Tiwari, Amaresh K.; Mohnen, Pierre; Palm, Franz; van der Loeff, Sybrand Schim

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Microeconometric Evidence of Financing Frictions and Innovative Activity

Amaresh K. Tiwari
Pierre Mohnen
Franz C. Palm
Sybrand Schim van der Loeff

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Abstract

Using Dutch data we empirically investigate how financing and innovation vary across firm characteristics. We find that when firms face financial constraints, debt financing and innovation choices are not independent of firm characteristics, and R&D slows down. In the absence of financial constraints, however, as they raise debt, firms become less inclined to innovate and the change in the propensity to innovate no longer varies with firm characteristics. We find that financing constraints faced, propensity to innovate, and R&D intensity are not uniform across firm characteristics. A new “control function” estimator to account for heterogeneity and endogeneity has been developed.

JEL-Code: G300, O300, C300.

Keywords: innovation, R&D, capital structure, financial constraints, firm characteristics, correlated random effects, control function, expected a posteriori.

Amaresh K. Tiwari
University of Liege
Liege / Belgium
A.Tiwari@ulg.ac.be

Pierre Mohnen
Maastricht University
Maastricht / The Netherlands
P.Mohnen@maastrichtuniversity.nl

Franz C. Palm
Maastricht University
Maastricht / The Netherlands
F.Palm@maastrichtuniversity.nl

Schim van der Loeff
Maastricht University
Maastricht / The Netherlands
S.Loeff@maastrichtuniversity.nl

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I. INTRODUCTION

In this paper we investigate how finance, innovation and R&D decisions are interrelated and depend on firm characteristics. It is well recognized in the literature that depending on the choice of capital structure firms are more or less financially constrained and that financial constraints have implication for firm dynamics (Albuquerque and Hopenhayn, 2004; Clementi and Hopenhayn, 2006). We also now that R&D investments and innovation call for particular financial choices (Brown et al., 2009, 2012), and that R&D and innovation depend on financial frictions (Hall and Lerner, 2010; Hajivassiliou and Savignac, 2011). What is lacking is an empirical model that integrates these three decisions and takes their endogeneity into account. This is the prime objective of this paper.

Empirical analysis in corporate finance, as discussed in Roberts and Whited (2010), is marred with issues of endogeneity. We develop a new “control functions” (see Blundell and Powell, 2003) method to handle endogeneity and unobserved heterogeneity. We estimate our structural model in three steps. First we estimate the system of reduced form equations, the estimates of which are then used to construct the control functions that correct for the bias that can arise because of the presence of endogenous financial state variables in the structural equations. With the control functions in place, in the second stage we jointly estimate the structural model of financial constraint faced by the firms and the decision to innovate. Finally in the third stage, conditional on the decision to innovate, we estimate the switching regression model of R&D investment to assess the impact of financial constraint on R&D investment.

Typically, in a simultaneous triangular system of equations with additive separability in the reduced form equation, the control functions are the unobserved time-varying errors in the reduced equation so that, conditional on reduced form errors, which are proxied by the residuals, the structural parameters can be consistently estimated. In panel data, with unobserved individual effects, the residuals of the reduced form equation, defined as the observed value of the endogenous variable minus its expectation conditional on observed regressors and the unobserved individual effects, remain unidentified. This is because the individual effects are unobserved. Besides being a conditioning element in the expected value of the response variable in the reduced form equation, the individual effects also
affect the outcome of the structural equations.

The novelty of our approach lies in integrating out the unobserved individual effects. The integration is performed with respect to the conditional distribution – conditional on the observed variables – of the individual effects, which is obtained as the posterior distribution of the individual effects. This posterior distribution is estimated using the results of the reduced form equation estimated in the first stage. This leaves us with the “expected a posteriori” (EAP) values of the individual effects, which can then be used to obtain the residuals of the reduced form that now become a function of the observed variables.

We apply our methodology to a unique micro data set of biannual data resulting from the merger of financial statistics, production statistics, and R&D and innovation surveys from the Central Bureau of Statistics of the Netherlands covering the period 1998 to 2002. Instead of using estimates of a constructed measure of financial constraints as in Whited and Wu (2005), or proxies of it as in Brown et al. (2009) (henceforth BFP), we use the firms’ direct reporting as to whether they faced financial constraints that hampered their innovation projects.

Our method allows us to construct counterfactual effects of changes in financing policy on the decision to innovate for financially constrained and unconstrained firms and gauge the effect of financial constraint on R&D investment. While we confirm the results from previous papers regarding the relationship between financial and innovation decisions and firm characteristics, we find that unconstrained firms are less likely to engage in innovative activities by financing them with long-term debt irrespective of characteristics such as size, age and leverage. Constrained firms may choose to finance their innovation activities by debt, but the likelihood of doing so depends on the degree of constraint they face, which depends on their characteristics. Other findings that underscore the fact that innovation and financing decision are not uniform across firm characteristics are that large and young firms are more likely to engage in innovative activity, that large and mature firms are less R&D intensive, and that small and younger firms are more financially constrained. These findings suggest that decisions to innovate, financing choices and firm dynamics are not independent. This paper aims to gain insight into how and why the incentives to innovate and the extent and the nature of financing frictions are not uniform across firm characteristics.
The rest of the paper is organized as follows. In section II we present the economic framework, in section III we discuss the empirical strategy employed, in section IV we discuss the data and the definition of the variables, in section V we present the results and in section VI we conclude. In a separate appendix, which for reasons of space have not been included in the core of the paper, but can be made available upon request, we discuss the identification of the structural parameters and the details of the econometric methodology.

II. FINANCING FRICTIONS AND INNOVATIVE ACTIVITY

A. Financing and Innovation Decision

Holmstrom (1989) points out that from the perspective of investment theory R&D has a number of characteristics that make it different from ordinary investment: it is long-term in nature, high risk in terms of the probability of failure, unpredictable in outcome, labor intensive, and idiosyncratic. The high risk involved and unpredictability of outcomes are potential sources of asymmetric information that give rise to agency issues in which the inventor frequently has better information about the likelihood of success and the nature of the contemplated innovation project than the investors. Leland and Pyle (1977) point out that investors have more difficulty distinguishing good or low risk projects from bad ones when they are long-term in nature. Besides, due to the ease of imitation of innovative ideas, as pointed out by Hall and Lerner (2010), firms are reluctant to reveal their innovative ideas to the marketplace, and there could be a substantial cost to revealing information to their competitors. Thus, the implication of asymmetric information coupled with the costliness of mitigating the problem is that firms and inventors will face a higher cost of debt financing for R&D.

Also, because the knowledge asset created by R&D investment is intangible, partly embedded in human capital, and ordinarily very specialized to the particular firm in which it resides, the capital structure of R&D intensive firms customarily exhibits considerably less leverage than that of other firms, see Titman and Wessels (1988). The logic is that the lack of a secondary market for R&D and the non-collaterability of R&D activity mitigates against debt-financed R&D activity. Aboody and Lev (2000) argue that because of
the relative uniqueness of R&D, which makes it difficult for outsiders to learn about the productivity and value of a given firm’s R&D from the performance and products of other firms in the industry, the extent of information asymmetry associated with R&D is larger than that associated with investment in tangible (e.g., property, plant, and equipment) and financial assets. Hence, bond holders, ceteris paribus, may be unwilling to hold the risks associated with greater R&D activity. BFP studying a panel of R&D intensive firms, find that equity, when more easily available, might be preferred to debt as a means of financing R&D.

Brown et al. (2012), Hall and Lerner (2010) and BFP point out that most of the R&D spending is in the form of payments to highly skilled workers, who often require a great deal of firm-specific knowledge and training. The effort of the skilled workers create the knowledge base of the firm, and is therefore embedded in the human capital of the firms. This knowledge base is lost once workers get laid off. The implication of this is that R&D intensive firms behave as if they faced large adjustment costs and therefore chose to smooth their R&D spending. Thus R&D intensive firms that face financing frictions, to smooth R&D relative to transitory finance shocks, build and manage internal buffer stocks of liquidity (e.g., cash reserves). Gamba and Triantis (2008) point out that cash balances, which give financial flexibility to firms, are held when external finance is costly and/or income uncertainty is high. With higher liquidity reserve firms can counter bad shocks by draining it.

Now, given the nature of R&D activity that makes borrowing costly, internal funds may be more preferable. Therefore, innovative firms, ceteris paribus, are less likely to distribute cash as dividends. Both Carpenter and Petersen (2002) and Chan et al. (2001) studying R&D intensive firms from COMPUSTAT files find that R&D intensive firms pay little or no dividend, indicating that most firms retain essentially all of their internal funds. In our data set we too find that, on average, innovating firms pay less dividends than non-innovating firms.

In this paper we study a firm’s decision to innovate and the financing choices of a panel of Dutch firms observed over three waves. While there are many studies that have explored a firm’s choice to innovate in the Schumpeterian tradition, few have considered how financing
and innovation choices are related. We formally model the decision to innovate as

\[ I_t = 1\{I_t^*(\text{Long-term Debt, Liquidity Reserve, Dividend, Controls, } \bar{\alpha}, \nu_t) > 0\}, \]

(2.1)

where \( I = 1\{ . \} \) is an indicator function that takes value 1 if the latent variable \( I_t^*(.) > 0 \). \( \bar{\alpha} \) is the unobserved heterogeneity, \( \nu_t \) the idiosyncratic term, and \( \text{Controls} \) being the traditional control variables. We term equation (2.1) as the Innovation equation. Given the above discussion, we should expect that, ceteris paribus, firms with higher long-term debt in their capital structure, firms that maintain low liquidity reserve, and firms that pay out dividends to be less likely to engage in innovative activity. We do not contend that other consideration such as taxes or issuance cost do not affect financial decisions. We also know that financing and investment decisions are history dependent and are forward looking. However, ceteris paribus, across time and cross section of firms the above hypothesized relationships are expected to hold on an average.

B. Financial Constraints and Innovation

Papers, such as Cooley and Quadrini (2001) (CQ), Albuquerque and Hopenhayn (2004) (AQ), and Clementi and Hopenhayn (2006) (CH), studying firm dynamics look at how financial constraint and capital structure affect firm growth and survival. These papers have shown that financing constraint and financing and investment decisions are not uniform across firm characteristics such as size and age. Now, it is well known that innovation too affects growth and survival of firms (see Klette and Kortum, 2004, (KK)), and that R&D effort is marred by various kinds uncertainties (see Berk et al., 2004) unique to the innovation process. Hence, a firm engaging in R&D will have its equity value affected, with implications for borrowing constraint, state contingent growth trajectory and future financing and innovation decision.

Therefore, while the unconditional relation between financing and innovation, discussed in subsection A, could be expected to be true, under financial constraint, firms could, depending on the extent of constraint, opt for a innovation and financing policy different from when they are unconstrained. This could be ascertained by looking at how the decision of a firm to engage in innovative activity changes by changing the financial policy of the
firm under varying degrees of financial constraint. To achieve this end, we start by studying how financial constraint arise for firms that report that they are financially constrained.

To formalize, we denote by $F_{it}$, which takes value 1 if the firm $i$ reports that it is financially constrained in time period $t$. Now, see HW, a firm may be constrained both because of high cost of external funds and/or because of high need for external funds. Thus, when a firm reports that it is financially constrained, $F_{it} = 1$, it could be because it is required to pay a high premium, which could be higher for firms engaging in R&D activity, on scarce external finance or because it is unable to access external funds. The premium, for example, could reflect bankruptcy cost (see Gale and Hellwig, 1985) or the cost of floating equity as in HW and CQ. In AH and CH this premium is formalized as higher repayment schedule to lenders as a fraction of its profits during such time as when the firm faces borrowing constraint and short-term capital advancement are low. Also, for a given financial state of a firm, higher expectation of profits from R&D activity will drive up the demand for R&D investment, creating a gap between desired and available funds, which in turn will cause the firm to report itself as being financially constrained. Hence, in our explanation of how financial constraint arise, we will need to control for future expected profitability.

Barring a few that have been documented in Hall and Lerner (2010), most papers in empirical corporate finance study corporate financing and firm level investment. Now, financing frictions with respect to R&D activity, which for reasons discussed earlier, can be acute when compared to financing investment in physical capital. Consequently, innovative firms might find themselves more constrained than those that are not. To test this, like Almeida and Campello (2007), we test if asset intangibility, which is higher for innovating firms and which limits the debt capacity of firms, have a bearing on the reported financial constraint.

Formally, we model financial constraint as

$$F_i = 1\{F_i^*(\text{Financial State Variables, Expected Profitability, Controls, } \tilde{\alpha}, \zeta_i) > 0\},$$ (2.2)

where $\tilde{\alpha}$ is unobserved heterogeneity and $\zeta_i$ is the idiosyncratic component of the Financial Constraint equation. As in Whited and Wu (2005) and Gomes et al. (2006), where the
shadow price of scarce external finance in the firm’s intertemporal optimization problem is assumed to be a function of observable variables, we hypothesize that the latent variable $F^*_t$, which captures the premium on external finance and the gap in financing, to be a function of observable and endogenously determined financial state variables. HW give a detailed discussion on constraint proxies that reflect high cost or high need for external finance. Our specification, discussed later, to explain financial constraint is rich enough to capture both aspects, high cost as well as high need for external finance.

Now, to return to the question of innovation and financing policy under financial constraint across firm characteristics, we look at how the propensity to innovate under financial constraint, both of which are determined endogenously, changes with endogenous financing policy, say an increase in long-term debt, of the firm. To put it formally, we look at how $\Pr(I = 1|F = 1)$ and $\Pr(I = 1|F = 0)$ changes with debt policy at different level of firm characteristics, such as size of the firm. These firm characteristics also indicate the extent of constraint the firm faces, so in effect by studying how $\Pr(I = 1|F = 1)$ changes with the financing policy of the firm at different level of firm characteristics, we are looking at how $\Pr(I = 1|F = 1)$ changes with the financing policy at different level of constraint.

C. Financial Constraints and R&D Investment

Beginning with Fazzari et al. (1988) there has been a huge amount of literature that has sought to test for financing frictions and quantifying the extent of market failure in company level investment due to the presence of financing frictions. A survey of this literature is beyond the scope of this paper. However, as Brown et al. (2012) point out there aren’t many papers that have looked at financing frictions and R&D investment. Few papers that have studied the implication of financial constraint for R&D investment have been surveyed in Hall and Lerner (2010).

Empirical study of the effect of financing frictions on investment has broadly followed two approaches. One approach is to ad hoc classify firms into those that are financially constrained and those that are not, and specify a reduced form accelerator type model for the constrained and unconstrained firms. The extent of financing frictions, controlling for the investment opportunity, is judged by the sensitivity of investment to cash flow. Another
approach, which is more structural, is to estimate Euler equations derived from standard intertemporal investment model augmented with financial state variables to account for financial frictions, where external financing constraint affect the intertemporal substitution of investment today for investment tomorrow, via the shadow value of scarce external funds, (see Whited and Wu, 2005). The few empirical studies on financing frictions and R&D investment, broadly speaking, follow these two approaches.

In this paper, besides studying financing and innovation decisions of firms under financial constraint across firm characteristic, we also study how financial constraint affect R&D investment, which is observed conditional on firms choosing to innovate, $I_t = 1$. We posit that the observed R&D intensity, measured as a ratio of R&D investment to total capital asset, for a firm $i$, can be explained by estimating the following R&D equation:

$$R_t = R_t(Financial\ Constraint,\ Expected\ Profitability, Controls, \tilde{\alpha}, \eta_t) \text{ if } I_t = 1,$$

(2.3)

where $\tilde{\alpha}$ is the unobserved heterogeneity, $\eta_t$ the idiosyncratic component. The specification is motivated by the fact that financing frictions, which could be either due to high cost of external funds or due to lack of access to it, is summarized by the reported financial constraint, $F_t$. Thus, given future expected profitability and other controls, we can gauge the extent of market failure for R&D investment due the presence of financing frictions by estimating the metric,

$$E[R_t(F_t = 0)|I_t = 1] - E[R_t(F_t = 1)|I_t = 1].$$

This metric could be construed as the difference between first best R&D investment and optimal R&D investment under financing constraint.

Using firm’s assessment of being financially constrained avoids the need to ad hoc classify the firms into constrained and unconstrained firms. Moreover, papers that a priori classify firms as constrained and unconstrained assume financial constraint faced by firms to be exogenous to investment decisions. In assessing the impact of reported financial constraint, $F_t = 1$, on R&D expenditure, ours is a departure from the reduced form accelerator type models, about which questions have been raised as to whether such a procedure can indeed identify the extent of financing frictions, (see Kaplan and Zingales 1997; Gomes
We address the issue of endogeneity of financial constraint by estimating simultaneously the Innovation equation (2.1), the Financial Constraint equation (2.2) and the R&D equation along with the equations for the financing choice made by the firms. Thus, in contrast to reduced form models, ours is a more structural approach.

Our framework for studying the effect of financing constraint on R&D in essence is a static one. Though one could derive a dynamic empirical model for R&D investment from a firm’s dynamic optimization problem with adjustment cost where the firm is subject to external financing constraints, or employ indirect inference approach as in Whited (2006) and HW to test for financing frictions and its implication for R&D investment, we avoid this route for two reasons. First, because in our data set we observe R&D investment every alternative year, this precludes us from estimating a dynamic empirical model of R&D investment, at least in the classical regression framework. The second reason is that, since firms tend to smooth R&D investment over time, adjustment costs, for firms that have decided to engage in R&D in the past, is unlikely to be a substantial factor in explaining R&D investment\(^1\). We believe that, given our comprehensive treatment of heterogeneity and endogeneity, a misspecification due to omission of adjustment cost should be taken care of.

Also, using the binary indicator on financial constraint as reported by firms allows us to generalize the R&D equation (2.3) to a switching regression model, where the endogenous financial constraint equation sorts the firms over the two different regimes, financially constrained and unconstrained. This allows us to investigate how firms with different characteristics, such as maturity and size, invest in R&D under financial constraint and under no constraint. In doing so we are able to underscore that financing frictions condition firm dynamics, which are brought about through R&D investment.

\(^1\) It is also possible that new innovators bear sunk cost of investment and costly learning expenses, giving rise to non-convex adjustment cost, which can interact with financing friction to alter the timing of R&D investment. However, estimating parameters of interest of a model that allows for sunk cost of investment would involve a different econometric approach, such as in Cooper and Haltiwanger (2006) or HW. And this is beyond the scope of our paper.
III. EMPIRICAL MODEL

The usual problem faced in any empirical exercise is that of accounting for heterogeneity and endogeneity. For the problem at hand, we know that the decision to innovate, the financial choices made, the financial constraint faced, and the amount to invest in R&D are all endogenously determined. In this paper we develop a control function approach to address the issue of heterogeneity and endogeneity. In this section we introduce our empirical model, the model assumptions, and some results. Technical details on identification of structural parameters of interest has been discussed in the Appendix.

To study the effect of endogenous financial constraint on R&D expenditure, the endogenous decision to innovate, and to account for the fact that R&D expenditure is observed only for firms that opt to innovate, the three structural equations – Innovation, Financial Constraint, and R&D – introduced in section 2 are

\[ I_{it} = 1 \{ I_{it}^* = X_{it}^I \gamma + \tilde{\alpha}_i + \nu_{it} > 0 \}, \]
\[ F_{it} = 1 \{ F_{it}^* = X_{it}^F \varphi + \tilde{\lambda}_i + \zeta_{it} > 0 \}, \]
\[ R_{it} = \begin{cases} F_{it} (\beta \epsilon F_{it} + X_{it}^F \beta_1 + \tilde{\mu}_1 \tilde{\alpha}_i + \eta_{1it}) + (1 - F_{it}) (X_{it}^R \beta_0 + \tilde{\mu}_0 \tilde{\alpha}_i + \eta_{0it}) & \text{if } I_{it} = 1 \\ F_{it} R_{1it} + (1 - F_{it}) R_{0it} & \text{if } I_{it} = 1 \end{cases}, \]

where \( I_{it} \) is a binary variable that takes value 1 if the firm \( i \) decides to innovate, \( F_{it} \) takes value 1 if it experiences financial constraint, and \( R_{it} \) is the observed R&D intensity, defined as the ratio of total R&D expenditure to total capital assets (tangible + intangible), if the firm decides to innovate\(^2\). To allow for the effect of \( X_i^R \) to be different in the two regimes, financially constrained and unconstrained, we model equation (3.3) as an endogenous switching regression model. That is,

\[ R_i = \begin{cases} R_{1i} = \beta \epsilon F_i + X_i^R \beta_1 + \tilde{\mu}_1 \tilde{\alpha}_i + \eta_{1i} & \text{if } F_i = 1 \text{ and } I_i = 1 \\ R_{0i} = X_i^R \beta_0 + \tilde{\mu}_0 \tilde{\alpha}_i + \eta_{0i} & \text{if } F_i = 0 \text{ and } I_i = 1. \end{cases} \]

In the above set of equations \( X_i^I = \{z_i^I, x_i^I\}'\), \( X_i^F = \{z_i^F, x_i^F\}'\), and \( X_i^R = \{z_i^R, x_i^R\}'\), where conditional on unobserved heterogeneity \( \tilde{\alpha}_i \), each of the \( z_i \) is a vector of exogenous

\(^2\)In the rest of the paper unless otherwise needed we drop the firm script \( i \).
variables. Each of the $x_t$, is a vector of endogenous variables, that is, $E(u_t | \tilde{\alpha}, x_t^I) \neq 0$. The same holds for the Financial Constraint and R&D equation.

Simultaneity in the decision to innovate, the financial constrained faced, and the amount to expend in R&D investment is captured by the unobserved heterogeneity that affects the decision to innovate, the constraint faced and R&D investment. Besides, the idiosyncratic errors in each of the equations, which are correlated with each other, and certain observable variables are common among the structural equations and which appear in reduced form equations in (3.4) also imply simultaneity.

Because $x_t$’s are endogenous, to obtain the consistent estimates for the structural equations we adopt a control function approach, which involves a multi-step procedure. In the first step we estimate

$$x_{it} = Z_i \delta + \tilde{\alpha}_i \kappa + \epsilon_{it}, \tag{3.4}$$

which is the system of ‘$m$’ equations written in a reduced form for the endogenous variables $x_t = (x_{1t}, \ldots, x_{mt})'$, where every component of $x_t^I$, $x_t^F$, and $x_t^R$ is also a component of $x_t$. In (3.4), $Z_t = \text{diag}(z_{1t}, \ldots, z_{mt})$ is the matrix of exogenous variables or instruments and $\delta = (\delta_1', \ldots, \delta_m')'$. Let $z_t$ be the union of all exogenous variables appearing in each of $z_t^I$, $z_t^F$, and $z_t^R$. For every $l \in (1, \ldots, m)$, $z_{il} = Z_t = (z_{il}, \tilde{z}_{il})'$, where the dimension of vector of instruments, $\tilde{z}$, is greater than or equal to the dimension $x$. This is the crucial identifying condition, see Blundell and Powell (2003) for details. Also define $X_i = \{x_{1i}', \ldots, x_{iT_i}'\}'$ and $Z_i = \{Z_{i1}', \ldots, Z_{iT_i}'\}'$.

$\epsilon_{it} = (\epsilon_{1it}, \ldots, \epsilon_{mit})'$ is the vector of idiosyncratic component. $\tilde{\alpha}_i$, the unobserved heterogeneity for firm $i$, which is correlated with $Z_i$, is modelled as a correlated random effect.

Since the unobserved heterogeneity affects the endogenous regressors as well as the firm’s innovation decision and it being financially constrained, to account for simultaneity that arises due to unobserved heterogeneity, we have factor loadings, such as, $\{\kappa_1, \ldots, \kappa_m\}$ in the reduced form equations, and $\tilde{\theta}, \tilde{\lambda}, \tilde{\mu}_0$, and $\tilde{\mu}_1$ in the structural equations.

The above structural equations – (3.1), (3.2), and (3.3) – can be succinctly written as

$$y_t^* = X_t' B + \tilde{\alpha} \tilde{k} + \Upsilon_t, \tag{3.5}$$

where $y_t^* = \{I_t^*, F_t^*, I_t F_t R_{tt}, I_t (1 - F_t) R_0t\}'$. $X_t = \text{diag}(X_t^I, X_t^F, X_t^R, X_t^{R0})$, where $X_t^R =$
\[{F_t, I_t F_t X_t^{R0}}\} \text{ and } X_{d1}^{R} = I_t(1 - F_t)X_t^{R}. \: \text{B in (3.5) is given by } B = \{\gamma', \phi', \beta_f, \beta_f', \beta_0'\}'.

Finally, \(\bar{\kappa} = \{\bar{\theta}, \bar{\lambda}, \bar{\mu}_1, \bar{\mu}_0\}'\) and \(\Upsilon_t = \{v_t, \zeta_t, \eta_{1t}, \eta_{0t}\}'\).

Some of the distributional assumptions that will eventually allow us to construct the control functions that correct the bias due to the endogeneity of \(x_t\) are:

\[A1. \: \Upsilon_{it} | \tilde{\alpha}_i, Z_i \sim \Upsilon_{it} | \tilde{\alpha}_i \text{ and } \epsilon_{it} | \tilde{\alpha}_i, Z_i \sim \epsilon_{it}, \]

\[A2. \: \text{The error terms } \tilde{\alpha}_i, \Upsilon_{it} \text{ and } \epsilon_{it} \text{ are normally distributed. } \Upsilon_{it} \text{ and } \epsilon_{it} \text{ are i.i.d.}^3 \]

and their joint distribution is given by

\[
\begin{pmatrix}
\Upsilon_{it} \\
\epsilon_{it}
\end{pmatrix}
\sim
N
\begin{pmatrix}
0 \\
0
\end{pmatrix}
\begin{pmatrix}
\Sigma_{\Upsilon\Upsilon} & \Sigma_{\Upsilon\epsilon} \\
\Sigma_{\epsilon\Upsilon} & \Sigma_{\epsilon\epsilon}
\end{pmatrix}.
\]

According to assumption \(A1\), in the structural model, conditional on \(\tilde{\alpha}\), \(Z\) is independent of \(\Upsilon_t\), which is a standard assumption made in the literature. However, in the reduced form equation \(Z\) and the unobserved heterogeneity are assumed to be independent of \(\epsilon_t\). If it were possible to recover the distribution of \(\tilde{\alpha}_i\) in the correlated random effect framework, which is required to obtain the control functions, the independence of \(\tilde{\alpha}\) and \(\epsilon_t\) wouldn’t be necessary for the identification of structural measures.

As stated earlier, to estimate the structural parameters of interest in equation (3.5), a multi-step estimation procedure has been proposed. In the first stage the parameters, \(\Theta_1\), of the system of reduced form equations is estimated. In the subsequent stages additional correction terms or control variables, obtained from the first stage reduced form estimates, correct for the bias due to endogeneity of the \(x_t\). We study the identification and estimation of structural parameters for nonlinear response models and show the construction of correction terms in subsection B and, in detail, in Appendix A. But before we discuss identification of structural parameters, we first discuss the estimation of the parameters of the reduced form equation.

\textbf{A. Estimation of the First Stage Reduced Form Equations}

In the first stage we estimate the system of reduced form equations (3.4). Since \(\tilde{\alpha}_i\) and \(Z_i\) are correlated in order to estimate \(\delta, \Sigma_{\epsilon\epsilon}, \text{ and } \kappa\) consistently, we use Mundlak’s (1978)

\[^3\text{Though the i.i.d. assumption is not strictly necessary, and can be relaxed.}\]
correlated random effects formulation. We assume that

\[ \mathcal{A}3. \quad E(\tilde{\alpha}_i|\bar{Z}_i) = \bar{Z}_i^\prime \delta, \]  

(3.6)

where \( \bar{Z}_i \) is the mean of time-varying variables in \( Z_{it} \). The assumption implies that the tail, \( \alpha_i = \tilde{\alpha}_i - E(\tilde{\alpha}_i|Z_i) = \tilde{\alpha}_i - \bar{Z}_i^\prime \delta \), is distributed normally with conditional mean zero and variance \( \sigma^2_\alpha \), and is also independent of \( Z_i \). Given the above, equation (3.4) can now be written as

\[ x_{it} = Z_{it}^\prime \delta + (\bar{Z}_i^\prime \delta + \alpha_i)\kappa + \epsilon_{it}. \]  

(3.4a)

To consistently estimate the reduced form parameters, \( \Theta_1 = \{\delta', \tilde{\delta}', \text{vech}(\Sigma_\epsilon)'\kappa', \sigma_\alpha\}' \), we employ the technique of step-wise maximum likelihood method in Biørn (2004). However, our model differs from Biørn. While Biørn estimates the covariance matrix \( \Sigma_\alpha \) of \( \alpha_i = \{\alpha_{1i}, \ldots, \alpha_{mi}\}' \), where each of the \( \alpha_{li}, l \in \{1, \ldots, m\} \), is unrestricted, we place the restriction \( \alpha_{li} = \kappa_l \alpha_i \). This implies that

\[ \Sigma_\alpha = \sigma^2_\alpha \Sigma_\kappa = \sigma^2_\alpha \begin{pmatrix} \kappa_1^2 & \kappa_1 \kappa_2 & \kappa_2^2 \\ \k_1 \k_2 & \kappa_2^2 \\ \vdots & \vdots \\ \k_1 \k_m & \k_2 \k_m & \ldots & \k_m^2 \end{pmatrix}. \]

Moreover, as can be seen from the modified equation (3.4a), we also impose the restriction that \( \tilde{\delta} \) remains the same across each of the \( m \) reduced form equations. In Appendix B we provide a note on the estimation strategy employed to estimate the parameters of the reduced form equations.

B. Identification and Estimation of the Structural Parameters

Consider the conditional distribution of \( \Upsilon_i \) given \( X, Z, \) and \( \tilde{\alpha} \).

\[ \Upsilon_i|X, Z, \tilde{\alpha} \sim \Upsilon_i|X - E(X|Z, \tilde{\alpha}), Z, \tilde{\alpha} \]

\[ \sim \Upsilon_i|\epsilon, Z, \tilde{\alpha} \]

\[ \sim \Upsilon_i|\epsilon, \tilde{\alpha}, \]  

(3.7)
where the second equality in distribution follows from the fact that $X_i - E(X_i|Z, \hat{\alpha}_i) = \epsilon_i$ and the third follows from $A1$. According to the above, the dependence of the structural error term $\Upsilon_t$ on $X, Z,$ and $\hat{\alpha}$ is completely characterized by the reduced form errors $\epsilon$ and the unobserved heterogeneity, $\hat{\alpha}$. The expectation of $\Upsilon_t$ given $\epsilon$ and $\hat{\alpha}$ is given by

$$E(\Upsilon_t|\epsilon, \hat{\alpha}) = E(\Upsilon_t|\epsilon_t, \hat{\alpha}) = \Sigma_{\Upsilon_\alpha} \hat{\alpha} + \Omega_{\Upsilon_\epsilon} f(\epsilon_t),$$

where the first equality follows from the assumption that conditional on $\epsilon_{it}$, $\Upsilon_{it}$ is independent of $\epsilon_{i,t-}$. This assumption has also been made in Papke and Wooldridge (2008), and Semykina and Wooldridge (2010). The second equality follows from the joint normality of $\Upsilon_t, \epsilon_t, \hat{\alpha}$ and the independence of $\epsilon$ and $\hat{\alpha}$. In (3.8), $\Sigma_{\Upsilon_\alpha}$ is a $(4 \times 1)$ matrix of correlations of $\hat{\alpha}$ and $\Upsilon_t$, $f(\epsilon_t)$ is a linear function of $\epsilon_{it}\footnote{If $\Upsilon_t$ and $\epsilon_t$ are jointly normally distributed then we know that $E(\Upsilon_t|\epsilon_i) = \Sigma_{\Upsilon, \epsilon}^{-1} \epsilon_i$, which we can write as $\Sigma_{\Upsilon, \epsilon}^{-1} \epsilon_i = \Omega_{\Upsilon, \epsilon} \Sigma_{\epsilon} \epsilon_i = \Omega_{\Upsilon, \epsilon} f(\epsilon_i)$, where the $(m \times m)$ matrix $\Sigma_{\epsilon}$ is diag$(\sigma_{\epsilon 1}, \ldots, \sigma_{\epsilon m})$, so that $\Omega_{\Upsilon, \epsilon} \Sigma_{\epsilon} = \Sigma_{\Upsilon, \epsilon}$. We prefer to write the above conditional expectation as $E(\Upsilon_t|\epsilon_i) = \Omega_{\Upsilon, \epsilon} \Sigma_{\epsilon} \epsilon_i = \Omega_{\Upsilon, \epsilon} \Sigma_{\epsilon} \epsilon_i$. Because the elements of $\Sigma_{\epsilon} \Sigma_{\epsilon}^{-1}$ are obtained from the estimates of the first stage reduced form estimation of our sequential estimation procedure, and the formulation in (3.9) helps us distinguish the parameters that are estimated in the first stage from those that are estimated in the subsequent stages.}$, and the $(4 \times m)$ matrix $\Omega_{\Upsilon_\epsilon}$ is

$$\Omega_{\Upsilon_\epsilon} = \begin{pmatrix} \rho_{\epsilon 1\epsilon} \sigma_\epsilon & \ldots & \rho_{\epsilon m\epsilon} \sigma_\epsilon \\ \rho_{\zeta 1\epsilon} \sigma_\zeta & \ldots & \rho_{\zeta m\epsilon} \sigma_\zeta \\ \rho_{\eta 1\epsilon} \sigma_\eta & \ldots & \rho_{\eta m\epsilon} \sigma_\eta \\ \rho_{\phi 1\epsilon} \sigma_\phi & \ldots & \rho_{\phi m\epsilon} \sigma_\phi \end{pmatrix}.$$

Given assumptions $A3$ and equation (3.8), we can write the expectation of $y_t^*$ given $X, Z,$ and $\hat{\alpha}$

$$E(y_t^*|X, Z, \hat{\alpha}) = X_t'B + \hat{\alpha}k + \Omega_{\Upsilon_\epsilon} f(\epsilon_t) = X_t'B + (\tilde{Z}'\delta + \alpha)k + \Omega_{\Upsilon_\epsilon} f(\epsilon_t) = E(y_t^*|X, Z, \alpha),$$

where $k = \tilde{k} + \Sigma_{\Upsilon_\alpha} = \{\theta, \lambda, \mu_1, \mu_0\}'$. To estimate the system of equations in (3.9) the standard technique is to replace $\epsilon_t$ by the residuals from the first stage reduced form regression, here equation (3.4a). However, the residuals $x_t - E(x_t|Z, \alpha) = x_t - Z_t'\delta - (\tilde{Z}'\delta + \alpha)k$, remain unidentified because the $\alpha$'s are unobserved.
of structural parameters derived in Appendix A, it can be shown that

\[
E(y_t^*|X, Z) = \int E(y_t^*|X, Z, \alpha)f(\alpha|X, Z)d\alpha = X_t^0B + (\tilde{Z}'\hat{\delta} + \hat{\alpha})k + \Omega_{\Upsilon t}f(\hat{\epsilon}_t),
\]

(3.10)

where \(\hat{\alpha}_i(\Theta_1, X_i, Z_i) = E(\alpha_i|X_i, Z_i)\) is the “expected a posteriori” (EAP) value of \(\alpha_i\) and \(\hat{\epsilon}_it(\Theta_1, X_i, Z_i) = x_{it} - E(x_{it}|X_i, Z_i) = x_{it} - Z_{it}'\delta - \kappa(Z_{it}'\hat{\delta} + \hat{\alpha}_i).\) \(\hat{\alpha}_i = \tilde{Z}'\hat{\delta} + \hat{\alpha}\) and \(\hat{\epsilon}_it\) are the “control functions” that correct for the bias which arises due to the correlation of \(\alpha\) and \(\Upsilon_t.\) The correlation of the exogenous variables \(Z_t\) with \(\hat{\alpha}\), is accounted by \(\tilde{Z}'\hat{\delta} + \hat{\alpha}\).

In Appendix A we show how to construct \(\hat{\alpha}_i.\) Given (3.10) we can write the projection of \(y_{it}^*\) given \(X_i, Z_i\) in error form as

\[
y_t^* = X_t^0B + (\tilde{Z}'\hat{\delta} + \hat{\alpha})k + \Omega_{\Upsilon t}f(\hat{\epsilon}_t) + \tilde{\Upsilon}_t,
\]

where \(\tilde{\Upsilon}_t = \{\tilde{\nu}_t, \tilde{\zeta}_t, \tilde{\eta}_{1it}, \tilde{\eta}_{0it}\}',\) defined in Appendix A, is independent of \(X\) and \(Z.\) \(\tilde{\Upsilon}_t\) is normally distributed with mean 0 and covariance matrix \(\tilde{\Sigma}_{\Upsilon\Upsilon}\), where the variance of, say, \(\tilde{\nu}_t\) is denoted by \(\sigma_{\nu}^2\), and the covariance of \(\tilde{\nu}_t\) and \(\tilde{\zeta}_t\) by \(\rho_{\nu\zeta}\sigma_{\nu}\sigma_{\zeta}.\) Thus, we have

\[
I_t = 1\{I_t^* = X_t^0'\gamma + \theta\hat{\alpha} + \Omega_{v\epsilon}f(\hat{\epsilon}_t) + \tilde{\nu}_t > 0\},
\]

(3.11)

\[
F_t = 1\{F_t^* = X_t^0'\varphi + \lambda\hat{\alpha} + \Omega_{\epsilon\eta}f(\hat{\epsilon}_t) + \tilde{\zeta}_t > 0\},
\]

(3.12)

\[
R_t = F_t(\beta_{1}F_t + X_t^0'\beta_1 + \mu_1\hat{\alpha} + \Omega_{\eta_{1t}}f(\hat{\epsilon}_t) + \tilde{\eta}_{1t})
\]

\[
+ (1 - F_t)(X_t^0'\beta_0 + \mu_0\hat{\alpha} + \Omega_{\eta_{0t}}f(\hat{\epsilon}_t) + \tilde{\eta}_{0t})\text{ if } I_t = 1.
\]

(3.13)

We would like to state that in the modified Innovation equation (3.11), for example, \(\Omega_{v\epsilon} = \{\rho_{\epsilon_1v_1}, \ldots, \rho_{\epsilon_nv_v}\}',\) where \(\rho_{\epsilon_1v_1}\) gives a measure of correlation between \(x_1\) and \(v,\) thus providing us a test of exogeneity of \(x_1\) in the Innovation equation. Similarly, the estimates of \(\Omega_{\zeta\epsilon}\) and \(\Omega_{\eta_{1\epsilon}}\) give us a test of exogeneity of \(x_i\) in the Financial Constraint and the R&D equation respectively.

Given \(\tilde{Z}'\hat{\delta} + \hat{\alpha}\) and \(\hat{\epsilon}_t,\) it may be possible to consistently estimate the structural parameters of interest by specifying a joint likelihood for \(I_t, F_t,\) and \(R_t.\) However, given the presence of nonlinearities in the model, the likelihood function will be difficult to optimize. Hence, we estimate the structural parameters of interest in equations (3.11) to (3.13) in two steps after the first stage reduced form estimation. In the second stage we estimate jointly the
structural parameters, $\Theta_2$, of the Innovation equation (3.11) and the Financial Constraint equation (3.12). Then in the third stage, given the control function and second stage estimates, we estimate the R&D equation (3.13).

Estimating the parameters of the second, $\Theta_2$, and third, $\Theta_3$, stage, given the first stage consistent estimates $\hat{\Theta}_1$, is asymptotically equivalent to estimating the subsequent stage parameters had the true value of $\Theta_1$ been known. To obtain correct inference about the structural parameters, $\Theta_2$ and $\Theta_3$, one has to account for the fact that instead of true values of first stage reduced form parameters, we use their estimated value. In Appendix D we provide analytical expression for the error adjusted covariance matrix for the estimates of the structural parameters.


Given the modified Innovation (3.11) and Financial Constraint (3.12) equations, the conditional log likelihood function for firm $i$ in period $t$ given $X$, $Z$, if the time period $t$ corresponds to CIS3 and CIS3.5, is given by

$$L_{t2}(\Theta_2 | \hat{\alpha}, \hat{\epsilon}_t) = I_t F_t \ln(\Pr(I_t = 1, F_t = 1)) + I_t (1 - F_t) \ln(\Pr(I_t = 1, F_t = 0))$$
$$+ F_t (1 - I_t) \ln(\Pr(I_t = 0, F_t = 1)) + (1 - F_t) (1 - I_t) \ln(\Pr(I_t = 0, F_t = 0)).$$

(3.14)

For CIS2.5, since we do not observe whether a firm is financially constrained or not for the non-innovating firms, for time period $t$ corresponding to CIS2.5, we have

$$L_{t2}(\Theta_2 | \hat{\alpha}, \hat{\epsilon}_t) =$$
$$F_t I_t \ln(\Pr(I_t = 1, F_t = 1)) + (1 - F_t) I_t \ln(\Pr(I_t = 1, F_t = 0)) + (1 - I_t) \ln(\Pr(I_t = 0)).$$

(3.15)

\footnote{For our empirical analysis, as discussed in next Section on data, we use three waves of Dutch Community Innovation Survey (CIS). For CIS3 and CIS3.5 we observe if the firm is financially constrained for both the innovating and the non-innovating firms, but for CIS2.5 the information on financial constraint is given for only the innovating firms.}
In the above two equations

\[ \Pr(I_t = 1, F_t = 1) = \Phi_2(\gamma_t, \varphi_t, \zeta_{\gamma v}), \quad \Pr(I_t = 1, F_t = 0) = \Phi_2(\gamma_t, -\varphi_t, \zeta_{\gamma v}), \]
\[ \Pr(I_t = 0, F_t = 1) = \Phi_2(-\gamma_t, \varphi_t, \zeta_{\gamma v}), \quad \Pr(I_t = 0, F_t = 0) = \Phi_2(-\gamma_t, -\varphi_t, \zeta_{\gamma v}), \]
and \( \Pr(I_t = 0) = \Phi(-\gamma_t), \)

where \( \Phi_2 \) is the cumulative distribution function of a standard bivariate normal, \( \zeta_{\gamma v} \) is the correlation of \( \tilde{\zeta}_t \) and \( \tilde{\upsilon}_t \), \( \gamma_t = (X_{\gamma} \alpha + \theta \hat{\alpha} + \Omega_{\gamma} \epsilon_{\gamma}) \frac{1}{\sigma_{\gamma}} \), \( \varphi_t = (X_{\varphi} \varphi + \lambda \hat{\alpha} + \Omega_{\varphi} \epsilon_{\varphi}) \frac{1}{\sigma_{\varphi}} \), (3.16)

and \( \Theta_2 = \{ \varphi', \lambda, \Omega_{\varphi}, \gamma, \theta, \Omega_{\varphi}, \zeta_{\gamma v} \}' \). The log likelihood of the second stage parameters is given by

\[ L_2(\Theta_2) = \sum_{i=1}^{N} \sum_{t=1}^{T_i} L_{it2}(\Theta_2|\hat{\alpha}_t, \hat{\epsilon}_{it}). \] (3.17)

We know that the coefficients in the structural equations (3.11) and (3.12) can only be identified up to a scale, where the scaling factor for the financial constraint equation and selection equation are \( \sigma_{\gamma} \) and \( \sigma_{\varphi} \), respectively. In what follows, with a slight abuse of notation, we will denote the scaled parameters of the second stage estimation by their original notation.

Given the control functions, \( \bar{Z} \hat{\delta} + \hat{\alpha}_t \) and \( \hat{\epsilon}_{it} \), the second stage parameters \( \Theta_2 \) can be consistently estimated. The true measure, however, of the effect of a certain variable, \( w \), on the probability of engaging in innovation or the probability of being financially constrained is the Average Partial Effect (APE) of a variable. In Appendix A we show that

\[ \int \frac{\partial \Pr(I_t = 1|\hat{\alpha}_t, \hat{\epsilon}_t)}{\partial w} dF_{\hat{\alpha}_t, \hat{\epsilon}_t} \] and \[ \int \frac{\partial}{\partial w} \left( \frac{\Pr(I_t = 1, F_t = 1|\hat{\alpha}_t, \hat{\epsilon}_t)}{\Pr(F_t = 1|\hat{\alpha}_t, \hat{\epsilon}_t)} \right) dF_{\hat{\alpha}_t, \hat{\epsilon}_t} \]

are the true measure of the effect of \( w \) on the probability of being an innovator and the probability of being an innovator conditional on being financially constrained. We discuss tests for the estimates of APE in Appendix E.

B.2. The Third Stage: Estimation of the R&D Switching Regression Model

The structural parameters of interest, \( \Theta_3 \), of the R&D switching regression equation in (3.13) are estimated in the third stage, which is an extension of Heckman’s classical two
step estimation to multivariate selection problem. Here we are dealing with two kinds of selection problems: (1) R&D investment conditional on being financially constrained or not, and (2) R&D investment conditional on being an innovator, where being an innovator determines if R&D expenditure needs to be declared or not. To consistently estimate the parameters of equation (3.13), in Appendix D we derive the correction terms that correct for the bias due to endogenous switching and endogenous sample selection. These correction terms are obtained for each firm-year observation. Adding these extra correction terms for each observation, we obtain consistent estimates of $\Theta_3$.

To this effect, consider the following conditional mean:

$$
E(R_t | F_t^*, I_t^* > 0, \hat{\alpha}, \hat{\epsilon}_t) = F_t \left( \beta_t + X_t R_t \beta_1 + \mu_1 \hat{\alpha} + \Omega \eta_{t*} f(\epsilon_t) + E(\tilde{\eta}_{1t} | F_t^* > 0, I_t^* > 0, X, Z) \right) \\
+ (1 - F_t) \left( X_t R_t \beta_0 + \mu_0 \hat{\alpha} + \Omega \eta_{0t} f(\epsilon_t) + E(\tilde{\eta}_{0t} | F_t^* \leq 0, I_t^* > 0, X, Z) \right) .
$$

(3.18)

Now, we know that

$$
E(\tilde{\eta}_{1t} | F_t^* > 0, I_t^* > 0, \hat{\alpha}, \hat{\epsilon}_t) = E[\tilde{\eta}_{1t} | \tilde{\zeta}_t > -\varphi_t, \tilde{v}_t > -\gamma_t],
$$

and

$$
E(\tilde{\eta}_{0t} | F_t^* \leq 0, I_t^* > 0, \hat{\alpha}, \hat{\epsilon}_t) = E[\tilde{\eta}_{0t} | \tilde{\zeta}_t \leq -\varphi_t, \tilde{v}_t > -\gamma_t],
$$

where $\varphi_t$ and $\gamma_t$ have been defined in (3.16). In Appendix C we show that

$$
E[\tilde{\eta}_{1t} | \tilde{\zeta}_t > -\varphi_t, \tilde{v}_t > -\gamma_t] = \Gamma_{\eta_{1t}} C_{11t} + \Gamma_{\eta_{1v}} C_{12t}
$$

(3.19)

and

$$
E[\tilde{\eta}_{0t} | \tilde{\zeta}_t \leq -\varphi_t, \tilde{v}_t > -\gamma_t] = \Gamma_{\eta_{0t}} C_{01t} + \Gamma_{\eta_{0v}} C_{02t},
$$

(3.20)

where, for example, $\Gamma_{\eta_{1t}} = \tilde{\sigma}_{\eta_{1t}} \tilde{\eta}_{1t}$.

Given estimates of $\hat{\alpha}, \hat{\epsilon}_t, \varphi_t, \gamma_t,$ and $\tilde{\eta}_{1t}$, we can construct the additional control functions $^6$ $C_{11t}, C_{12t}, C_{01t}, C_{02t} –$ which account for the bias that arises due to endogeneity of financial

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$^6$The addition control functions $C_{11t}, C_{12t}, C_{01t},$ and $C_{02t}$ respectively are

$$
C_{11t} \equiv \phi(\varphi_t) \frac{\Phi((\gamma_t - \varphi_t \gamma_t)/\sqrt{1 - \varphi_t})}{\Phi_2(\varphi_t, \gamma_t, \varphi_\zeta)}, \quad C_{12t} \equiv \phi(\gamma_t) \frac{\Phi((\varphi_t - \varphi_t \varphi_t)/\sqrt{1 - \varphi_t})}{\Phi_2(\varphi_t, \gamma_t, \varphi_\zeta)},
$$
constraint faced and endogenous selection. With the above defined, we can now write the R&D switching equations in (3.13), conditional on $F_t$, $I_t = 1$, $X$, $Z$ as

$$R_t = F_t \left( \beta_t + \lambda_{Xt} R_t + \nu_1 \alpha + \Omega_{\eta_{12}} f(\epsilon_t) + \Gamma_{\eta_{12}} C_{11t} + \Gamma_{\eta_{12}} C_{12t} + \eta_{1t} \right)$$

$$+ (1 - F_t) \left( \alpha_{0t} + \mu_0 \alpha + \Omega_{\eta_{01}} f(\epsilon_t) + \Gamma_{\eta_{01}} C_{01t} + \Gamma_{\eta_{01}} C_{02t} + \eta_{0t} \right),$$

(3.21)

where $\eta_{1t}$ and $\eta_{0t}$ are distributed with zero conditional mean. With the additional correction terms – $C_{11}$, $C_{12}$, $C_{01}$, and $C_{02}$ – constructed for every firm year observation, the parameters of the R&D switching regression model can be consistently estimated by running a simple pooled OLS for the sample of selected/innovating firms. Analytical expression for the error adjusted covariance matrix for the estimates of $\Theta_3$ has been derived in Appendix D.

For a firm $i$ in time period $t$, given $X_t = \bar{X}$, where $X_t$ is the union of elements in $X^F_t$, $X^R_t$, and $X^T_t$, the average partial effect (APE) of financial constraint on R&D intensity is the difference in the expected R&D expenditure between the two regimes, financially constrained and unconstrained, averaged over $\hat{\alpha}$ and $\hat{\epsilon}$:

$$\Delta_F E(R_t | \bar{X}) = \int E(R_{1t} | \bar{X}, F_t = 1, I_t = 1, \hat{\alpha}, \hat{\epsilon}) dF_{\hat{\alpha}, \hat{\epsilon}}$$

$$- \int E(R_{0t} | \bar{X}, F_t = 0, I_t = 1, \hat{\alpha}, \hat{\epsilon}) dF_{\hat{\alpha}, \hat{\epsilon}}.$$  

(3.22)

The measure gives us the magnitude by which R&D intensity is affected due to the presence of financial constraint. In Appendix E we discuss the estimation and the testing of the above measure.

**IV. DATA AND DEFINITION OF VARIABLES**

For our empirical analysis we had to merge two data sets, one containing information on R&D related variables and the other on the financial status of the firms. The data on information related to R&D is obtained from the Dutch Community Innovation Surveys

$$C_{01t} \equiv -\Phi(\varphi_t) \frac{\Phi_{2}(\gamma_t - \varphi_t \nu_t) / \sqrt{1 - \varphi_t^2}}{\Phi_{2}(\varphi_t - \gamma_t \nu_t) / \sqrt{1 - \varphi_t^2}},$$

and

$$C_{02t} \equiv \Phi(\gamma_t) \frac{\Phi_{2}(\gamma_t - \varphi_t \nu_t) / \sqrt{1 - \varphi_t^2}}{\Phi_{2}(\varphi_t - \gamma_t \nu_t) / \sqrt{1 - \varphi_t^2}}.$$  

In the above $\Phi$ is the standard normal density function, $\Phi$ the cumulative distribution function of a standard normal, and $\Phi_2$ is the cumulative distribution function of a standard bivariate normal.
(CIS), which are conducted every two years by the Central Bureau of Statistics (CBS) of The Netherlands. The Innovation Survey data are collected at the enterprise level. Information on financial variables is available at the firm/company level, which could be constituted of many enterprises consolidated within the firm. The financial data, known as Statistiek Financiën (SF), is from the balance sheet of the individual firms.

A combination of a census and a stratified random sampling is used to collect the CIS data. A census of large (250 or more employees) enterprises, and a stratified random sample for small and medium sized enterprises from the frame population is used to construct the data set for every survey. The stratum variables are the economic activity and the size of an enterprise, where the economic activity is given by the Dutch standard industrial classification. For our empirical analysis we use three waves of innovation survey data: CIS2.5, CIS3, and CIS3.5 pertaining respectively to the years 1996-98, 1998-2000, and 2000-02, and only those firms and enterprises which are present in at least two of the waves.

However, since not all enterprises belonging to the firm have been surveyed in the CIS data the problem when merging the SF data and the CIS data is to infer the size of the relevant R&D variables for each firm. To do this we use the information on the sampling design used by CBS.

For any given year, let $N$ be the total population of R&D performing enterprises in the Netherlands. From this population a stratified random sampling is done. These strata are again based on size and the activity class. Let $S$ be the total number of strata, and each stratum is indexed by $s = 1, 2, \ldots, S$. Then, $\sum_{s=1}^{S} N_s = N$, where $N_s$ is the population size of R&D performing enterprise belonging to stratum $s$. Let $n_s$ be the sample size of each stratum and let $\Theta_s = \{1, 2, \ldots, i_s, \ldots, i_s\}$ be the set of enterprises for the $s^{th}$ stratum, that is $|\Theta_s| = n_s$.

Let $x$ be the variable of interest and $x_i$ the value of $x$ for the $i^{th}$ enterprise. The average value of $x$ for an enterprise belonging to the $s^{th}$ stratum is $\bar{x}_s = (\sum_{i \in \Theta_s} x_i)/n_s$. Now consider a firm $f$. Let $N_{fs}$ be the total number of enterprises belonging to the firm $f$ and stratum $s$ and $n_{fs}$ be the number of enterprises belonging to firm $f$ and stratum $s$ that have been surveyed.
Then the estimated value of \( x \) for the firm \( f \), \( \hat{x}_f \) is given by

\[
\hat{x}_f = \sum_{s=1}^{S} (N_{fs} - n_{fs}) \bar{x}_s + \sum_{s=1}^{S} n_{fs} \sum_{k=1}^{n_{fs}} x_{fsk},
\]

where \( x_{fsk} \) is the value of \( x \) for the \( k^{th} \) enterprise belonging to stratum \( s \) and firm \( f \) that has been surveyed, and \( N_{fs} - n_{fs} \) is the number of enterprises of the \( f^{th} \) firm in stratum \( s \) that have not been surveyed. It can be shown under appropriate conditions that \( \hat{x}_f \) is an unbiased estimator of the expected value of \( x \) for firm \( f \).

\[\text{[Table 1 about here]}\]

For our analysis \( N_f = \sum_{s=1}^{S} N_{fs} \) was obtained from the Frame Population constructed by the CBS and \( n_f = \sum_{s=1}^{S} n_{fs} \) was obtained from the CIS surveys. The exact count of firms for which \( N_f = n_f \) and for which \( (N_f - n_f) > 0 \) can be found in Table 3. The sample of firms used in the estimation is, however, much smaller than shown in Table 3. Enterprises in the innovation survey belonging to firms not present in the SF data had to be dropped. For these firms we required that at least one of their potentially R&D performing enterprises be present in the innovation surveys. Finally, only those firms that were present in at least two of the three waves were kept. The percentage of firms in the sample for which imputation, using equation (4.1), had to be done was 18.06% in CIS2.5, 24.62% in CIS3 and 23.75% in CIS3.5. The majority of the firms happened to be single enterprises: 78.97%, 74.01%, and 73.87% respectively for CIS2.5, CIS3, and CIS3.5.

The two variables of interest for which the aggregating exercise in equation (4.1) was done are the R&D expenditure and the share of innovative sales in the total sales (\( SINS \)) of

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\text{Proof:}

The proof is based on the assumption that the expected value of \( x \) is the same for each enterprise in a particular stratum. Let \( \mu_{xf} \) be the population mean of \( x \) for the firm \( f \) and let \( \mu_{xs} \) be the population mean of \( x \) for an enterprise belonging to stratum \( s \). Given our assumption, we know that \( \bar{x}_s \) is an unbiased estimator of \( \mu_{xs} \), that \( \mu_{xf} = \sum_{s=1}^{S} N_{fs} \mu_{xs} \), and that the expected value of \( \sum_{s=1}^{S} \sum_{k=1}^{n_{fs}} x_{fsk} \), the second term on the RHS of equation (4.1), is \( \sum_{s=1}^{S} n_{fs} \mu_{xs} \). Taking expectations in (4.1) and substituting the expected value of \( E(\sum_{s=1}^{S} \sum_{k=1}^{n_{fs}} x_{fsk}) = \sum_{s=1}^{S} n_{fs} \mu_{xs} \) and noting that \( E(\sum_{s=1}^{S} n_{fs} \bar{x}_s) = \sum_{s=1}^{S} n_{fs} \mu_{xs} \), we get \( E(\hat{x}_f) = \mu_{xf} = \sum_{s=1}^{S} N_{fs} \mu_{xs} \).
the enterprise. Here we would like to mention that we do not have any information on these two variables for those firms that have been categorized as non-innovators. An enterprise is considered to be an innovator if either one of the following conditions is satisfied: (a) it has introduced a new product to the market, (b) it has introduced a new process to the market, (c) it has some unfinished R&D project, and (d) it has begun an R&D project, and abandoned it during the time period that the survey covers. Given that the criteria, classifying an enterprise as an innovator, are exhaustive, we, for the purpose of aggregation, reasonably assumed that if an enterprise meets none of the above criteria, it has no R&D expenditure and no new products.

We consider a firm to be financially constrained as soon as any one of its enterprises declares to be financially constrained. When $N_f > n_f$, a firm is characterized as an innovator if one the constituent enterprises surveyed has innovated or if anyone of the enterprises that have not been surveyed is found in a stratum that is classified as an innovating stratum\(^8\), where a stratum is defined to be innovative if $\bar{x}_s > 0$.

The total number of employees as a measure of the size of the firm was also constructed using information from the CIS data and the General Business Register. As far as the number of employees in a firm is concerned, if all the enterprises belonging to a firm are surveyed, that is if $N_f = n_f$, then we simply add up the number employees of each of the constituent enterprises. However, when $N_f > n_f$, for those enterprises that have not been surveyed we take the mid point of the size class of those enterprises that have not been surveyed. The size class to which an enterprise belongs to is available from the General Business Register for every year.

In Table 2 below we tabulate the number of innovating and non-innovating firms for each of the three waves, and the number of firms that declare to be financially constrained in their innovation activities. As can be seen from the table, for CIS2.5 information on financial constraint is available only for the innovators. It can be seen that the number

\(^8\)An example could help illustrate. Suppose there is a firm that has three enterprises: $E_1$, $E_2$, and $E_3$. Assume that of the three enterprises only $E_3$ has been surveyed, and has been found not to innovate. Now, we know to which stratum $E_1$ and $E_2$ respectively belong to. Let $E_2$ belong to the stratum $s$ and $E_1$ to stratum $s'$. If we find that $\bar{x}_s > 0$ and that $\bar{x}_{s'} = 0$, we will still regard the firm to be an innovator, with R&D expenditure $\bar{x}_s$. 
of financially constrained firms in the sample is lower than the number of unconstrained firms, and that the number of financially constrained firms is larger for the innovating firms than for the non-innovating ones.

[Table 2 about here]

As mentioned earlier the CIS survey is conducted every two years. The question on being innovative or being financially constrained pertains to all the years that each survey covers. However, the variables, share of innovative sales in the total sales \((SINS)\) and R&D expenditure are reported only for the last year that the survey covers. The stock variables – long-term debt, liquidity reserve, assets of the firms, and the number of employees, indexed \(t\) – are the values of the variables as recorded at the beginning of period \(t\). The flow variables are the observed values as recorded during period \(t\).

Below we provide the definition and the list of the variables that were used in the empirical exercise.

1. \(R_t\): R&D intensity defined as the ratio of R&D expenditure to total (tangible+ intangible) capital assets
2. \(F_t\): Binary variable equal to one if the firm is financially constrained
3. \(I_t\): Binary variable equal to one if the firm is an innovator
4. \(DEBT_t\): Long-term debt constituted of the book value of long-term liabilities owed to group companies, members of cooperative society and other participating interests, plus subordinated loans and debentures
5. \(LQ_t\): Liquidity reserve including cash, bills of exchange, cheques, deposit accounts, current accounts, and other short-term receivables
6. \(DIV_t\): Dividend payments to shareholders, group companies, and cooperative societies
7. \(SIZE_t\): Logarithm of the number of people employed
8. \(RAINT_t\): Ratio of intangible assets to total (tangible+ intangible) capital assets
9. \(SINS_t\): Share of sales in the total sales of the firm which is due to newly introduced products
10. \(CF_t\): Cash flow defined as operating profit after tax, interest payment, and preference dividend plus the provision for depreciation of assets
11. \(MKSH_t\): Market share defined as the ratio of firms sales to the total industry sales
12. \(DNFC_t\): Dummy variable that takes value one for negative realization of cash flow
13. $DMULTI_t$: Dummy that takes value one if a firm has multiple enterprises
14. $AGE_t$: Age of the firm\textsuperscript{9}.
15. Industry dummies and Year dummies

To minimize heteroscedasticity we scale long-term debt ($DEBT_t$), cash flow ($CF_t$), liquidity reserve ($LQ_t$), and dividend payout ($DIV_t$) by total capital assets. Henceforth whenever we refer to these variables, it would mean the scaled value of these variables.

[Table 4 about here]

A. Endogenous Explanatory Variables

The set of endogenous regressors, $x_t$, that appear in the structural equations, and for which we construct control functions to account for their endogeneity are:

1. Long-term debt ($DEBT_t$)
2. Liquidity reserve ($LQ_t$)
3. Dividend payout ($DIV_t$)
4. Logarithm of the number of people employed ($SIZE_t$)
5. Ratio of intangible assets to total assets ($RAINT_t$)
6. Share of innovative sales in the total sales of the firm ($SINS_t$)

Since, both AH and CH have shown that under endogenous borrowing constraint, debt and equity value of the firm are together endogenously determined with size of the firm, we, along with the financial state variables, include size of the firm among the set of endogenous covariates. Ratio of intangible assets to total assets, $RAINT_t$, is regarded as endogenous because it could be determined by the decision to innovate and investment in R&D.

Share of innovative sales in the total sales of the firm, $SINS_t$, is likely be endogenous because it could be determined by current investment decision. $SINS_t$ is only observed for innovators. For the purpose of estimating the reduced form equation we assume that $SINS_t$ is zero for the non-innovators. Given that the classification criteria, classifying firms as innovators, is fairly exhaustive, we believe that this is not a strong assumption.

\textsuperscript{9}We do not the age of the firms that existed prior to 1967 as the General Business Register, from which we calculated the age of the firms, was initiated in 1967. For such cases we assume that the firm began in 1967.
B. Exogenous Explanatory Variables

The vector of exogenous variables, $z_t$, that appear in the structural and reduced form equation are:

1. Cash flow of the firm ($CF_t$)
2. Dummy for negative realization of cash flow ($DNFC_t$)
3. Market share of the firm ($MKSH_t$)
4. Age of the firm ($AGE_t$)
5. Dummy that takes value 1 if the firm consists of multiple enterprises ($DMULTI_t$)
6. Industry dummies
7. Year dummies

Cash flow is assumed to be exogenous because cash flow, as Moyen (2004) points out, is highly correlated with the income shock, which is largely driven by exogenous shocks. It should be pointed out, however, that cash flow is exogenous conditional on unobserved heterogeneity, $\tilde{\alpha}_t$. Hence, any component of cash flow that is endogenous to the system of equations has been accounted for by allowing it to be correlated with the unobserved heterogeneity. Similarly, while market share, $MKSH_t$, and dummy for multiple enterprise, $DMULTI_t$, may not be strictly exogenous, they are likely to be, given unobserved heterogeneity\textsuperscript{10}.

C. Additional Instruments

Our additional set of instruments, $\tilde{z}_t$, needed to identify the structural parameters through the control functions constructed from the first stage reduced estimates are:

1. Cash flow in period $t - 1$ ($CF_{t-1}$)
2. Dummy for negative cash flow ($DNFC_{t-1}$)
3. Square of cash flow in period $t - 1$ ($CF^2_{t-1}$)
4. Square of cash flow in period $t$ ($CF^2_t$)

\textsuperscript{10}Most paper studying nonlinear panel data models assume all regressors to be exogenous conditional on unobserved heterogeneity. In this paper we have relaxed this assumption to allow certain variables, $x_t$, to be correlated with the idiosyncratic component even after having accounted for their correlation with unobserved heterogeneity.
5. Market share in period \( t - 1 \) (\( MKSH_{t-1} \))
6. Dummy that takes value 1 if the firm consists of multiple enterprises in period \( t - 1 \) (\( DMULTI_{t-1} \))
7. Dummy if the firm existed prior to 1967 (\( DAGE_t \))

We include past realization of cash flow in the set of instruments because, as argued earlier, cash flow is strongly correlated with exogenous revenue shocks experienced by the firm. To the extent that financing decisions of the firms are state contingent, current and past realizations will influence all financing decision. For example, AH have shown that firms with better realization of past revenue shocks imply a lower leverage, and that higher revenues imply higher long-term debt. Reddick and Whited (2009) show that saving and cash flow are negatively correlated because firms optimally lower liquidity reserves to invest after receiving a positive cash flow shocks. Hence, liquidity holdings of the firm and past level of income shocks are expected to be correlated. Similarly, a higher dividend payout could be expected with better realization of past revenue shocks.

It has been found that firms with monopoly and those that are multiple enterprise firm are more likely to engage in innovative activity. Hence, firms that have had a higher degree of monopoly in the past or have been a multiple enterprise firm in the past could be expected to have a higher share of innovative sales, \( SINS_t \), today, and a higher ratio of intangible assets to total capital assets, \( RAINT_t \). Finally, given that age and size of a firm are correlated, \( DAGE_t \) of the firm has been assumed to instrument size. We also interact cash flow and market share in period \( t - 1 \) with \( DMULTI_{t-1} \) and \( DAGE_t \). It is important to mention that, unlike most control function approaches in the literature, our method, as shown in Appendix A, allows for discrete instruments.

We stress again that variables included in \( Z_t = \{ z_t', \tilde{z}_t \} \) may or may not be strictly exogenous, but, conditional on unobserved individual effects, these variables are unlikely to be correlated with idiosyncratic component in the structural equations. To the extent that we take into account the correlation between \( Z_t \) and \( \tilde{\alpha}_t \), the presence of these variables in the specification of the structural equations or as instruments will not lead to inconsistent results.
V. RESULTS

A. Financing and Innovation Decision

The results of the second stage, where we jointly estimate the financial constraint and the innovation equation, are shown in Table 5 and Table 6. While Table 5 has the coefficient estimates, in Table 6 the Average Partial Effects (APE) of the covariates are reported. In Specification 2 and Specification 3 shown in Table 5 and 6 we do not have dummies for multiple enterprises in the financial constraint equation. And while the specification for the innovation equation in Specification 1 and 2 are same, in Specification 3 we remove the control function/correction term for share of innovative sales.

We begin by discussing the results of the Innovation equation\(^{11}\). We find that firms with higher long-term debt, \(DEBT\), are less likely to take up innovative activity. This is consistent with the theoretical prediction that bond holders are unwilling to hold the higher risks associated with R&D activity, and also with the findings of empirical papers, such as BFP and others, who find that equity rather than debt may be more suitable to finance innovative activity.

\[\text{[Table 5 about here]}\]
\[\text{[Table 6 about here]}\]

We also find that firms that take up innovative activity maintain higher amount of liquidity reserve, \(LQ\). Again, because R&D intensive firms face large adjustment costs of hiring and firing skilled personnel, they choose to smooth their R&D spending. This

\(^{11}\)In the innovation equation, unlike Hajivassiliou and Savignac (2011), we do not include the financial constraint variable \(F_t\). This is because our aim in this paper is to study innovation and financing decision of firms unlike Hajivassiliou and Savignac (2011), who look at how financial constraints affect the innovation of potentially innovating firms. Given their objective, they exclude firms that have no wish to innovate. Excluding such firms helps them identify the impact of \(F_t\) on \(I_t\), which takes value 1 for firms that innovate and 0 for those who want to innovate but cannot. In our data set, as discussed earlier, for CIS2.5 we can not distinguish between those firms that want to innovate but due to constraints cannot innovate and those who have no wish to innovate. That is, in CIS2.5 only innovators report if they are financially constrained. Hence in our data set we cannot identify if innovation is hampered due to the presence of financing constraints. Moreover, our aim is to study how financing and innovation choices are related and how \(Pr(I = 1|F = 1)\) and \(Pr(I = 1|F = 0)\) changes with the financing policy of firms with different characteristics.
necessitates that innovative firms maintain a higher level of cash reserve to counter periods of negative revenue shocks.

As far as dividend pay out is concerned, in Specification 3, where we remove the correction term for $SINS$ in the innovation equation, we find a significant negative coefficient for dividends, $DIV$. We remove the correction term for $SINS$ in the selection because $SINS$, which is observed only for the innovators, is not included in the specification for the innovation equation\textsuperscript{12}. This suggests that firms that pay out dividends are less likely to innovate. Now, given the nature of R&D activity that makes borrowing costly, internal funds may be more preferable. Therefore, innovative firms, ceteris paribus, are less likely to distribute cash as dividends.

We find that large firms are more likely to be ones taking up innovative activity. While the finding is consistent with the Schumpeterian view that large firms have a higher incentive to engage in innovative activities because they can amortize the large fixed costs of investing by selling more units of output, we also know that large firms, as shown in AH and CH, are less likely to face constraint in accessing external capital and therefore, are more likely to engage in R&D activity.

We find that younger firms are more innovative. This corroborates with the findings of other studies that find that young firms in their bid to survive and grow take up more innovative activity. Entry (see Audretsch, 1995; Huergo and Jaumandreu, 2004) is envisaged as the way in which firms explore the value of new ideas in an uncertain context. Entry, the likelihood of survival and subsequent growth are determined by barriers to survival, which differ by industries according to technological opportunities. In this framework entry is innovative and increases with uncertainty. Also, firms with large market share, $MKSH$, are found to be engaging more in innovative activity. This result confirms the fact that to prevent entry of potential rivals a firm is more incited to innovate if it enjoys a monopoly position, as has been argued in the Schumpeterian tradition.

The ratio of intangible assets to total capital assets, $RAINT$, has been found to be

\textsuperscript{12} As stated earlier, since $SINS$ is not observed for non-innovators, we assumed $SINS$ to be zero for the non-innovators when estimating the system of reduced form equation. Therefore, like $SINS$, the correction term for $SINS$ will be highly correlated with $I$, the decision to innovate. This could be the reason for the very high significance of correction term/control function for $SINS$ in Specification 1 and Specification 2.
significantly positive in the innovation equation. Since firms that engage in innovative activity have more intangible assets in their asset base, this should be expected. Besides, as Raymond et al. (2010) point out, innovation decision exhibits a certain degree of path dependency. To the extent that \( RAIN T \) is the outcome of past innovation activity, it captures the persistence in the innovation decision of the firm. We also find that firms that have many enterprises consolidated within them, \( DMULTI \), are more likely to be innovative. Cassiman et al. (2005) argue that enterprises merged or acquired may realize economies of scale in R&D, and therefore have bigger incentive to perform R&D than before. Also, when merged entities are technologically complementary they realize synergies and economies of scope in the R&D process through their merger, and become more active R&D performers after being merged or acquired.

We also find that factor loading, \( \theta \), which is the coefficients of \( \bar{Z}' \delta + \hat{\alpha} \) in the Innovation equation is significant. This and the fact that the control functions to correct for the bias in the structural equations due to the presence of endogenous regressors are all significant suggest a strong simultaneity in the decision to innovate and the financing choices made.

B. Financial constraint and Innovation

In this subsection we discuss the specification and the results of the Financial Constraint equation. To begin with, given the financial state of a firm, higher expected profitability from R&D investment could lead to a firm being financially constrained. Therefore we need to control for the investment opportunity of the firm. To this end, we include cash flow of the firm in specification for Financial Constraint equation. However, the realized cash flow of the firm may not be only from the firm’s R&D activity. A measure to control for the investment opportunity for R&D related activity should be based on a measure such as Tobin’s “\( q \)” for R&D related activity or cash flows that result from R&D output. However, in the absence of any such measure, we use the share of innovative sales in the total sales of the firm, \( SINS \), which can potentially signal demand for R&D related activity. Besides, Moyen (2004) finds that Tobin’s “\( q \)” is a poor proxy for investment opportunities, cash flow is an excellent proxy, and that cash flow is an increasing function of the income shock. We find that both \( CF \) and \( SINS \) have a significant positive sign in the Financial
Constraint equation\textsuperscript{13}. This suggests that both cash flow and the share of innovative sales are correlated with the R&D investment opportunity set and, ceteris paribus, are indicative of the financing gap that firms face. We note here that while $CF$, which is largely driven by exogenous shocks and is exogenous conditional on $\tilde{\alpha}$, $SINS$ is an outcome of current and past R&D efforts. Therefore we endogenise $SINS$. The coefficient of the control function for $SINS$ suggest that financial constraints and $SINS$ are determined endogenously.

Dummy for negative cash flow, $DNCF$, is found to have a significantly positive coefficient. It seems that variations over time from negative to positive cash flow are more indicative of positive “shifts” in the supply of internal equity finance that relax financial constraint than variation in cash flow itself.

For all the specifications we obtain a significant positive sign on debt to assets ratio, $DEBT$, indicating that highly leveraged firms are more likely to be financially constrained. This is consistent with the prediction in AH and CH, who show that firms with higher long-term debt in their capital structure are more likely to face tighter short-term borrowing constraint. This could also reflect the debt overhang problem studied in Myers (1977). It is also possible that, ceteris paribus, firms with higher leverage face a threat of default and therefore a higher premium on additional borrowing due to bankruptcy costs. Also, as can be evinced from the APE’s in Table 6, for an average firm, the likelihood of experiencing higher financial constraint is quite high for a firm that has higher long-term debt in its capital structure.

We find that firms that maintain higher liquidity reserve, $LQ$, are less likely to be constrained. Gamba and Triantis (2008) point out that cash balances, which give financial flexibility to firms, are held when external finance is costly and/or income uncertainty is high. With higher liquidity reserve, firms can counter bad shocks by draining it. Hence, when a firm is not sure about a steady supply of positive cash flow it is likely to practice

\textsuperscript{13}While it may be desirable to include a measure of expected profitability from R&D investment in the Innovation equation, we do not include cash flow, $CF$, and share of innovative sales in the total sales, $SINS$, in the Innovation equation. We do not include $SINS$ because it is observed only for innovators. We do not include cash flow in the Innovation equation because, as explained in section 4, in our data the decision to innovate precedes the realization of cash flow. Hence, cash flow can not identify a firm’s decision to innovate.
precautionary savings to reduce its risks of being financially constrained during periods of bad shocks. Besides, R&D intensive firms behave as if they face large adjustment costs, and therefore chose to smooth their R&D spending. Hence, financing flexibility could be important for innovation firms.

Our results suggest that dividends $DIV$ paying firms are less likely to be financially constrained. HW also find low dividend paying firms face high costs of external funds. Besides, AH and CH show that when a firm faces borrowing constraint, all profits are reinvested or paid to the lenders so that the burden of debt is reduced and the firm grows to its optimal size, and no dividends are paid. Also, the APE of dividends is very high, which lends credence to papers that employ dividend payout as a criterion for classifying firms as financially constrained or unconstrained.

We find that large and mature firms are less likely to be financially constrained. HW also find large differences between the cost of external funds for small and large firms. AH and CH show that over time as the firm pays off its debt, it reduces its debt burden and increases its equity value. This increase in the value of equity reduces the problem of threat of default in AH and the problem of moral hazard in CH, with the result that the extent of borrowing constraint decreases, the advancement of working capital from the lender increases and the firm grows in size. Consequently larger and mature firms are less likely to face financial constraint. On the other hand, old firms having survived through time have built a reputation over the years and are therefore less likely to face adverse information asymmetry problems as compared to young firms.

We include the ratio of intangible assets to total capital assets, $RAINT$, in the specification for financial constraint. Since secondary markets for intangible asset is fraught with more frictions and generally does not exist, firms with a higher percentage of intangible assets have a lower amount of pledgable support to borrow, and are thus expected to be more financially constrained. Almeida and Campello (2007) also find that firms with lower levels of asset tangibility are more financially constrained, and that investments in intangible assets do not generate additional debt capacity. Our results suggest that firms that have a higher percentage of intangible assets are indeed more likely to be financially constrained. Since a large part of the capital of an R&D intensive firm resides in the knowledge base of the firm, which is intangible, innovating and R&D intensive firms, as can be evinced
in Table 4, have a higher intangible asset base. Given this fact, innovating firms are thus more likely to face financial constraint.

We do not, however, find firms with a high market share, which serves as a proxy for monopoly power, and firms with multiple enterprises to be significantly less or more financially constrained.

In Table 5 we find $\lambda$, which is the coefficient of $\delta Z_i + \hat{\alpha}_i$ in the Financial Constraint equation and all correction terms to be significant, suggesting that the share of innovative sales, long-term debt, liquidity reserve, dividends, size, and the ratio of intangible assets to total assets are endogenously determined.

In Figure 1 we plot the APE of long-term debt on the propensity to innovate conditional on being financially constrained $\left( \int \frac{\partial \Pr(I=1|F=1, \hat{\lambda}, \hat{\epsilon})}{\partial \text{DEBT}} dF_{\hat{\alpha}, \hat{\epsilon}} \right)$ and conditional on being financially unconstrained $\left( \int \frac{\partial \Pr(I=1|F=0, \hat{\lambda}, \hat{\epsilon})}{\partial \text{DEBT}} dF_{\hat{\alpha}, \hat{\epsilon}} \right)$. We plot the APE of $\text{DEBT}$ against size, age and leverage. These plots of APE against age, size and leverage are based on Specification 2 of the second stage estimation. The APE plots based on other specifications are almost exactly same.

We find that conditional on not being financially constrained, the APE of $\text{DEBT}$ on innovation to be negative and almost constant over the distribution of size, age and leverage. In contrast, the APE of $\text{DEBT}$ on innovation conditional on being financially constrained varies widely over the distribution of age, size and leverage, and is less negative and sometime positive when compared to the APE of $\text{DEBT}$ on innovation conditional being unconstrained. This indicates that unconstrained firms, regardless of size, maturity, and existing level of debt, are almost uniformly less inclined to innovate by financing themselves with debt. In other words, when borrowing constraint do not bind and debt is accessible on easier terms, and if for some reason the firm has to finance itself with debt, then it is very unlikely the debt financing will be used for engaging in or starting an innovative activity. The following scenario can elucidate this. Suppose there is a profitable firm that has a substantial amount of cash holdings, which it can distribute to its shareholders. Being profitable, it is likely that it has a rather large debt capacity and suppose its existing debt levels are such that it has not reached its debt capacity. In such a situation, the firm
can distribute cash and borrow more to finance its investment. However, if it decides to innovate or spend more on R&D related activity, then as our results suggests, it would be less inclined to distribute cash as dividends, be more inclined to maintain a high cash reserves and not borrow more; in other words, finance itself with cash flow or retained earnings. This is in congruity with the findings of BFP, who show that in the absence of constraint, when internal and external equity are easily available, the preferred means for financing innovation is not debt.

When financial constraints set in, innovating firms, though still averse to debt financing, do innovate by borrowing as is reflected in the relatively higher change in propensity or willingness to innovate by increasing DEBT as compared to when firms are unconstrained. Now, under financial constraint, as Lambrecht and Myers (2008) explain, there can be two possibilities: (a) postpone investment or (b) borrow more to invest. Given that most of the firms that report being financially constrained are innovators, it is true that these firms have not entirely abandoned innovative activity. Therefore, the fact that the change in propensity to innovate by increasing DEBT is relatively higher, than under no financial constraint, suggests that some projects might have been valuable enough to be pursued by borrowing, even if that entailed a higher cost.

However, under financial constraint, the change propensity to innovate by increasing DEBT varies with size, age, and existing leverage. This is because under financial constraint, the relative cost of, or access to, external financing depends on firm’s age, size, and the existing levels of debt.

Consider the plot of APE of DEBT on innovation conditional on financial constraint against size of the firm. We see that under financial constraint large firms are more likely to innovate by increasing their leverage as compared to small firms. This is because as firms become large, the extent of constraint weakens, and if some R&D projects are valuable enough to be pursued, large firms have more leeway to finance their project by borrowing than small firms. Both AH and CH show that a firm with a given need of external financing to fund an initial investment and working capital, for a given level of growth opportunity and profitability, over time, during which firms face borrowing constraint and dividend payment is restricted, firms by paying off debt reduces its debt and increases its equity value. As the firm increases its equity value, with the result that the problem of threat
of default in AH and the problem of moral hazard in CH decreases, the advancement of working capital from the lender increases and the firm grows in size. Thus, if a large firm sees an investment opportunity in some R&D project it will be in a better position to borrow than a small firm. Also, HW find that large firms face lower bankruptcy and equity flotation costs as compared to small firms, which gives an advantage to large firms when it comes to borrowing for R&D. While the above argument explains, through the role of finance, why, for a given investment opportunity, large firms facing financial constraint are more likely to be willing to engage in innovation by borrowing more, it is also true that large firms, by Schumpeterian argument, have a higher incentive to innovate, and, given that large firms have a higher stock of knowledge, they are able to find more valuable R&D investment projects.

Incentives to innovate also explain the plot of APE of DEBT on the conditional probability to innovate against age of the firms. We know that even though younger firms are more likely to be financially constrained, it is the young firms that are more likely to take up innovative activity. This is because, as discussed earlier, survival and subsequent growth of young firms, especially those that are in the high-tech sector, depend on their innovation. Hence, under financial constraint it is young firms that are more willing to finance themselves by increasing their DEBT than matured firms. This, however, makes the young firms more prone to default as discussed in CQ and more likely to be financially constrained, which our results too suggests. However, the difference in APE of DEBT on innovation conditional on being financially constrained for young and old is not large as compared to the same for small and large firms. This could be due to the fact that once conditioned on size, here at the mean value of all firm-year observations, APE of DEBT on engaging in innovation does not vary much with age.

Lastly, under financial constraint, we find that change in propensity to innovate by increasing DEBT declines with higher leverage, which only shows that, ceteris paribus, the borrowing constraint get tighter with higher long-term debt in the capital structure, and the firm find it difficult to engage in innovative activity by increasing long-term debt.
C. Financing Constraints and R&D Investment

In the third stage we estimate the R&D switching regression model, given in equation (3.21), to assess the impact of financial constraint, as reported by the firms, on R&D investment. The distinguishing feature of our R&D model is that it takes into consideration the fact that R&D investment is determined endogenously along the decision to innovate and other financial choices. To the extent that the latent variable, $F_t^*$, underlying $F_t$ reflects high premium on external finance and the high financing need of firms, the switching regression model for R&D investment allows us test whether financing frictions affect R&D activity adversely.

[Table 7 about here]

The results of the third stage switching regression estimates are presented in Table 7. The additional correction terms – $C_{11}$, $C_{12}$, $C_{01}$, $C_{02}$ – that correct for the bias that can arise due to endogeneity of selection, $I_t$, and financial constraint, $F_t$, are constructed out of the estimates of the Specification 2 of the second stage estimates. Results of the third stage that are based on the other specification of the second stage estimates are almost exactly the same, the coefficients differing at the third or fourth decimal places. Table 7 has two specifications: in Specification 2 the correction term for size, not being significant in Specification 1, has been dropped.

In order to see the effect of financial constraint, $F_t$, on R&D investment, we have to fix the firm’s investment opportunity. Since we do not have any information on the market valuation of the firms, we can not construct average “q” for our firms or any such measure related to the firm’s R&D investment. Hence, for reasons stated in Subsection V-B, where we discussed the results of the second stage estimation, we include cash flow, $CF$, and share of innovative sales, $SINS$. These variables are arguably indicative of demand signals and correlated with the R&D investment opportunity set.

The specification for the R&D equation does not include any financial state variables such as long-term debt or cash reserves. This is because in the structural model for R&D investment, R&D investment is determined only by the degree of financial constraint a firm faces and the expected profitability from R&D investment. Therefore, it is unlikely that leverage and cash holdings will have an independent effect, other than through the financial
constraint affecting the firm. Now, we know that conditional on control functions, $\hat{\alpha}_i$ and $\hat{\epsilon}_h$, the financial state variables become exogenous to Innovation, Financial Constraint, and R&D investment. Hence, the natural exclusion of the financial variables from the R&D equation helps us to identify the parameters of the R&D equation when going from the second and the third stage. This is similar to the exclusion restriction required in the Heckman two-step sample selection model.

Now, even though cash flow turns out to be significantly positive and larger for the financially constrained firms as compared to those that are not, a test for the existence of financial frictions in our model is not predicated on sensitivity of R&D investment to cash flow for constrained and unconstrained firms, but through the test of the effect of reported financial constraint on R&D investment. While sensitivity of R&D investment to cash flow can indicate the existence of financing frictions, as BFP claim, it could be possible that cash flow are correlated with the R&D investment opportunity set and provide information about future investment opportunities, hence, R&D investment-cash flow sensitivity may equally occur because firms respond to demand signals that cash flow contain. Besides, $SINS$, which we include in the specification to control for future expected profitability, may not perfectly control for the firm’s R&D investment opportunity, giving predictive power to cash flow. Moyen (2004) too finds that cash flow is an excellent proxy for investment opportunity, and that cash flow is an increasing function of the income shock. HW discuss mechanisms, that are related to costs of issuing new equity, bankruptcy costs, and curvature of profit functions, that drive investment-cash flow sensitivity. However, it is beyond the scope of this paper to test for exact mechanism that drives the results on R&D investment-cash flow sensitivity across constrained and unconstrained firms.

We find that firms whose share of innovative sales, $SINS$, is high are more likely to be R&D intensive. This suggests that the share of innovative sales is also indicative of demand signals for R&D activity. This finding is in line with stylized facts studied in KK, where more innovative firms have higher R&D intensity. However, the difference, though positive, in the size of the coefficients of $SINS$ across constrained and unconstrained firms, is not large. The significance of correction term for $SINS$ suggests its endogeneity with respect to R&D investment.
Here, we want to test whether financing frictions, as summarized by $F_t$, adversely affects a firm’s R&D investment. In Specification 2, where the correction term for $SIZE$ has been dropped, we find that the coefficient of $F_t$ is significantly negative. Now, while the $SIZE$ of the firm turns out to be endogenous to the decision to innovate, it seems that $SIZE$, conditional on unobserved heterogeneity $\tilde{\alpha}_i$, as reflected in Specification 1 of Table 7, is exogenous to the amount invested in R&D. This could be either because the additional correction terms – $C_{11}, C_{12}, C_{01}, C_{02}$ – that take in account the endogeneity of the decision to innovate also accounts for the endogeneity of $SIZE$. It could also reflect the fact that R&D investment, which is a fraction of total investment, affects $SIZE$ of the firm in a predetermined way. However, what does not turn out significant is the APE of financial constraint on R&D intensity, $\Delta_F E(R_{it} | \tilde{X})$, defined in equation (3.22).

The other variables included in the specification are $SIZE$, $MKSH$, $AGE$, and $DMULTI$. The results indicate that even though large firms are more likely to engage in innovative activity, among the innovators smaller firms invest relatively more to their size in R&D than larger firms. This finding is contrary to that in KK, who model firm dynamics with R&D, where R&D intensity is independent of firm size. This is because KK do not consider the financing aspect of R&D. The finding that smaller firms are more R&D intensive could be because smaller firms, as has been argued in CQ and Gomes (2001), have a higher Tobin’s “$q$” than large firms, which can even be true of R&D capital. Thus, smaller firms in their bid to grow exhibit risky behavior in terms of investment in R&D. Also, for larger firms investing as much as or proportionately more in R&D than smaller firms would imply subjecting themselves to higher risk. This is because large firms, as argued in CQ, operating on a larger scale are more subject to exogenous shocks, and tying up more capital, or in proportionate to size, in a risky venture as R&D can potentially make large firms more susceptible to default. This is specially true when the price process of R&D output is correlated with the output of the existing operation of the firm. Thus, given the fact that R&D capital is highly intangible, which lacks second hand market, and with decreasing returns to R&D, investing in R&D proportionate to size or more would imply making itself more prone to default. Also, young firms are found to be more R&D intensive. We also find that for any given $SIZE$ and $AGE$, a constrained firm will invest less in R&D.
In our sample we find that constrained firms with a large market share, $MKSH$, invest more in R&D, but market share does not have any explanatory power for unconstrained firms. In another set of regression, where we had removed $DMULTI$ from the specification we did find a marginally significant positive sign for market share among the unconstrained firms, but the comparison of the size and the significance of the coefficients across the two regimes remained the same. Similar to the result on innovation, we find that firms that have a number of enterprises consolidated within them, $DMULTI$, are more R&D intensive.

In our analysis we find that the correction term for long-term debt and dividends are significant for financially constrained firms but not for the unconstrained ones, suggesting that financing with long-term debt and dividend payout are determined endogenously with R&D investment for constrained firms but not for the unconstrained ones. This is consistent with the results of the some of the papers cited above that model endogenous borrowing constraint, firm investment, and firm dynamics. We find that the control function for liquidity reserve is significant for the unconstrained firms but not for the constrained ones. In another set of regressions, where we had removed $DMULTI$ from the specification, we found the control function for liquidity reserve for the constrained firms to be significant. This finding suggests that R&D investment, along with other financial decision, and cash retention are endogenously determined. This is in line with the findings of Gamba and Triantis (2008) where they analyze optimal liquidity policies and their resulting effects on firm value. In their model the decisions on investment, borrowing and cash retention/distribution represent endogenous response to the costs of external financing, the level of corporate and personal tax rates that determine the effective cost of holding cash, the firm’s growth potential, maturity, and the reversibility of capital.

While the significance of individual control functions correcting for endogeneity of financial state variables differ across constrained and unconstrained firms, we find that $\bar{Z}_i\hat{\delta} + \hat{\alpha}_i$ is significant across both the regimes, suggesting overall a strong simultaneity in R&D investment and financial choices. Besides, we find that the additional correction terms – $C_{11}, C_{12}, C_{01}, C_{02}$ – that account for the endogeneity of the decision to innovate and the financial constraint faced to be significant.
VI. CONCLUDING REMARKS

The main objective of this paper was to empirically study how incentives to innovate interact with financing frictions, which, given the risky and idiosyncratic nature of R&D and innovative activity, assume a special status. We focused on (I) how endogenous financial choices made by the firms affect the firms decision to innovate and the financial constraint faced. Then, conditional on financial choices made, the decision to innovate, and the constraint faced we tried to determine (II) how financial constraints affect R&D investment.

To the above mentioned end, we presented an empirical strategy to estimate a model of R&D investment, financial constraint, decision to innovate, and a model for financial choices made, all of which are determined endogenously. The strategy entailed estimating (1) a system of structural equations pertaining to the decision to innovate, the perception of financial constraints and the amount of R&D investment. The structural part (I) of the analysis was carried out conditional on the first stage reduced form estimation, and part (II) was done conditional on the first and second stage estimates.

Our methodology combined the method of correlated random effect and control function to account for unobserved heterogeneity and endogeneity of regressors in the structural equations. We believe that the estimation technique is new to the literature and solves the much discussed endogeneity problem in empirical corporate finance. From the estimates of the second stage, where we estimated jointly the probability of being an innovator and the probability of being financially constrained, conditional on endogenous financial choices, we could garner that debt is not the preferred means of external finance for firms engaging in R&D activity, and that a highly leveraged firm is more likely to be financially constrained. We found that large and young firms, and those enjoying a higher degree of monopoly are more likely to be innovators. Also, firms that have many enterprises consolidated within them are more likely to be innovators. We found that small and young firms and firms with lower collateralizable assets are more likely to be financially constrained. Besides, the analysis also revealed that the decision to engage in R&D activity, the various financial choices, and the financial constraint faced are all endogenously determined.

Interestingly, we found that when a firm is not financially constrained, regardless of its
characteristics, it will be unwilling to engage in innovative activity by raising debt. On the other hand, under constraint, even though on average debt is not a preferred means to finance innovative activity, firms do show a propensity to engage in innovative activity by raising debt, but the propensity to innovate with debt financing varies with the distribution of firm characteristics. This propensity is influenced both by the incentives to innovate and the capacity to raise debt, both of which vary with firm characteristics.

Financial constraint does adversely affect R&D investment. We found that small, young, and firms with multiple enterprises are more R&D intensive. However, for a given size and age, the financially constrained ones invest less, which again shows how financing frictions condition firm dynamics that are brought about through R&D investment. Besides, our analysis confirm that R&D investment and financing decisions are determined simultaneously. Our results also suggest that financing frictions that affect innovation and R&D activity also affect firm dynamics. While models in industrial organization do study firm and industry dynamics where R&D and the stochastic nature of innovation drive the dynamics, the financial aspect and its interaction with innovative activity is found lacking. Our results suggest that future work in this area is needed.

Finally, one of the aims of this paper was to gauge the magnitude of the impact of financial constraint. However, since the measure of the magnitude is not statistically significant we cannot assert this finding. Trying to account for as many sources of endogeneity, selection and unobserved heterogeneity comes at the cost of losing precision.

REFERENCES


Hadjivassiliou, Vassilis, and Frédérique Savignac, 2011, Novel Approaches to Coherency Conditions in LDV Models with an Application to Interactions between Financing Constraints and a Firm’s Decision and Ability to Innovate, LSE discussion papers.


TABLE 1

Number of Enterprises and Number of Strata

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<th>CSI3</th>
<th>CIS3.5</th>
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<td>Total no. of enterprises</td>
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<td>10750</td>
<td>10533</td>
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<td>Total no. of strata</td>
<td>240</td>
<td>249</td>
<td>280</td>
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These figures are from the original/raw data set.

TABLE 2

Innovating/Non-Innovating and Financially Constrained/Unconstrained Firms

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<tr>
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<th>Financially Constrained</th>
<th>Financially Unconstrained</th>
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<tr>
<td>Innovators</td>
<td>525</td>
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<td>Non-Innovators</td>
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<td>Total</td>
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CIS3 (1998-00)

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<tr>
<td>Innovators</td>
<td>336</td>
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<td>1,844</td>
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<td>Non-Innovators</td>
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<td>1,579</td>
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<td>Total</td>
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CIS3.5 (2000-02)

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<tr>
<td>Innovators</td>
<td>154</td>
<td>1,826</td>
<td>1,980</td>
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<td>Non-Innovators</td>
<td>32</td>
<td>2,234</td>
<td>2,266</td>
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<tr>
<td>Total</td>
<td>186</td>
<td>4,060</td>
<td>4,246</td>
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</table>

These figures are for the data set used in estimation.
In CIS 2.5, non-innovating firms do not report if they are financially constrained.
The table illustrates the number of firms, in each of the three CIS waves, for which the number of enterprises surveyed is equal to the number of enterprises present in the firm, \( N_f = n_f \), and the number of firms, for which the number of enterprises present in the firm exceeds the number of enterprises surveyed. These figures pertain to the CIS data set prior to merging with the SF data set.

Since not all the CIS firms are in the SF data set, the CIS data used for estimation after cleaning is a bit less than half the size of the original data set.

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<th>CIS2.5</th>
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<th>No. of firms for which</th>
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## TABLE 4

Means of Variables for Innovators and Non-Innovators

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<tr>
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<th>CIS2.5 Innovator</th>
<th>CIS2.5 Non-Innovator</th>
<th>CSI3 Innovator</th>
<th>CSI3 Non-Innovator</th>
<th>CIS3.5 Innovator</th>
<th>CIS3.5 Non-Innovator</th>
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<tr>
<td>R&amp;D*</td>
<td>0.506</td>
<td>0.338</td>
<td>0.192</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Share of Innovative Sales in Total Sales (%)</td>
<td>8.532</td>
<td>10.944</td>
<td>8.025</td>
<td></td>
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<td></td>
</tr>
<tr>
<td>Long-term Debt*</td>
<td>0.789</td>
<td>0.834</td>
<td>0.739</td>
<td>0.8080</td>
<td>1.149</td>
<td>0.954</td>
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<tr>
<td>Cash flow*</td>
<td>0.869</td>
<td>0.841</td>
<td>0.638</td>
<td>1.167</td>
<td>0.589</td>
<td>0.352</td>
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<tr>
<td>Dummy for Multiple Enterprises</td>
<td>0.369</td>
<td>0.019</td>
<td>0.478</td>
<td>0.008</td>
<td>0.539</td>
<td>0.019</td>
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<tr>
<td>Liquidity Reserve*</td>
<td>0.913</td>
<td>1.837</td>
<td>0.840</td>
<td>1.689</td>
<td>1.152</td>
<td>1.532</td>
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<tr>
<td>Dividends*</td>
<td>0.082</td>
<td>0.133</td>
<td>0.089</td>
<td>0.268</td>
<td>0.176</td>
<td>0.253</td>
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<td>Market Share (%)</td>
<td>0.926</td>
<td>0.067</td>
<td>1.295</td>
<td>0.073</td>
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<td>Size (Log of Employed)</td>
<td>5.038</td>
<td>4.007</td>
<td>4.808</td>
<td>3.304</td>
<td>4.980</td>
<td>3.759</td>
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<tr>
<td>Ratio of Intangible to Total Assets (%)</td>
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<td>2.230</td>
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<td>Dummy for Negative Cash flow</td>
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</table>

* Variables normalized by total capital assets
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<th>Specification 3</th>
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<td>Share of Innovative Sales</td>
<td>0.201***</td>
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<td>0.206***</td>
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<td>(0.021)</td>
<td>(0.021)</td>
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<td>Long Term Debt</td>
<td>0.781***</td>
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<td></td>
<td>(0.247)</td>
<td>(0.108)</td>
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<td>0.317***</td>
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Control Functions | for

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<td>(\varepsilon_{cv})</td>
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<td>0.589***</td>
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Total Number of Observations: 13032

Significance levels: * : 10%  ** : 5%  *** : 1%

†The estimated coefficients of the Control Function for six the endogenous variables (1) Share of Innovative Sales, (2) Long-term Debt, (3) Dividends, (4) Liquidity Reserve, (5) Ratio of Intangible to total Assets, and (6) Size are the terms of \(\Omega_{\upsilon \epsilon} = \{\rho_{\upsilon 1\upsilon \epsilon}, \ldots, \rho_{\upsilon 6\upsilon \epsilon}\}\) of the Innovation equation (3.11) and \(\Omega_{\zeta \epsilon} = \{\rho_{\zeta 1\zeta \epsilon}, \ldots, \rho_{\zeta 6\zeta \epsilon}\}\) of the Financial Constraint equation (3.12).
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<td>0.043***</td>
<td>0.043***</td>
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<td>(0.006)</td>
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<td>(0.023)</td>
<td>(0.005)</td>
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<td>-0.502***</td>
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<td>(0.005)</td>
<td>(0.005)</td>
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<td>0.072***</td>
<td>-0.066***</td>
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<td>(0.009)</td>
<td>(0.009)</td>
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<td>Market Share</td>
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<td>0.032***</td>
<td>0.001</td>
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<td>(0.001)</td>
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<td>-0.003***</td>
<td>-0.002***</td>
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<td>(0)</td>
<td>(0.001)</td>
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<td>Ratio of Intangible Assets to Total Assets</td>
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<td>-0.064***</td>
<td>0.008***</td>
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<td>(0.008)</td>
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<td>(0.023)</td>
<td>(0.097)</td>
<td>(0.013)</td>
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Significance levels:  * : 10%  ** : 5%  *** : 1%
Figure 1: Plot of APE of Long-term Debt on the Probability of Innovation conditional on being Financially Constrained, $\int \frac{\partial \Pr(I=1|F=1, \hat{\alpha}, \hat{\epsilon})}{\partial \text{DEBT}} dF_{\hat{\alpha}, \hat{\epsilon}}$, or not Financially Constrained, $\int \frac{\partial \Pr(I=1|F=0, \hat{\alpha}, \hat{\epsilon})}{\partial \text{DEBT}} dF_{\hat{\alpha}, \hat{\epsilon}}$, against Age, Size, and Leverage.

(a) Age

(b) Log of Employed

(c) Long-Term Debt
### TABLE 7
Third Stage Estimates: R&D Switching Regression Model

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<th>Variables of Interest</th>
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<th>Specification 2</th>
<th>Control Functions</th>
<th>Specification 1</th>
<th>Specification 2</th>
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<td>(0.141)</td>
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<td>(1 - f) Share of Innovative Sales</td>
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<td>0.205***</td>
<td>Long-term Debt</td>
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Average Partial Effect of Financial Constraint -0.241 -0.175

Total Number of Observations: 6771

Significance levels: * : 10%  ** : 5%  *** : 1%

† The estimated coefficients of the Control Function for six the endogenous variables (1) Share of Innovative Sales, (2) Long-term Debt, (3) Dividends, (4) Liquidity Reserve, (5) Ratio of Intangible to total Assets, and (6) Size are the terms of \( \Omega_{h1c} = \{ \rho_{h1c1} \ldots, \rho_{h1c6} \} \) for the financially constrained firms and \( \Omega_{h0c} = \{ \rho_{h0c1} \ldots, \rho_{h0c6} \} \) for the unconstrained firms. See R&D equation (3.21).