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# Heuristic Optimization Methods for Dynamic Panel Data Model Selection. Application on the Russian Innovative Performance \*

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## Abstract

Innovations, be they radical new products or technology improvements are widely recognized as a key factor of economic growth. To identify the factors triggering innovative activities is a main concern for economic theory and empirical analysis. As the number of hypotheses is large, the process of model selection becomes a crucial part of the empirical implementation. The problem is complicated by the fact that unobserved heterogeneity and possible endogeneity of regressors have to be taken into account. A new efficient solution to this problem is suggested, applying optimization heuristics, which exploits the inherent discrete nature of the problem. The model selection is based on information criteria and the Sargan test of overidentifying restrictions. The method is applied to Russian regional data within the framework of a log-linear dynamic panel data model. To illustrate the performance of the method, we also report the results of Monte-Carlo simulations.

**Keywords:** Innovation, dynamic panel data, GMM, model selection, threshold accepting, genetic algorithms.

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# 1 Introduction

Innovative activity, “creative destruction”, is widely seen as the main factor of economic growth. A vast literature is available on this interrelation (see, e.g., Schumpeter (1943) and Porter (2003)). There is also a large body of empirical research on this issue (see Bilbao-Osorio and Rodriguez-Pose (2004) and Merivate and Pernias (2006)). However, evidence on the effectiveness of different instruments stimulating innovations is mixed. This might also be due to ad hoc or intuitive decisions in the model specification step.

In fact, the model selection process is crucial for the further analysis of multiple regression models. Picking up too many regressors increases the variance of the constructed model, and taking less regressors than needed results in inconsistent estimates.

In our application, we face the problem of selecting relevant factors explaining the innovative performance of Russian regions based on regional data for the period 1999–2006. For Russia as for many economies in transition this issue is of high relevance due to the necessity to set development priorities (Savin and Winker 2009).

During the last decade several research strategies have been introduced to extract necessary information from large databases. Among these are Bayesian model averaging by Fernandez *et al.* (2001), the general-to-specific approach (PcGets) discussed by Hendry and Krolzig (2005) and its bottom-up alternative (RETINA) analyzed by Perez-Amaral *et al.* (2003). In brief, these strategies are based on  $R^2$  and  $t$ -statistics with stepwise regression procedures. However, in general, there will be no consensus model resulting from the application of these methods. Another option is presented by the least absolute shrinkage and selection operator (Lasso), which selects the model and estimates it simultaneously. The Lasso-type estimator is found to be more effective in comparison to the conventional methods, but has an asymptotic bias due to shrinkage (see, e.g., Hsu *et al.* (2007)). An alternative model selection approach is based on information criteria (IC) which rank models according to their fitness and a penalty for model complexity (see, e.g., Kapetanios (2007)).

To deal with the problem of model selection, an efficient algorithm is required selecting the model specification with the best value of the IC or at least a good approximation to this optimum. To this end, we compare two selection procedures based on two heuristic optimization approaches: Threshold Accepting and Genetic Algorithms.

An important new feature of this paper is the application of heuristic model selection methods to a panel dataset with short time series (using the system Generalized Method of Moments estimation method). Because of

the unobserved heterogeneity and possible endogeneity of regressors we consider both static and dynamic model specifications. Furthermore, additional restrictions on subgroups of regressors are taken into account.

The remainder of the paper proceeds as follows. Section 2 introduces both the economic background and the estimation framework for our application. Section 3 presents the model selection problem and the heuristic techniques proposed as an effective alternative to the standard procedures. Section 4 reports the results of our Monte Carlo analysis and Section 5 presents the results for the real data. Finally, Section 6 contains concluding remarks.

## 2 The Concept of Innovations and Their Stimulation

The practical example we analyze is the innovative performance of Russian regions. As no data at the firm level is available, we use regionally aggregated data for the period between 1999 and 2006 from the 'Regions of Russia: Social-economic indicators' database (Rosstat).

The quality of the data is not perfect. Hence, our conclusions should be considered rather suggestive than irrevocable. Our main goal in this paper is to introduce the new method of model selection in dynamic panel data models.

Analyzing the data, Russian regions can be considered as 'potential innovative clusters' (Porter 2003). Among the main actors of any cluster are companies, financial and educational institutions, public authorities and specific cluster organizations specialized in transferring knowledge and providing further services. But these clusters are potential in the sense that not in every region, and not in the frame of a whole region effective clustering occurs. For further details on the theory of innovative clusters see Sölvell (2008).

There are many different approaches devoted to specific factors triggering innovative activity (see, e.g., Opitz and Sauer (1999)). Nevertheless, as far as we know, no generally accepted model is available encompassing all the factors of interest.

Our main indicator of innovative activity is the value of innovative output of organizations<sup>1</sup> in a region. This is in line with Rosenberg *et al.* (1992) who argues that the better measure of innovative success is not technology itself, but its market success. The data of Rosstat do not allow to distinguish different types of innovations as, e.g., completely new products or technology

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<sup>1</sup>Organizations according to the Russian Civil Code are public and private companies as well as scientific institutes and high-schools.

improvements. As a result we also consider a larger number of organizations related to innovative processes by implementing established technologies.

## 2.1 Advanced Hypotheses and Data Description

To identify the driving factors of innovations, we split the database in eight groups of variables according to the hypotheses tested in this study.

1. Product market competition. There is a long discussion in the theory of industrial organization on whether competitive pressure induces or reduces innovative output of companies. Firstly, according to Schumpeter (1943), there is a negative correlation between innovative activity, 'creative destruction', and competitive pressure as profits become too small to implement innovations. On contrary, Blundell *et al.* (1999) empirically confirmed that competition enhances R&D activity in order to gain an advantage towards main competitors. During the last years, the idea of an inverse 'U-curve' dependence of innovative activities on the competition intensity has become popular (Bucci and Parelo 2009). Previous empirical research based on survey data for Russia confirmed the existence of a 'U-relationship' (Kozlov and Yudaeva (2004)).

Dealing with the regionally aggregated data of Rosstat, we can use neither standard indices of the extent of market competition like the Lerner Index nor a number of competitors as a proxy measure. We can only approximate the number and percentage share of companies that produce innovative output, conduct R&D activities, apply and register patents and implement advanced technologies in their production process in a particular region. This substitution has certain disadvantages, e.g., it does not differentiate between industries, where innovative firms act, but is included in order to compare results.

2. Scale of production. An intensive discussion can also be found on the role of small businesses in developing innovative products. From one point of view, big companies may substantially benefit from economies of scale and scope and, therefore, are rather expected to be more innovative. But at the same time, small and medium-sized companies (SMEs) are more willing to undertake risks and are more flexible to react to changes in consumer preferences (Merivate and Pernias 2006).

In our model we test the hypothesis on firm size by using variables on SME's activity: share of small companies in the total number of organizations in a region and share of SME's output in gross regional product (GRP).

3. Form of ownership. We distinguish between three types of ownership. In the case of public property, there are few incentives for managers to run a business in the best way; in the case of international corporations,

it is believed that they carry out most of their research activities in their headquarters; the local capital is widely seen as the most efficient owner of innovative enterprises (Jefferson *et al.* 2003). In our model we are interested in revealing whether public ownership has an impact on the innovative activity and in testing possible correlation between foreign investments and innovative output.

Among variables tested in this group are foreign direct and portfolio investments, shares of equity and borrowed funds in companies' investments in fixed capital. In addition, percentage shares of public, municipal and private investments in total regional investments in fixed capital and shares of privatized public and municipal organizations are included.

4. Economic performance. There are two controversial opinions in regard to dependence of innovative activities on the economic performance of companies. On one hand, companies that face financial difficulties try to diversify their activities by implementing innovations (Funk 2006). On the other hand, there is empirical evidence that companies with stable profits in previous years adopt and implement innovations more actively (Cainelli *et al.* 2006), which might be a result of financial constraints (Winker 1999).

For testing this hypothesis we use data on regional companies' aggregated net profit, average net profits and their credit debt (regionally aggregated and average values) in domestic and foreign currency.

5. Infrastructure. It is argued that the actual level of infrastructure has an important impact on innovative performance. By improving infrastructure, significant reductions in transaction costs and, hence, an improvement in the market efficiency in general may be obtained. All these factors induce restructuring processes in companies and introduction of new products. Among infrastructure factors, which accelerate innovations, the most important are transport, telecommunication and financial services, especially banking services (Cainelli *et al.* 2006).

To test the impact of infrastructure on innovations the following variables are used: investments in fixed capital, in particular on transport, communication, public health and education services; density of motor and rail roads; turnover of goods by means of rail and motor roads; usage of communication services and their availability; share of credit organizations and their affiliates relative to the total number of organizations in a region.

6. and 7. Knowledge spillovers. Inter-regional spillovers describe potential benefits from cooperation with other innovative clusters. Knowledge diffusion has an important role in fostering innovative performance, especially in developing countries. This study concentrates on two aspects.

First, on the regional trade activity and regional ability to absorb new knowledge as factors, inducing innovations (MacGarvie 2001). Considering

factors that improve this knowledge transfer, the level of education (Bilbao-Osorio and Rodriguez-Pose 2004) and the above mentioned infrastructure level are most important. The variables of regional education level are represented by the share of public and private high school graduates, doctoral students and R&D employees. We also test the share of export and import with CIS and other countries and the trade agreements on technologies and export related services.

Second, we test R&D activity in neighboring regions as well as their education level as stimulating factors for innovative activity in a particular region. There are numerous methods to determine one's spatial neighbors, for instance, contiguity matrices and distance-decay-functions (Klotz 1997). We define only direct neighbors by land as neighboring regions and calculate respective variables as arithmetic means of those in neighboring regions.

8. Control variables. We also aim to test some general hypothesis on regional socio-economic characteristics stimulating innovations. It is of particular interest to investigate whether innovations are rather attributed to economically strong regions with large GRPs and budget revenues. Among variables tested are long term assets value, shares of urban population, unemployment and criminal activity. The full list of variables can be found in Table 6 in Appendix 7.1.

Innovations can be explained by the economic performance of companies, investments in infrastructure, and product market competition. However, they also induce improvements in economic performance, further investments in infrastructure and increase market competition (Cainelli *et al.* 2006). Therefore, we face the problem of a potential simultaneity bias. In order to tackle this problem, we use the instrumental variable approach in the context of a dynamic model specification.

## 2.2 Model Specification

In spite of the huge number of models proposed to explain the innovation process, there is no generally accepted model available encompassing all the factors of interest. Reviewing a great diversity of models, Forrest (1991) suggested some essential characteristics for a comprehensive model. First of all, the model should be nonlinear capturing an interrelationship of various stages of innovative activity. Then, it should include "identifiable" inputs and outputs. In addition, the generalized model must incorporate external effects, e.g., market competition and indicators of socio-economic environment. After all, the model should take into account the possible heterogeneity of regions.

In order to set up such a generalized model, we consider the modified Cobb-Douglas Knowledge Production Function (KPF) (Crescenzi *et al.* 2007,

p. 170). Transforming it into a log-linear form approximating the initial model with arguments according to the hypotheses stated above we obtain:

$$\begin{aligned} \ln Y_i = & \alpha + \beta_1 \ln PMC_i + \beta_2 \ln SME_i + \beta_3 \ln FO_i + \beta_4 \ln EP_i \\ & + \beta_5 \ln Infra_i + \beta_6 \ln SpillAbs_i + \beta_7 \ln SpillN_i \\ & + \beta_8 \ln Macro_i + u_i, \end{aligned} \quad (1)$$

where:

$Y_i$	innovative output of region $i$ ;
$\alpha$	a constant;
$PMC_i$	indicators of market competition in region $i$ ;
$SME_i$	indicators of SME's activity in region $i$ ;
$FO_i$	proxies for ownership structure of companies;
$EP_i$	proxies for companies' economic performance;
$Infra_i$	proxies for regional infrastructure development;
$SpillAbs_i$	a vector of regional socio-economic characteristics, which may improve ability to absorb new knowledge;
$SpillN_i$	socio-economic characteristics in neighboring regions;
$Macro_i$	further control variables, which address relevant socio-economic characteristics of region $i$ .

Moving from the KPF to (1), we approximate the stock of initial knowledge by several proxies of regional socio-economic characteristics ( $SpillAbs_i$ ), e.g., the number of doctoral students and employees in R&D departments. The number of patent applications (Crescenzi *et al.* 2007) is used as a proxy for the stock of initial knowledge in parallel with the number of patents granted. Furthermore, in the dynamic specification of the model we include the regional innovative output in the previous period ( $Y_{i,t-1}$ ) as an additional proxy for the stock of knowledge. Regional R&D activity is proxied by some market competition indicators ( $PMC_i$ ), e.g., the internal R&D costs.

Due to the logarithmic transformation in (1),  $\beta$  is an elasticity: the percent change in  $Y$  as a function of the percent change in the respective variable. As the transformation can be applied only to strictly positive data, some of the variables have to be expressed as percentage shares or average values. For these variables,  $\beta$  is a rate of proportional change in  $Y$  per unit change in the respective regressor.

Gathering dependent and explanatory variables in vector  $y$  and matrix  $X$ , respectively, model (1) can be written as:



$$y = \alpha \iota_N + X\beta + u, \quad (2)$$

where  $\alpha$  is a scalar,  $\iota_N$  stands for a  $N \times 1$  vector of ones,  $X$  is a  $k \times N$  matrix of  $k$  regressors and their values for  $N$  regions,  $\beta$  is a  $k \times 1$  vector of their coefficients and  $u$  is a  $N \times 1$  vector of residuals. Here we use the panel data subscripts  $i$  for regions and  $t$  for time.

### 2.2.1 Static Model Specification

Application of the Hausman test (Hausman and Taylor 1981) to preliminary estimates of (2) indicates that regional fixed effects ( $\mu_i$ ) should be taken into account. To deal with these fixed effects we first specify a static model (3), where  $Z_\mu$  stands for the matrix of regional dummies:

$$y = \alpha \iota_N + X\beta + Z_\mu \mu + \nu. \quad (3)$$

Transforming the data into deviations from individual means we perform the LSDV (least squares dummy variables) estimation, which is also known as within estimation:

$$y_{it} - \bar{y}_i = \beta(x_{it} - \bar{x}_i) + (\nu_{it} - \bar{\nu}_i). \quad (4)$$

Assuming that  $\nu \sim iid(0, \sigma^2)$  and strict exogeneity of  $X$ , the LSDV is the best linear unbiased estimator and consistent.

### 2.2.2 Dynamic Model Specification

As we are concerned about potential endogeneity of some of our explanatory variables, we consider a dynamic model suggested by Blundell and Bond (1998) with instruments in levels especially suitable for panel data with short time dimensions:

$$y_{it} = \delta y_{i,t-1} + X_{it}\beta + Z_\mu \mu + \nu_{it}. \quad (5)$$

The GMM method for dynamic panel data models with not strictly exogenous variables was developed by Arellano and Bond (1991), introducing some basic restrictions on the model, e.g., no serial correlation, and using values of  $y_{it}$  and  $X_{it}$  lagged two periods or more as instrumental variables in equations with first-differences. Later, it was shown that this estimator is weak and biased (Alonso-Borrego and Arellano 1999). The system GMM procedure introduced by Blundell and Bond (1998) appears superior, as it imposes additional restrictions on the initial condition process. It adds lagged

differences of  $y_{it}$  and  $X_{it}$  as additional instruments in order to improve the efficiency for short time-series samples.

We consider two scenarios, where the explanatory variables  $X$  are considered either as endogenous or predetermined. Depending on which of these assumptions is maintained, different numbers of lags and lagged differences as instruments are used in the system GMM estimation. To test the validity of the instruments we apply the Sargan test (ST). The details of the system GMM estimation procedure are presented in Appendix 7.2.<sup>2</sup>

### 3 The Model Selection Procedure

#### 3.1 The Optimization Problem

Let us first clarify the basic approach to the optimization problem. Consider the following regression function:

$$y_t = \alpha + \beta x_t^{opt} + u, \quad (6)$$

where  $x_t = (x_{1,t}, \dots, x_{k,t})$  is a  $k$ -dimensional vector of variables with  $x_t^{opt}$  being the subset of all possible regressors we seek to identify. This might be the ‘true’ model in a Monte Carlo simulation setting or an optimal approximation to the unknown real data generating process. A vector  $\omega$  specifies which variables are included in the model. It assigns the value of one or zero to indicate the selected or not selected variables. To select a model IC are implemented, which rank alternative models according to their fitness, while taking into account a penalty for model complexity.

Over the last years IC became a standard instrument in model selection problems ranging from lag order selection in multivariate linear (VAR and VEC) and nonlinear (MS-VAR) autoregression models to selection between rival nonnested models (Winker and Maringer 2004, Gatu *et al.* 2008).

In this study we implement Akaike’s IC (AIC), the Bayesian IC (BIC) and the Hannan-Quinn IC (HQIC). All these criteria have a similar structure:

$$IC = \ln(\sigma^2) + f(k, n), \quad (7)$$

where  $\sigma^2$  is the maximum likelihood estimation of the residual sum of squares. The second term is a penalty for the number of included parameters ( $k$ ). This term also depends on the sample size ( $n$ ). In particular,  $2k/n$ ,  $k \ln(n)/n$  and  $2k \ln(\ln(n))/n$  are the AIC, BIC and HQIC penalties.

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<sup>2</sup>We also apply the system GMM estimation procedure implemented in Stata 10 as a reference to compare our results.

Imposing some weak assumptions on the model space ( $x_{i,t}$  and  $\varepsilon_{i,t}$ ) according to the results of Sin and White (1996) it can be shown that the vector  $\omega^i$  that minimizes the *IC* converges to  $\omega^{true}$  with probability close to 1 as  $n \rightarrow \infty$ . But for this to be true, it is essential that the penalty term  $f(k, n) \rightarrow \infty$  and  $f(k, n)/n \rightarrow 0$  as  $n \rightarrow \infty$ . In this sense, BIC and HQIC are consistent, while AIC is inconsistent.

In addition to the penalty for model complexity, we impose the constraint that at least one regressor from each group of variables specified in (1) is included. This constraint is enforced by imposing an additional multiplicative penalty ( $p_j$ ) to the objective function (7) in an optimization procedure. The penalty increases over the iterations of the optimization algorithm to make sure that eventually the constraint is satisfied. This constraint is optional, as we might realize that no statistically significant variable is present for a particular group. Furthermore, for the dynamic specification of the model the objective function is multiplied by an additional penalty term (*penST*) derived from the results of the Sargan test to ensure that only valid instrument variables are considered:

$$IC = (\ln(\hat{v}^2) + f(k, n)) \left( 1 + \sum_{j=1}^8 p_j \right) (1 + penST), \quad (8)$$

where  $j$  stands for a group of variables and  $\hat{v}$  denotes residuals from the two-step estimator (see Appendix 7.2) and

$$penST = \begin{cases} 0 & \text{if } ST_{prob} > 0.1 \\ 1/ST_{prob} & \text{otherwise,} \end{cases} \quad (9)$$

where  $ST_{prob}$  is the probability value of the Sargan test.

### 3.2 Heuristic Algorithms

Quality and precision of econometric estimation is crucially dependent on detecting the global optimum of any objective function. Breiman (2001) demonstrates the so called ‘‘Rashomon Effect’’, where different model specifications with very similar IC values provide different conclusions. Minimizing objective function (8) is not as simple as it might seem at first sight. In fact, the search space of candidate models is discrete (Winker (2001, p. 192)). The full enumeration of all possible solutions is only feasible for a small dimensional  $x_t$ . In our empirical problem the selection is made out of 80 variables resulting in  $2^{80}$  potential sub-models. Therefore, the full enumeration is infeasible even using efficient algorithms (Gatu *et al.* 2008).

In the last two decades, new nature-inspired optimization methods have become available. For an overview of these optimization techniques see Winker (2001) and Gilli and Winker (2004). In the following we describe the two heuristic methods implemented, the Threshold Accepting (TA) and the Genetic Algorithms (GA).

### 3.2.1 Threshold Accepting

The TA algorithm, suggested by Dueck and Scheurer (1990), is a refinement of classical local search procedures. In contrast to a local search, where a new solution is accepted only if an improvement is realized, TA also accepts uphill moves as long as they do not exceed a given threshold value  $\tau$ . A pseudocode of the TA implementation can be found in Algorithm 1.

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#### Algorithm 1 Pseudocode for Threshold Accepting.

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```

1: Generate at random a solution  $\omega^0$ , initialize  $I_{max}$  and  $\tau$ 
2: for  $I = 1$  to  $I_{max}$  do
3:   Generate at random neighbor  $\omega^1 \in \mathcal{N}(\omega^0)$ 
4:   if  $f(\omega^0) - f(\omega^1) < \tau$  then
5:      $\omega^0 = \omega^1$ 
6:   end if
7:   Reduce  $\tau$ 
8: end for

```

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In TA we generate an initial solution  $\omega^0$  as a vector of  $k$  binary components corresponding to our  $X$  variables. A fixed number of variables (here it is 2) is included in each group and they are randomly distributed across the vector. Generating an initial solution at random instead of constructing it based on, e.g., empirical evidence or expectations, has the advantage that the algorithm will not start with a possible local optimum.

We generate a new solution  $\omega^1$  by exchanging two randomly chosen components with components located in a close neighborhood,<sup>3</sup> in particular in the radius of three vector components. We choose the 'neighbor' by means of the uniform random distribution and if it has the same value as the first component, than its value is changed to an opposite binary value: from 0 to 1 and vice versa. The same is true if the 'neighbor' turns out to be the initially chosen component.

To generate an effective threshold sequence for all three IC, we obtain threshold values by a data driven method (Winker 2001, p. 170). To this end, we calculate absolute differences between the initial and new objective

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<sup>3</sup>Changing the value of one element makes the algorithm slower and, e.g., of four elements causes a larger variance of results.

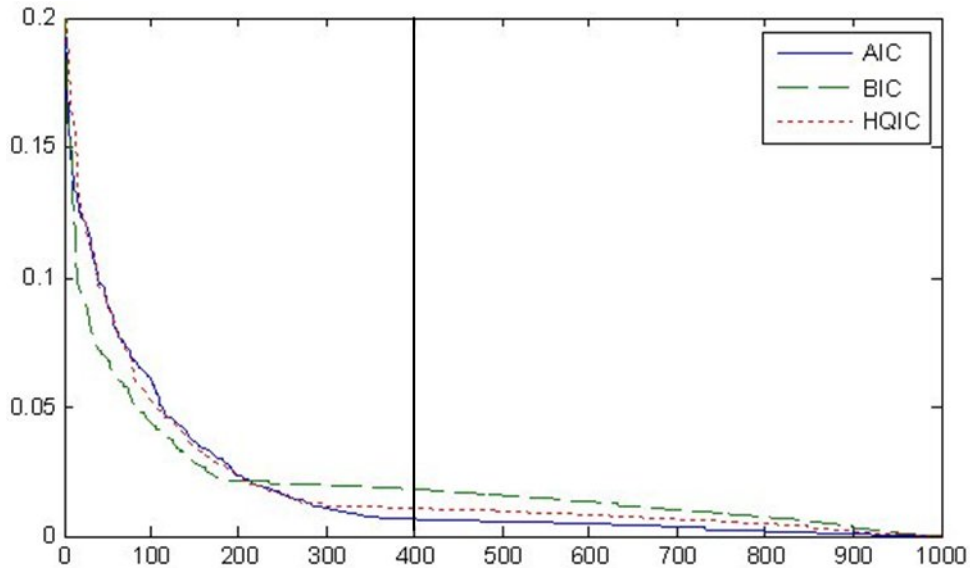


Figure 1: Threshold sequences from local deviation simulations.

function values with no penalty term for the number of groups included, and arrange them in decreasing order (Figure 1).

We use only a lower fraction  $\varrho$  of these sequences. This is made to improve the performance of the algorithm and not to accept solutions almost arbitrarily during the early iterations. The vertical line in Figure 1 corresponds to  $\varrho = 0.6$  selected based on tuning experiments.

As TA is a stochastic process it may find the best possible solution in the search space and then lose it during the searching procedure. To avoid this, the best found solution is saved.

### 3.2.2 Genetic Algorithms

Unlike TA, GA, proposed by Holland (1975), are population based heuristic methods that operate on a set of solutions (population). Thus, a GA investigates the search space in many directions simultaneously so that the probability of getting stuck into a local optimum is reduced.

The members in the GA population (chromosomes) are represented as bit strings, in which each position (gene) has two possible values: 1 and 0. In each generation GA replaces parts of a population with new chromosomes (children) aimed to represent better solutions for a particular problem. Children are generated using a crossover mechanism, that combines parts of chromosomes (parents), and mutation, that randomly changes genes in chro-

mosomes. For optimal model selection we implement the GA pseudocode described in Algorithm 2.

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**Algorithm 2** Pseudocode for Genetic Algorithms.

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```

1: Generate initial population  $K$  of solutions, initialize  $G_{max}$  and  $C$ 
2: for  $g = 1$  to  $G_{max}$  do
3:   Sort chromosomes in  $K$ 
4:   Select  $K' \subset K$  (parents), select  $K^* \subset K$  (elitist)
5:   initialize  $K'' = \emptyset$  (set of children)
6:   for  $c = 1$  to  $C$  do
7:     Select individuals  $x^{parent1}$  and  $x^{parent2}$  at random from  $K'$ 
8:     Apply cross-over to  $x^{parent1}$  and  $x^{parent2}$  to produce  $x^{child}$ 
9:      $K'' = K'' \cup x^{child}$ 
10:  end for
11:   $K = (K', K'')$ 
12:  Mutate  $K \setminus K^*$  at 8 random points
13: end for

```

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$K$  is a matrix of  $p$  initial solutions. We use  $p = 500$  considering this number to be large enough to screen the search space in different directions and at the same time small enough to allow for effective sorting and selection of the best solutions.<sup>4</sup> As in TA, chromosomes in the initial population are generated with a fixed number of included variables, randomly distributed over the vectors. Thereafter, the population is sorted in an ascending order according to the objective function value. Then, the 50% of the chromosomes with the best target values (parents,  $K'$ ) are transferred to the new population. We also select the ten best (elitist) chromosomes ( $K^*$ ). Based on  $K'$  we construct new chromosomes (children) by crossing them over. Generating children we allow parents with superior objective values to be selected more often. First, we select 200 parents at random with an equal probability for the parents to be selected and generate 200 children. Then, the 40 parents with the best objective values generate 40 more children. The 10 last children are generated from the elitist solutions by changing at random one gene.

In the implementation we compare two crossover mechanisms: single-point crossover and uniform crossover. In the single-point crossover two parents are split at a random gene (crossover-point). From the split parts two new children are generated by combining the first part of one parent with the second part of the other parent. The crossover-point is placed between the second and the next to last genes (Kapetanios 2007).

In contrast, in the uniform crossover parents may be split not only at one particular gene, but at each gene. With probability  $P_0$  we swap genes from

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<sup>4</sup>We also tested populations of 100, 300 and 1000 solutions and found that the population of 500 solutions is more effective in terms of both CPU time and solution quality.

$$\begin{array}{l}
x^{parent1} = (1 \ 1 \ 0 \ 1 \ 0 \ 1 \ 0 \ \dots \ 1)_{1 \times k} \\
x^{parent2} = (1 \ 0 \ 1 \ 0 \ 1 \ 1 \ 0 \ \dots \ 1)_{1 \times k} \\
\hline
mask_1 = (0 \ 1 \ 1 \ 0 \ 0 \ 0 \ 1 \ \dots \ 1)_{1 \times k} \\
mask_2 = (1 \ 0 \ 0 \ 1 \ 1 \ 1 \ 0 \ \dots \ 0)_{1 \times k} \\
\hline
x^{child1} = (1 \ 1 \ 0 \ 0 \ 1 \ 1 \ 0 \ \dots \ 1)_{1 \times k} \\
x^{child2} = (1 \ 0 \ 1 \ 1 \ 0 \ 1 \ 0 \ \dots \ 1)_{1 \times k}
\end{array}$$

Figure 2: The uniform crossover mechanism.

two parents in a child. The uniform crossover can be presented as generating a mask of zeros and ones (see Figure 2), indicating for each gene from which parent it has to be taken. We set  $P_0 = 0.5$  resulting in equal probability for each entry in the masks.

Performance analysis of the uniform crossover based on several binary function optimization problems can be found in Fogel (2006). It was shown that the uniform crossover outperforms both one- and two-point crossover mechanisms on average.

Testing both the single-point and uniform crossover for this particular problem based on repeated and independent Monte-Carlo simulations with 500 restarts we see that the uniform mechanism provides high quality solutions more reliably. The 95th percentiles of the results for the uniform crossover converge to the minimum value found in all replications (see Figure 3), whereas for the single-point crossover a difference between the 5th and the rest 95th percentiles persists.<sup>5</sup>

The uniform crossover might be criticized for destroying superior chromosome structures. We avoid this problem by preserving elitist solutions and, thus, screening the search space in a more efficient way.

After a new population is formed, mutation is applied at eight random genes with a probability of 50%.<sup>6</sup> Mutation is applied to the whole new population  $K$  except for the 10 elitist solutions and the 10 children generated from the elitist solutions by mutation. This procedure is repeated for a given number of generations  $G_{max}$ .

<sup>5</sup>In Figure 3, all objective function values accepted by the GA lie within the interval between 6.65 and 6.72.

<sup>6</sup>We examined different number of genes and rates of mutation as well. By reducing the number of genes or the probability of mutation, the computational time increases, while increasing both values increases the risk to miss high quality solutions.

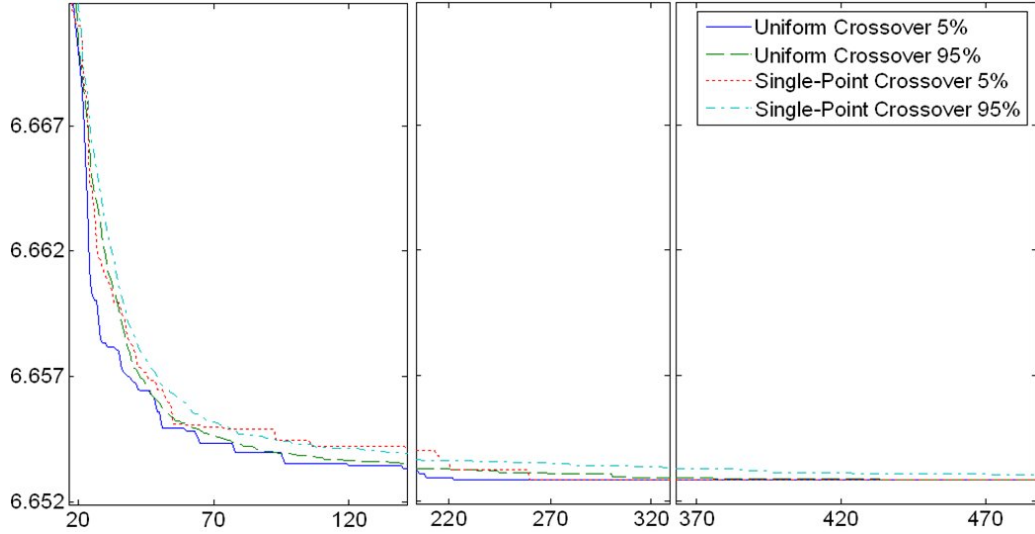


Figure 3: Results of the single-point and uniform crossover.

## 4 Monte-Carlo Study

### 4.1 The Data Generating Process

In order to assess the performance of the implemented heuristic methods with an objective function as described in equations (7) and (8) we generate artificial data based on the panel dataset of Rosstat. First, a set of regressors ( $X_{MC}$ ) is randomly drawn from the database. Then, regression coefficients ( $\beta_{MC}$ ) are estimated based on the dependent variable ( $y$ ). Finally, a new dependent variable ( $y_{MC}$ ) is generated using the estimated coefficients adding an identically and independently distributed error term:

$$y_{MC} = X_{MC}\beta_{MC} + \varepsilon, \quad \varepsilon \sim N(0, \sigma_\varepsilon^2), \quad (10)$$

where  $\sigma_\varepsilon^2$  is the variance of the residuals.

Using a Data Generating Process (DGP) mimicking the empirical data, i.e., also with a cross-section dimension of 75 and eight time periods, we expect that the performance of the heuristics and the IC estimated based on this Monte-Carlo study is a good approximation for our real data problem.

### 4.2 Simulation Results

Table 1 presents results of TA and GA computational performance. The two algorithms are compared in terms of mean and minimum objective function



values and standard deviations. The descriptive results are obtained based on 10 restarts for each algorithm. The number of iterations for TA is taken equal to the number of chromosomes times the number of generations for GA resulting in the same number of function evaluations for both algorithms.

Table 1: Performance of the algorithms for different computing times.

		Method					
		Threshold Accepting			Genetic Algorithms		
		AIC	BIC	HQIC	AIC	BIC	HQIC
		50 000 iterations			100 generations		
mean		6.5890	6.7322	6.6663	6.5890	6.7272	6.6556
std		[0.0060]	[0.0086]	[0.0093]	[0.0024]	[0.0021]	[0.0011]
min		(6.5877)	(6.7192)	(6.6690)	(6.5844)	(6.7251)	(6.6544)
		250 000 iterations			500 generations		
mean		6.5887	6.7264	6.6646	6.5848	6.7158	6.6528
std		[0.0041]	[0.0053]	[0.0056]	[0.0013]	[0.0017]	[0.0000]
min		(6.5863)	(6.7173)	(6.6532)	(6.5837)	(6.7142)	(6.6528)
		1 000 000 iterations			2000 generations		
mean		6.5876	6.7163	6.6536	6.5843	6.7142	6.6528
std		[0.0018]	[0.0008]	[0.0004]	[0.0011]	[0.0000]	[0.0000]
min		(6.5854)	(6.7153)	(6.6529)	(6.5837)	(6.7142)	(6.6528)

For TA with an increasing number of iterations we observe that mean, minimum objective function values and standard deviations decrease for all three information criteria (see Table 1).

For GA we obtain similar results, though the improvement is moderate. Comparing the results for the two heuristics we see that GA is able to find a good solution already with a relatively small number of generations (in particular, with 500 generations as it is seen from Table 1). Increasing the computational time up to 2000 generations mainly reduces the variance of the results. Further increases of computational time (e.g., up to 5000000 iterations for TA and 10000 generations for GA) do not improve the results significantly. As a result we conclude that GA appears superior to TA for this particular problem. First, the GA is about 20 percent faster than the TA for a comparable number of iterations.<sup>7</sup> Second, GA provides us with

<sup>7</sup>Both algorithms are implemented using Matlab 7.7 on a Pentium IV 2.67 GHz. The CPU time needed for 2000 generations of the GA is about 700 s, while the TA implementation with 1000000 requires 850 s. The small difference in CPU time is due to the more complex generation of neighbors for the TA as described above.

smaller standard deviations and slightly better objective function values (in terms of both mean and minimum values).

Now, to test the performance of our algorithms with an objective function of type (8) in detecting 'true' variables we run the algorithms for ten different artificial sets of data with eight 'true' variables in each dataset. The simulation results are compared using the True Positive Rate (TPR) and the False Positive Rate (FPR)<sup>8</sup> in the upper panel of Table 2.

Table 2: Performance of the algorithms.

	Method					
	Threshold Accepting			Genetic Algorithms		
	AIC	BIC	HQIC	AIC	BIC	HQIC
	1 000 000 iterations			2000 generations		
	8 years period					
TPR	23%	43%	37%	30%	49%	38%
FPR	21%	8%	10%	16%	6%	9%
	20 years period					
TPR	30%	55%	48%	35%	58%	49%
FPR	19%	5%	8%	15%	4%	7%

As expected the objective function based on the Akaike criterion accepts too many 'false' variables. Accepting on average 19-20 variables, AIC correctly defines approximately 4 variables. BIC and HQIC significantly outperform AIC, accepting less false variables (on average 8 and 11 regressors in total, respectively). As it is clear from Table 2 BIC is the most efficient IC in declining 'false' variables, while HQIC regularly allows for more 'incorrect' variables in the final solution. It is also evident that similarly to objective values, GA provides us with slightly better results than TA.

We believe that the main reason for the limited efficiency of all IC in Table 2 is the relatively small sample size: 75 regional observations for a period of eight years are not sufficient for the IC to identify the 'true' model. Analyzing the data for eight years and using an optimization technique we find an IC-value smaller than the one corresponding to the 'true' model.

In order to test the performance of the IC for a larger sample size, we artificially increase the time-series dimension: we select 'blocks' from the dataset at random points (from 1 to 8) and add them to the current dataset.

<sup>8</sup>TPR is the percentage of 'true' regressors from all regressors selected. FPR is the percentage of selected 'false' regressors among all 'false' regressors.

Selecting the blocks at the same point for all variables, we produce a new dataset of 20 years. Although the dynamic structure of these artificial data differs from the one of the real data, we might still use them to test the performance of the selection criteria for larger sample sizes. Results of these experiments are presented in the lower panel of Table 2. It is obvious that the performance for all IC is significantly improved. Unfortunately, actual data for a longer period is not available for Russia.

Table 3: Performance of the algorithms with no group penalty.

	Method					
	Threshold Accepting			Genetic Algorithms		
	AIC	BIC	HQIC	AIC	BIC	HQIC
	1 000 000 iterations			2000 generations		
8 'true' variables						
TPR	25%	84%	48%	39%	89%	54%
FPR	19%	1%	6%	14%	1%	5%
16 'true' variables						
TPR	40%	85%	61%	44%	93%	66%
FPR	18%	1%	6%	13%	1%	3%
37 'true' variables						
TPR	61%	87%	75%	66%	96%	83%
FPR	20%	2%	7%	19%	1%	6%

Considering again the original structure with eight periods, we also analyze the performance of the IC when no penalties on the number of groups included are introduced (see Table 3). Thus, in the Monte-Carlo experiment with eight 'true' variables, one from each group, BIC selects four variables on average with three to four of them correct and HQIC selects eight variables on average with four to five correct, accepting more false regressors. Increasing the number of a priori 'true' variables the algorithms marginally increase the number of selected variables, improving their performance in terms of both: the TPR and FPR. For example, for 37 'true' variables (five variables in each group except of scale of production) HQIC selects 14 variables with 12 correct. However, it is obvious that for all IC this effect is accompanied with an increase of the number of true variables not included in the final model. This is also due to the finite sample size, where the asymptotic properties of the IC can be observed to a limited extent. In Table 3 it is also clear that GA have a tendency to select less variables for all the IC used, including less

true variables and rejecting more false variables. These facts should be taken into account when interpreting the results in Section 5.

## 5 Empirical Results on the Example of Russia

Based on the Monte-Carlo simulation results, we apply the superior GA algorithm on the database of Russian regions in order to specify the log-linear model of the form given in equation (1). We use the objective function (7)-(8) with AIC, BIC and HQIC with and without the penalty term on groups of variables included. The empirical results are obtained by running the GA 10 times with 2000 generations for each IC. We only present the model specifications related to the smallest objective function values. Results for the static model are provided in Table 4 and for the dynamic model in Table 5.

The models obtained are similar in terms of variables included for all running sessions, but differ significantly between static and dynamic model specifications. Comparing the results in Tables 4 and 5 it is clear that the regression coefficients are different for most variables included in both specifications. A good example to consider here is the GRP per capita. In the static model this variable has a strongly significant coefficient: 1% increase in the regressor is associated, *ceteris paribus*, with approximately 2% increase in the innovative output. But GRP can hardly be considered as exogenous with respect to the regional innovative performance. Considering this indicator as endogenous changes the result: in the GMM estimation the variable is estimated with an inverted sign and there is less evidence that it has a significant effect on the dependent variable. In fact, in regions with *ex ante* high GRP per capita, e.g., regions in the North of Ural extracting oil, companies may have less incentives to innovate due to a different regional specialization. Therefore, in the following we concentrate on the system GMM estimation results, keeping the within estimation for a comparison.

An argument supporting the relevance of the obtained results is the fact that the set of regressors included is relatively stable for both assumptions on predetermined and endogenous variables. Another evidence for this is the fact that statistically significant<sup>9</sup> variables are included with and without the penalty on the number of groups included, while insignificant variables are dropped in specifications without this penalty.

According to the results in Table 5 the number of granted patents and

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<sup>9</sup>The significance test is based on asymptotic standard errors for the one-step estimator, which are seen to be more reliable if the residuals obtained from the estimator are heteroscedastic (see Arellano and Bond (1991) and Blundell and Bond (1998)).

Table 4: Within estimation results.

Regressors	With group penalty			No group penalty		
	AIC	BIC	HQIC	AIC	BIC	HQIC
shInterCostLab	0.01***	-	-	0.02**	-	-
shInterCostMat	-0.01*	-	-	-0.01*	-	-
lnApplPatent	-0.13	-0.13	-	-	-	-
lnAdvProdTech	-0.18**	-	-0.17*	-0.22**	-	-0.16**
shSMEoutput	-	0.01**	-	-	-	-
shSME	0.03**	-	0.01	0.03**	-	-
shPubInvFixCap	0.01**	0.01*	0.01**	0.01**	-	0.01**
shPriInvFixCap	0.02***	0.02	0.01**	0.02**	-	0.02**
avNetProfit	0.08	-	0.08	-	-	-
lnAggrCredDinFX	-	-0.03	-	-	-	-
lnNumPhonepc	3.66***	-	3.03***	3.37***	-	3.08***
lnTurnMotorRoad	0.38**	-	0.41**	0.40**	-	0.43**
shFCInvIndProd	0.01**	0.02***	0.02***	0.01**	0.02***	0.02***
shFCInvComm	-0.04**	-	-	-0.04**	-	-
shFCInvTrade	-0.06***	-	-0.05**	-0.06**	-	-0.04*
shFCInvPHealth	0.06***	-	0.04**	0.05***	-	0.05**
shPrivHighSGrad	3.25*	-	-	3.19**	-	-
lnDocStudent	0.45***	0.35**	0.36***	0.47***	0.34***	0.39***
lnImpNumofTech	-0.46***	-	-0.28**	-0.47***	-	-0.27**
lnRDCostSpill	-0.64*	-	-0.84**	-0.78**	-	-0.77**
shOrgRDactSpill	0.22***	0.18***	0.21***	0.21***	0.20***	0.24***
lnGPatentSpill	-0.44**	-	-0.42**	-0.42**	-	-0.40**
shPHighSGSpill	-2.07*	-	-	-2.37**	-	-
lnGRPpc	1.89***	1.79***	2.31***	1.93***	1.81***	2.10***
shUrbanPop	0.11*	-	0.14**	0.10*	-	0.14**
lnNumofApplLF	-0.38***	-0.36***	-0.35***	-0.37***	-0.34***	-0.30**
$R^2$	0.40	0.32	0.37	0.40	0.31	0.36
$R^2$ -adjusted	0.37	0.31	0.35	0.37	0.31	0.35
F-test' P-value	0.00	0.00	0.00	0.00	0.00	0.00

\*\*\*,\*\*, \* Statistically significant, respectively, at the 1, 5 and 10% level

the number of advanced production technologies used have, *ceteris paribus*, a positive effect on the regional innovative output. This result does not allow us to make any statement about the state of competition and its impact on the innovative activity. This finding rather provides us with an indirect estimate of knowledge spillovers within the limits of one region: new patents and technologies are widely seen as an instrument of knowledge transfer.

In conjunction to this result it is useful to consider the results on the hypothesis of knowledge spillovers from neighbor regions. The positive spillover effect of the innovative output in neighboring regions is contrasted with the negative effect of the number of granted patents. The positive influence of the value of innovative products in neighboring regions can be considered as plausible: a good or a service is a data carrier itself, and being exported can transfer knowledge to companies in neighboring regions.

On the contrary, the negative regression coefficient of the granted patents is a surprising result, as empirical evidence from the US and Western Europe confirms patents as an instrument of knowledge diffusion (Bacchiocchi and Montobbio 2009). One might interpret this as a result of the property rights policy: technologies or goods patented in one region are protected from copying in neighbor regions. In this case, technologies implemented to produce innovative products in neighbor regions need to be either very close or even the same, which is a very strong assumption. Another explanation for this may be a concentration of Russian innovative companies in a few 'special economic zones' (RusSEZ) with certain tax reliefs and further benefits for innovative companies. By this, these regions absorb production from neighbor regions instead of transferring knowledge.

Based on this result one might conclude that knowledge is regionally bound in Russia and particular measures to develop inter-regional knowledge diffusion are worth to undertake. These two effects are found to be strongly significant and are included with all IC in the final model specification. Remember that these results are obtained with the neighborhood concept we have chosen. It is also relevant for further examination to test this hypothesis with a different concept, allowing, e.g., for knowledge spillovers between Moscow and St. Petersburg. These two most innovative regions in Russia are also expected to exhibit spillover effects with each other.

For the ownership hypothesis a positive partial effect of foreign direct investment (FDI) is identified. This is one of the few robust findings of this effect for the Russian economy (Tytell and Yudaeva 2006). Notice that for the static model specification FDI was not selected, and in the dynamic model it is included by all IC with the exception of BIC. According to the Monte-Carlo simulations BIC rejects more true variables than the other IC. However, the effect of FDI is fairly low. This may be due to a broader definition

Table 5: System GMM estimation results.

Regressors	Endogenous regressors						Predetermined regressors					
	With group penalty			No group penalty			With group penalty			No group penalty		
	AIC	BIC	HQIC	AIC	BIC	HQIC	AIC	BIC	HQIC	AIC	BIC	HQIC
Lagged dependent variable	0.18***	0.19***	0.15***	0.19***	0.29***	0.24***	0.20***	0.24***	0.17***	0.19***	0.25***	0.17***
shInnovOrg	0.04*	-	-	0.03*	-	-	0.02	-	-	-	-	-
lnGrantPatent	0.24***	-	0.21***	0.26*	0.26**	0.24**	0.22**	0.22*	0.17*	0.23*	0.22*	0.18*
lnAdvProdTech	0.21***	0.43***	0.30***	0.21**	0.29**	0.23**	0.29***	0.34***	0.29***	0.32***	0.25***	0.33**
shSMEoutput	0.004	0.004	0.001	-	-	-	0.002	0.004	0.004	-	-	-
lnFDI	0.05**	0.05*	0.05*	0.04**	-	0.05**	0.03*	-	0.03*	0.04**	-	0.05**
shPrInInvFixCap	0.01	-	-	0.01	-	0.01*	0.01	0.01	0.01	0.01	-	0.01**
shAggrNetPinGRP	0.02***	0.02***	0.02***	0.02***	0.03***	0.03***	0.02***	0.01*	0.02**	0.02***	0.02***	0.01*
avNetProfit	0.06	-	0.09	-	-	-	-	-	0.04	-	-	-
lnAggrCredDimRu	0.08	0.09	0.08	0.02	-	0.01	0.04	-	-	0.05	-	-
lnRailRoadDen	0.14**	0.15***	0.13***	0.11*	0.17**	0.15***	0.02	-	-	-	-	-
lnTurnRailRoad	0.01	-	-	-	-	-	-	-	-	-	-	-
lnTurnMotorRoad	-	-	-	-	-	-	0.21	0.24	0.34***	0.19***	-	0.15***
lnInvFixCap	0.26	0.51	0.22	0.34	-	-	0.47*	0.49*	0.52*	0.49*	0.49***	0.50*
shFInvPHealth	0.03**	-	0.05**	0.04**	-	-	0.02**	-	0.04***	0.04***	-	0.04***
shPubGradOEI	-	-0.04**	-0.04*	-0.06**	-0.07**	-0.05**	-0.05**	-0.05**	-0.05**	-0.04***	-0.05***	-0.04*
lnPostdocStud	-0.23	-	-	-	-	-	-0.12	-	-0.10	-	-	-
lnInnOutSpill	0.25***	0.26***	0.28***	0.24***	0.31***	0.29***	0.30*	0.19***	0.28***	0.25***	0.25***	0.24***
lnGPatentSpill	-0.33***	-0.26***	-0.31***	-0.29***	-0.36***	-0.33***	-0.44*	-0.26*	-0.33***	-0.31***	-0.31*	-0.31*
lnGRPpc	-0.14	-0.32*	-0.17	-	-	-	-	-	-	-	-	-
lnGRP	-	-	-	-	-	-	0.27	0.39	0.14	-	-	-
R <sup>2</sup>	0.89	0.88	0.89	0.88	0.87	0.88	0.88	0.88	0.89	0.88	0.87	0.88
R <sup>2</sup> -adjusted	0.88	0.87	0.88	0.88	0.87	0.88	0.88	0.87	0.88	0.88	0.87	0.88
Sargan Test P-value	1.00	1.00	0.99	1.00	1.00	1.00	1.00	1.00	0.99	1.00	1.00	1.00

\*\*\*,\*\*, \* Statistically significant, respectively, at the 1, 5 and 10% level

of innovation used by Rosstat, including new products and services, which are not offered or produced in the country, and processes, which increase efficiency of the production. Another reason may be the low FDI inflow itself in relation to GDP in Russia (Tytell and Yudaeva 2006).

For the hypothesis on financial performance the only significant indicator selected with all criteria is the share of aggregated net profits in GRP. However, its regression coefficient is of a fairly small value. To draw any concrete conclusions, the hypothesis must be tested on microdata.

Similarly, for the hypothesis on adoption of new knowledge, only the share of graduates from other public educational institutions (technical schools, colleges, academies) is selected and is found to be significant. In this case, the regression coefficient is negative, demonstrating that the share of graduates has, *ceteris paribus*, a negative impact on the innovative success. Taken in relation to the total regional population this indicator varies from its value around 1%, having a marginal impact on the innovative output. Nevertheless, the evidence is not obvious as the graduates of these schools are expected to enhance technical innovations. The negative impact might be explained by a selection bias: other public educational institutions being less attractive for potential students in comparison to universities are less efficient in preparing good specialists.

Among indicators on infrastructure the density of rail roads and the turnover of motor roads have partial negative effects on the dependent variable. Though, their inclusion in the final model is dependent on the assumption on the initial conditions process (endogenous or predetermined regressors). Similar evidence is found for the investments in fixed capital. The only exception for this are the investments in public health services. This regressor has a significant partial positive impact for both assumptions on the initial condition process. So far, we do not have an exhaustive explanation for this. Thus, we find some evidence that different infrastructure indicators have a positive impact on the innovative performance of regions, but until now, it is impossible to draw more specific conclusions.

Finally, there is no significant indicator on scale of production. Besides, the hypotheses on impact of public, municipal and private forms of ownership are not confirmed (the latter is not significant). None of the control variables are found to be significant.



## 6 Conclusions and Outlook

In this paper the innovative performance of Russian regions is analyzed. The innovative process is described in numerous studies with sometimes contradictory results. As there is no generally accepted model available encompassing all the factors of interest, a generalized log-linear model based on the regional data of Rosstat is suggested.

We optimize the model structure by selecting only those variables, which are relevant according to the information criteria. It is demonstrated that the corresponding optimization problem is complex due to the large discrete search space. Therefore, no classical optimization methods can be applied.

To deal with this problem two heuristic optimization approaches are suggested: Threshold Accepting and Genetic Algorithms. They are shown to be able to find an optimum or at least a very good result in terms of the IC value with, respectively, 1 000 000 iterations and 2 000 generations on average.

Comparing the heuristics we argue that for this particular problem for a given CPU time, GA provides marginally better results than TA in terms of the mean, minimum values and variance.

One problem that becomes obvious for our application is the asymptotic behavior of the IC. A sample size of 600 observations is too small for the information criteria to identify the 'true' model. Instead, only up to 50% of the true variables are detected in a MC simulation. Relaxing the constraint that at least one variable from each group of potential regressors has to be included reduces the number of false variables included in the final model substantially (especially for BIC). However, the problem of relevant variables possibly not selected by the IC remains open.

Taking the unobserved heterogeneity and possible endogeneity of regressors into account, we compare both static and dynamic model specifications using GA. In particular, for the dynamic model specification, the system GMM estimation is undertaken. Based on this comparison a series of hypotheses on stimulating innovations is tested.

In conclusion, we argue that the heuristic methods based on the IC are effective methods of model selection. In the future we will enhance our model selection procedure enabling to distinguish between strict exogenous, predetermined and endogenous variables simultaneously. For further study remains also the incorporation of the optimal choice of moments that could efficiently explore linear GMM moment restrictions and reduce the variance of the estimator. Application of the algorithms on a different dataset, in particular with a larger number of cross and time-series observations and with more accurate proxies on the market competition, investment climate and other hypotheses, is also of interest.

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## 7 Appendix

### 7.1 Variables Used in the Analysis

Table 6: List of tested explanatory variables.

Product market competition	
shInnovOrg	Share of organizations which produce innovative output
lnRDCost	Log of internal R&D costs
shInterCostLab	Share of expenditure on labor remuneration in internal R&D costs
shInterCostSTax	Share of expenditure on social taxes in internal R&D costs
shInterCostEqp	Share of expenditure on machines and equipment in internal R&D costs
shInterCostMat	Share of expenditure on materials
shOrgRDactiv	Share of organizations which conduct R&D activities
lnApplPatent	Log of number of applications for patents
lnGrantPatent	Log of number of granted patents
lnAdvProdTech	Log of number of advanced production technologies used
Infrastructure	
lnRevCommServ	Log of revenues from communication services per capita
lnNumPhonepc	Log of number of telephones per thousand inhabitants
shMobPhoneSubs	Share of mobile telephone subscribers in regional population
lnRailRoadDen	Log of kilometers of railroads of general use per 10000 $km^2$
lnMotorRoadDen	Log of kilometers of motor roads of general use per 1000 $km^2$
shCreditOrg	Share of credit organizations in the total number of organizations
shCreditOrgAff	Share of credit organizations' affiliates in the total number of organizations
lnTurnRailRoad	Log of turnover of goods by means of railroads
lnTurnMotorRoad	Log of turnover of goods by means of motor roads
lnInvFixCap	Log of fixed capital investments (FCInv's)
shFCInvIndProd	Share of FCInv's in industrial production
shFCInvAgricul	Share of FCInv's in agriculture
shFCInvConstr	Share of FCInv's in construction
shFCInvTrans	Share of FCInv's in transport
shFCInvComm	Share of FCInv's in communication
shFCInvTrade	Share of FCInv's in trade
shFCInvPHealth	Share of FCInv's in public health
shFCInvEduc	Share of FCInv's in education
	} distribution according to economic activity
Scale of production	
shSME	Share of small companies
shSMEoutput	Share of SME's output in gross regional product (GRP)
Form of ownership	
lnFDI	Log of foreign direct investments
lnFPI	Log of foreign portfolio investments
lnFIE	Log of foreign investments not elsewhere specified
shPubInvFixCap	Share of public investments in FCInv's
shMunInvFixCap	Share of municipal investments in FCInv's
shPriInvFixCap	Share of private investments in FCInv's
	} distribution according to ownership structure

shPrivPubMunOrg	Share of privatized public and municipal organizations
shEqInvFixCap	Share of equity in FCIInv's
shBCrInvFixCap	Share of bank credits in FCIInv's
} distribution according to source of finance	
Economic performance	
shAggrNetPinGRP	Share of aggregated net profit of companies in GRP
avNetProfit	Average net profit of companies in roubles (m)
lnAggrCredDinRu	Log of aggregated credit debts of companies in roubles
lnAggrCredDinFX	Log of aggregated credit debts of companies in foreign currency
avCredDinRu	Average credit debts of companies in roubles (m)
avCredDinFX	Average credit debts of companies in foreign currency (in roubles, m)
Knowledge spillovers I	
shPubHighSGrad	Share of public high-school graduates in total population (TP)
shPrivHighSGrad	Share of private high-school graduates in TP
shPubGradOEI	Share of graduates from other public educational institutions in TP
shPrivGradOEI	Share of graduates from other private educational institutions in TP
shPubHStoAllHS	Share of public graduates in all high-school graduates
shPubtoAllGrad	Share of public graduates in all graduates from other educational institutions
lnRDstaff	Log of the number of employees in R&D departments
lnDocStudent	Log of number of doctoral students
lnPostdocStud	Log of number of postdoctoral students
shExpRWorld	Share of export to the rest of the world relative to GRP
shImpRWorld	Share of import to the rest of the world relative to GRP
shExpCIS	Share of export to the CIS countries relative to GRP
shImpCIS	Share of import to the CIS countries relative to GRP
lnExpNumofTech	Log of number of contracts for export of technologies
lnExpValofTech	Log of value of contracts for export of technologies
lnExpEarnofTech	Log of annual earnings of contracts for export of technologies
lnImpNumofTech	Log of number of contracts for import of technologies
lnImpValofTech	Log of value of contracts for import of technologies
lnImpEarnofTech	Log of annual earnings of contracts for import of technologies
Knowledge spillovers II	
lnInnOutSpill	Log of value of innovative products in neighboring regions (NR)
lnRDCostSpill	Log of internal costs on R&D in neighboring regions in NR
shOrgRDactSpill	Share of organizations which conduct R&D activities in NR
lnGPatentSpill	Log of number of granted patents in NR
lnAdvPrTSpill	Log of number of advanced production technologies used in NR
shPHighSGSpill	Share of public high-school graduates in the total population in NR
lnRDstaffSpill	Log of the number of employees in R&D departments in NR
Control variables	
lnGRP	Log of GRP in current prices
lnGRPpc	Log of gross regional product per capita in current prices
lnRevConsBudg	Log of revenues of regional consolidated budgets
lnValLTAssets	Log of value of regional long term assets
shEmplPop	Share of employable population in total population
shUrbanPop	Share of urban population in total population
shUnEmplPop	Share of unemployed population (relative to employable population)
lnNumofAppILF	Log of number of applications for labor force
lnNumofRegCrime	Log of number of registered crimes per 100 000 inhabitants

## 7.2 System GMM Estimation Technique

Here we will state the assumptions of the system GMM estimators applied. First,  $\mu_i$  and  $\nu_{it}$  are independently identically distributed so that

$$E(\mu_i) = 0; \quad E(\nu_{it}) = 0; \quad E(\nu_{it}\mu_i) = 0; \quad i = 1, \dots, N; \quad t = 2, \dots, T \quad (11)$$

and there is lack of serial correlation, but not necessarily independence over time:

$$E(\nu_{it}\nu_{is}) = 0; \quad i = 1, \dots, N; \quad t = 2, \dots, T; \quad \forall t \neq s. \quad (12)$$

Following Blundell and Bond (1998) we also make the standard assumption concerning the initial conditions  $y_{i1}$ :

$$E(y_{i1}\nu_{it}) = 0; \quad i = 1, \dots, N; \quad t = 2, \dots, T. \quad (13)$$

Conditions (11), (12), (13) are sufficient for the following  $(T-1)(T-2)/2$  linear moment conditions to be valid:

$$E[y_{i,t-2}\Delta(\mu_i + \nu_{it})] = 0; \quad t = 3, \dots, T, \quad (14)$$

where  $\Delta(\mu_i + \nu_{it}) = \Delta u_{it} = u_{it} - u_{i,t-1} = \Delta y_{i,t} - \hat{\delta}\Delta y_{i,t-1} - \Delta X_{i,t}\hat{\beta}$ . Introducing lagged values of  $y_{it}$  as instruments, we estimate  $\delta$  in first-differences for datasets with a time-series dimension  $T \geq 3$ . But as these estimations are biased (Alonso-Borrego and Arellano 1999), we need to make an additional mild stationarity assumption about the initial conditions  $y_{i1}$  allowing the use of an extended 'system GMM' estimator that uses lagged differences of  $y_{it}$  as instruments for equations in levels. This stationarity condition on  $y_{i1}$  requires  $E[(y_{i1} - \frac{\mu_i}{1-\delta})\mu_i] = 0$  for  $i = 1, \dots, N$ , so that  $y_{it}$  converges towards its mean  $\frac{\mu_i}{1-\delta}$  for each region from period  $t = 2$  onwards. This yields the condition:

$$E[\Delta y_{i,t-1}\mu_i] = 0; \quad i = 1, \dots, N. \quad (15)$$

If (11), (12), (13) and (15) hold, the additional  $(T-1)(T-2)/2$  moment conditions are valid:

$$E[\Delta y_{i,t-1}(\mu_i + \nu_{it})] = 0; \quad t = 3, \dots, T. \quad (16)$$

Together the moment conditions on equations in first-differences (14) and on equations in levels (16) yield the system GMM estimator (Blundell and Bond 1998).



We do not assume that the explanatory variables  $X$  are all strictly exogenous, but either endogenous or predetermined.  $X$  might be endogenous in the sense that  $X_{it}$  are correlated with  $\nu_{it}$  and earlier shocks, but not correlated with subsequent shocks:

$$E(X_{it}\nu_{is}) \neq 0; \quad i = 1, \dots, N; \quad \forall s \leq t. \quad (17)$$

$X$  are predetermined if in addition it is assumed that there is no correlation between  $X_{it}$  and  $\nu_{it}$ . Then, conditions (13), (14), (15) and (16) are also true for  $X_{it}$ , allowing to include  $X_{i,t-2}$  and  $\Delta X_{i,t-1}$  as valid instruments in the system GMM estimator.

Then we can obtain  $\hat{\delta}$  and  $\hat{\beta}$  in a two-step procedure. In the first step, we transform (5) in the first-difference equation:

$$y_{it} - y_{i,t-1} = \delta(y_{i,t-1} - y_{i,t-2}) + (X_{it} - X_{i,t-1})\beta + (\nu_{it} - \nu_{i,t-1}), \quad (18)$$

and perform the Generalized Least Squares (GLS) preliminary one-step consistent estimation:

$$\begin{pmatrix} \hat{\delta}_1 \\ \hat{\beta}_1 \end{pmatrix} = \begin{bmatrix} \left( \begin{array}{cc} \Delta y_{t-1} & \Delta X_t \\ y_{t-1} & X_t \end{array} \right)' W (\sum_{i=1}^N W_i' G W_i)^{-1} W' \begin{pmatrix} \Delta y_{t-1} & \Delta X_t \\ y_{t-1} & X_t \end{pmatrix} \\ \left( \begin{array}{cc} \Delta y_{t-1} & \Delta X_t \\ y_{t-1} & X_t \end{array} \right)' W (\sum_{i=1}^N W_i' G W_i)^{-1} W' \begin{pmatrix} \Delta y_t \\ y_t \end{pmatrix} \end{bmatrix}^{-1}. \quad (19)$$

where  $W = [W_1', \dots, W_i']'$  is a matrix of instruments for all regions  $W_i$ :

$$W_i = \begin{pmatrix} W_i^d & 0 \\ 0 & W_i^l \end{pmatrix}, \quad (20)$$

where  $W_i^d$  contains instruments in first-differences, and  $W_i^l$  contains non-redundant instruments in levels. For endogenous  $X$ ,  $W_i$  has the form:<sup>10</sup>

$$W_i^d = \begin{pmatrix} [y_{i1}, x'_{i1}] & 0 & \dots & 0 \\ 0 & [y_{i1}, y_{i2}, x'_{i1}, x'_{i2}] & \dots & \vdots \\ \vdots & \ddots & \ddots & \vdots \\ 0 & \dots & \dots & [y_{i1}, \dots, y_{i,T-2}, x'_{i1}, \dots, x'_{i,T-2}] \end{pmatrix},$$

<sup>10</sup>For predetermined  $X$  one more lag in  $W_i^d$  and first-differences from  $\Delta x'_{i3}$  up to  $\Delta x'_{i,T}$  are included.

$$W_i^l = \begin{pmatrix} [\Delta y_{i2}, \Delta x'_{i2}] & 0 & \cdots & 0 \\ 0 & [\Delta y_{i3}, \Delta x'_{i3}] & \cdots & \vdots \\ \vdots & \ddots & \ddots & \vdots \\ 0 & \cdots & \cdots & [\Delta y_{i,T-1}, \Delta x'_{i,T-1}] \end{pmatrix}.$$

For a more detailed analysis of the redundant moment conditions in dynamic panel data models see, e.g., Okui (2009).  $W_i$  is a  $2(T-2) \times (k+1)(T-2)(T+1)/2$  matrix with  $k$  independent variables of  $X$ .  $G$  is a  $2(T-2)$  square matrix consisting of two  $(T-2)$  square matrices and zero otherwise:

$$G = \begin{pmatrix} G^d & 0 \\ 0 & G^l \end{pmatrix}. \quad (21)$$

$G^d$  is a square matrix of dimension  $T-2$  that has twos in the main diagonal, minus ones in the first subdiagonals and zeros otherwise.  $G^l$  is the identity matrix of dimension  $T-2$ .

In (19) a stacked system  $\begin{pmatrix} \Delta y_{it} \\ y_{it} \end{pmatrix}$  is used, comprising  $(T-2)$  equations in first differences and the  $(T-2)$  equations in levels corresponding to periods 3, ...,  $T$ , for which instruments are observed (Blundell and Bond 1998).

After that we obtain  $\Delta \widehat{\nu}_{i,t} = \begin{pmatrix} \Delta y_{i,t} \\ y_{i,t} \end{pmatrix} - \widehat{\delta} \begin{pmatrix} \Delta y_{i,t-1} \\ y_{i,t-1} \end{pmatrix} - \begin{pmatrix} \Delta X_{i,t} \\ X_{i,t} \end{pmatrix} \widehat{\beta}$  as a  $2(T-2) \times 1$  vector and construct the optimal weighting matrix of  $W_i' \Delta \widehat{\nu}_{i,t}$ :

$$\widehat{V}_N = \left[ \sum_{i=1}^N W_i' (\Delta \widehat{\nu}_i) (\Delta \widehat{\nu}_i)' W_i \right]^{-1}, \quad (22)$$

where the generalized Moore-Penrose inverse (MPI) is used (Penrose 1956). The MPI is applied because the matrix in (22) might be close to singular, triggering inaccurate results of the classical matrix inversion.

Inserting (22) in (19), we estimate the final coefficients. When  $\nu_{i,t}$  are *i.i.d.*, the one-step and two-step estimators are asymptotically equivalent.

The system GMM estimator that uses instruments both in lags and in levels would lose its consistency if in fact the assumptions made in (14) and (16) were not fulfilled. To test the validity of the instrumental variables we perform the Sargan test (ST):

$$S_t = \Delta \widehat{\nu}' W \left[ \sum_{i=1}^N W_i' (\Delta \widehat{\nu}_i) (\Delta \widehat{\nu}_i)' W_i \right]^{-1} W' \Delta \widehat{\nu} \sim \chi_{p-k}^2, \quad (23)$$

where  $\widehat{\nu}$  denote residuals from the two-step estimator,  $p$  is the number of columns in  $W_i$  (number of moment conditions) and  $k$  is the number of explanatory variables. The null-hypothesis of the ST asserts that the over-identifying restrictions are valid, i.e., the orthogonality conditions mentioned in (14) and (16) hold.