IS FINANCIAL SUPPORT FOR PRIVATE R&D ALWAYS JUSTIFIED?
A DISCUSSION BASED ON THE LITERATURE ON GROWTH

Benjamin Montmartin∗ and Nadine Massard†

Abstract

Many economists have long held that market failures create a gap between social and private returns to Research and Development (R&D), thereby limiting private incentives to invest in R&D. However, this common belief that firms significantly underinvest in R&D is increasingly being challenged, leading the rationale behind public support for private R&D to be questioned. In this paper, we attempt to clarify the perspectives of two sources: the theoretical literature on endogenous growth, and its recent developments in integrating a geographical dimension, and the empirical literature that measures the social returns to R&D in relation to the private returns. Ultimately, we are able to clearly distinguish among different types of market failures and compare their relative impact on the gap between the private and social returns to R&D. Two main conclusions are reached. First, systematic firm underinvestment in R&D is not demonstrated. Second, even though instances of underinvestment do occur, they are mainly explained by surplus appropriability problems rather than by knowledge externalities. This suggests the need for a new policy mix that employs more demand-oriented instruments and is more concentrated on identifying efficient allocations among activities rather than merely increasing global private R&D investment.

JEL Classification: E61, 041, O38, R11

Keywords: Returns to R&D, Market failures, R&D-based growth, Economic Geography, R&D policy

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Introduction

In most countries, investment in R&D is considered to be crucial for innovation and thus for future growth and competitiveness. Consequently, many countries have set ambitious targets for R&D investment. For example, among the five targets defined by the Europe 2020 strategy for growth is a goal of 3% of EU GDP devoted to R&D investment (2/3 of which should be realized by private funding). All OECD countries have set similar targets. Moreover, these global strategies are generally based on the idea that private incentives to invest in R&D are insufficient because of the specific attributes of such activities. Highlighting the public-good attributes of the knowledge produced by R&D, the economics literature emphasizes sources of market failures that create a negative gap between private and social returns to R&D and hence reduce the incentive for firms to invest in R&D.

Based on this research, belief in the global underinvestment of firms in R&D has rapidly become widespread among public authorities, so much so that it is currently often taken for granted and considered to justify the implementation of many public policies aimed at supporting R&D activities within firms. Such policies seek not only to establish a favorable institutional context for R&D investment (notably based on the patenting system), but also, increasingly, to direct financial subsidies or indirect tax credits to firms to support R&D.

However, this commonly held belief in the widespread underinvestment of firms in R&D relative to the socially optimal level is increasingly being questioned. Such questioning is motivated by various factors. From a political perspective, increasing tensions within the public sector generated by the financial crisis have reinforced the need to strongly justify and to rigorously evaluate public expenditures. Indeed, given available data on the volume of private investment in R&D, the capacity of already implemented public policies to actually produce the expected incentive effects may reasonably be questioned. R&D financed by the private sector within the European Union has increased only minimally over the last decade, rising from 1.03% of GDP in 1999 to 1.09% in 2009, whereas in many countries, the cost of national public support for R&D activities has increased significantly (Montmartin, 2013b). Additionally, a review of the economics literature in the field reveals significant weaknesses in both the theoretical and the empirical rationale for the belief in widespread underinvestment in R&D. On the theoretical front, new analyses questioning the importance, and even the existence, of firm underinvestment in R&D have recently been published. Beyond knowledge externalities, these analyses consider other sources of market failures in R&D, which, once considered together, can lead to a diversity of theoretical results that do not always support firm underinvestment in R&D. On the empirical front, the weaknesses of existing empirical measures of the social return to R&D have cast doubt on the consensus that social returns to R&D exceed private returns.

Within this context, the objective of this paper is to investigate the notion of firm underinvestment in R&D using the theoretical framework provided by the R&D-based growth literature. This extensive stream of the economics literature, which places innovation and
R&D investment at the heart of the growth process, is a particularly suitable framework for this discussion. In its refinements, the framework is also capable of better accounting for the primary empirical observations characterizing R&D and its relation to growth, including, notably, the diversity of the forms and processes of innovation and the geographical dimension of innovation (owing to the integration of economic geography and growth models). This review will allow us to precisely identify the main sources of market failure and to characterize their effects (positive or negative) on the incentives for firms to invest in R&D. In doing so, our objective is to assemble currently dispersed analyses in order to provide a comprehensive and concise overview of the origins and joint impact of the various types of market failures on R&D. This overview will help to precisely characterize situations in which differences between social and private returns to R&D arise and to design relevant public policy instruments.

Five different sources of market failure are identified. Surplus appropriability problems clearly lead private agents to underinvest in R&D, whereas duplication in R&D activities and rent transfer problems due to destructive creation lead to overinvest. The two remaining sources of market failure, which are related to knowledge externalities and economic geography, have ambiguous effects. Thus, our review of the literature on growth shows that various types of market failures have opposing effects on private incentives to invest in R&D; therefore, we are ultimately unable to reach a specific conclusion regarding the existence of widespread underinvestment in R&D by private firms. Facing this theoretical inconclusiveness, we searched for clarification in the empirical literature that documents and measures private sector underinvestment in R&D. After demonstrating the limitations of this research, based on estimated extended innovation production functions, we looked to studies that calibrate theoretical models. These studies not only take diverse theoretically identified types of market failures into account, but also estimate their relative importance, which may have significant implications for public policy. Overall, the arguments of the more recent calibration exercises tend to cast doubt on the idea of the massive, global insufficiency of private investment in R&D. Private sector underinvestment in R&D is seen as occurring only in specific contexts.

The remainder of this paper is organized as follows. Section 1 presents a rapid overview of the evolution of modeling of R&D and innovation in the R&D-based growth literature, with a specific focus on its implications for public policy. Section 2 provides more detailed descriptions of the origins and impacts of the main types of market failures identified here, as well as measures that could potentially correct them. Section 3 discusses whether private sector underinvestment in R&D actually exists in light of econometric and calibration exercises that seek to measure the gap between private and social returns to R&D. Our main proposals regarding the use of financial instruments in public policies and avenues for future research are developed in the conclusion.
1 R&D, innovation and growth: Theoretical modeling and the role of public policy

In this section, we will describe how the R&D-based growth literature (since the 1990s) has modeled the origins and evolution of Total Factor Productivity (TFP) and try to highlight main R&D public policy implications. The literature surveyed is summarized in Table 1 at the end of the paper.

1.1 The first generation of R&D based-growth models: An initial justification of support for private R&D

The first generation of R&D-based growth models - see Romer (1990), Grossman and Helpman (1991) and Aghion and Howitt (1992) - explains the evolution of technical progress via the research efforts conducted by entrepreneurs. The nature of innovation is the main element of differentiation in this stream of literature. Two main classes of innovation are modeled: (1) the introduction of new products and (2) quality improvements to existing products (which is isomorphic to process innovations). In the former class, the level of the economy’s technical progress is determined by the number of (differentiated) intermediate available products that are used in the production of a final consumption good. Thus, the growth of TFP is determined by the arrival rate of new intermediate products, which increases the specialization and rationalization of the production process. In the latter class, the level of the economy’s technical progress is determined by the quality level of the intermediate products that are used in the production of a final consumption good. Thus, the growth of TFP is determined by the arrival rate of higher quality intermediate products, which increases their productivity in the final good production process, thereby reflecting the same growth mechanism as a process innovation. We summarize the core elements and results of such models in the following table:

<table>
<thead>
<tr>
<th></th>
<th>Variety models</th>
<th>Quality models</th>
</tr>
</thead>
<tbody>
<tr>
<td>Final good production function</td>
<td>$Y_t = \int_0^A x_i^\sigma di$ (1)</td>
<td>$Y_t = \sum_{i=1}^m A_{it}x_{it}^\sigma$ (3)</td>
</tr>
<tr>
<td>Innovation production function</td>
<td>$\dot{A}_t = \delta A_t aL_t$ (2)</td>
<td>$A_{i,t+1} = \gamma^{1/m} A_{i,t}$ (4)</td>
</tr>
<tr>
<td>Economic growth rate ($g_Y$)</td>
<td>$f(aL_t)$</td>
<td>$f(aL_t)$</td>
</tr>
</tbody>
</table>

Table 2: Core elements of the first generation of R&D-based growth models

where $Y'$ represents the final consumption good, $A$ represents the number of intermediate goods or their level of quality, $x_i$ is the quantity of intermediate products $i$ used in production. $\gamma > 1$ measures the productivity effect of higher quality, $m$ is the number of sector and $\sigma \in [0; 1]$ represents the degree of substitution between each intermediate product. $f(.)$ represents a linear function, $a \in [0; 1]$ represents the proportion of workers engaged in R&D activities, $L_t$ is the quantity of labor and $\delta$ is an exogenous R&D productivity parameter.
The steady state of these models is characterized by a constant TFP growth rate that generates a positive long-run growth of production ($g_Y$). In both models, the growth rate increases with the population size ($L_t$) and the share of labor devoted to R&D ($a$). In other words, the higher the number of researchers in an economy is, the higher the growth rate is. Thus, the implementation of public support for R&D is able to positively influence the economy’s long-run dynamics. If this fundamental conclusion is present in the two frameworks, a major difference concerning the need of R&D public support remains. In the quality models, a successful innovator displaces the previous innovator, whereas in variety models, a new innovator competes with all past innovators. Consequently, the creative destruction process of innovation is stronger in quality models. This element has a fundamental implication for R&D policies: the amount of private R&D investment in the decentralized equilibrium can be higher than the optimal amount determined in quality models (which is impossible with variety models).

1.2 The second generation of R&D based-growth models: A discussion on the pro-growth effect of R&D policies

The second generation of R&D-based growth models has emerged to avoid the strong scale effect that is present in first generation models. This scale effect is represented by the linear relationship between the growth rate ($g_Y$) and the population size ($L_t$) - see table 1. Two primary methods have developed from the second generation of models to avoid the strong scale effect: (1) assuming diminishing returns to knowledge in the R&D sector or (2) introducing two complementary R&D sectors (quality and variety enhancing), one of which exhibits diminishing returns to knowledge and the other, constant returns. The main contributions that use the first method include Jones (1995b), Kortum (1997) and Segrestrom (1998) (hereinafter J/K/S; these models are also known as semi-endogenous growth models). The main contributions that use the second method include Aghion and Howitt (1998, chap.12), Peretto (1998), Young (1998) and Dinopoulos and Thompson (1998) (hereinafter AH/P/Y/DT). We summarize the core elements of such models in the following table:

<table>
<thead>
<tr>
<th></th>
<th>J/K/S models</th>
<th>AH/P/Y/DT models</th>
</tr>
</thead>
<tbody>
<tr>
<td>Final good production function</td>
<td>$Y_t = \int_0^{A_t} x_i^\sigma di$ (5)</td>
<td>$Y_t = \int_0^{A_t} x_i^\sigma di$ (5)</td>
</tr>
<tr>
<td>Innovation production function</td>
<td>$\dot{A}_t = \delta A_t (a L_t)^\lambda$ (6)</td>
<td>$\dot{A}_t = a L_t$ (7)</td>
</tr>
<tr>
<td></td>
<td>$x_{it} = B_{it} (1-b)(1-a)L_t/A_t$ (8)</td>
<td>$\dot{B}<em>{it} = \delta (1-a)L_t/B</em>{it}$ (9)</td>
</tr>
<tr>
<td>Growth rate ($g_Y$)</td>
<td>$f(n)$</td>
<td>$f(n) + f(\frac{\delta(1-a)}{a})$</td>
</tr>
</tbody>
</table>

Table 3: Core elements of the second generation of R&D-based growth models

$A$ represents the number of intermediate goods and $n$ is the rate of population growth in both models. In the J/K/S models, $\epsilon < 1$ represents the degree of intertemporal knowledge externalities (which is assumed to be equal to one in first generation models -
see table 2) and $\lambda \in [0; 1]$ refers to the existence of duplications in R&D activities. The other parameters have the same meaning as those in previous models. In the AH/P/Y/DT models, $a$ represents the proportion of workers engaged in R&D to develop new intermediate products, whereas $b(1-a)$ represents the proportion of workers engaged in R&D to improve the quality of intermediate products. $B_i$ represents the level of quality for the intermediate product $i$.

In the J/K/S innovation production function, the diminishing returns to knowledge induced by $\epsilon < 1$ generate a long-run economic growth that is pinned down by population growth (as in the Solow model). Concerning the AH/P/Y/DT models, the variety R&D sector production function also exhibits diminishing returns to knowledge implying that the growth rate of new intermediate products is also pinned down by population growth. Nevertheless, the quality R&D sector production function exhibits constant returns to knowledge, implying that the growth rate of higher product quality is not pinned down by population growth. More specifically, as shown in (9), the growth rate of higher product quality and therefore economic growth are endogenously determined by the allocation of workers in the two R&D sectors. The scale effect does not occur because when the population increases, the number of available intermediate products increases proportionally (see (7) and (9)), leaving the amount of research per variety - and therefore growth - unchanged.

To summarize, these two approaches remove the strong scale effect in very different ways, which has many implications for public policies related to R&D. Indeed, in the J/K/S models, support for private R&D will only have a short-run effect but will not change the steady-state growth of the economy in the long-run. In the AH/P/Y/DT models, however, support for private R&D is able to generate a permanent effect on economic growth by modifying the proportion of workers employed in the two R&D sectors. At a first glance, the scale effect may be argued to be of key importance for justifying public support for private R&D. Nevertheless, many economists, such as Jones (1999) or Temple (2003), have widely discussed this point of view. Indeed Jones (1999) shows that the core result of AH/P/Y/DT models relies on a knife-edge assumption. In equations (7) and (9), we have $L^\lambda_t$ with $\lambda = 1$. Jones (1999) shows that the result of AH/P/Y/DT models is no longer valid when $\lambda \neq 1$. When this specific condition (which is absolutely arbitrary) is not met, the AH/P/Y/DT models converge toward either a model with a strong scale effect or a J/K/S model. Considering this convergence, Temple (2003) highlights a more fundamental criticism of the scale effect debate. He argues that the central issue in growth theories lies in understanding the relationship between parameter changes and the level of welfare, not in determining the long-run behavior of growth rate. Indeed, although investment in R&D has no long-run effects on growth in the J/K/S models, it does have a direct effect on the level of per-capita income. Consequently, determining the channel through which a public policy influences the level of welfare is not really important because an effect on the growth rate is not obviously more effective than an effect on the income level. Indeed, if a policy that increases the growth rate has the same effect on welfare as a policy that increases per-capita income, then the debate between endogenous and non-endogenous growth does not appear to be very relevant. The more important questions resulting from this observation
concern the extent to which the free market equilibrium differs from the optimal outcome and the public policies that are able to reach this optimal outcome.

On this basis, the difference between models with or without a scale effect as well as models with or without endogenous long-run growth appears to be smaller than at first sight. Indeed, both first and second generation models show that in most cases, support for private R&D is able to increase the level of welfare in the economy (but not through the same channels). In this respect, the main difference is between the first generation of variety models and the other models: In the former, there is always an underinvestment in R&D in the free market outcome, whereas in the latter, overinvestment in R&D can occur. This difference is fundamentally related to the market failures that are included in the models. Compared to Romer (1990) or Grossman and Helpman models (1991, chap.3), first generation quality models include a stronger creative destruction effect, J/K/S models include less positive knowledge externalities and the existence of duplication and, finally, AH/P/Y/DT models include (in addition to the previous elements) interdependencies between two different R&D sectors (see section 3.4 for more details on the implications of such interdependencies on the possible existence of R&D overinvestment).

1.3 Beyond the scale effect debate: The influence of the innovation process and geography on the need for public intervention

Although the scale effect debate was one of the main drivers in the R&D-based growth literature in the 1990s, it does not appear to be of primary importance for our purposes. On the contrary, we have to explore other developments of this literature that highlight other market failures creating a gap between the free market level of R&D and the optimal level. Given our core interest, we focus on two specific developments that have emerged in the late of 1990s and during the 2000s. Their main interest is to better account for some well-known stylized facts regarding innovation processes that have been neglected in previous R&D-based growth models. One of these developments concerns the importance of the incremental nature of technological progress and of the relations between innovation and competition, which results in a great variety of sectoral contexts. The other introduces location dynamics and considers the importance of the geographical distribution of R&D and production activities for growth.

The first refinement, driven by the works of Aghion et al. (1997, 2001, 2005), concerns modeling a new nature of technological progress. Indeed, the step-by-step approach developed in these papers assumes that laggards cannot develop superior technologies directly but are instead forced to first catch up with the leading-edge technology before they can achieve technological leadership in the future. This vision of technological progress provides new theoretical results with regard to the relation between product market competition (PMC) and growth. Indeed, this model no longer implies a negative linear relationship between PMC and innovation (which is the case in all previously cited models) but rather
an inverted-U relationship. The reason for this inverted-U relationship is that more competition may increase the incremental profits from innovating and thereby encourage R&D investments with the objective of "escaping competition". In other words, these models add a new effect of competition on the incentives to innovate while maintaining the classical Schumpeterian (negative) effects of competition on monopoly rents. The implications of this inverted-U relationship are of primary importance for our purposes because the need of support for private R&D will be directly linked to the shape of this relationship, which is industry specific and primarily depends on the technological gap between leaders and followers in a particular industry. In other words, the step-by-step approach highlights more potential cases for overinvestment in R&D at the free market equilibrium.

The second important development in the R&D-based growth literature concerns the integration of a very promising and important dimension for R&D activities, namely, the role of location. Indeed, empirical works by Audretsch and Feldman (1996, 2004) and Autant-Bernard et al. (2011, 2013) use the spatial dimension of knowledge externalities to explain the strong concentration of innovative activities and therefore the substantial heterogeneity of the dynamics of economies. Moreover, studies on R&D public support are increasingly integrating a geographical dimension, such as the development of tax credit in American states or the increasing amount of direct subsidies implemented at a regional level, which often follow clusters policies, in European countries. This body of literature, driven by the works of Martin and Ottaviano (1999), Baldwin et al. (2001), Minniti and Parello (2001), provides synthetic frameworks between the New Economic Geography models (NEG) and those in the R&D-based growth literature and reports stylized facts regarding the interactions among economic geography, innovation and growth. Consequently, this framework is especially interesting in the study of the effects and rationale of R&D policies because, by mixing international economics with growth theories, we are able to analyse R&D policies in a context of globalization with heterogenous economies. Assuming a world composed of two asymmetric countries, we can summarize the core elements of these models in the following table:

<table>
<thead>
<tr>
<th>Final good production function</th>
<th>$Y_t = \int_0^{A_{it}} x_{it}^\sigma di + \int_0^{A_{jt}} x_{jt}^\sigma dj$ (10)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Innovation production function</td>
<td>$\dot{A}_t = \delta aL_tWA_t$ (11)</td>
</tr>
<tr>
<td>Growth rate of economies ($\gamma Y$)</td>
<td>$f(aL_tW)$</td>
</tr>
</tbody>
</table>

Table 4: Core elements of New Economic Geography and Growth (NEGG) models

where $A_{i(j)}$ represents the number of varieties produced in countries $i$ and $j$ respectively with $A_t = A_{it} + A_{jt}$, and $x_{i(j)}$ represents the quantity of each variety produced. $s_n \equiv A_{it}/A_t$ represents the share of intermediate firms operating in country $i$ and the parameter $\gamma \in [0,1]$ accounts for the localized nature of knowledge spillovers. If $\gamma = 0$, then knowledge spillovers are purely localized, i.e., R&D activities located in country $i$ will only accede to the $A_{it}$ stock of knowledge, whereas those located in country $j$ will only accede to the $A_{jt}$ stock of knowledge. When $\gamma = 1$, knowledge spillovers are purely global;
in this case, geography does not matter and we obtain innovation production (2). When \( \gamma \in [0, 1] \), knowledge spillovers are partially localized; that is, the R&D activities located in one country can only partially benefit from knowledge produced abroad. The other parameters have the same meaning as those in previous models.

In these models (see table 4), the long-run growth rates of economies (and therefore the welfare) is driven by the interaction between the investment in R&D and the location of economic activities between countries. Consequently, support for private R&D will influence the level of welfare by modifying not only the investment in R&D but also the geography of economic activities. Taking the spatial component of growth and therefore welfare into account can largely modify the gap between the free market level of R&D and the optimal level. For instance, the welfare analysis carried out by Montmartin (2013a) highlights that the positive effect of R&D subsidies on welfare can be lower than the negative effects of R&D subsidies due to the influence of R&D support on the economic geography. This simple illustration shows the importance of taking potential market failures related to the spatial organization of firms into account in the study of the need for and design of public support for private R&D.

In this section, we have briefly described the evolution of the links among R&D, innovation and growth in the R&D-based growth literature and implications for private incentives to invest in R&D. Following Jones (1999) and Temple (2003), if our objective is to discuss the reality of private underinvestment in R&D, we should concentrate our efforts on welfare issues related to R&D and clearly identify R&D-related market failures that are likely to create a gap between free market and optimal investment in R&D. This is the purpose of the next section.

2 The R&D-related sources of market failures and public instruments that can correct them

Although it is still the source for many discussions concerning the modeling of R&D and innovation, the R&D-based growth literature that we have reviewed above raises the following central questions: To what extent could the results of a decentralized economy diverge from the social optimum? What would the origins of such divergence be and which are the most suitable policies that can be implemented to fill this gap?

In this section, we detail the main sources of market failure that have been identified in the R&D-based growth literature. Along with the sources and possible corrections for well-known market failures, such as those due to intertemporal knowledge externalities, appropriability problems, duplications, or rent transfer, we also emphasize new types of externalities identified by the introduction of the New Economic Geography framework into endogenous growth models. For each type of market failure, we indicate the incentive
instruments for public policy that are capable of correcting them. A summary of this second section can be found in Table 5 at the end of the paper.

2.1 Intertemporal knowledge externalities: The "standing on shoulders" and "fishing in the same lake" effects

The existence of knowledge externalities is explained by the very nature of the knowledge generated by R&D. Indeed, knowledge displays some well-known characteristics of public goods (non-rivalry and only partial excludability) that contribute to its free diffusion to firms that have not participated in its production. Within endogenous growth models, such externalities are intertemporal, i.e., externalities produced by a firm during period $t$ will increase the global knowledge stock available at $t+1$. The theoretical literature distinguishes between two main possible effects of this increase in the knowledge stock. The first refers to the "standing on shoulders of giants" phenomenon, which is derived from the quotation by Isaac Newton and implies that the knowledge production process is cumulative: the more important the available stock of knowledge is, the easier it is for researchers to invent and produce new knowledge. The second effect, the "fishing in the same lake" phenomenon, has the opposite consequence. It states that the most obvious inventions are generated first; therefore, an increase in produced knowledge reduces future technological opportunities. According to the second effect, knowledge externalities contribute to reducing future R&D productivity. The economic literature generally postulates that the first effect dominates the second so that knowledge externalities are generally positive, i.e., they have a positive impact on future R&D productivity (which corresponds to a positive value for $\epsilon$ in (6)).

The presence of knowledge externalities will create a gap between the level of investment in R&D chosen by firms and the socially optimal level. Indeed, when firms make their R&D investment decisions, they do not take into account the impact of current R&D on future R&D productivity (which will reduce or increase innovation costs for future innovators, depending on the sign of externalities). Hence, in case of positive (negative) knowledge externalities, a decentralized economy leads to underinvestment (overinvestment) in R&D compared to the optimal level. Various instruments can correct the market failures generated by knowledge externalities. When they are positive, policy instruments should increase the profitability of private R&D so that firms become more inclined to invest in these activities. The implementation of subsidies that are proportional either to the cost of R&D or to the supply price of new knowledge is often proposed to correct such market failures (Grossman and Helpman 1991, Steger 2005). Likewise, when knowledge externalities are negative, it is necessary to levy taxes that are proportional to the cost of R&D or to supply price of new knowledge to reduce R&D profitability and limit incentives to invest in R&D.
2.2 The surplus appropriability problems: Consumer surplus appropriability and the deadweight loss effects of market power

The surplus appropriability problem results from the fact that it is impossible for firms to appropriate the entire potential increases in welfare generated by the commercialization of their innovations. Although the patent system creates an incentive to innovate by conferring monopolistic rents to inventors, it does not allow inventors to capture all the increases in welfare generated by their innovations. This is due to the type of authorized monopoly, which is not discriminant. Consequently, the classical monopolistic behavior of innovative firms creates distortions in prices and produced quantities compared to optimal levels and leads firms to underinvest in R&D. To illustrate our point, we graphically represent the static inefficiency linked to the imperfect appropriation of welfare (Figure 1) and illustrate the consequences in terms of dynamic inefficiency. The graph on Figure 1 represents the social welfare generated by the supply of a new differentiated good (an innovation). Let $D(P)$ be the demand function for the new good, $P^{MC}$ be the price defined by the monopoly firm and $P^{PC}$ be the marginal cost of production of the good (i.e., the market price in a competitive market). $Q^{MC}$ is the production of the monopoly firm while $Q^{PC}$ represents the production of the firm in pure and perfect competition.

![Figure 1: The surplus appropriability problems]

At the decentralized equilibrium, the static welfare generated by the commercialization of a new differentiated good is represented by areas $A$ and $B$. Area $A$ measures the consumer surplus, i.e., the increase in welfare obtained by consumers whose reserve prices are higher than the selling price of the good. Area $B$ represents the firm profits, i.e., the difference between its total revenues and production costs. As we can see on the graph, the firm’s monopolistic behavior induces a static inefficiency, measured by area $C$. By fixing the selling price above the marginal cost, the monopolistic firm restricts demand and consequently production compared to a situation in which the goods would be sold at their marginal cost (this is the famous deadweight loss effect).
In terms of dynamic inefficiency, the incentives to carry on R&D activities depend on the profitability of innovation, which is measured by the flow of profits obtained by firms in the intermediate sector following the market launch of a new product variety. The profit obtained at each period is represented by area $B$, whereas the potential increase in social welfare due to the launch of the new product is represented by area $ABC$. Thus, dynamic inefficiency does not only integrate static inefficiency (area $C$) but also takes into account the deficit in consumer surplus appropriation due to monopolistic behavior (area $A$). This deficit in the appropriation of the potential increase in welfare created by innovation is the source of the difference between the private and social returns to R&D. Consequently, this surplus appropriability problem constitutes a market failure that leads firms to underinvest in R&D compared to the optimal level.

Various public policies are likely to correct this type of failure. Using a variant of the model of Jones (1995b), Sorensen (2006) shows that the surplus appropriability failure caused by static and dynamic inefficiencies can be corrected by either a single instrument or by a mix of two instruments. The instrument capable of simultaneously correcting the static and dynamic inefficiencies consists of proposing a subsidy that partly covers the purchasing costs of differentiated goods. Such a subsidy would allow for increases in the demand for differentiated goods and the profits of the innovative firms, thereby augmenting the profitability of innovation and generating stronger incentives for firms to engage in R&D activities. Hence, such a subsidy allows for the correction of static (by increasing demand for differentiated goods) and dynamic (by increasing incentives to invest in R&D) inefficiencies. Sorensen (2006) also shows that this type of market failure can be corrected by a mix of two instruments. The first is a subsidy proportional to the production of differentiated goods and the second is a subsidy proportional to the cost of R&D. Subsidizing the production of differentiated goods encourages firms in the intermediate sector to increase their production and thereby allows for the correction of static inefficiency (leading to the production of too few differentiated goods). However, such a subsidy does not contribute to increasing firm profits compared to the monopolistic situation because, although it encourages firms to produce more, it also causes them to reduce their prices to the marginal cost level. Hence, the profit obtained by firms is identical to the decentralized equilibrium profit. Using this instrument alone cannot incentivize firms to increase their investments in R&D; this is why it is necessary to combine this subsidy with another policy instrument capable of correcting dynamic inefficiency. A subsidy for R&D, which reduces R&D costs, can encourage more firms to engage in such activities. As a consequence, the global R&D investment level would be augmented and the dynamic inefficiency linked to the surplus appropriability problem would be corrected.

2.3 Duplication of R&D activities: The "stepping on toes" effect

Whereas the two types of market failure presented above lead firms to underinvest in R&D, other failures can have the opposite effect. Within an industrial sector, firms may engage in innovation races with the hope of being the first to file a patent for a new product or process.
R&D programs may be set up concomitantly, which creates an important risk of duplication. From the perspective of social returns to R&D, such duplications constitute inefficiency. Indeed, when they make their investment decisions, firms do not account for the fact that part of their R&D activities will also be carried out by other firms. Thus, duplication externalities lead firms to overinvest in R&D compared to the socially optimal level. The existence of duplication is often used to support the hypothesis of decreasing returns to R&D: Doubling the resources engaged in R&D activities will not double innovation. In equation \( (6) \), \( \lambda \in [0, 1] \) represents the degree of duplication externalities, i.e., the lower \( \lambda \), the higher the duplication of R&D activities is.

To correct this failure, the theoretical literature proposes the same types of instruments as those used to correct the knowledge externalities failure. As shown by Steger (2005), a tax (or negative subsidy) based on the costs of R&D or the production of new knowledge can correct the duplication problem. Indeed, regardless of whether duplications are caused by intentional behavior due to innovation races or accidental processes, taxes will increase the cost of R&D for firms and thereby limit global R&D investment. In addition, it should be noted that the microeconomic literature often proposes R&D cooperation as a way to reduce or even eliminate duplication problems (Dahlia et al. 2004). It is also specified that the most integrative forms of cooperation are generally the most efficient in eliminating duplication problems. In particular, the creation of Research Joint Ventures (RJV), in which firms cooperate all along the innovation production process (from R&D activities to production decisions), would provide the required incentives to correct this failure.

2.4 The rent transfer problem: The "business stealing" effect

The transfer of rents from past to new innovators constitutes another failure that leads firms to overinvest in R&D. The most radical case can be found in quality-based growth models such as that of Aghion and Howitt (1992). Indeed, in this conception of growth dynamics, innovation renders existing products and technologies obsolete such that each new wave of innovation leads to the total transfer of rents from past to new innovators. In variety-based models, the transfer of rent is less radical. The launch of a new product variety by a firm reduces the demand for all the other firms producing differentiated goods and consequently reduces their profits, but it does not completely annihilate them.

The market failure caused by this rent transfer results in the tendency for firms to over-invest in R&D because they do not account for the negative effect of the commercialization of their innovation on the profitability of incumbent firms. Thus, at a decentralized equilibrium, the incentive to invest in R&D is too high and the pace of innovation is too rapid. The primary authors of the new growth theories (Grossman and Helpman 1991, Aghion and Howitt 1992) clearly associate this rent transfer with the famous creative destruction phenomenon described by Schumpeter. Following Grossman and Helpman (1991, chp.3,p.82-83), we should note that the use of a CES production function within variety-based growth models implies complete compensation between the marginal effect of an innovation on the
consumer surplus (Area $A$ on Figure 1) and its effects on the reduction of incumbent firm profitability. Such a rent transfer will thereby limit the tendency to underinvest in R&D due to surplus appropriability problems. More precisely, this means that within variety-based growth models, the dynamic inefficiency caused by surplus appropriability problems is only linked to its static inefficiency (Area $C$), i.e., its monopolistic behavior. In contrast, this compensation is not automatic within the framework of quality-based growth models (Grossman and Helpman, 1991, chp.4, p.110-111). Indeed, because the rent transfer is total (and therefore more important), there is no automatic compensation between the welfare gains of consumers and the lost profits of incumbent firms.

As noted by Steger (2005), the instruments capable of correcting this failure are the same as those used to correct duplication problems, namely the implementation of a tax proportional to the cost of R&D or the selling price of knowledge. Such taxes will allow for reductions in returns to innovation and consequently the investment in R&D. The economy will grow at a lower rate and innovators will benefit from higher monopolistic rents over time.

2.5 Location externalities: Both sides of proximity effects

New Economic Geography and Growth models, which synthesize economic geography models with variety-based growth models, offer an interesting framework to account for interactions between the geography of economic activities and growth dynamics. Within these models, a new potential market failure appears to be linked to the economic geography. This market failure is the result of externalities generated by the chosen locations of firms (and consequently the locations of knowledge), which influence incentives to engage in R&D activities. Indeed, the assumption of (partially) localized knowledge spillovers implies that the marginal cost of knowledge production decreases with the spatial concentration of economic activities. Thus, in these models, the economic geography directly influences incentives to engage in R&D by changing the costs of such activities. In models with a NEG framework, the location choices of firms are only based on comparisons of the profits that they can obtain in each potential location. Consequently, firms do not consider the potential welfare effects of their choices. More precisely, in these models, the location choices of firms generate two main externalities that influence the level of investment in R&D in the economy.

The first externality generated by the location decisions of firms refers to the impact of the economic geography on (1) the value of assets and (2) the CES price indices of differentiated goods. Due to perfect competition in the R&D sector, the value of knowledge is given by its marginal cost of production. As in those models, the higher the spatial concentration, the lower the marginal production cost of knowledge is (due to higher spillovers), the nominal income of the owner of knowledge therefore decreases with the level of spatial concentration. Consequently, the economic geography that maximizes the nominal wealth of the knowledge owner is a dispersed equilibrium. Similarly, the location choices
of firms also influence the proportion of transaction costs supported by each location. The NEGG literature (Martin and Ottaviano 1999, Montmartin 2013a) shows that the economic geography that minimizes global transaction costs is again a dispersed economic geography. Consequently, from the perspective of this externality (which includes two effects), when the economic geography is not perfectly dispersed (which is always the case when \( A_i(0) \neq A_j(0) \)), then the equilibrium location is not optimal because there is too much concentration. As a higher concentration implies a lower marginal cost of R&D, it follows that this externality leads agents to overinvest in R&D because they benefit from R&D costs that are lower than the optimal level.

The second externality generated by the location decisions of firms refers to the impact of the economic geography on the growth rate. As seen in (11), a higher concentration of economic activities reduces the cost of R&D, thereby increasing incentives to invest in R&D as well as aggregate growth. Thus, the aggregate growth rate is maximized when the cost of R&D is the lowest, that is, when activities are entirely concentrated in one location. From the perspective of this externality, when the economic geography is not completely concentrated in one country, the equilibrium location is not optimal because there is too much dispersion. As a higher dispersion of firms implies a higher R&D cost, it follows that this externality leads agents to underinvest in R&D because they suffer from R&D costs that are higher than the optimal level.

To summarize, the location choices of firms generate two main externalities that provide private firms with opposing incentives to invest in R&D. Consequently, the market failure generated by the location choices of firms seems to be ambiguous. Given the complexity of such models, we cannot analytically determine the optimal economic geography and know whether location externalities lead the market to over- or under-invest in R&D. We can, however, distinguish between two scenarios. If the concentration of firms in the market outcome is higher than the concentration in the optimal outcome, then externalities related to location choices generate a market failure that leads to overinvestment in R&D. In contrast, if the concentration of firms in the market outcome is lower than the concentration in the optimal outcome, then externalities related to location choices generate a market failure that leads to underinvestment in R&D.

The literature shows that the main instruments that are able to correct this market failure are location subsidies or taxes. Indeed, such instruments influence the relative profitability of each location for private firms. Consequently, firms will respond to these incentives, which modify the relative attractiveness of each potential location. Obviously, the appropriate policy depends on the sign of the gap between the concentrations of firms in the market and optimal outcomes. If this gap is positive (the market concentration is higher than the optimal concentration) then the appropriate policy will be to tax the core location, which hosts the majority of firms, or subsidize the peripheral location, which hosts fewer firms. The opposite policy should be implemented if the gap between the concentration of firms in the market and optimal outcomes is negative.
3 Too little or too much private R&D: How can we measure the gap between the social and private returns to R&D

In the previous section, we showed that different types of market failures may create a gap between the amount of R&D investment resulting from the decentralized equilibrium and its optimal level; some failures lead firms to underinvest in R&D whereas others lead them to overinvest. Theoretically, models generally fail to determine the overall result in terms of under- or over-investment. Answers have also been sought empirically. Indeed, different methods have been implemented to employ data to measure the real gap between the private and social returns to R&D and thereby infer any insufficiencies or excesses in private investment in R&D. This section is dedicated to presenting these methodologies and the obtained results to discuss the reality (and, if demonstrated, the magnitude) of the gap between the social and private returns to R&D. A summary of the present section can be found in Table 6 at the end of the paper.

3.1 The limitations of econometric estimates

Using a growth-accounting approach, the productivity literature proposes an econometrical measure of the impact of R&D activities on growth. This approach essentially connects the growth of total factor productivity (TFP) to R&D. R&D investment is treated similarly to other capital investments within a classical production function. According to the following specification, the social return to R&D is defined by the partial derivative of production with respect to the R&D stock:

\[ \Delta \log A_t = \delta + \tilde{r}_{PL} \frac{R_t}{Y_t} + u_t \]  

(12)

where \( A \) represents the TFP, \( R \) measures the level of resources devoted to R&D and \( Y \) is the GDP. Parameters \( \delta \) and \( u \) represent the constant and the error term of the model, respectively. In this specification, we regress the TFP growth on the R&D share of output so that \( \tilde{r}_{PL} \) measures the contribution of the R&D investment to the TFP growth, that is, the rate of return to R&D.

In this literature, private return to R&D are usually estimated empirically using the share of total turnover devoted to R&D at the firm level, whereas the measurement of the social return uses the intensity of R&D expenditures at the sectoral level to identify knowledge externalities between firms. This measure of the social return to R&D expanded rapidly and was greatly developed by Scherer (1982) and Griliches and Lichtenberg (1984), among others. Beyond the sectoral social return to R&D (i.e., private return plus intrasectoral knowledge externalities), the objective is to estimate the "imported" return (which refers to the impact of R&D activities carried out in other sectors on the productivity of the sector under consideration). The measurement of this "second component" of the social
return to R&D requires the inclusion of a new variable within the production function: a measure of the R&D expenditures of other sectors. Weighting the role of each sector is generally performed using technological flow matrices among industries based on patent data or input-output exchanges.

According to this methodology, estimations generate two main results. On the one hand, the social return to R&D appears to be much higher than the private return, which would lead firms to significantly underinvest in R&D. On the other hand, knowledge externalities play a prominent role in this gap (see Griliches (1992) and Jones and Williams (1998) for a review). Therefore, Griliches concluded his survey of this literature (Griliches, 1992, p.43) as follows: "[...] there has been a significant number of reasonably well done studies all pointing in the same direction: R&D spillovers are present, their magnitude may be quite large, and social rates of return remain significantly above private rates."

As also stated by Griliches (1992, p.44), however, the estimations provided in this field may overestimate the impact of knowledge externalities due to important measurement problems. These are partly related to the fuzziness of the very notion of knowledge externalities, whose definitions and perimeters vary from one author to another. According to Griliches (1992, p.36), for instance, pecuniary externalities relative to the use of innovative inputs coming from other industries should not be regarded as knowledge externalities for firms, although they may generate important increases in productivity. Because they result from the difficulty of correctly evaluating the real value of purchased innovative inputs and are mediated through prices, they are not directly linked to the free use of new knowledge produced by external R&D activities. Consequently, they should be clearly distinguished from knowledge externalities. Such a distinction between knowledge externalities and other pecuniary externalities of innovation is, however, difficult to implement empirically. Therefore, estimations made in the productivity literature are likely to recognize pecuniary externalities of innovation as knowledge externalities, which may lead to an upward bias in explaining the gap between the private and social returns to R&D through knowledge externalities.

In addition, these measurement issues are also aggravated by the omission of numerous possible distortions associated with R&D in empirical studies. Jones and Williams (1998, p.1120) note, therefore, that, "In fact, theory provides some reason to question findings of the empirical productivity literature. The results of this literature are nearly based on a neoclassical theory of growth [...] that ignores many of the distortions associated with research that are formalized by new growth theory [...]. Because these considerations are omitted in the empirical literature, we may in fact have very little information about the true social rate of return to R&D."

The lack of modeling distortions such as those caused by appropriability problems, duplication or rent transfers within empirical studies, may have two types of consequences. First, it leads to the inclusion of phenomena that cause different types of distortions under the single umbrella term of "knowledge externalities", subsequently confounding the
implications relevant for public policies. Indeed, it should be noted that when comparing the difference between the returns to R&D at the individual and macro-economic levels, the econometric literature on productivity effectively measures the global effect not only of knowledge externalities but also of rent externality problems. However, it does not make it possible to distinguish between these different effects. Second, although the employed econometric specifications have steadily improved to better reveal the diversity of the channels through which knowledge externalities are transmitted, they still largely neglect the other sources of market failures formalized by endogenous growth models (particularly those that lead firms to overinvest in R&D).

Recent reviews of the latest econometric studies that measure returns to R&D by Sena (2004) and Hall et al. (2010) present detailed examinations of the empirical studies that trace spillovers via connections between firms, industries, and countries. Also notable is the important strand of empirical literature relying on the theoretical intersection between the New Economic Geography and Economics of Innovation that proliferated during the 90s and 2000s and whose ambition was to measure the geographical dimension of knowledge externalities and estimate their impact on agglomeration forces and social return to R&D (for a review, see Rosenthal and Strange (2004) and Autant-Bernard et al. (2011, 2013)). However, although Hall et al. (2010) and Eberhart et al. (2013) note the enormous progress that has been made in econometric techniques to address the estimation problems revealed by the first round of productivity estimates, they also show that much remains to be done to robustly estimate the private and social returns to R&D and the difference between them\(^\text{11}\). Moreover, the rather clear conclusion that still emerges from this empirical literature, that private return to R&D is higher than to ordinary capital and that social return is even higher than private return, remains exclusively based on R&D spillover issues and continues to ignore other sources of differences between the private and social returns to R&D activities revealed by the theoretical literature.

As a result, we find the conclusion of Jones and Williams (1998) that the econometric literature on productivity fails to satisfactorily estimate the social return to R&D and contributes to the overestimation of the specific role of knowledge externalities to remain largely valid. However, considering the great variability in the obtained results, depending on the sectors or countries considered and the various possible biases revealed by the methodological reviews, it is unclear whether this leads to an upward or downward bias in measuring the gap between private and social returns to R&D. Given these limitations, many authors call for the reinforcement of the conceptual framework on which the empirical estimations are based. Hence, the approach proposed by Jones and Williams (1998) is worth presenting. Using a semi-endogenous growth model such as that of Jones (1995b), which allows for the diverse failures of a decentralized economy to be accounted for, it points the way towards more theoretically based measurement strategies.
3.2 The advantage of theory-based measurement methods: Taking the diverse sources of market failures into account

Jones and Williams (1998) chose to theoretically define the social return to R&D as the total gain in consumption at time $t+1$ resulting from the reallocation of one unit of consumption towards R&D activities at period $t$, assuming that the knowledge stock remains unchanged at $t+2$. When applied to a variety-based, semi-endogenous growth model, this definition allows first, for the distinct formalization of the different possible forms of market failures; second, for the analytical derivation of the relationship between the theory-based measure of the social return to R&D and the existing econometric estimates of this return; and third, the analytical provision of a measure of the gap between the actual and optimal levels of investment in R&D.

The production possibilities of the economy are rather similar to that of Jones’ model (1995). The most important difference concerns the innovation production function because Jones and Williams add another potential externality related to R&D activities:

$$ (1 + \psi)A_t = \delta(aL_t)^{\lambda}A_t^\epsilon $$

where all parameters and variables have the same significance as in (6). Remember that $\lambda$ and $\epsilon$ refer to duplication and knowledge externalities, respectively. The new parameter $\psi > 0$ was introduced by Jones and Williams to better take the creative destruction process into account in variety-growth models. Indeed, even though growth models based on variety already include a rent transfer process from former towards new inventors, this transfer is less important and radical than in quality-based models. This parameter basically refers to the concept of innovation clusters. Innovations generally do not occur in isolation, which means that firms have to adopt all the interrelated innovations contained in a cluster to benefit from innovation. In the model, the introduction of $\psi$ implies that some new intermediate goods represent only an upgrade in existing goods and are not real innovations. Consequently, from the social point of view, only $1/(1 + \psi)$ new goods actually increase welfare. In contrast, from the innovator’s point of view, all new goods provide monopolistic rents (regardless of whether they are really new or not) so the introduction of $\psi$ will generate a new market failure that leads firms to overinvest in R&D.

Because the literature on productivity does not include all the market failures formalized in their model, Jones and Williams cannot directly link the social returns to R&D, as estimated within this literature, to the parameters of their model. They show, however, that it is possible to linearly approximate this relationship as follows:

$$ \tilde{r}_{JW} = \tilde{r}_{PL} + (1 - \lambda)gY $$

where $\tilde{r}_{JW}$ represents the social return to R&D measured by the model of Jones and Williams (1998), $\tilde{r}_{PL}$ is the social return to R&D provided by the productivity literature and $(1 - \lambda)gY$ represents all effects that empirical literature does not take into account. Note that $(1 - \lambda)gY$ is strictly positive because $\lambda \in [0,1]$ and $gY > 0$ at the equilibrium.
Such a theoretical interpretation of the econometric estimations of the social return to R&D leads Jones and Williams to a rather surprising conclusion. While the model introduces new sources of market failure that lead to overinvestment, the results still show that the literature on productivity underestimates the social return to R&D (with a maximum bias equal to the production growth rate when there is no duplication in the R&D sector). Thus, the econometric estimations provided by the literature on productivity would correspond to the lower bounds of the true social return to R&D. The explanation given for this is as follows: econometric studies ignore two dynamic factors that determine the social return to R&D, namely intertemporal knowledge externalities and the gains (or losses) in capital caused by the time-dependency of the value of knowledge.

The framework constructed by Jones and Williams also allows them to define the functional relationship between the global level of R&D investment and its social return and then to derive an analytical measure of the gap between equilibrium ($I$) and optimal investment ($I^*$):

$$\frac{I^*}{I} = \frac{\tilde{r}_{PL}}{\tilde{r}_p - (1 - \lambda)g_Y}$$

where $\tilde{r}_{PL}$ is the social return to R&D provided by the productivity literature and $\tilde{r}_p$ is the private return to R&D. To evaluate the magnitude of private underinvestment in R&D, Jones and Williams (1998, p.1129), rely, on the one hand, on the existing econometric estimation of the social return to R&D, which ranges from 30% on average to 100% when including impact transiting from other industries, and, on the other hand, an estimation of the private return to R&D that ranges from 7% to 14%, in accordance with the average real stock market return. This conservative estimate indicates that optimal investment in research is more than two to four times actual investment.

With this methodology, Jones and Williams are able to estimate the gap between private and social returns to R&D that clearly takes the diverse market failures contained in R&D-based growth models into account. However, although it accounts for the diversity of R&D-based market failures and produces a clear answer regarding the degree of private underinvestment in R&D, such a structural approach still relies on econometric estimations of returns to R&D. Hence, it is not free of the measurement errors found in this literature. As stated by Hall et al. (2010, p.1135), "there is no reason to expect estimates of the ex post returns to be particularly stable over time or across sectors or countries". Consequently, if these estimates can still be useful for making comparisons among various sectors or countries and can guide R&D-related policy-making, it is necessary "to keep in mind that the measurement process is not a search for a scientific constant." (Hall et al., 2010, p.1136). Moreover, the method proposes a global estimation and does not tell us anything about the relative impact of each market failure when this has important policy implications. Public policies must not only be justified, they must be adequately designed to provoke the expected effects and the greatest degree of responsiveness on the part of firms.
3.3 Calibrating theoretical models to measure the relative impact of different market failures

Returning to the theory to better distinguish among the different sources of market failures appears to be necessary. According to Temple (2003), however, it would be illusory to try to directly confront the predictions of theoretical endogenous growth models against data from that perspective. Focusing on the search for a balanced growth path, these models demand restrictive assumptions and "It is not clear that we should expect models with this property to be the best approximation to the data [...]" Temple (2003, p.507). In contrast, if, as suggested in section 2, we consider these models to be useful devices for the analysis of welfare effects, one interesting approach would be to calibrate theoretical models. "[...] it will be virtually impossible to test the long-run predictions of growth models against the data. [...] Given this difficulty, one approach would be to calibrate a variety of models, under a range of assumptions. In the unlikely event that knife-edge restrictions are met in the real world, and hence long-run growth is endogenous, a suitably parameterized semi-endogenous model could still provide a reasonably good approximation to actual welfare effects." (Temple, 2003, p.503).

The sensitivity analysis method developed by Stokey (1995) is still a reference for calibration exercises on theoretical growth models. The general idea of Stockey’s method is to calibrate the most known parameters of the model with data from previous studies and historical data (such as the GDP growth rate) and then analyze the sensitivity of the results depending on a large range of values for the most unknown parameters which often correspond to the key parameters of interest in the models (level of duplications, knowledge externalities, markups, etc.). Thus, this method addresses the problem of great uncertainty about the true magnitude of the various external effects present in such models. In this pioneering work, Stockey (1995) investigates the gap between market and optimal R&D investment by calibrating (for the US) a generalized\textsuperscript{13} first-generation variety growth model such as that of Grossman and Helpman (1991, chap.4). Thus, Stockey’s model includes the first four market failures presented in section 2. Even if the author does not provide a specific measurement for the impact of each market failure, this paper provides some interesting results for our purposes. Stockey (1995) shows that when the innovation technology is linear with the R&D stock, it is unlikely that the equilibrium level of R&D will exceed the optimal level. This result means that the "business-stealing" effect described in section 2 seems unlikely to lead to excessive innovation by itself. On the contrary, it seems that a curvature in the R&D technology (which corresponds to the values of $\epsilon$ and $\lambda$ in (13)) has the most systematic and strongest influencing on whether the equilibrium displays too much or too little R&D relative to the optimal level. The level of substitutability between goods and hence the market power of firms can also strongly influence the gap. More generally, the results provided by Stockey (1995) tend to show (1) a greater number of cases in which the market exhibits too little R&D rather than too much and (2) a higher potential magnitude for underinvestment compared to that for overinvestment.

Following Stokey’s (1995) seminal work, Jones and Williams (2000) investigate the
same question while focusing on measuring the impact of each specific market failure. The model developed in this paper is very similar to that of Jones (1995), i.e., a one-sector semi-endogenous growth model exhibiting decreasing returns to R&D. The model again incorporates the first four market failures presented in section 2 and is calibrated according to micro- and macro-econometric data. With realistic parameter values, the R&D investment of firms resulting from the decentralized equilibrium is 50% to 200% lower than the socially desirable level when duplication is limited (less than 75%). Indeed, when duplicated R&D activities and interest rates are too high, the simulations show that a decentralized economy can exhibit overinvestment. To measure the contribution of each market failure, the authors simulate the level of R&D investment when alternatively internalizing each source of market failure (assuming that the three others are still effective). When considering that the share of duplicated R&D activities ranges from 0% to 75%, the simulations generate 4 main results:

- the internalization of knowledge externalities would increase the R&D investments of firms by 16 to 36%;
- the internalization of the surplus appropriability problems would increase the R&D investments of firms by 140% (regardless of the degree of duplication);
- the internalization of failures due to the creative destruction process (rent transfer and innovation clusters) would lead to a 24% reduction in the R&D investments of firms (regardless of the degree of duplication);
- the internalization of duplication failures would have a "one-for-one" impact, i.e., when 25% of R&D activities are duplicated, the internalization of the corresponding failure would reduce the R&D investment of firms by the same proportion.

These simulations show that the impact of the surplus appropriability failure is generally prominent. More precisely, they clearly designate this failure as the main explanation for the pronounced underinvestment of firms in R&D. Indeed, once it is internalized, the model cannot conclude that there are situations of underinvestment and becomes highly sensitive to the chosen parameter values. This result seems to significantly contradict those usually presented by the literature on productivity, which places knowledge externalities at the heart of the explanation of the gap between the private and social returns to R&D. This difference, however, is more a matter of language than fact. As underlined by Griliches (1992, p.36), the literature on productivity recognizes pecuniary externalities of innovation as knowledge externalities. Now, as explained above, these externalities cannot be theoretically assimilated with knowledge externalities. They result from the imperfect market valuations of innovative inputs and not from the free unintentional diffusion of the knowledge necessary to produce them. Similarly, the proximity between the notion of pecuniary externalities and the surplus appropriability problems described in section 2.2 can easily be noted. Indeed, whereas the latter refer to informational and pricing constraints, which prevent innovative firms from capturing the entire increases in welfare generated by the market launch of their innovations, the former, describing the imperfect market valuation of innovative products and services, clearly reveals that part of the surplus generated by innovation benefits users and not innovators. Consequently, by at least partially integrating pecuniary
externalities of innovation within the measure of knowledge externalities, the productivity literature undeniably confounds the impact of the two different sources of market failure, knowledge externalities and surplus appropriability, under the same measure. Therefore, when the econometric studies on productivity state that knowledge externalities are the main explanation for the difference between the private and social returns to R&D, this is much more indicative of an incorrect interpretation than a real contrast with the results of Jones and Williams (2000). This capacity of the employed methodology to distinguish between the two types of failure is what authorizes Jones and Williams to attribute the main part of the gap between private and social returns to R&D to surplus appropriability problems.

Concerning the importance of location externalities, the theoretical literature does not provide much insight. Indeed, the complexity of this class of models does not allow for the analytical determination of (1) the optimal location and, hence, (2) the social planner solution. Nevertheless, the welfare analysis carried out by Montmartin (2013), in which a NEGG model was calibrated, raises some interesting elements. Due to linear R&D technology, the simulations show that in most of cases, an increase in the market level of R&D investment increases welfare, indicating the existence of underinvestment in R&D. Nevertheless, the key result of the paper is to show that when knowledge externalities are strongly geographically localized (i.e., when the economic geography is more important for growth), an R&D subsidy policy generates opposite effects on the welfare of each location. This suggests that location externalities may have a strong influence on the deviation between the market and optimal economic geography.

Overall, although the different strands of the literature emphasize the existence and magnitude of a positive gap between the social and private returns to R&D, they do not attribute the causes of this to the same factors (knowledge externalities for some and surplus appropriability for others). This difference is especially important for public action because these two types of market failure require different instruments to be corrected (see section 2.2 and 2.3). Hence, the capacity to better account for the inherent characteristics of R&D activities explains the attractiveness of the theory-based simulation method developed by Stockey (1995) for subsequent contributions to research in this field.

3.4 Toward the idea of a smaller gap between free market and optimal R&D: Recent contributions and refinements

In general, the main results provided by the economics literature until the early 2000s are conclusive regarding the existence of a significant gap between actual investment in R&D and the optimal level of investment in R&D\textsuperscript{14}. More recent contributions to this debate based on calibration methods, however, identify new elements that tend to call this central result into question.

Comin (2004) proposes a new method for measuring the contribution of R&D investment to TFP growth. Based on the free entry condition in the R&D sector that is commonly
used in growth models, this method offers the main advantage of not imposing a specific form on the dynamics of knowledge creation. The author uses data on R&D expenditure in the US to calibrate the parameters of his model and obtains results that are markedly different from those proposed both by Jones and Williams (2000) and econometrical studies on productivity. Indeed, the contribution of R&D to productivity growth appears to be rather weak because it would only explain approximately 10% of average annual TFP growth. For the author, two factors could explain this weak contribution. The first factor concerns the low observed intensity of R&D expenditures (approximately 2% of US GDP) in the long run, which would imply weak intertemporal knowledge externalities. The reasoning underlying this explanation is that if knowledge externalities were strong, a weak intensity of R&D expenditures at time \( t \) would generate a high growth rate and would substantially reduce the innovation costs of production at time \( t + 1 \). Economic agents would be encouraged to increase their investments in R&D at \( t + 1 \), which would be inconsistent with the observed stability of the intensity of R&D expenditures. The second factor concerns the low intensity of R&D expenditures that leads to a limited knowledge growth rate and that thus reduces the potential impact of R&D on productivity growth (compared to other sources of productivity growth, such as human capital). It should also be noted that the chosen model for innovation embodied in new intermediate goods limits the size of externalities and thereby bounds the R&D contribution to productivity.

To propose a measure of the gap between the equilibrium and socially optimal levels of investment in R&D, the author specifies an R&D production function to obtain an analytical expression of the optimal level. The calibration of this function according to US data shows that the optimal and observed investment levels are very similar. This result appears to be robust to significant variations in the parameters used. Therefore, according to Comin (2004), firms sufficiently invest in R&D activities because the global amount of private investment is close to the optimal level. As specified by the author, this result, which markedly differs from the existing literature, is linked to the chosen measure of the social returns to R&D (based on the free entry condition and not derived from a production function). The approaches developed by Alvarez-Pelaez and Groth (2005), Reis and Sequiera (2007) and Strulik (2007) also raise elements which question the magnitude of the underinvestment in private R&D presented by Jones and Williams (2000).

Alvarez-Pelaez and Groth (2005) proceed from the recognition that, in variety-based growth models, firm market power, the share of differentiated goods within final production and the return to specialization are rigidly and arbitrary linked. Their objective is to investigate private underinvestment in R&D by developing a semi-endogenous growth model that does not directly link these elements. They first show that relaxing these restrictive relationships between parameters allows for more potential situations of overinvestment than that suggested by the variety-based models, such as that of Jones and Williams (2000). The intuition behind this result is straightforward: Assume that there is a positive link between return to specialization (innovation) and market power. This implies that a positive return to specialization generates an incentive to underinvest in R&D (due to the increase of surplus appropriability problems - see 2.2). If we disentangle these two key
parameters, we automatically reduce potential endogenous sources of underinvestment in R&D. After having discussed this result, they apply the empirically estimated US values for markup, the share of capital within GDP, and return to R&D to their model and demonstrate that although the existence of private underinvestment in R&D is a realistic hypothesis for the US, its magnitude is far lower than that suggested by previous studies.

Similarly, Reis and Sequeira (2007) develop a synthesis model à la Arnold (1988) that incorporates both an endogenous growth process à la Romer (1990), and a human capital accumulation process, à la Lucas (1988). In addition to relaxing the relationship between market power and return to specialization, they include negative externalities for human capital accumulation. In doing so, the authors intend to account for the "erosion effect" described by Galor and Moav (2002, p. 1148): "the time required for learning the new technology diminishes with the level of education and increases with the rate of technological change". This effect was also empirically confirmed by Kumar (2003) and Tamura (2006). According to this model, a decentralized economy is marked by three failures. The first two, which relate to knowledge externalities and firm market power (the surplus appropriability problems), lead private agents to underinvest in R&D, whereas the introduction of the "erosion effect" creates a new failure that encourages firms to overinvest in R&D. Indeed, at the individual level, researchers do not account for the negative impact of their activities on human capital accumulation, which can be considered as an effect of creative destruction. Because the emergence of a gap between equilibrium and optimal investment in R&D depends on the relative strength of these three effects, the authors calibrate their model by using the results of empirical studies. As a result, we can define a threshold value for the "erosion" parameter, from which the economy overinvests in R&D compared to the level that would be socially optimal. Comparing this value to that provided by the estimations of Kumar (2003) shows that situations of overinvestment are as plausible as situations of underinvestment. When the returns to specialization are very high, however, a decentralized economy clearly underinvests in R&D.

By developing an augmented two-R&D-sector model, à la Young (1998), with human capital accumulation, Strulik (2007) proposes an even more radical reassessment of the deviation of market R&D investment from the socially optimal level. Indeed, the existence of two interdependent R&D sectors that generate different degrees of externalities will moderate the influence of market failures on the equilibrium R&D investment level due to substitution effects between R&D sectors. Assume, for instance, that an increase in externalities is generated by the variety R&D sector. In this case, a social planner would allocate more resources to this R&D sector than the market would but could simultaneously allocate fewer resources to the quality R&D sector, implying a potentially small impact on the overall R&D investment. However, the presence of human capital accumulation in the model also mitigates the influence of market failures on the market level of R&D investment. Indeed, channels through which population growth negatively affects growth and reduces the role of R&D externalities can appear because growth in per-capita income is no longer driven solely by TFP but is also driven by growth in labor quality. The numerical experiments conducted by Strulik (2007) with US data show that the market share of employment in
R&D is much closer to the socially optimal level than that suggested by earlier numerical studies (especially that of Jones and Williams, 2000). More precisely, the ratio between optimal and market R&D is estimated to be between 0.91 and 1.03, suggesting that the potential deviations of the overall market R&D investment level from its optimal level are very small. In contrast, Strulik’s results highlight large sectoral misallocations of factors between R&D sectors. As noted by Strulik (2007, p.384), "the analysis has also shown that small deviation of the economy-wide R&D effort from the social optimum is compatible with relatively large sectoral deviations. Hence, the conclusion that laissez-faire provides approximately the optimal resource allocation does not necessarily follow. Due to specific sectoral externalities, a social planner might allocate researchers to sectors quite differently than the market, even though he chooses almost the same overall employment in research".

The works that we have presented in this section, while never excluding the possibility that a decentralized economy could lead to underinvestment in R&D, strongly challenge the previous consensus regarding the presence of an important gap between private and social returns to R&D. Based on various refinements in the modeling of R&D within endogenous growth, these new developments highlight new sources of market failures (particularly in relation to human capital accumulation) and allow for a better understanding of this complex problem related to the allocation of resources to R&D in a way that does not merely answer the question of whether there is too much or too little R&D with "yes" or "no". These refinements clearly reveal the emergence of a gap between equilibrium and optimal investment that results from the relative strength of the effects of different (opposite) market failures and show how specific contexts determine the relative influence of these effects. Perhaps the main message of this work for public policies related to R&D could be the following: It increasingly appears that the main challenge that policy makers are now facing concerning R&D policies is not to increase the global amount of incentives for R&D but rather to try to efficiently allocate various instruments and funds across industries, regions and types of research.

**Conclusion**

Many policy makers and economists who study R&D have long believed that market failures create a gap between the social and private returns to R&D, thereby limiting private incentives to invest in R&D. Thus, government intervention would be necessary to correct such failures and improve social welfare. Based on these arguments, many governments have implemented policies aimed at stimulating private sector R&D investment since the 80s.

However, this common belief in the widespread and significant underinvestment in R&D by firms compared to the socially optimal level of investment is increasingly being challenged. In particular, political, theoretical and empirical considerations have emerged that raise new questions regarding the rationale behind and efficacy of public policies designed
to stimulate private R&D investment. The main questions are whether the market failures that cause insufficient private R&D investment really exist and whether massive, global public policy support for private investment in R&D is always justified.

In this paper, we have sought to clarify the answers to these questions provided, on the one hand, in the theoretical literature on endogenous growth theory and its integration with economic geography, and, on the other hand, in the empirical literature seeking to measure the social return to R&D in relation to its private return. In general, whereas the existing literature often considers only one type of market failure or confounds different types, creating imprecise analyses, we have clearly distinguished among different types of market failures and described their differing effects (positive or negative) on the gap between private and social returns to R&D. This has enabled us to clarify their differing policy implications.

Two main conclusions with non-negligible policy implications arise from this analysis:

1. Contrary to widespread belief, recent developments in both the theoretical and empirical literature on R&D-based endogenous growth do not support the existence of systematic underinvestment in R&D by firms. Indeed, when we account for the separate effects of different sources of market failures and estimate their relative importance, we find that circumstances in which there is insufficient private investment in R&D are less numerous and of less importance than previously thought (due to the non-negligible role of certain types of market failures, such as duplication, creative destruction or location externalities, which cause overinvestment in R&D).

In terms of public policy, these results lead to the following question: is massive global public support for private investment in R&D justified? Indeed, it appears that public financial support for private R&D should not be automatically and systematically implemented. Careful analysis of the factors that influence private investment in R&D should be undertaken to better target public interventions and implement them only when and where the existence of an underinvestment problem is confirmed, i.e., when market failure is more strongly associated with underinvestment than with overinvestment in R&D. In particular, there is a need for a new policy mix that does not merely increase incentives to invest in R&D but rather concentrates on searching for the most efficient allocation of funds across industries, regions and types of research.

2. Even when situations of underinvestment are identified, new measures of the social return to R&D, attained through the calibration of theoretical models, provide new evidence regarding the relative importance of different types of market failures. In particular, contrary to econometric analyses based on the estimation of innovation production functions, in which knowledge externalities play a prominent role (even though their impact cannot be clearly isolated), this new work finds the problem of surplus appropriability to be the main explanation for firm underinvestment in R&D.

In terms of public policy, the appropriate balance of different financial instruments designed to address underinvestment in R&D is the relevant issue. Indeed, current public
policies are mainly supply-oriented, employing such measures as subsidies or fiscal incentives to stimulate private investment in R&D. However, the greater impact of the surplus appropriability distortion relative to positive knowledge externalities would require a different policy orientation, one that is more consumption- or demand-oriented, i.e., designed to encourage the purchase of innovations.

This paper also reveals some of the main shortcomings in the macroeconomic growth literature and suggests avenues for future research. Although R&D-based growth theory is now able to consider most of the well-known sources of market failures described in other parts of the economics of innovation literature\textsuperscript{17}, important research gaps remain. In particular, we argue for the development of theoretical and empirical growth models that integrate sources of market failure that are linked to capital market imperfections, uncertainty and financing problems. Improvements in models, which combine endogenous growth and new economic geography, also seem necessary to improve our understanding of the effects of interactions among geography, innovation and growth on incentives to undertake R&D investments. In light of the recent development in R&D policies that incorporate a geographical dimension (for example, cluster policy), this is certainly an important topic for future research.

Finally, it would also be interesting to further develop the implications of models that take the diversity of innovation processes and the competitive context into account with respect to incentive policies. Such research would certainly encourage economists to refine the design of incentive instruments (for example, using many different forms of subsidies) in order to better adapt them based on this diversity.

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Notes

1 All countries within the OECD, for example, provide direct financial support for R&D and the number of OECD countries providing indirect financial support has grown from 12 in 1996 to 27 in 2011 (http://www.oecd.org/sti/rd-tax-stats.htm).

2 See Aghion and Howitt (1992) or section 2.4 of the paper for further details.

3 Note that the term industry could be extended to service here, as this framework highlights the way toward a better understanding of innovation growth dynamics in competitive sectors characterized by more incremental innovation (such as in certain services for example). However, due to the complexity of the step-by-step approach, this framework does not allow for the analysis of welfare in relation to R&D policies.

4 We refer the reader to the famous paper of Krugman (1991) and the paper of Candeau (2008) for a complete survey of NEG models.

5 These stylized facts include: (1) the location of economic activities (both industrial and innovation) is characterized by agglomeration and (2) the capital accumulation is driven by the spatial concentration of economic activities.

6 Although other sources of market failure may appear in microeconomic models, for example, here, we remain focused on market failures that have been identified to create a gap between the equilibrium level of R&D investment and the level that would be socially optimal in a R&D-based growth context.

7 In this case, we define global transaction costs as the sum of the price indices in both countries or regions.

8 See Carlaw and Lipsey (2003) for a review of the various interpretations and misinterpretations of TFP as an instrument capable of driving public policies for growth. Within this paper, we do not provide any additional discussion about the concerns on measurement and interpretation related to TFP; rather, we focus our attention on specific issues regarding how the productivity literature has been used to measure the magnitude of the gap between the private and social returns to R&D.

9 For an in-depth discussion on these measurement issues, see Griliches (1979) and Griliches (1992).

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16 These stylized facts include: (1) the location of economic activities (both industrial and innovation) is characterized by agglomeration and (2) the capital accumulation is driven by the spatial concentration of economic activities.

17 This result appears to be robust to great variations in the parameter values. With an assumed R&D intensity of 6% of GDP, R&D expenditures still cannot explain more than half of productivity growth. Moreover, the author extends his model by integrating problems of imitation and creative destruction and by using diverse production functions for non-innovative goods. The obtained results all confirm the weak contribution of R&D expenditures to productivity growth.

18 It is worth noting here that this stream of literature, which focuses on macroeconomic growth mechanisms rather than firms strategies, sometimes roughly describes phenomena that are studied in much more detail in other part of the economics of innovation literature. Therefore, we can consider a number of very different modalities of knowledge diffusion or technology imitation to fall under the knowledge externalities concept.
All R&D based growth models show that financial R&D policies can influence the growth rate (at least in the short run) and the welfare of an economy. Consequently, the need of such policies depends on the gap between the private and public returns to R&D. The origins (and the importance) of this gap is (mainly) due to the market failures generated by R&D activities attributes.
### Table 5: Main sources of market failures and instruments to correct them

<table>
<thead>
<tr>
<th>Market failures</th>
<th>Implications on incentives to invest in R&amp;D</th>
<th>instruments</th>
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<tr>
<td><strong>Knowledge externalities</strong></td>
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</table>
| standing on shoulders > fishing in the same lake | Under-investment | - Proportional Subsidies to R&D cost or patent  
- Cooperation incentives can reduce the need of subsidies |
| fishing in the same lake > standing on shoulders | Over-investment | - Proportional Taxes on R&D cost or patent |
| **Surplus appropriability** | | |
| Consumer surplus  
Market power | Under-investment | 1) Proportional Subsidies to purchase cost of innovation  
2) A mix of two instruments : proportional subsidy to the production of innovative goods + proportional subsidy to R&D cost |
| **Duplication** | | |
| Stepping on toes | Overinvestment | - Taxes on R&D cost or on patent  
- Cooperation incentives can reduce the need of taxes |
| **Rent transfer** | | |
| Business stealing effect | Overinvestment | - Taxes on R&D cost or on patent |
| **Location externalities** | | |
| Positive proximity externalities > negative proximity externalities | Underinvestment | - Subsidy to the “core” location or tax to the “periphery” location (in order to increase spatial concentration) |
| Negative proximity externalities > Positive proximity externalities | Overinvestment | - Taxes to the “core” location or subsidy to the “periphery” location (in order to reduce spatial concentration) |
### Table 6: Measuring the gap between private and social return to R&D: methods and results

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<tr>
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<th>Econometric measures</th>
<th>Theoretical – based simulations</th>
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<td><strong>Methods</strong></td>
<td>Estimation of production functions or cost/profit functions</td>
<td>Linking theoretical endogenous growth models to econometric results on productivity measures</td>
</tr>
<tr>
<td><strong>Market failures</strong></td>
<td>Knowledge externalities and surplus appropriability problems</td>
<td>The four types: knowledge externalities, appropriability problems, duplication and rent transfer</td>
</tr>
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<td><strong>considered</strong></td>
<td>But not distinguished</td>
<td></td>
</tr>
<tr>
<td><strong>Main results</strong></td>
<td>R&amp;D social return largely superior to R&amp;D private return</td>
<td>Jones and Williams (1998, 2000): Underinvestment but essentially due to appropriability problems</td>
</tr>
<tr>
<td></td>
<td>Private return: 7 to 15 %</td>
<td>Comin (2004): actual investment equal optimal investment</td>
</tr>
<tr>
<td></td>
<td>Social return: 30 to 100%</td>
<td>Alvareza-Pelaez and Groth (2005); Reis and Sequeira (2007); Strulik (2007): potential situations of overinvestment</td>
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<td></td>
<td>Inducing private underinvestment in R&amp;D</td>
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References


