been research councils, industry funds and ministries. Pure subsidies have mostly been awarded through the research councils. Grants from the industry funds are often subsidized loans, but still with a own risk capital claim. Grants from ministries consist of various R&D contracts, many of which are defense related. We believe that the demand for own risk capital has been weaker in these projects.

Table 6 reports the results of regressions with subsidies from the three main sources included as separate variables. We see that there are no clear cut differences between the effects of the various subsidies, but all regressions agree that subsidies from industry funds have a coefficient which is somewhat lower than the others. If the sample is

extended to include all manufacturing industries, the regression results[12], suggest that subsidies from research councils have a somewhat more positive effect than subsidies from the other two sources.

3.3.4. Dynamic effects

So far we have implicitly assumed that there are no dynamic effects associated with receiving R&D subsidies. As we will explain below, different models of accumulation of knowledge have different predictions with respect to the dynamic effects of R&D subsidies. A very simple first approach is to include lagged R&D subsidies in the regressions above. The results are reported in Table 7. We see that R&D subsidies lagged two years have a significantly positive effect in the fixed effects regression based on a linear functional form. In column (2), using first differences, there is also a positive coefficient, but it is not statistically significant, while in column (3), the loglog specification, there is a non-significant negative coefficient. When extending the sample to include all manufacturing industries, the coefficients in column (1) and (2) increases both in magnitude and significance[13], while the coefficient in column (3), the loglog specification, becomes essentially zero[14]. This suggests that R&D subsidies is likely to have a positive dynamic effect,[15] and we would like to point out explicitly the lack of evidence for a negative effect.

Dynamic effects of subsidies are obviously important for public policies, as they may influence the social return to subsidies. Positive dynamic effects indicate that the government *permanently* changes the firms' profit opportunities in favor of more R&D intensive products by awarding *temporary* subsidies which induce them to increase their R&D investment. A positive dynamic effect, then, will increase the social return to R&D subsidies, if the level of commercial R&D is below its social optimum at the outset.

4. Dynamic effects of R&D subsidies: A theoretical analysis

In the rest of this paper we explore the dynamic effects of R&D subsidies more thoroughly. We start out by discussing the predictions of conventional models of R&D investments. Next we present an alternative structural model which we find better suited to explain the data. This alternative model captures the idea that firms which have invested heavily in R&D in the past, and hence have a large knowledge capital, will produce new knowledge more efficiently than less experienced firms. In the last part of the paper we attempt to estimate this structural model, before summing up our main findings.

4.1. The conventional R&D investment model

The most widely used specification for the accumulation of knowledge capital, K, is to treat R&D the same way as physical capital i.e.

$$K_t = K_{t-1}(1-\delta) + R_t. \tag{4.1}$$

[12]Not reported.

[13]The coefficient in column (1) is then 0,58 and significant at the 1 percent level.

[14]Testing for differences between large and small firms, we find that the positive dynamic effect is strongest for small firms. This positive small firm effect can also be detected with a loglog specification.

[15]Further evidence for the existence of this effect is given in Figure 2, explained in section 4.1.

where δ is the rate of depreciation, cf. Griliches (1979, 1995). As is well known, with this specification, knowledge capital is adjusted so that

$$\pi'(K_t) = w'_t\,(r+\delta) - \Delta\overline{w}_{t+1} \tag{4.2}$$

where $\pi'(K_t)$ is the nominal marginal profit of knowledge capital, r is the discount rate and $\Delta\overline{w}_{t+1}$ is the change in the market price of R&D[16]. From equation (4.2) and (4.1) we can deduce some simple comparative statics results. First, by totally differentiating (4.2) and adopting the standard assumption of a decreasing marginal product of knowledge capital, we get

$$\frac{dR_t}{dw'_t} = \frac{r+\delta}{\pi''} < 0 \tag{4.3}$$

Furthermore, along an optimal investment path we get that

$$\begin{aligned}\frac{dR_{t+1}}{dw'_t} &= \frac{dR_{t+1}}{dK_t}\cdot\frac{dK_t}{dR_t}\cdot\frac{dR_t}{dw'_t} \\ &= -(1-\delta)\cdot 1\cdot\frac{r+\delta}{\pi''} > 0.\end{aligned} \tag{4.4}$$

Here $\frac{dR_{t+1}}{dK_t}$ is calculated by totally differentiating equation (4.1) and setting dK_{t+1} equal to zero.

If firms are subsidized at the margin, the effect on optimal R&D investments of a 50 percent subsidy can be quite dramatic, at least if the profit function is not too concave in K. In particular, consider the case where an R&D subsidy in the form of a matching grant disappears. A 50 percent increase in *marginal* R&D costs when the subsidy disappears, should induce a significant reduction in the optimal amount of knowledge capital. Hence, it would be optimal to deinvest or at least not to continue investing in knowledge capital when the R&D subsidy disappears for reasonable specifications of the profit function and the depreciation rate. In the Cobb-Douglas case, the reduction in the optimal capital stock is 50 percent for a given level of output, if the R&D price increases by 50 percent.

If firms do not get to decide the size of their subsidized project, i.e. if they are not subsidized at the margin, R_t must be considered an exogenous variable unless the R&D subsidies are completely crowded out. Given the results in section 3, this does not seem to be the case. Keeping the assumption of a decreasing marginal product of knowledge capital, and a constant market price of R&D, and then totally differentiating equation (4.2) in period $t+1$, when writing K_{t+1} as a function of K_{t-1}, R_t, and R_{t+1} with R_t as a function of w'_t, we find that

$$\frac{dR_{t+1}}{dR_t} = -(1-\delta) < 0 \tag{4.5}$$

Hence, whether or not firms are subsidized at the margin, R&D investments in period $t+1$ will be reduced relative to period t in firms which loose their subsidies. This runs contrary to the results reported in Table 7 where the effect of lagged R&D, $\frac{dR_{t+1}}{dR_t}$, was positive or at least not negative.

Further support for our claim that the predictions of the conventional model do not fit the data can be found in Figure 2, graphing the distribution of growth rates[17]

[16]The exact expression also includes the term $\delta\Delta\overline{w}_{t+1}$ which will be close to zero.

[17]Growth is measured in percent of the average level of investments in year $t-2$ and year $t+2$.

in R&D investments from year $t-2$ to year $t+2$ for business units which were not subsidized in those years, but which received subsidies in the middle year, t. This is the leftmost box-and-whisker plot[18] and may be compared with the rightmost plot of firms not subsidized at all. First note that there are no firms which stop investing in R&D when their R&D grant expires, and a large number of firms increase their R&D investments relative to the pre-subsidy level. Average growth for the subsidized firms is 11 percent, whereas average growth for the non-subsidized firms in the rightmost distribution is -10%. From the figure we also see that median growth is higher for firms which have received subsidies[19].

We conclude from the empirical results that the standard, perpetual inventory model for knowledge accumulation, equation (4.1), is too simple to serve as a basis for a realistic model of R&D investment behavior. Let us now consider various modifications of this model, before we turn to a more drastic respecification.

4.2. Modifications of the conventional model: Rescue attempts

An obvious first step in making the perpetual inventory model more realistic is to add a non-negativity constraint to R&D investments such that $R \geq 0$, i.e. one can not deinvest by selling already acquired knowledge. The pattern of optimal investments in this extended version of the model has been examined in some detail by Arrow (1968) and others. Arrow's analysis shows that the basic effect of this extension for the case with an expected rise in R&D costs, e.g. due to the elimination of R&D subsidies, would be that the non-negativity constraint will tend to be binding somewhat earlier, while the option of R&D subsidies still are in place. The intuition is that the firms stop their R&D investment before the subsidy is removed to avoid the non-negativity constraint being too costly. Clearly, this result does not make the behavior predicted by the model more realistic, the effect is rather to the contrary, given that firms typically continue their R&D activity also after the R&D subsidy disappears as shown above.

A more promising suggestion would be to add convex adjustment costs similar to the model used to derive Euler equations for physical capital investment as in Summers (1981). This would make large changes in investment more costly and induce the firms to adjust their level of R&D more slowly. Given a reasonable specification of the profit function, the firms would like to reduce their R&D investments after the R&D subsidies have been eliminated, and they will do it gradually. However, while we find it natural to think about adjustment costs for expanding the R&D activity rapidly, it is less clear to us that there are similar adjustment costs involved when downscaling an R&D project making it optimal to do it gradually.

Finally, let us make a remark about another, less structural, model of R&D investments, the so-called error-correction model widely used in time-series econometrics. This model also has the equilibrium condition (4.2) as its point of departure, but suggests that the firms adjust to deviations from this condition with a lag and then only

[18]The "box" in the Box-and-Whisker plots extends from the 25th percentile (x_{25}) to the 75th percentile (x_{75}), i.e. the interquartile range (IQ). The lines emerging from the box are the "whiskers", and extends to the upper and lower adjacent values. The upper adjacent value is defined as the largest data point less than or equal to $x_{75} + (1.5 * IQ)$. The lower adjacent value is defined symmetrically. Observed data points more extreme than the adjacent values are individually plotted.

[19]Unfortunately, the number of business units that have a pattern of subsidies which allows them to be included in Figure 2 is very small, 13 in the leftmost distribution and 69 in the rightmost distribution. The results are, however, robust towards extending the sample to include all manufacturing industries. Doing this, the distributions consists of 29 and 234 business units respectivly.

gradually due to some unspecified adjustment costs. Our skepticism about what such adjustment costs really are meant to represent do not need to be repeated; the issue here is that a lagged response of, say, two years do not make much sense for the kind of shocks we are considering. A story that a firm needs two years to realize or at least to react to an anticipated increase in R&D costs after the grant period has expired, does not seem very convincing.

To sum up, R&D investment models based on variations of the standard model for knowledge accumulation predict that firms will reduce their own R&D investments after an R&D grant has expired or somewhat earlier, possibly down to zero if a non-negativity constraint on R&D is binding, or they rely on adjustment costs that we do not find convincing. These models do not seem appropriate as models of R&D investment behavior, and we now turn to an alternative specification that will induce the somewhat sluggish adjustments we observe in the data and which offers a specific explanation by emphasizing learning and feedback in R&D investments and knowledge accumulation.

4.3. Modelling R&D investments with learning-by-doing

The following accumulation equation for knowledge has been suggested by Hall and Hayashi (1989), Lach and Rob (1995), Jones (1995) and Klette (1996) among others:

$$K_{t+1} = K_t^{\rho-\nu} R_t^{\nu} \tag{4.6}$$

ρ is the scale elasticity in knowledge production and ν is a parameter capturing the productiveness of R&D in generating new knowledge[20]. Note that the multiplicative relationship between K_t and R_t on the right hand side of (4.6) implies positive complimentarity between new R&D investments and already acquired knowledge. This can be thought of as representing learning-by-doing in R&D.

A firm operating from period $t = 0$ to $t = T$, and who wants to maximize its present value, faces the following problem

$$\max_{R_0,\ldots,R_T} PV = \{\pi(K_0) - w_0 R_0 + \sum_{t=1}^{t=T} \beta^t [\pi(K_t) - w_t R_t]\} \tag{4.7}$$

subject to (4.6). $\pi(K_t)$ is the profit function, β is the discount factor, and w_t is the firm's average unit cost of R&D. In order to simplify the model and derive comparative static results, we make the following assumptions:

- $T = 2$
- $\rho = 1$ (i.e. constant returns to scale in knowledge production.)

It is trivial to see that $R_2 = 0$ must be part of an optimal R&D investments path as the effect of R_2 do not materialize within the time period considered[21]. Given this, the problem reduces to

$$\max_{R_0,R_1} PV = \left\{ [\pi(K_0) - w_0 R_0] + \beta [\pi(K_1) - w_1 R_1] + \beta^2 \pi(K_2) \right\}. \tag{4.8}$$

[20]The exact formulation is from Klette (1996). We recognize that (4.6) has the rather extreme and unrealistic implication that a firm which stops its R&D in a single year will loose all its knowledge capital. Alternative specifications that avoid this problem tend to give more complicated estimating equations that we do not explore in this study. However, as most firms have continual R&D activity, we believe equation (4.6) can be thought of as a reasonable approximation.

[21]We have for simplicity asumed that the firm's knowledge capital cannot be sold in the market.

The first order conditions are

$$\begin{aligned}\frac{\partial PV}{\partial R_0} &= -w_0' + \beta\nu\pi'(K_1)\left(\frac{K_0}{R_0}\right)^{1-\nu} \\ &\quad +\beta^2\nu(1-\nu)\pi'(K_2)K_0^{(1-\nu)^2}R_0^{\nu(1-\nu)-1}R_1^{\nu} = 0 \end{aligned} \tag{4.9}$$

and

$$\frac{\partial PV}{\partial R_1} = -\beta w_1' + \beta^2\nu\pi'(K_2)\left(\frac{K_1}{R_1}\right)^{1-\nu} = 0 \tag{4.10}$$

This gives the following expressions for optimal R&D investments

$$R_1 = K_0^{1-\nu}R_0^{\nu}\left(\frac{\beta\nu\pi'(K_2)}{w_1'}\right)^{\frac{1}{1-\nu}} \tag{4.11}$$

and

$$R_0 = K_0\left(\frac{\beta\nu}{w_0'}\right)^{\frac{1}{1-\nu}}\left[\pi'(K_1) + \beta(1-\nu)\left(\pi'(K_2)\right)^{\frac{1}{1-\nu}}\left(\frac{\beta\nu}{w_1'}\right)^{\frac{\nu}{1-\nu}}\right]^{\frac{1}{1-\nu}} \tag{4.12}$$

We are particularly interested in the effects of varying w', the marginal cost of R&D. The relevant derivatives are

$$\frac{\partial R_1}{\partial w_1'} < 0 \qquad \frac{\partial R_0}{\partial w_0'} < 0 \tag{4.13}$$

$$\frac{\partial R_1}{\partial w_0'} \lesseqgtr 0 \qquad \frac{\partial R_0}{\partial w_1'} \lesseqgtr 0. \tag{4.14}$$

The algebraic expressions are given in appendix B.

Consider now the effect on R&D of a subsidy which makes investments in R&D cheaper at the margin. The same period effect is given in (4.13), and not surprisingly, we see that firms will increase their R&D activity when R&D is subsidized. In this respect, the model performs similar to the traditional framework, cf. equation (4.3). The dynamic effects, however, are more interesting. From the leftward derivative in (4.14) we see that a temporary subsidy at $t = 0$, may induce the firm to undertake more R&D also in the next period even if it is not subsidized then. This contrasts the conventional model of R&D investments, where the dynamic effect is negative, cf. equation (4.4). Note also that it is the diminishing returns to knowledge capital which makes (4.14) indeterminate. If we isolate the learning-by-doing feature of our model by assuming $\pi'(K)$ constant[22] and thereby that $\pi''(K) = 0$, we see from the expressions in appendix B that the pure effect of learning is positive, i.e. $\frac{\partial R_1}{\partial w_0'} < 0$. Learning-by-doing in R&D is therefore able to explain the empirical results in Table 7. From (4.14) we also see that a known subsidy at $t = 1$, may induce the firm to increase its R&D activity already at $t = 0$. This is another result which is impossible within the conventional framework built on the analogy between physical capital and R&D. A firm which knows that capital will be subsidized at $t = 1$, and not at $t = 0$, will definitely not increase its investments in the period when capital is not subsidized.

The intuition behind the dynamic behavior of our model is that when there is learning-by-doing in R&D, increased R&D today will make firms more efficient R&D

[22] In this case the optimal level of investment is not defined within the conventional framework.

performers in later periods through their increased knowledge capital. This increases the profitability of future R&D. Likewise, if a firm gets to know that the price of R&D will be lowered in the future, it will find it profitable to increase its present R&D, as this makes it a more efficient R&D performer in later periods when it will increase its R&D activity due to the lower price.

Note that a subsidy regime which induces firms to increase their same period R&D without altering the marginal price will have the same dynamic effects as

$$\frac{\partial R_1}{\partial R_0} \gtreqless 0 \qquad \frac{\partial R_0}{\partial R_1} \gtreqless 0 \tag{4.15}$$

The rightmost result is derived by treating R_1 as an exogenous variable and using implicit derivation on (4.9). Once again, going to appendix B and setting $\pi''(K) = 0$, we find a certain positive dynamic effect.

5. A structural, econometric analysis of the dynamic effects of R&D subsidies

We now want to pursue a more complete structural modelling of R&D investments suitable for empirical applications, building on the framework of Klette (1996) and Klette and Johansen (1997). First we present the model and extends it by incorporating uncertainty in the knowledge production function, as uncertainty is an important characteristic of R&D investments. Next we modify the model to handle R&D subsidies, and derive the estimation equation.

5.1. An empirical infinite horizon model with uncertainty in knowledge production

To incorporate uncertainty in the knowledge production function, rewrite (4.6)

$$K_{t+1} = K_t^{\rho-\nu} R_t^{\nu} \varepsilon_t \tag{5.1}$$

where ε_t is a mean-one stochastic factor accounting for the randomness in research activities. One way to identify the optimal investment behavior given the accumulation equation above is to consider the Bellman-equation

$$\begin{aligned} V(K_t) &= \max_{R_t} \{\pi_t(K_t) - w_t R_t + \beta E_t [V(K_{t+1})]\} \\ &= \max_{R_t} \{\pi_t(K_t) - w_t R_t + \beta E_t [\pi_{t+1}(K_{t+1}) - w_{t+1} R_{t+1}] \\ &\qquad + \beta^2 E_t [V(K_{t+2})]\}, \end{aligned} \tag{5.2}$$

where K_{t+1} is as specified in (5.1). E_t is the expectation operator, conditioned on the firm's information set available when it makes its decision about the investment R_t.

We can identify an optimal path by considering the marginal change in R_{t+1} induced by a marginal change in R_t such that an optimal path remains unchanged from period $t+2$ onwards, i.e.

$$\begin{aligned} E_t dK_{t+2} &= E_t d\left[(K_t^{\rho-\nu} R_t^{\nu} \varepsilon_t)^{\rho-\nu} R_{t+1}^{\nu} \varepsilon_{t+1}\right] \\ &= E_t \left[\nu(\rho-\nu)\frac{K_{t+2}}{R_t} dR_t + \nu \frac{K_{t+2}}{R_{t+1}} dR_{t+1}\right] \\ &= E_t \left[\nu K_{t+2}\left\{(\rho-\nu)\frac{dR_t}{R_t} + \frac{dR_{t+1}}{R_{t+1}}\right\}\right] = 0 \end{aligned} \tag{5.3}$$

implying that, in expectational terms,

$$\frac{dR_{t+1}}{dR_t} = -\left(\rho - \nu\right)\frac{R_{t+1}}{R_t}. \tag{5.4}$$

The first order condition associated with (5.2), given that K_{t+2} is fixed is

$$w_t = \beta\, E_t \left[\pi'_{t+1}(K_{t+1})\frac{\partial K_{t+1}}{\partial R_t} - w_{t+1}\frac{dR_{t+1}}{dR_t} \right] \tag{5.5}$$

which, using (5.1) and (5.4), can be restated as

$$w_t R_t = \beta\, E_t\left[\nu \pi'_{t+1}(K_{t+1})K_{t+1}\right] + \beta(\rho - \nu)E_t\left[w_{t+1}R_{t+1}\right]. \tag{5.6}$$

A common specification of the profit function implies that $\pi'_t(K_t)K_t = \gamma\, S_t$, where S_t is sales (see Klette, 1996). Hence, an optimal R&D investment path requires that

$$w_t R_t = \beta\nu\gamma\ E_t\left[\, S_{t+1}\right] + \beta(\rho - \nu\,)E_t\left[\, w_{t+1}R_{t+1}\right] \tag{5.7}$$

The Euler equation (5.7) gives a tight relationship between R&D expenditures in period t and *expected* sales and *planned* R&D expenditures in period $t+1$.

5.2. Incorporating "matching grants" R&D subsidies in the empirical model

To incorporate public R&D-subsidies let $R_t = R_t^{PP} + R_t^{PG} + R_t^G$. Based on the discussion in section 2, we have three analytically interesting situations which implies different modifications to the Euler equation:

1. If there is full crowding out, we cannot distinguish between the R&D investments of subsidized and non-subsidized firms, and the Euler equation does not change. In this situation it is also obvious that the firms cannot be subsidized at the margin.

2. If there is less than full crowding out, but not a significant degree of additionality, firms are not likely to be subsidized at the margin. The subsidies do, however, increase the firms' total R&D-investments. A situation where there is significant additionality, but where firms nonetheless are constrained with respect to the size of the subsidized project, will with respect to the Euler equation have the same implications. We will discuss these below.

3. If there is significant additionality, and the firms are unconstrained with respect to the size of the subsidized project, the marginal cost of R&D is given by equation (2.3), with $\alpha = 1$ as a limiting case implying that there is full additionality.

In the cases grouped under item 2 above, w' is not affected by the subsidy, hence $w' = \overline{w}$. Furthermore, R^G and R^{PG} are exogenous to our analysis. In these cases, introducing public R&D-subsidies induces two changes in the Bellmann equation (5.2), and these are the replacement of R by R^{PP} as the control variable and the replacement of R by $\left(R^{PP} + R^{PG}\right)$ inside the brace. The first order condition (5.5), then becomes[23]

$$\overline{w}_t = \beta\, E_t\left[\pi'_{t+1}(K_{t+1})\frac{\partial K_{t+1}}{\partial R_t^{PP}} - \overline{w}_{t+1}\frac{dR_{t+1}^{PP}}{dR_t^{PP}} \right] \tag{5.8}$$

[23] We assume here that $\frac{dR_{t+1}^{PG}}{dR_t^{PP}} = 0$. In a more complete model where one endogenizes the allocation of R&D subsidies, one would want to allow the amount of privately financed R&D invested this year to influence the amount of subsidies received next year. Such a fine point, however, is beyond the scope of this exposition.

which can be rewritten

$$\overline{w}_t R_t = \beta\,\nu E_t\left[\pi'_{t+1}(K_{t+1})K_{t+1}\right] + \beta(\rho-\nu)E_t\left[\overline{w}_{t+1}R_{t+1}\right]. \tag{5.9}$$

Note that this equation, maybe somewhat surprisingly, is identical to equation (5.6). As long as a firm is not subsidized at the margin, therefore, its optimal R&D investment path will follow (5.6), and hence (5.7), whether or not it receives subsidies. This, however, is not to say that receiving subsidies is without implications for the firms' investment decision, something which can be seen by rewriting (5.7) specifying the various components of R_t and R_{t+1}:

$$\begin{aligned}\overline{w}_t\left(R_t^{PP}+R_t^{PG}+R_t^{G}\right) &= \beta\nu\gamma\; E_t\left[\,S_{t+1}\right] \\ &\quad +\beta(\rho-\nu\,)E_t\left[\,\overline{w}_{t+1}\left(R_{t+1}^{PP}+R_{t+1}^{PG}+R_{t+1}^{G}\right)\right]\end{aligned} \tag{5.10}$$

We see that a firm which do not receive subsidies at time t (when it decides R_t^{PP}), but which do expect to receive subsidies at time $t+1$, will undertake more R&D at time t than a firm with the same expectations about sales, but which do not expect to receive subsidies next period. There is a simple rationale for this: The firm knows that it will get some additional R&D resources next period which, by assumption, cannot be completely crowded out. These resources can according to equation (5.1) be utilized more efficiently the higher is its knowledge capital base, K_{t+1}, at that time. Given this, it is optimal for the firm to "prepare" for the expected R&D-expansion by building up more knowledge in advance through an increase in R_t^{PP}. Due to the same dynamic effect, a firm which receives subsidies at time t, but which do not expect to receive subsidies at time $t+1$, will do more R&D at time $t+1$, than a firm with the same expectations about sales, but which do not receive subsidies at time t. This is because the subsidized firm starts out at time $t+1$ with a larger knowledge capital base then the non-subsidized firm, something which makes it a more efficient "knowledge producer". For this reason it finds it optimal to invest more in R&D at time $t+1$ than it would have done without the subsidy at time t. This will of course also increase its knowledge capital at time $t+2$, relative to the scenario without a subsidy at time t, and consequently we can conclude that a temporary R&D subsidy which is not completely crowded out, will have a lasting positive impact on the firm's future R&D investments. This effect will of course be more significant the less crowding out or more additionality there is associated with the subsidy.

Let us now consider the case described under item 3 above, i.e. the case with additionality and where the firms get to decide the size of the subsidized projects. In a period where firms are subsidized, their marginal cost of R&D is given by equation (2.3). We must then distinguish between three different situations;

- (i) the firms are subsidized at the margin at time t, but do not expect to be subsidized at the margin at time $t+1$.
- (ii) the firms are not subsidized at the margin at time t, but expect to be subsidized at the margin at time $t+1$.
- (iii) the firms are subsidized at the margin at time t, and expect to be subsidized at the margin at time $t+1$.

When the firms are not subsidized at the margin, their marginal cost of R&D is $w' = \overline{w}$, and this makes it possible easily to incorporate a fourth category within the framework that we are now building up. This category comprise all other firms, i.e.

- (iv) those firms which are not subsidized at the margin at time t, and which do not expect to be subsidized at the margin at time $t+1$.

Using dummy variables to distinguish between firms in different situations, the Euler equation (5.7), becomes

$$\left\{ D2 + D4 + (D1 + D3)\,\frac{\alpha}{1+\alpha} \right\} \overline{w}_t R_t = \beta\nu\gamma\, E_t\,[\,S_{t+1}] \\ +\beta(\rho-\nu)E_t\left[\left\{ D1 + D4 + (D2 + D3)\,\frac{\alpha}{1+\alpha} \right\} \overline{w}_{t+1} R_{t+1} \right] \quad (5.11)$$

where D1 is one for firms in category (i) and zero otherwise, D2 is one for firms in category (ii) and zero otherwise, D3 is one for firms in category (iii) and zero otherwise, and D4 is one for firms in category (iv) and zero otherwise. Given the application and data collection procedure, cf. footnote 6, it seems likely that the firms are well informed about whether or not they will receive subsidies one year ahead of time. Assuming, therefore, perfect foresight with respect to next year's subsidies, equation (5.11) can be reformulated

$$\begin{aligned} \overline{w}_t R_t \;=\; & \beta\nu\gamma\; E_t\,[\,S_{t+1}] + \frac{\beta\nu\gamma}{\alpha}\,\{(D1 + D3)\cdot E_t\,[\,S_{t+1}]\} \\ & +\beta(\rho-\nu\,)E_t\,[\,\overline{w}_{t+1}R_{t+1}] \\ & +\frac{\beta(\rho-\nu\,)}{\alpha}\,\{D1\cdot E_t\,[\,\overline{w}_{t+1}R_{t+1}]\} \\ & -\frac{\beta(\rho-\nu\,)}{1+\alpha}\,\{D2\cdot E_t\,[\,\overline{w}_{t+1}R_{t+1}]\}\,. \end{aligned} \quad (5.12)$$

Note that as $\alpha \to 0$, some of the coefficients go to infinity, once again reflecting that firms are not likely to be subsidized at the margin for such values of α, and thus, that there is not likely to be firms in category (i)-(iii) if α is low. Note also that if some firms are misclassified as belonging to one of the categories (i)-(iii) when belonging to category (iv), these observations still have all relevant variables included. They do, however, also have non-zero additional variables, namely those involving dummies in (5.12). From an econometric point of view, this can be interpreted as the inclusion of irrelevant variables, and the estimated coefficients for these variables should be insignificant and close to zero if in fact the majority of firms are not subsidized at the margin.

5.3. Estimating the Euler Equation

We will start out by assuming that subsidized firms are subsidized at the margin. This hypothesis can be tested. Equation (5.12) can be estimated and will, given the necessary data, identify the degree of additionality through the parameter α if the hypothesis is correct. If it is wrong, it will be falsified through non-significant parameters for the terms involving dummy variables.

The Norwegian R&D surveys contain information on planned R&D, $E_t\,[\overline{w}_{t+1}R_{t+1}]$, but not on expected sales. To circumvent this problem, we have used real sales in the following year as a proxy, and instrumented this variable by its present and lagged value to avoid the endogeneity problem thus involved. The sales data are merged in from the manufacturing statistics.

Another problem is to decide which firms belong to which of the four categories determining the values of the dummy variables. Assuming perfect foresight one year

ahead is reasonable and helps, but we have yearly R&D data only for the period 1982-1985. For the period 1985-1995, the R&D surveys were only conducted every second year, and hence, for these years we do not know which firms received a subsidy in period $t+1$. One way to proceed, is to assume that firms received subsidies at time $t+1$ if they received subsidies both at time t and $t+2$, as there is positive autocorrelation in subsidy allocation. Likewise, therefore, it seems reasonable to assume that firms did not receive subsidies at time $t+1$ if they did not receive subsidies at time t nor at $t+2$. Similar reasoning cannot be adopted for firms which received subsidies at t, but not at time $t+2$, or the other way around. These observations, therefore, have to be excluded. Unfortunately, then, there is rather few observations in our data set which can identify the coefficients in front of the last to terms in equation (5.12), as the majority of the observations are from the period 1985-1995, and there is only a small fraction of the firms that change their subsidy recipient status in the years 1982-1985 . There are 17 observations in category (i), 13 observations in category (ii), 31 observations in category (iii) and 121 observations in category (iv). To correct for heteroscedasticity, all observations are weighted with the square root of inverse sales. Further information about the variable construction can be found in appendix A.

The estimation results are given in Table 8. The coefficients of equation (5.12) are reported in column (1). Two of the dummy variable terms are statistically insignificant and have opposite signs of those predicted by theory. The last one is correctly signed and weakly significant. Using the correctly signed and weakly significant coefficient to identify α gives $\widehat{\alpha} = 7.45$, a value way outside the theoretical range, $\alpha \in \langle 0, 1 \rangle$. This means that this coefficient also is too close to zero to have a meaningful interpretation. We conclude from this that the hypothesis underlying the regression is wrong, i.e. firms are not subsidized at the margin. This view is also supported by our result of no additionality in section 3.3, cf. the discussion at the very end of section 2.

If the subsidized firms are not subsidized at the margin, all firms will have to be reclassified to category (iv), and the dummy variable terms will not be part of the regression equation. Table 8, column (2) reports the estimation results based on this assumption. With this specification, both coefficients are significant at conventional levels.

6. Conclusions and loose ends

6.1. Summary of results

Whereas many countries subsidize R&D in private companies through tax credits, subsidies to the Norwegian high tech industries are given as "matching grants", i.e. the subsidies are targeted, and the firms have to contribute a 50 percent own risk capital to the projects. It is, however, an open question to what extent this induces firms to increase their total R&D investments as they may reduce non-subsidized R&D activities upon receiving an R&D grant. Our results suggest that grants do not crowd out privately financed R&D, but that subsidized firms do not increase their privately financed R&D either. Hence, the own risk capital seems to be taken from ordinary R&D budgets, and there is no "additionality" associated with matching grants subsidies.

Our results also suggest that the subsidies most efficiently stimulate R&D investments in small and large firms as opposed to medium size firms. One hypothesis which may explain this is that R&D investments in small firms are liquidity constrained, whereas large firms are so closely monitored by the governmental agencies awarding

the subsidies that it is difficult for them to get support for projects which are profitable without subsidies. A variable measuring the firms' cash flow do not indicate that small firms are liquidity constrained, however. This might be because this variable rather measures the present success of the firms, something which may be considered a proxy for future success and thereby for the incentive to invest in R&D. Our main result of neither crowding out, nor additionality seems to be robust both over time and across a wider sample of manufacturing firms than those belonging to the traditional high tech industries. There are no clear cut differences between the effects of subsidies awarded by research councils, industry funds and ministries, either.

We have also investigated possible log run effects of R&D subsidies, and we have shown that the conventional perpetual inventory model of R&D investments predict the dynamic effects of subsidies to be negative. There is, however, no empirical evidence supporting this claim. On the contrary, there seems to be a positive dynamic effect, i.e. temporary R&D subsidies seem to stimulate firms to increase their R&D investments even when the grants have expired. We have argued that learning-by-doing in R&D activities is a possible explanation for this, and our theoretical analysis show that such effects alter the predictions of the conventional models. The intuition behind the dynamic behavior of our model is that with learning-by-doing in R&D, increased R&D in one period makes firms more efficient R&D performers in future periods through increased knowledge capital. This increases the profitability of future R&D.

A structural, econometric model of R&D investments incorporating such learning effects have been estimated with reasonable results. These suggest that matching grants subsidies do not affect the firms' marginal price of R&D, a finding which is to be expected if there is little or no additionality associated with subsidies in the period they are awarded.

6.2. Topics left for future research

This paper is part of an ongoing research program, and several topics need to be elaborated on in future work. First, we would like discuss implications of our results for the debate over targeted R&D subsidies vs. tax credits. Second, there are several possible selection biases which we have not taken account of in our empirical investigations so far, except by including fixed effects in the regressions. Third, we need to interpret the main coefficients of the Euler equation (5.12). It is our ambition to combine the Euler equation in this paper with the performance equation of Klette (1996), in order to identify the parameters necessary to predict the strength of the dynamic effects, and not the least to estimate the returns to private and public R&D investments.

7. Appendix A: Data

The core of the high tech industries is the manufacture of office machinery and communication equipment, i.e. ISIC 3825 and 3832. This is the kind of production most intensely promoted by the government, but subsidies have been awarded to a wider set of high tech projects than those performed within these two sub-industries. To get a sample of reasonable size, and to avoid classification problems associated with companies having production and research activities covering a broader class of products than ISIC 3825 and 3832, we have used production and R&D aggregated to the three digit line of business level. For the purpose of empirical analyses in this paper, we have therefore defined high tech as the manufacture of machinery, electrical equipment and technical instruments, i.e. ISIC 382, 383 and 385. These industries have many R&D performing firms and are technologically related.

7.1. Data sources

The analysis uses merged data from R&D surveys and time series files of the manufacturing statistics. The manufacturing statistics of Statistics Norway is an annual census of all plants in the Norwegian manufacturing industries. From this source we use information on sales and cash flow. See Halvorsen et al. (1991) for documentation of the data base. R&D surveys are available for the years 1982-85, 1987, 1989, 1991, 1993 and 1995. These surveys were carried out by the Royal Norwegian Council for Scientific and Industrial Research (NTNF) until 1989 and by Statistics Norway from 1991. See Skorge et al. (1996) for definitions and industry level figures. We have aggregated R&D expenditures to the three digit (ISIC) line of business level before merging these variables to the manufacturing statistics. This means that our observations are not firms, but business units. A business unit is defined as all production activities within a firm having the same three digit ISIC classification. Single plant firms consist of one business unit, whereas multiplant firms may consist of several business units. Approximately 75 percent of all manufacturing firms are single plant firms.

7.2. Sample construction

The R&D surveys had close to full coverage of firms with more than 20 employees in the industries studied, i.e. ISIC 382, 383 and 385. There is altogether 1658 time-year observations of business units at the three digit line of business level in these industries included in the surveys. 1278 of these are successfully merged to the manufacturing statistics. 714 observations had a time average of more than 20 employees, positive R&D investments and were included in at least two surveys. This sample was moderately trimmed leaving 697 observations for our empirical investigations. Outliers were defined as firms having value added per man-hour below the one percent percentile, above the 99 percent percentile or having an R&D intensity above the 99 percent percentile. Table 1 give some sample statistics.

7.3. Variable construction

Sales is measured as the value of gross production corrected for taxes and subsidies. Cash Flow before R&D is measured as sales subtracted labor expenses, material expenses and rentals. This measure is added R&D expenses financed by own means as

given in the R&D surveys. Nominal variables in the manufacturing statistics are deflated using industry level deflators from the Norwegian national accounts. The R&D variables include both intramural and extramural R&D expenditures. The R&D expenditures, consisting mainly of labor costs, are deflated using an index based on the movement of average wage in ISIC 382, 383 and 385.

For the years 1982-1987, planned R&D is reported in man-years. When estimating the Euler equation, this variable is transformed to kroner using the firm specific ratio between R&D man-years and R&D investments in the year of the survey, and inflated with the growth in the R&D price index during the following year. Another weakness with the data for planned R&D is that they in 1995 include R&D-related capital investments. To adjust for this, the variable is reduced with the 1995 share of R&D-related capital investments in the sum of R&D and R&D-related capital investments.

There are also problems related to the instruments used in the Euler equation. We do not have data for sales in 1996, and the 1995-observations therefore lack our proxy for expected sales. To circumvent this, we have constructed the proxy using sales in 1995, if possible, multiplied by the firm specific growth rate from 1994 to 1995. We use a similar procedure for firms who exit the panel before 1995, and to construct the instrumental variable lagged sales where this is missing.

8. Appendix B: Algebraic expressions for the derivatives in section 4.3

$$\begin{aligned}\frac{\partial R_1}{\partial w_1'} &= \{\pi''(K_2)\left(\frac{K_1}{R_1}\right)^{1-\nu}\nu w_1' \\ &\quad -\left[\frac{K_1}{1-\nu}(\beta\nu)^{\frac{1}{1-\nu}}\left(\frac{\pi'(K_2)}{w_1'}\right)^{\frac{\nu}{1-\nu}}\right]^{-1}\}^{-1} < 0 \end{aligned} \tag{8.1}$$

$$\begin{aligned}\frac{\partial R_0}{\partial w_0'} &= -\frac{K_0}{w_0'(1-\nu)}\left(\frac{\beta\nu}{w_0'}\right)^{\frac{1}{1-\nu}} \\ &\quad \cdot\left[\pi'(K_1)+\beta(1-\nu)\left(\pi'(K_2)\right)^{\frac{1}{1-\nu}}\left(\frac{\beta\nu}{w_1'}\right)^{\frac{\nu}{1-\nu}}\right] \\ &\quad \cdot\{1-\frac{K_0}{1-\nu}\left(\frac{\beta\nu}{w_0'}\right)^{\frac{1}{1-\nu}} \\ &\quad \cdot\left[\pi'(K_1)+\beta(1-\nu)\left(\pi'(K_2)\right)^{\frac{1}{1-\nu}}\left(\frac{\beta\nu}{w_1'}\right)^{\frac{\nu}{1-\nu}}\right]^{\frac{1}{1-\nu}} \\ &\quad \cdot\left[\pi''(K_1)\frac{\partial K_1}{\partial R_0}+\beta\left(\frac{\beta\nu}{w_1'}\right)^{\frac{\nu}{1-\nu}}\pi''(K_2)\frac{\partial K_2}{\partial R_0}\right]\}^{-1} < 0 \end{aligned} \tag{8.2}$$

$$\begin{aligned}\frac{\partial R_1}{\partial w_0'} &= \nu\left(\frac{K_0}{R_0}\right)^{1-\nu}\left(\frac{\beta\nu\pi'(K_2)}{w_1'}\right)^{\frac{1}{1-\nu}}\frac{\partial R_0}{\partial w_0'} \\ &\quad +\frac{K_1\pi'(K_2)}{(1-\nu)}\left(\frac{\beta\nu}{w_1'}\right)^2\pi''(K_2)\frac{\partial K_2}{\partial R_0}\frac{\partial R_0}{\partial w_0'} \gtreqless 0 \end{aligned} \tag{8.3}$$

$$\begin{aligned}\frac{\partial R_0}{\partial w_1'} &= \frac{\beta K_0}{1-\nu}\left(\frac{\beta\nu\pi'(K_2)}{w_0'}\right)^{\frac{1}{1-\nu}} \\ &\quad \cdot\left[\frac{\beta\nu}{w_1'}\left\{\pi'(K_1)+\beta(1-\nu)\left(\pi'(K_2)\right)^{\frac{1}{1-\nu}}\left(\frac{\beta\nu}{w_1'}\right)^{\frac{\nu}{1-\nu}}\right\}\right]^{\frac{\nu}{1-\nu}} \\ &\quad \cdot\left\{\pi''(K_2)\frac{\partial K_2}{\partial R_1}\frac{\partial R_1}{\partial w_1'}-\frac{\nu}{w_1'}\right\} \gtreqless 0 \end{aligned} \tag{8.4}$$

$$\begin{aligned}\frac{\partial R_1}{\partial R_0} &= \left\{\nu\left(\frac{\beta\nu\pi'(K_2)}{w_1'}\right)^{\frac{1}{1-\nu}}+\frac{\beta\nu}{w_1(1-\nu)}R_0\left(\frac{\beta\nu\pi'(K_2)}{w_1'}\right)^{\frac{\nu}{1-\nu}}\pi''(K_2)\frac{\partial K_2}{\partial R_0}\right\} \\ &\quad \cdot\left(\frac{K_0}{R_0}\right)^{1-\nu} \gtreqless 0 \end{aligned} \tag{8.5}$$

$$\begin{aligned}\frac{\partial R_0}{\partial R_1} &= -\beta(1-\nu)K_0^{(1-\nu)^2}R_0^{1-\nu^2}\left\{\pi''(K_2)\frac{\partial K_2}{\partial R_1}+\nu R_1^{\nu}\pi'(K_2)\right\} \\ &\quad \cdot\{\beta(1-\nu)K_0^{(1-\nu)^2}R_0^{1-\nu^2}\left\{\pi''(K_2)\frac{\partial K_2}{\partial R_0}-\left(1+\nu^2-\nu\right)\frac{R_1^{\nu}}{R_0}\pi'(K_2)\right\} \\ &\quad +\pi''(K_1)K_0^{1-\nu}R_0-(1-\nu)\pi' K\}^{-1} \gtreqless 0 \end{aligned} \tag{8.6}$$

9. References

Arrow, K.J. (1962): Economic Welfare and the Allocation of Resources for Invention. In R.R.Nelson (ed.): The Rate and Direction of Inventive Activity. New Jersey: Princton University Press.

Arrow, K.J. (1968): Optimal capital policy with irreversible investment. In J.N.Wolfe (ed.): Value, capital and growth. Edinburgh: Edinburgh University Press.

Bound, J. C.Cummins, Z.Griliches, B.H. Hall and A.Jaffe: Who Does R&D and Who Patents? In Z. Griliches: R&D, Patents and Productivity, The University of Chicago Press (Chicago).

Cohen, W.M. and S.Klepper (1996): A Reprise of Size and R&D, Economic Journal, 106, 925-951.

Ergas, H. (1987): Does technology policy matter? In B.Guile and H.Brooks (eds.): Technology and global industry. Washington D.C.: National Academy Press.

Førre, S.E. (1997): Er store foretak mer forskningsintensive? En anvendelse av diagnostiske metoder. Rapport nr 97/11, Statistics Norway.

Griffith, R., D.Sandler and J.Van Reenen (1995): Tax incentives for R&D, Fiscal Studies 16, 21-44.

Griliches, Z. (1979): Issues in Assessing the Contributions of Research and Development to Productivity Growth, Bell Journal of Economics, 10, 92-116.

Griliches, Z. (1995): R&D and Productivity: Econometric Results and Measurement Issues. In P.Stoneman (ed): Handbook of the Economics of Technological Change. Oxford: Basil Blackwell, 52-89.

Grønhaug, K. and T.Fredriksen (1984): Governmental innovation support in Norway, Research Policy 13, 165-73.

Hall, B. and F. Hayashi (1989): Research and Development as an Investment. NBER Working paper no. 2973

Halvorsen, R., R.Jensen and F.Foyn (1991): Dokumentasjon av industristatistikkens tidsseriedatabase. Mimeo, Statistics Norway.

Hervik, A. and L.K.Brunstad (1989): Evaluering av Industrifondet. Arbeidsrapport 8904, Møreforskning.

Hervik, A. and S. Waagø (1997): Evaluering av brukerstyrt forskning Rapport, Handelshøyskolen BI og NTNU.

Hervik, A., D.M.Berge and B.Wichsteed (1992): Evaluering av NTNF-programmet "Nyskaping i næringslivet". Rapport 9213, Møreforskning.

Irwin,D.A. and P.J.Klenow (1996): High-tech R&D subsidies: Estimating the effects of Sematech, Journal of International Economics 40, 323-44.

Jones, C.I. (1995): R&D-based models of economic growth, Journal of Political Economy 103, 759-84.

Kauko, K. (1996): Effectiveness of R&D subsidies - a sceptical note on the empirical literature, Research Policy 25, 321-3.

Keck, O. (1993): The national system for innovation in Germany, in R.R.Nelson (ed.): National Innovation Systems: A comparative study. Oxford: Oxford University Press.

Klette, T.J. (1996): R&D, Scope Economies and Plant Performance, RAND Journal of Economics 27, 502-22.

Klette, T.J. and F. Johansen (1997): Accumulation of R&D-capital and dynamic firm performance: a not-so-fixed effect model, Annales d'Economie et de Statistique (Forthcoming).

Lach, S. and R.Rob (1995): R&D, investment and industry dynamics, Federal Reserve Discussion Paper 95-47.

Lichtenberg, F.R. (1984): The relationship between federal contract R&D and company R&D, American Economic Review, Papers and Proceedings 74, 73-8.

Lichtenberg, F.R. (1987): The Effect of Government Funding on Private Industrial Research and Development: A Re-assessment, Journal of Industrial Economics 36, 97-104

Mowery, D. (1995): The practice of technology policy, in P. Stoneman (ed.): Handbook of the economics of innovation and technological change, Oxford: Blackwell.

OECD (1996): Science, technology and Industry outlook 1996, Paris: OECD.

Olsen, O.E. et al. (1997): Fra kjekt å vite til mye a gjøre - Evaluering av IT-plan for næringslivet, Rapport RF-97/054, Rogalandsforskning (Norway).

Romer, P.M. (1990): Endogenous technological change, Journal of Political Economy 98, S71-S102.

Scott, J.T. (1984): Firm versus Industry Variability in R&D Intensity. In Z. Griliches: R&D, Patents and Productivity, The University of Chicago Press (Chicago).

Skorge, O.,F.Foyn and G.Frengen (1996): Forsknings- og utviklingsvirksomhet i norsk industri 1993, Reports 96/14. Oslo: Statistics Norway.

Summer, L.H. (1981): Taxation and corporate investment: A q-theory approach. Brookings Papers on Economic Activity, 67-127.

Swenson, C.W. (1992): Some tests of the incentive effects of the research and experimentation tax credit, Journal of Public Economics 49, 203-218.

Vickery, G. (1987): Diffusing new technologies: micro-electronics, STI Review 2, 41-80.

Figure 1: The Firm's Demand Curve for R&D

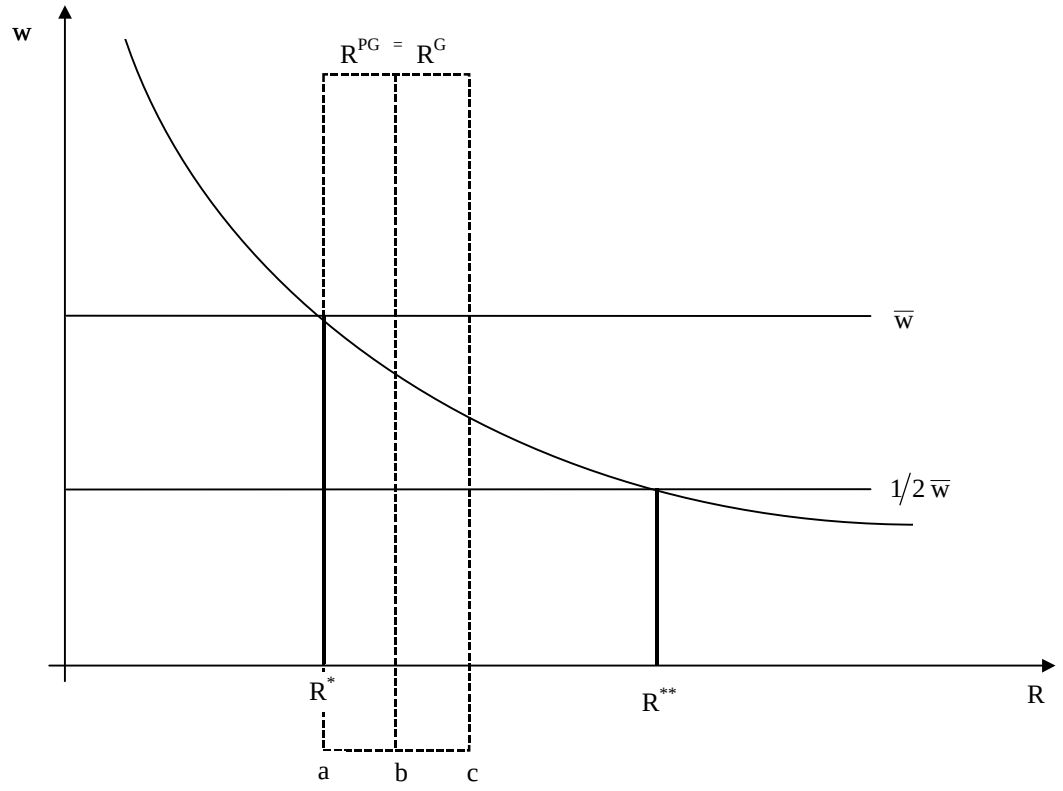


Figure 2: The change in R&D accompanying a Subsidy Regime change

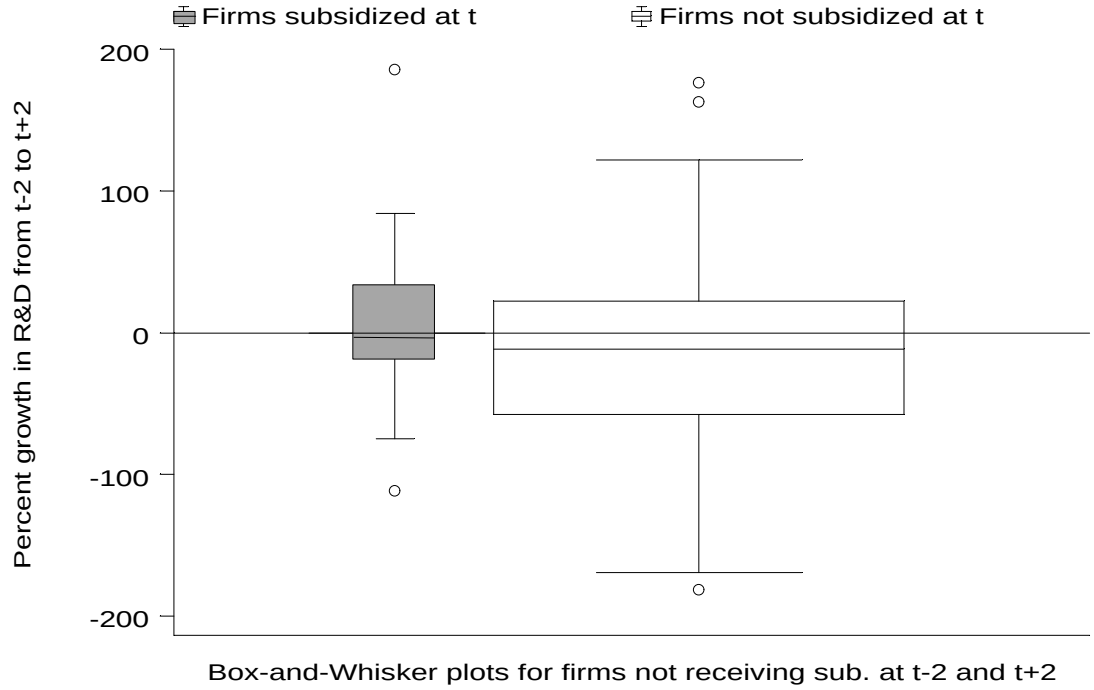


Table 1: Sample Statistics

ISIC 382, 383 and 385	
Total no. of observations	697
no. of business units	192
average no. of observations per business unit	3,6
Observations with subsidies	300
subsidized from research councils	197
subsidized from industry funds	111
subsidized from ministries	98
Observations of small business units (Average no. of workers<25th perc.)	176
Observations of large business units (Average no. of workers>75th perc.)	168
Average no. of workers per business unit	334
25th. percentile	58
median	107
75th. percentile	263
Average R&D intensity	0,07
Median R&D intensity	0,04
Average subsidy share (excluding observations with zero subsidy)	0,23
Median subsidy share (excluding observations with zero subsidy)	0,17

Sample: R&D performing business units in 1982-1995 included in at least two R&D surveys,
having at least 20 workers on average, and beeing successfully merged with the manucaturing statistics.
The sample is moderately trimmed. See appendix A for further details.

Table 2: Norwegian Interview Studies of the Crowding Out Effect of R&D Subsidies

Study	GF84	HB89	HBW92	HW97	OKOH97	
Sample size	54	191	213	200	49	Weighted
Time periode	78-82	80-84	84-89	90-95	92-95	average
Project done without subsidy	34 %	33 %	15 %	6 %	2 %	18 %
Project delayed or diminished	46 %	45 %	46 %	57 %	28 %	48 %
Project not done without subsidy	20 %	23 %	40 %	37 %	70 %	34 %

Studies: GF84; Grønhaug and Fredriksen (1984), HB89; Hervik and Brunstad (1989), HBW92; Hervik, Berge and Wicksteed (1992), HW97; Hervik and Waagø (1997), OKOH97; Olsen et.al. (1997). Respondents who could not or did not answer are not included. Only in HB89, where the full sample consisted of 230 projects, was this cathegory of any significance.

Table 3: Correlation Coefficients Between Deviation From Planned R&D and Change in R&D-Subsidy

	Corr.coef.	Sign.level	No. of obs.
One year horizon: Planned R&D in man-years	0,006	0,95	107
Two year horizon: Planned R&D in man-years	0,34	0,00	147
Two year horizon: Planned R&D in kroner	0,17	0,10	99

9 observations in 1991 where deviation from planned R&D measured in man years and kroner have opposite signs are excluded.

Table 4: The Effect of R&D-Subsidies on Total R&D

	(1)		(2)		(3)	
Functional form	linear		linear		loglog	
Estimation method	fe		diff		fe	
Sales	-0,025**	(0,0088)	0,0050	(0,0080)	-0,62	(1,52)
Sales squared	1,5e-8***	(4,7e-7)	-2,9e-10	(5,0e-9)	0,020	(0,046)
Total R&D-subsidy	1,03***	(0,16)	1,06***	(0,17)	0,064***	(0,012)
Cash flow	0,087***	(0,025)	0,097***	(0,033)	0,019	(0,015)
R-Square	0,95		0,39		0,90	
No. of observations	697		379		697	

*** Significant at the 1% level
** Significant at the 5% level
* Significant at the 10% level
The observations are weighted with the square root of inverse sales [log of sales in (3)] to correct for heteroscedasticity.
Time dummies included in all regressions. Deflated variables. Robust standard errors in parenthesis.

Table 5: The Effect of R&D-Subsidies on Total R&D: Differences Between Small and Large Firms

	(1)		(2)		(3)	
Functional form	linear		linear		loglog	
Estimation method	fe		diff		fe	
Sales	-0,022***	(0,0084)	0,0076	(0,0074)	-0,55	(1,50)
Sales squared	1,3e-8***	(4,8e-9)	-2,6e-9	(5,7e-9)	0,018	(0,046)
Total R&D-subsidy	0,51*	(0,27)	0,47**	(0,22)	0,056***	(0,014)
*small firm dummy	0,48	(0,32)	0,63**	(0,29)	0,022	(0,025)
*large firm dummy	0,74**	(0,36)	0,74**	(0,33)	0,012	(0,032)
Cash Flow	0,041*	(0,025)	0,034	(0,025)	0,0093	(0,019)
*small firm dummy	0,028	(0,055)	0,040	(0,059)	0,015	(0,032)
*large firm dummy	0,056	(0,039)	0,077*	(0,047)	0,017	(0,038)
R-Square	0,95		0,41		0,90	
No. of observations	697		379		697	

*** Significant at the 1% level
** Significant at the 5% level
* Significant at the 10% level
The observations are weighted with the square root of inverse sales [log of sales in (3)] to correct for heteroscedasticity.
Time dummies included in all regressions. Deflated variables. Robust standard errors in parenthesis.
Large and small firms are defined as firms with average employment below the 25th percetile and above the 75th percentile respectively.

Table 6: The Effect of R&D-Subsidies on Total R&D: Differences Between Sources of Subsidies

	(1)		(2)		(3)	
Functional form	linear		linear		loglog	
Estimation method	fe		diff		fe	
Sales	-0,024***	(0,0087)	0,0050	(0,0080)	-0,58	(1,57)
Sales squared	1,4e-8***	(4,8e-9)	-4,8e-10	(5,0e-9)	0,020	(0,048)
Subsidy from research councils	0,95***	(0,23)	1,57***	(0,59)	0,043***	(0,012)
Subsidy from industry funds	0,72***	(0,29)	0,97***	(0,26)	0,029***	(0,011)
R&D grants from ministries	1,17***	(0,25)	1,07***	(0,24)	0,053***	(0,016)
Cash flow	0,085***	(0,024)	0,098***	(0,033)	0,020	(0,015)
R-Square	0,95		0,39		0,89	
No. of observations	697		379		697	

*** Significant at the 1% level
** Significant at the 5% level
* Significant at the 10% level
The observations are weighted with the square root of inverse sales [log of sales in (3)] to correct for heteroscedasticity.
Time dummies included in all regressions. Deflated variables. Robust standard errors in parenthesis.

Table 7: The Effect of R&D-Subsidies on Total R&D: Dynamics

	(1)		(2)		(3)	
Functional form	linear		linear		loglog	
Estimation method	fe		diff		fe	
Sales	-0,020**	(0,019)	-0,0058	(0,013)	3,38	(3,35)
Sales squared	1,2e-8***	(1,1e-8)	4,4e-9	(9,0e-9)	-0,099	(0,10)
Total R&D-subsidy	1,15***	(0,24)	0,96***	(0,32)	0,051***	(0,020)
Total R&D-subsidy at t-2	0,36*	(0,20)	0,16	(0,15)	-0,019	(0,016)
Cash flow	0,083**	(0,037)	0,087**	(0,035)	0,038	(0,024)
R-Square	0,96		0,29		0,91	
No. of observations	379		181		379	

*** Significant at the 1% level
** Significant at the 5% level
* Significant at the 10% level
The observations are weighted with the square root of inverse sales [log of sales in (3)] to correct for heteroscedasticity.
Time dummies included in all regressions. Deflated variables. Robust standard errors in parenthesis.

Table 8: Euler Equation Estimates

	(1)		(2)	
Expected sales	0,0023*	(0,0013)	0,0033**	(0,0016)
* dummy for subsidy only at time t or both at t and t+1 (D1+D3)	-0,0020	(0,0029)		
Planned R&D	0,82***	(0,017)	0,090***	(0,031)
* dummy for subsidy only at time t (D1)	-0,22	(0,17)		
* dummy for subsidy only at time t+1 (D2)	-0,097*	(0,051)		
Root MSE	5,7		13,6	
No. of observations	182		528	

*** Significant at the 1% level
** Significant at the 5% level
* Significant at the 10% level
The observations are weighted with the square root of inverse sales to correct for heteroscedasticity. Robust standard errors in parenthesis.
2SLS regression on nominal values. Sales at period t+1 is used as proxy for expected sales and instrumented with sales in period t and t-1.