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## The productivity impact of R&D investment: evidence from European microdata

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# JENA ECONOMIC RESEARCH PAPERS



# 2008 – 050

## **The Productivity Impact of R&D Investment: Evidence from European Microdata**

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## **The Productivity Impact of R&D Investment: Evidence from European Microdata**

June 2008

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### **Abstract**

The aim of this study is to investigate the relationship between a firm's R&D activities and its productivity using a unique micro data panel dataset and looking at sectoral peculiarities which may emerge; more specifically, we used an unbalanced longitudinal database consisting of 532 top European R&D investors over the six-year period 2000-2005. Our main findings can be summarised along the following lines: knowledge stock has a significant positive impact on a firm's productivity, with an overall elasticity of about 0.125; this general result is largely consistent with previous literature in terms of the sign, the significance and the estimated magnitude of the relevant coefficient. More interestingly, the coefficient increases monotonically when we move from the low-tech to the medium-high and high-tech sectors, ranging from a minimum of 0.05/0.07 to a maximum of 0.16/0.18. This outcome, in contrast with recently-renewed acceptance of low-tech sectors as a preferred target of R&D investment, suggests that firms in high-tech sectors are still far ahead in terms of the impact on productivity of their R&D investments, at least as regards top European R&D investors.

JEL-classification: O33

Keywords: R&D, productivity, knowledge stock, panel data, perpetual inventory method

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## **1. Introduction**

Recent studies question the role of R&D as a fundamental determinant of a firm's improved economic performance (see Jaruzelski, Dehoff, and Bordia, 2005 and 2006)<sup>1</sup>. Indeed, the literature on the economics of innovation has focused on the role of R&D investment in enhancing a firm's productivity, while the final outcome in terms of sales growth, profits, and shareholders' returns obviously depends on many factors other than R&D, such as advertising, economies of scale, the firm's market power, demand evolution and so on. In this paper, the scope is limited to an investigation of the R&D/productivity link in order to see whether previous evidence supporting a positive and significant relationship can be confirmed by analysing the recent performance of a panel of 532 top European R&D investors.

A second issue in the current debate is the alleged advantage of low-tech compared with high-tech sectors in achieving more efficiency gains from R&D investments. The argument here is that catching-up low-tech sectors are investing less in R&D but benefit from a "late-comer advantage", while firms in high-tech sectors would be affected by decreasing returns (see Marsili, 2001; Von Tunzelmann and Acha, 2005; Mairesse and Mohnen 2005). If such was the case, we would expect a weaker relationship between R&D and productivity growth in high-tech sectors in comparison with their low-tech counterparts. This hypothesis contrasts with the previously-available empirical evidence<sup>2</sup>. Hence, the second aim of this study is to investigate whether low (high) – tech sectors are more (less) efficient in achieving productivity gains from R&D activities.

The principal innovative aspects of this study are twofold. Firstly, we propose a sectoral breakdown, using firm-level micro data; this approach has very few antecedents (reviewed in

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<sup>1</sup> While the Booz-Allen-Hamilton reports have not significantly influenced academia, they have had a great impact on the financial and economic specialised media, under headings such as "No Relationship Between R&D Spending and Sales Growth, Earnings, or Shareholder Returns"; "Lavish R&D Budgets Don't Guarantee Performance", "Money Isn't Everything", etc.

<sup>2</sup> See next section for a survey of this literature.

the next section). Secondly, we use a unique new longitudinal database comprising very recent data on 532 top European R&D investors which includes both manufacturing and services.

To sum up, the objective of this study is to investigate the relationship between a firm's R&D investment and its productivity, using a unique micro data panel dataset and looking at any sectoral differences which may emerge. Section 2 gives a concise survey of the previous literature, while in Section 3 the data used and the adopted methodology are discussed, Section 4 deals with the empirical results and Section 5 briefly concludes.

## **2. Previous literature**

There is a well-established stream of literature analysing the impact of R&D activities on productivity (for surveys of the earlier literature, see Mairesse and Sassenou, 1991; Griliches 1995 and 2000; Mairesse and Mohnen, 2001). As of the seminal article by Griliches (1979), and up to and including more recent contributions such as those by Klette and Kortum (2004), Janz, Lööf and Peters (2004), Rogers (2006) and Lööf and Heshmati (2006), previous empirical works have found a significant contribution by R&D in enhancing a firm's productivity. The estimated overall average elasticities range from 0.05 to 0.25, depending on the methods of measurement and the data used.

Most of these studies focus either on cross-country analyses or on one specific sector, mainly dealing with high-tech sectors such as the pharmaceutical or ICT-related sectors. In contrast, considerably less attention has been devoted to determining whether the productivity returns from R&D are different across industrial sectors. Indeed, technological opportunities and appropriability conditions are so different across sectors (see Freeman, 1982; Pavitt, 1984; Winter, 1984; Dosi, 1997; Malerba, 2004) as to suggest the possibility of substantial differences in the specific sectoral R&D-productivity links. In this context, this paper will try to address the following questions: are the productivity impacts of R&D investments equally significant across sectors? If this is the case, what are the differences in the magnitudes of these effects? Does the productivity of a firm in a high-tech sector benefit more from an increase in R&D than that of one in a low-tech sector, or vice versa?

At the same time, given that R&D input is generally added to labour and capital inputs in a production function framework, distinguishing by sectors will also allow us to better understand the impact of physical capital on productivity and how this may differ across sectors.

Although it targets sectoral differences, this study will be based on firm-level data; to our knowledge, not many studies have investigated the relationship between R&D and productivity on a sectoral basis and of these only a few have used micro data.

Examples are Griliches and Mairesse (1982) and Cuneo and Mairesse (1983), who performed two comparable studies using micro-level data and making a distinction between firms belonging to science-related sectors and firms belonging to other sectors. They found that the impact of R&D on productivity for scientific firms (elasticity equal to 0.20) was significantly greater than for other firms (0.10).

In a more recent paper, Verspagen (1995) used OECD sectoral-level data on value added, employment, capital expenditures and R&D investment in a standard production function framework. The author singled out three macro sectors: high-tech, medium-tech and low-tech, according to the OECD classification (Hatzichronoglou, 1997). The major finding of the study was that the influence of R&D on firm output was significant and positive only in high-tech sectors, while for medium and low-tech sectors no significant effects could be found.

Wakelin (2001) applied a Cobb–Douglas production function where productivity was regressed on R&D expenditures, capital and labour using data on 170 UK quoted firms during the period 1988-1992. She found R&D expenditure had a positive and significant role in influencing a firm's productivity growth; moreover, firms belonging to sectors defined as "net users of innovations" turned out to have a higher rate of return on R&D.

Rincon and Vecchi (2003) also used a Cobb–Douglas framework in dealing with micro-data extracted from the Compustat database over the time period 1991-2001. They found that R&D-reporting firms were more productive than their non-R&D-reporting counterparts throughout the entire time period. However, the positive impact of R&D expenditures turned out to be statistically significant both in manufacturing and services in the US, but only in manufacturing in the main three European countries (Germany, France and the UK). Their estimated significant elasticities ranged from 0.15 to 0.20.

Finally, Tsai and Wang (2004) also applied a Cobb-Douglas production function to a stratified sample of 156 large firms quoted on the Taiwan Stock Exchange. Their estimates made use of a balanced panel over the seven-year period from 1994 to 2000. They found that R&D investment had a significant and positive impact on the growth of a firm's productivity (with an elasticity equal to 0.18). When a distinction was made between high-tech and other firms, this impact was much greater for high-tech firms (0.3) than for other firms (0.07).

Overall, previous general and extensive empirical evidence on the subject supports the hypothesis of a positive and significant impact of R&D on productivity at country, sector and firm level. More specifically, previous (rather scarce) studies including cross-section sectoral breakdowns seem to suggest a greater impact of R&D investments on firm productivity in the high-tech sectors rather than in the low-tech ones. These results will be tested again through a panel analysis applied to the unique dataset described in the next section.

### **3. Data and methodology**

We used an unbalanced longitudinal database consisting of 577 top European R&D investors over the six-year period 2000-2005. This unique database was constructed by merging UK-DTI R&D Scoreboard data and UK-DTI Value Added Scoreboard data<sup>3</sup>. The UK Department of Trade and Industry (DTI) collects detailed and tracked data on the larger European firms in terms of R&D investment and value added (VA); the two separate DTI datasets contain information at the firm level, distinguishing by country and sector<sup>4</sup>. By merging the two databases we obtained the necessary information to compute our dependent variable (labour productivity, defined as the VA per employee ratio), our main impact variable (R&D<sup>5</sup>) and

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<sup>3</sup> Different editions of the DTI Scoreboards are downloadable from the website: [www.innovation.gov.uk/rd\\_scoreboard](http://www.innovation.gov.uk/rd_scoreboard).

<sup>4</sup> Although including data from 14 European countries (Austria, Belgium, Denmark, Finland, France, Germany, Ireland, Italy, Norway, Spain, Sweden, Switzerland, the Netherlands and the UK), British firms are over-represented in the DTI databases.

<sup>5</sup> The measurement of R&D investment is subject to accounting definitions for R&D. In particular, for UK companies, the applied definition is that contained in the Statement of Standard Accounting Practice (SSAP) 13: "Accounting for research and development". As far as non-UK companies are concerned, the definition is that contained in the International Accounting Standard (IAS) and corresponding to the R&D component of the accounting category 38: "Intangible assets". Both figures

our additional variables (capital and labour). Of the 577 firms, 27 firms belonging to marginal sectors were dropped<sup>6</sup>, 6 outliers were excluded according to the results of Grubbs' tests centred on the sectoral average growth rates of firms' knowledge stock intensity (K/VA) over the investigated period<sup>7</sup>, and 12 additional firms were dropped for reasons related to the computation of the R&D and capital initial stocks in the year 2000<sup>8</sup>. Finally, M&A were treated in a way that does not compromise the comparability of longitudinal data; specifically, when an M&A occurs, a new entry appears in the database, while the merged firms exit.

It has to be underlined that the final sample of 532 firms still comprises very large top European R&D investors. This obvious sample bias - inherited from the original datasets we used in this study - has two important consequences. Firstly, our results cannot easily be generalised but should be considered pertinent to large firms heavily engaged in R&D activities. Secondly, this kind of "pick the winner" effect is particularly severe in low-tech sectors, where the "real" populations are dominated by small firms which are scarcely or not at all engaged in R&D investment (Becker and Pain, 2002).

As far as the sectoral classification is concerned, the original DTI datasets related firms to 39 industrial and service sectors, defined according to the Industry Classification Benchmark (ICB)<sup>9</sup>. As we were interested in singling out sectoral differences in the R&D/productivity relationship, we split our panel into three subgroups of comparable size: high-tech, medium-high-tech and other sectors (medium-low and low-tech sectors)<sup>10</sup>. *Ex ante*, we endogenously grouped the sectors according to their overall R&D intensity (R&D/VA), assuming the

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are based on the OECD "Frascati" manual definition of corporate R&D and therefore are fully comparable.

<sup>6</sup> In the following analysis we kept only 28 of the original 39 DTI sectors, having excluded sectors with less than five firms (see Table 1).

<sup>7</sup> For a definition of K, see below. Notice that Grubbs' test – also known as the maximum normalised residual test – assumes normality (which is a desirable property anyway). Accordingly, we ran normality tests on the relevant variables and this assumption was never rejected. Results from both Grubb's and normality tests are available on request.

<sup>8</sup> See equations 2 to 5 below; in the rare cases a negative  $g$  turns out to be larger in absolute value than the depreciation rate  $\delta$ , the perpetual inventory method generates an unacceptable negative initial stock in time zero.

<sup>9</sup> The detailed ICB sectoral classification is given on the following website: <http://www.icbenchmark.com>

<sup>10</sup> Compared with the OECD classification, we grouped low-tech and middle-low-tech sectors together, in order to have enough observations in each of the sectoral groups.



thresholds of 5% and 15%<sup>11</sup>. *Ex post*, we compared the outcome of our taxonomy with the OECD classification, and we registered a high degree of consistency at least as far as the comparable manufacturing sectors are concerned<sup>12</sup>. The remaining service sectors were allocated accordingly. Table 1 gives the sectors under analysis grouped in the three technological categories, their R&D intensities and other descriptive information including the corresponding OECD classification.

**Table 1: Sectoral classification and composition of the samples**

	<i>R&amp;D intensity</i>	<i>OECD classification (manufacturing only)</i>	<i>firms</i>	<i>observations</i>
<b>High-tech</b>	<b>0.21</b>		<b>170</b>	<b>600</b>
Technology hardware & equipment	0.41	High	22	77
Pharmaceuticals & biotechnology	0.28	High	30	120
Leisure goods	0.25	High	7	25
Aerospace & defence	0.20	High	21	82
Automobiles & parts	0.16	Medium high	37	140
Software & computer services	0.16		21	56
Electronic & electrical equipment	0.15	High	32	100
<b>Medium-high-tech</b>	<b>0.08</b>		<b>196</b>	<b>671</b>
Chemicals	0.12	Medium high	42	154
Industrial engineering	0.08	Medium high	58	209
Health care equipment & services	0.08		14	43
Household goods	0.06	Medium high	18	51
General industrials	0.05	Medium high	20	69
Food producers	0.05	Low	31	105
Media	0.05		13	40
<b>Low-tech<sup>13</sup></b>	<b>0.02</b>		<b>166</b>	<b>516</b>
Fixed line telecommunications	0.03		14	43
Industrial metals	0.02	Medium low	14	39
Electricity	0.02		13	43
Oil equipment, services & distribution	0.02		7	22
General retailers	0.02		9	29
Support services	0.02		22	67
Construction & materials	0.02		15	65
Banks	0.02		6	6
Gas, water & multiutilities	0.01		23	75
Oil & gas producers	0.01		13	48
Mobile telecommunications	0.01		6	17

<sup>11</sup> Note that these thresholds are significantly higher than those adopted by the OECD for the manufacturing sectors only (2% and 5%, see Hatzichronoglou 1997); this is the obvious consequence of dealing with the top European R&D investors.

<sup>12</sup> Only two sectors (automobile and food) turned out to be up-graded; this is a consequence of dealing with top R&D investors.

<sup>13</sup> In this and the following tables the medium-low/low-tech sectors group is indicated simply as 'low-tech'.

Industrial transportation	0.01		11	23
Beverages	0.01	Low	8	20
Mining	0.00		5	19
<b>Total</b>	<b>0.09</b>		<b>532</b>	<b>1787</b>

Turning our attention to the econometric analysis, we started from the following specification, obtainable from a standard production function (see Griliches, 1986; Lichtenberg and Siegel, 1989; Hall and Mairesse, 1995; Verspagen, 1995).

$$\ln(VA/E) = \alpha + \beta \ln(K/E) + \gamma \ln(C/E) + \lambda \ln(E) + \eta_i + v_{i,t} \quad (1)$$

with:  $i = 1 \dots 532$ ;  $t = 2000 \dots 2005$

where  $\eta$  is the idiosyncratic individual effect and  $v$  the usual error term. All the variables were taken in natural logarithms and deflated according to the different national GDP deflators provided by EUROSTAT. In all the following estimates, time and two-digit sector dummies were implemented in order to take into account both common macroeconomic effects and sectoral peculiarities. Both time and sectoral dummies turned out to be significant in both the aggregate and the three sectoral estimates. This means that even within the sectoral subgroups, specific two-digit technological opportunities and appropriability conditions continue to play an important role.

In accordance with data availability, our proxy for a firm's productivity is labour productivity, our pivotal impact variable is the knowledge capital ( $K$ ) per employee, and our second impact variable is capital expenditures ( $C$ ) per employee. Taking per capita values permits both standardisation of our data and elimination of firms' size effects (see, for example, Crépon, Duguet and Mairesse, 1998, p.123). Total employment ( $E$ ) is a control variable and  $\lambda$  measures the scale elasticity (if greater than zero, it indicates increasing returns).

As is common in this type of literature (see Hulten, 1991; Jorgenson, 1990; Hall and Mairesse, 1995; Bönnte, 2003; Parisi, Schiantarelli and Sembenelli, 2006), stock indicators (rather than flows) were inserted as impact variables; indeed, a firm's productivity is affected by the cumulated stocks of capital and R&D expenditures and not only by current or lagged

flows. In this framework, knowledge and physical capital stocks were computed using the *perpetual inventory method* based on the following formulas:

$$K_{t0} = \frac{R \& D_{t0}}{(g_{s,c} + \delta_g)} \quad \text{with: } s = 1, \dots, 28 \quad c = 1, \dots, 14 \quad g = 1, 2, 3 \quad (2)$$

$$t0 = 2000$$

$$K_t = K_{t-1} \cdot (1 - \delta_g) + R \& D_t \quad \text{with: } t = 2000, \dots, 2005 \quad (3)$$

where  $R\&D$  = R&D expenditures

and:

$$C_{t0} = \frac{I_{t0}}{(g_{s,c} + \delta_g)} \quad (4)$$

$$C_t = C_{t-1} \cdot (1 - \delta_g) + I_t \quad (5)$$

where:  $I$  = gross investment (capital expenditures)

As far as the growth rates ( $g$ ) for  $K$  and  $C$  are concerned, we used the OECD ANBERD and the OECD STAN databases respectively. In particular, we computed the compounded average rates of change in real R&D expenditures and fixed capital expenditures in the relevant sectors ( $s$ ) and countries ( $c$ )<sup>14</sup> over the period 1990-1999 (the ten-year period preceding the period investigated in this study).

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<sup>14</sup> See Appendix A for a detailed view of the OECD to ICB sectoral conversion. German sectoral figures were applied to Swiss firms because of the unavailability of OECD data.

As far as the depreciation rates ( $\delta$ ) for  $K$  and  $C$  are concerned, we chose to apply different  $\delta$  to each of our three sectoral groups ( $g$ ). In fact, more technologically-advanced sectors are characterised (on average) by shorter product life cycles and by a faster technological progress that accelerates the obsolescence of the current knowledge and physical capital<sup>15</sup>. Accordingly, we applied sectoral depreciation rates of 20%, 15% and 12% to the knowledge capital and 8%, 6% and 4% to the physical capital (respectively for the high tech, medium-high-tech and medium-low/low-tech sectors). The resulting weighted averages were 15.6% for the R&D stock and 6.0% for the capital stock respectively; these values are very close or identical to the 15% and 6% commonly used in the literature (see Musgrave 1986; Bischoff and Kokkelenberg, 1987; and Nadiri and Prucha, 1996 for physical capital; Pakes and Schankerman, 1986; Hall and Mairesse, 1995 and Hall, 2007 for knowledge capital).

#### **4. Results**

Table 2 gives some descriptive statistics regarding the main variables in our study.

**Table 2: Descriptive statistics**

<i>Variable</i>	<i>All firms</i>		<i>High-tech</i>		<i>Medium-high</i>		<i>Low-tech</i>	
	<i>Mean</i>	<i>SD</i>	<i>Mean</i>	<i>SD</i>	<i>Mean</i>	<i>SD</i>	<i>Mean</i>	<i>SD</i>
<b>VA/E</b>	0.068	0.062	0.063	0.037	0.053	0.024	0.095	0.100
<b>K/E</b>	0.032	0.049	0.062	0.069	0.021	0.026	0.012	0.013
<b>C/E</b>	0.473	1.756	0.158	0.400	0.135	0.176	1.280	3.091
<b>E</b>	36120	62434	40626	73890	22736	38350	48258	69635

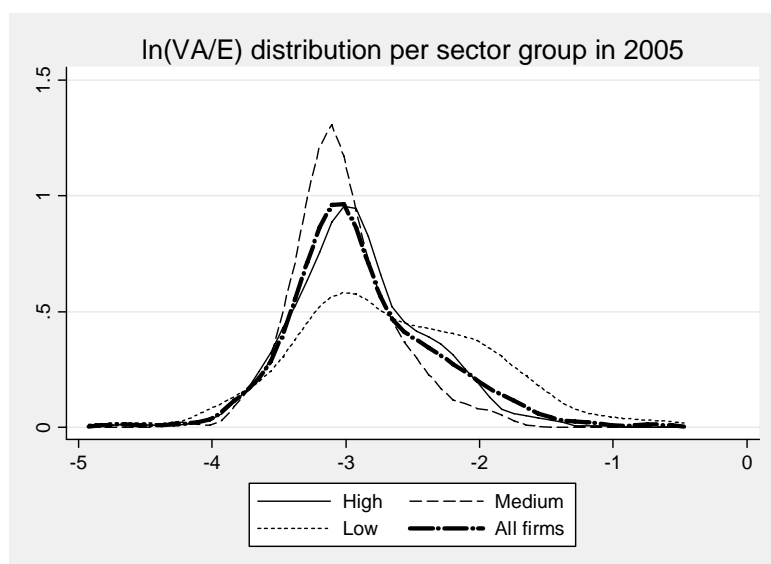
As can be seen, the per-capita R&D stock (K/E) is – not surprisingly – significantly different in the three sectoral groups and turns out to be consistent with our classification based on

<sup>15</sup> Physical capital also embodies technology, and rapid technological progress makes scrapping more

R&D intensity (R&D/VA). While high-tech firms are characterised by a higher knowledge stock, low-tech firms appear to be larger, much more capital intensive (C/E) and more productive (VA/E). All these characteristics are correlated with the "pick the winner" bias (see previous section) which is obviously more marked within the low-tech sectors<sup>16</sup>.

Figures 1 to 3 show the density functions for the relevant variables (in natural logarithms, as they will be used in the regressions) in the last available year (2005); overall and macro-sectoral distributions are reported. Tables with the basic statistics regarding the variables are also included to aid better understanding of the data.

**Figure 1**

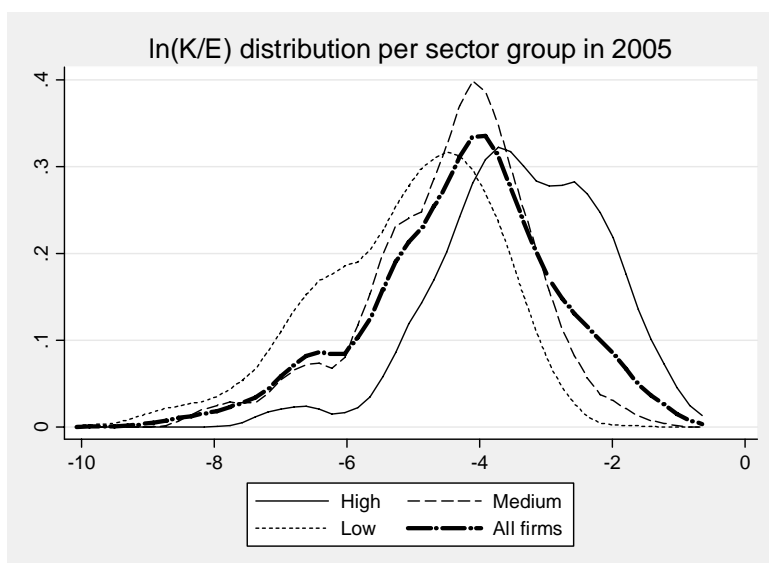


Variable	All firms		High-tech		Medium-high		Low-tech	
	Mean	SD	Mean	SD	Mean	SD	Mean	SD
<b>ln(VA/E)</b>	-2.879	0.564	-2.901	0.501	-3.031	0.388	-2.651	0.733

frequent.

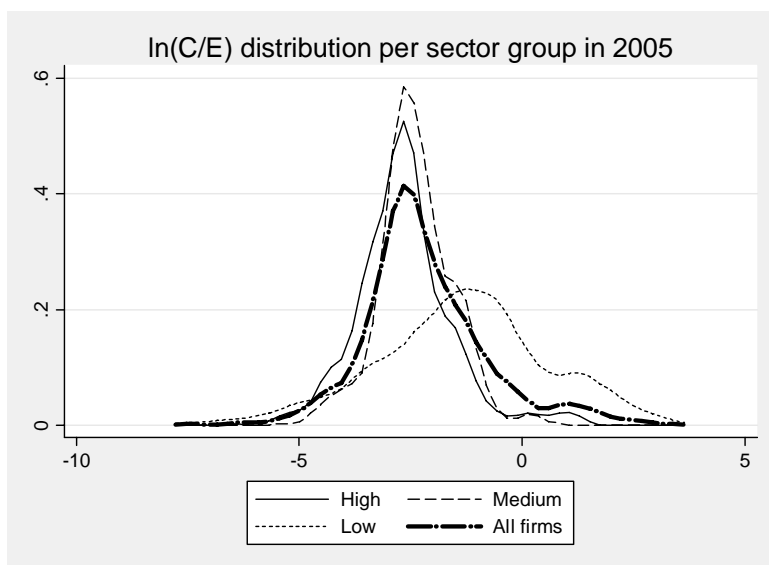
<sup>16</sup> The original DTI dataset selects top R&D investors based on their absolute R&D figures, implying that only outstanding firms for each low-tech sector are taken into consideration.

**Figure 2**



<i>Variable</i>	<i>All firms</i>		<i>High-tech</i>		<i>Medium-high</i>		<i>Low-tech</i>	
	Mean	SD	Mean	SD	Mean	SD	Mean	SD
<b>ln(K/E)</b>	-4.291	1.418	-3.377	1.201	-4.467	1.204	-5.117	1.317

**Figure 3**



<i>Variable</i>	<i>All firms</i>		<i>High-tech</i>		<i>Medium-high</i>		<i>Low-tech</i>	
	Mean	SD	Mean	SD	Mean	SD	Mean	SD
<b>ln(C/E)</b>	-2.176	1.422	-2.649	1.077	-2.388	0.844	-1.357	1.931

As can be seen, the 2005 density functions are in line with the overall figures reported in Table 2. It should be noted that the possibly greater "pick the winner" bias within the low-tech sectors renders these sectors more likely to turn out to be more efficient in terms of the R&D/productivity link<sup>17</sup>. However, this does not seem to be the case, at least from the preliminary results reported in the correlation matrices in Table 3:

**Table 3: correlation matrices**

	<b>ln(VA/E)</b>	<b>ln(K/E)</b>	<b>ln(C/E)</b>	<b>ln(VA/E)</b>	<b>ln(K/E)</b>	<b>ln(C/E)</b>
	<i>All firms</i>			<i>High-tech</i>		
<b>ln(VA/E)</b>	1.0000			1.0000		
<b>ln(K/E)</b>	0.3455 (0.0000)	1.0000		0.6147 (0.0000)	1.0000	
<b>ln(C/E)</b>	0.5414 (0.0000)	0.0816 (0.0006)	1.0000	0.1180 (0.0000)	0.2973 (0.0000)	1.0000
	<i>Medium-high</i>			<i>Low-tech</i>		
<b>ln(VA/E)</b>	1.0000			1.0000		
<b>ln(K/E)</b>	0.5202 (0.0000)	1.0000		0.4046 (0.0000)	1.0000	
<b>ln(C/E)</b>	0.4605 (0.0000)	0.2994 (0.0000)	1.0000	0.7039 (0.0000)	0.3388 (0.0000)	1.0000

*Note:* p-values in parentheses

<sup>17</sup> As will become clear from the following analysis, this is not at all the case. However, the sample bias affecting our data (which we cannot control for) should not make the obtained results more likely, its possible influence actually working in the opposite direction. In fact - as is clear from Table 2 and Figures 1 to 3 - the selected low-tech firms turn out to be larger and more capital-intensive than their more technologically-oriented counterparts; assuming possible scale economies in R&D activities (see Piga and Vivarelli, 2004) and innovative complementarities (see Catozzella and Vivarelli, 2007), this selection should render a greater impact of R&D expenditures on productivity more likely in the selected "best" low-tech firms. In addition, these firms turn out to invest considerably less in R&D than their high-tech counterparts, yet they are more efficient (see Figure 1); hence, the "decreasing returns" argument should not apply to the selected sample of firms; as the larger and most efficient low-tech companies in Europe and still under-investing in research activities, the selected firms should be in a better position to achieve higher productivity returns by increasing their R&D expenditures.

On the basis of this preliminary and univariate exercise, and consistently with the previous studies discussed in Section 2, the R&D-productivity link turns out to be positive and significant overall, but more obvious once we move from the low-tech to the medium-high-tech and finally to the high-tech sectors. A reverse pattern seems to emerge as far as the productivity impact of physical capital is concerned.

Indeed, this first evidence is confirmed by the econometric analysis reported in Table 4. Specification (1) was tested through pooled ordinary least squares (POLS) and random effects (RE) models. We chose a random rather than a fixed effects specification for various reasons. Firstly, the nature of our unbalanced short panel (six years with an average of 3.4 observations available per firm) severely affects the within-firm variability component of our data. Secondly, and consistently with the previous observation, the within-firm component of the variability of the dependent variable turns out to be overwhelmed by the between-firms component (the standard deviations being 0.15 and 0.58 respectively)<sup>18</sup>. Thirdly, the Hausman test comparing the random and fixed effects models for the whole sample clearly supports the former ( $\chi^2=4.65$ ,  $p\text{-value}=0.79$ ). Fourthly, in the fixed effects model the estimation of the coefficient of any time-invariant regressor – such as an indicator of sectoral belonging – is not possible as it is absorbed into the individual-specific effect; this is particularly unfortunate in our case, where the two-digit sectoral dummies always turn out to be both jointly significant (see the corresponding Wald tests in Table 4) and individually significant in the vast majority of cases (for instance, in 25 cases out of 27 sectoral dummies for the whole sample).

As expected, all the estimated specifications turned out to be affected by heteroskedasticity (White, 1980); hence, robust standard errors were used. In particular, in the following regressions we used the Eicker/Huber/White sandwich estimator (see Wooldridge, 2002 and Arellano, 2003 for a detailed analysis of the application of this robust estimator to random-effects methodology).

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<sup>18</sup> As robustness checks, between estimates – just using the cross-sectional variation of data – were run and outcomes were consistent and similar to those obtained from the more comprehensive random effects estimates reported in the following Table 4 (results available upon request).



**Table 4: Econometric estimates; dependent variable:  $\ln(\text{VA}/\text{E})$** 

Model Specification	<i>Whole Sample</i>		<i>High-tech</i>		<i>Medium-high</i>		<i>Low-tech</i>	
	POLS	RE	POLS	RE	POLS	RE	POLS	RE
$\ln(\text{K}/\text{E})$	0.123 (0.014)	0.125 (0.015)	0.180 (0.018)	0.160 (0.029)	0.138 (0.012)	0.146 (0.026)	0.048 (0.014)	0.068 (0.021)
$\ln(\text{C}/\text{E})$	0.122 (0.013)	0.117 (0.018)	<u>-0.011</u> (0.019)	<u>0.014</u> (0.025)	0.133 (0.018)	0.137 (0.029)	0.230 (0.020)	0.210 (0.031)
$\ln(\text{E})$	-0.063 (0.007)	-0.092 (0.013)	-0.036 (0.010)	-0.074 (0.019)	-0.061 (0.012)	-0.072 (0.022)	-0.084 (0.014)	-0.113 (0.022)
Constant	<u>-0.189</u> (0.183)	<u>0.096</u> (0.220)	-1.863 (0.149)	-1.571 (0.221)	-1.412 (0.149)	-1.231 (0.309)	-0.598 (0.188)	-1.443 (0.252)
Wald time-dummies joint significance test (p-value)	8.80 (0.000)	95.28 (0.000)	3.30 (0.006)	29.53 (0.000)	3.66 (0.003)	32.22 (0.000)	7.17 (0.000)	58.15 (0.000)
Wald sector-dummies joint significance test (p-value)	46.62 (0.000)	368.21 (0.000)	38.07 (0.000)	54.76 (0.000)	14.89 (0.000)	19.49 (0.003)	45.51 (0.000)	186.66 (0.000)
White heterosk. test (p-value)	671.84 (0.000)		188.43 (0.000)		246.47 (0.000)		245.16 (0.000)	
R-squared (overall)	0.649	0.639	0.550	0.532	0.484	0.478	0.784	0.773
R-squared (within)		0.245		0.190		0.283		0.334
R-squared (between)		0.652		0.540		0.460		0.772
F(k-1, N-(k-1)) (p-value)	83.73 (0.000)		46.61 (0.000)		36.51 (0.000)		86.03 (0.000)	
Wald chi2(k-1) (p-value)		972.14 (0.000)		673.05 (0.000)		185.74 (0.000)		616.20 (0.000)
observations	1787		600		671		516	
firms	532		170		196		166	

**Notes:** robust standard errors in brackets; all coefficients are significant at the 99% level of confidence apart from those underlined (not significant).

As can be seen, the knowledge stock has a significant positive impact on a firm's productivity with an overall elasticity of about 0.125; this general result is largely consistent with the previous literature both in terms of the sign, the significance and the estimated magnitude of the relevant coefficient. More interestingly, the coefficient increases monotonically when we move from the low-tech to the medium-high and the high-tech sectors, ranging from a minimum of 0.05/0.07 to a maximum of 0.16/0.18. This outcome - highly significant and confirmed by the two methodologies - is consistent with the previous empirical contributions

discussed in Section 2 and contrasts with recent assumptions about the alleged advantage of low-tech sectors in achieving efficiency gains from R&D investments.

As far as the other variables are concerned, physical capital also increases a firm's productivity, with an overall elasticity which turns out to be very similar to that for R&D; however, this effect is concentrated in low-tech and medium-high tech sectors, while it is not significant in the high-tech sectors. This evidence seems to suggest that "*embodied technological change*"<sup>19</sup> is crucial in all sectors except for high-tech, where technological progress is mainly introduced through R&D investments and new products rather than new processes. Finally, the investigated firms reveal decreasing returns with the (relatively) smaller firms showing higher productivity gains<sup>20</sup>.

Diagnosis tests reveal the satisfactory fitness of the chosen models and the usefulness of including both the time and sectoral sets of dummies<sup>21</sup>.

Table 5 presents the results of a robustness check consisting in replicating the estimates of (1) with all the regressors lagged one period, in order to check for possible endogeneity problems. As can be seen, results remain very stable, with the knowledge stock coefficients monotonically increasing when moving from the low-tech to the high-tech sectors. The diagnosis statistics do not significantly differ from those reported in the previous table.

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<sup>19</sup> The embodied nature of technological progress and the effects related to its spread in the economy were originally discussed by Salter (1960); in particular, vintage capital models describe an endogenous process of innovation in which the replacement of old equipment is the main way through which firms update their own technologies (see Freeman, Clark and Soete, 1982; Freeman and Soete, 1987).

<sup>20</sup> It has to be noticed that this is not an argument in favour of the role of R&D in SMEs, since our sample is made up only of large firms.

<sup>21</sup> Poolability tests adjusted to our unbalanced panel (see Cameron and Trivedi, 2005, pp. 737 and ff.; Park, 2005) clearly reject the null of pure POLS without year dummies [ $F(20; 1763) = 2.10^{***}$ ], while a clear case for the additional insertion of sectoral dummies does not emerge.

**Table 5: First robustness check with lagged variables; dependent variable:  $\ln(\text{VA}/E)$** 

Model Specification:	<i>Whole Sample</i>		<i>High-tech</i>		<i>Medium-high</i>		<i>Low-tech</i>	
	POLS	RE	POLS	RE	POLS	RE	POLS	RE
$\ln(K/E)_{t-1}$	0.120 (0.011)	0.095 (0.018)	0.185 (0.020)	0.175 (0.032)	0.128 (0.016)	0.073 (0.029)	0.047 (0.018)	<u>0.032</u> (0.031)
$\ln(C/E)_{t-1}$	0.138 (0.015)	0.096 (0.022)	<u>-0.013</u> (0.022)	<u>-0.003</u> (0.038)	0.143 (0.021)	<u>0.044</u> (0.035)	0.255 (0.024)	0.222 (0.037)
$\ln(E)_{t-1}$	-0.046 (0.007)	-0.048 (0.016)	-0.027 (0.012)	<u>-0.042</u> (0.022)	-0.037 (0.016)	<u>-0.008</u> (0.036)	-0.062 (0.017)	-0.062 (0.026)
Constant	<u>-0.766</u> (0.209)	<u>-1.682</u> (0.264)	-1.879 (0.171)	-1.798 (0.304)	-1.733 (0.206)	-2.594 (0.515)	<u>-1.506</u> (0.189)	-1.123 (0.416)
Wald time-dummies joint significance test (p-value)	4.71 (0.001)	54.14 (0.000)	2.79 (0.026)	19.76 (0.000)	1.12 (0.347)	24.81 (0.000)	6.53 (0.000)	44.25 (0.000)
Wald sector-dummies joint significance test (p-value)	35.32 (0.000)	242.45 (0.000)	25.13 (0.000)	46.12 (0.000)	11.67 (0.000)	26.57 (0.000)	34.94 (0.000)	93.00 (0.000)
White heterosk. test (p-value)	528.56 (0.000)		167.05 (0.000)		214.47 (0.000)		194.04 (0.000)	
R-squared (overall)	0.669	0.654	0.562	0.552	0.506	0.424	0.817	0.810
R-squared (within)		0.136		0.195		0.081		0.265
R-squared (between)		0.655		0.553		0.414		0.801
F(k-1, N-(k-1)) (p-value)	77.68 (0.000)		39.53 (0.000)		29.74 (0.000)		93.06 (0.000)	
Wald chi2(k-1) (p-value)		728.27 (0.000)		182.35 (0.000)		108.08 (0.000)		577.45 (0.000)
observations	1214		414		464		336	
firms	403		133		154		116	

**Notes:** robust standard errors in brackets; all coefficients are significant at least at the 95% level of confidence apart from those underlined (not significant).

Finally, we tried to control for the important role of spillovers. As commonly found in the literature (see Bernstein and Nadiri, 1989; Los and Verspagen, 2000; Medda and Piga, 2007), we proxied intra-sectoral spillovers<sup>22</sup> through total sectoral R&D expenditures. We obtained the relevant national/sectoral figures from the OECD-ANBERD database, which is the only official source to provide reliable and comparable sectoral data concerning company R&D activities. Unfortunately, this statistical source is updated only to 2003 and so we extrapolated figures for 2004 and 2005 using the compounded average rates of change over the previous

<sup>22</sup> With our data we have no way of controlling for inter-sectoral spillovers; however, given our level of sectoral disaggregation (basically two-digit), it can legitimately be assumed that most spillovers are intra-sectoral.

four-year period. Then flows were transformed into sectoral stocks per employee using the same procedures described in eqs. 2 to 5. As can be seen from the following Table 6, although generally positive, the spillover coefficients ( $\ln S/E$ ) are rarely significant; previous results remain virtually unchanged.

**Table 6: Second robustness check including spillovers; dependent variable:  $\ln(VA/E)$**

Model Specification	Whole Sample		High-tech		Medium-high		Low-tech	
	POLS	RE	POLS	RE	POLS	RE	POLS	RE
$\ln(K/E)$	0.124 (0.008)	0.123 (0.015)	0.181 (0.015)	0.164 (0.023)	0.137 (0.010)	0.145 (0.017)	0.047 (0.014)	0.065 (0.023)
$\ln(C/E)$	0.123 (0.010)	0.121 (0.019)	<u>-0.017</u> (0.017)	<u>0.009</u> (0.024)	0.136 (0.015)	0.140 (0.024)	0.236 (0.018)	0.223 (0.028)
$\ln(S/E)$	<u>0.004</u> (0.006)	<u>0.008</u> (0.005)	0.021 (0.010)	<u>0.008</u> (0.008)	0.020 (0.008)	<u>0.015</u> (0.006)	<u>-0.017</u> (0.010)	<u>0.008</u> (0.008)
$\ln(E)$	-0.065 (0.006)	-0.093 (0.013)	-0.035 (0.010)	0.073 (0.008)	-0.061 (0.010)	-0.072 (0.017)	-0.084 (0.012)	-0.114 (0.020)
Constant	-0560 (0.115)	0.080 (0.224)	-1.856 (0.141)	-1.617 (0.218)	-1.483 (0.139)	-1.296 (0.194)	0.490 (0.196)	-1.480 (0.235)
Wald time-dummies joint significance test (p-value)	7.57 (0.000)	89.64 (0.000)	3.39 (0.005)	25.65 (0.000)	2.94 (0.012)	32.81 (0.000)	6.56 (0.000)	63.79 (0.000)
Wald sector-dummies joint significance test (p-value)	43.37 (0.000)	365.58 (0.000)	26.06 (0.000)	51.17 (0.000)	13.75 (0.000)	18.47 (0.005)	40.47 (0.000)	192.15 (0.000)
White heterosk. test (p-value)								
R-squared (overall)	0.649	0.640	0.554	0.535	0.489	0.483	0.788	0.775
R-squared (within)		0.244		0.189		0.290		0.342
R-squared (between)		0.651		0.542		0.467		0.773
F(k-1, N-(k-1)) (p-value)	88.12 (0.000)		47.53 (0.000)		40.76 (0.000)		81.92 (0.000)	
Wald chi2(k-1) (p-value)		1315.07 (0.000)		284.86 (0.000)		346.79 (0.000)		681.06 (0.000)
observations	1753		589		656		508	
firms	527		168		194		165	

**Notes:** robust standard errors in brackets; all coefficients are significant at least at the 95% level of confidence apart from those underlined (not significant).

## **5. Conclusions**

While the general link between R&D and productivity has been proved by previous literature, very few studies have provided empirical evidence about possible sectoral differences in the productivity gains obtainable from R&D activities. In order to fill this gap, in this research we conducted a detailed analysis of the effect of R&D expenditures on firms' productivity using panel micro-data based on information from the top European R&D investors. The main results can be summarised along the following lines:

- firstly, the positive and significant impact of R&D on productivity is always confirmed. While this result does not fully dispel the concern about the lack of a link between R&D and the ultimate economic performance of a firm (since the latter is dependent on many other factors), it clearly suggests that R&D is a fundamental determinant of possible competitive advantage;
- secondly, firms in high-tech sectors not only invest more in R&D, but also achieve more in terms of efficiency gains connected with research activities. In contrast with recent acceptance of low-tech sectors as favourite targets for R&D investment, our results show that firms in high-tech sectors are still far ahead in terms of the productivity impact of their research activities, at least among the top European R&D investors. Moreover, productivity growth in low-tech firms is still heavily dependent on investment in physical capital (*embodied technological change*).

Empirical results proved to be robust to the inclusion of lags and to the consideration of sectoral spillovers. While these results cannot readily be generalised to the overall economy, they do not support the idea that "low R&D" is "more efficient R&D", but rather the opposite view. Further research – based on larger and more comprehensive samples – is needed to see whether this result can be further qualified.

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**Appendix A: ICB-NACE conversion**

	ICB	NACE	
		code	division name
<b>High-tech</b>	Technology hardware & equipment	30	Manufacture of machinery and equipment n.e.c. Manufacture of office machinery and computers
		32	Manufacture of radio, television and communication equipment and apparatus
	Pharmaceuticals & biotechnology	24	Manufacture of chemicals and chemical products
		73	Research and development
	Leisure goods	32	Manufacture of radio, television and communication equipment and apparatus
		36	Manufacture of furniture; manufacturing n.e.c.
	Aerospace & defence	35	Manufacture of other transport equipment
		75	Public administration and defence; compulsory social security
	Automobiles & parts	25	Manufacture of rubber and plastic products
		34	Manufacture of medical, precision and optical instruments, watches and clocks Manufacture of motor vehicles, trailers and semi-trailers
Software & computer services	72	Computer and related activities	
Electronic & electrical equipment	31	Manufacture of electrical machinery and apparatus n.e.c.	
	32	Manufacture of radio, television and communication equipment and apparatus	
<b>Medium-tech</b>	Chemicals	24	Manufacture of chemicals and chemical products (except 2441)
	Industrial engineering	29	Manufacture of machinery and equipment n.e.c.
		35	Manufacture of other transport equipment
	Health care equipment & services	33	Manufacture of medical, precision and optical instruments, watches and clocks
		36	Manufacture of furniture; manufacturing n.e.c.
		85	Health and social work
	Household goods	36	Manufacture of furniture; manufacturing n.e.c.
	General industrials	26	Manufacture of rubber and plastic products
		74	Other business activities
	Food producers	5	Fishing, fish farming and related service activities
15		Manufacture of food products and beverages	
Media	22	Publishing, printing and reproduction of recorded media	
	92	Recreational, cultural and sporting activities	
<b>Low-tech</b>	Fixed line telecommunications	64	Post and telecommunications
	Industrial metals	27	Manufacture of basic metals
	Electricity	40	Electricity, gas, steam and hot water supply
	Oil equipment, services & distribution	11	Extraction of crude petroleum and natural gas; service activities incidental to oil and gas extraction, excluding surveying
	General retailers	52	Retail trade, except of motor vehicles and motorcycles; repair of personal and household goods
		93	Other service activities
	Support services	51	Wholesale trade and commission trade, except of motor vehicles and motorcycles
		74	Other business activities
	Construction & materials	26	Manufacture of other non-metallic mineral products
		45	Construction
	Banks	65	Financial intermediation, except insurance and pension funding
	Gas, water & multiutilities	40	Electricity, gas, steam and hot water supply
		41	Collection, purification and distribution of water
	Oil & gas producers	11	Extraction of crude petroleum and natural gas; service activities incidental to oil and gas extraction, excluding surveying
	Mobile telecommunications	64	Post and telecommunications
	Industrial transportation	60	Land transport; transport via pipelines
		63	Supporting and auxiliary transport activities; activities of travel agencies
64		Post and telecommunications	
Beverages	15	Manufacture of food products and beverages	