

Proteccionism under R&D Policy: Innovation Rate and Welfare *

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Abstract

The pressure from national lobbies may lead governments to shift from an optimal into a non-optimal innovation policy. This paper examines the growth and welfare effects of optimal and non-optimal innovation policies. The non-optimal policy corresponds to a subsidy for national innovators that is equivalent to an optimal policy of incentives (tax cuts) to foreign investors. Since we are assessing what can nationals do with the support that could be oriented to foreign firms, we are measuring what the economy loses for not supporting foreign firms. We find welfare loss when supporting national R&D instead of foreign R&D. We conclude that the same support given to innovation can produce strikingly different outcomes depending on who receives the support.

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1 Introduction

The emergence of a knowledge-based economy implies that economic success can only be sustained if supported by a perennial capacity to innovate and create proprietary assets. Literature in growth theory points to research and innovation as the engine of growth. Acknowledging that innovation is the key to business growth, governments start pursuing R&D strategies. European governments, under the *Lisbon Strategy*, are working together with funding agencies, regulatory authorities, academia and industry to create a fast-growing, dynamic research environment. The main idea is to “make Europe, by 2010, the most competitive and the most dynamic knowledge-based economy in the world” (European-Council, 2000). Areas of investigation that involve new production technologies, because of their relationship with the creation of new jobs, are especially welcomed in this context, receiving a significant part of the European Funds.

Researchers and policy-makers reckon Foreign Direct Investment (FDI) to constitute an important channel to innovation. Foreign investment increases growth through the access to better technologies. Romer (1993) emphasizes that FDI will influence the growth rate via externalities or spillover effects¹. Several empirical studies support this argument. (Blomström, Lipsey and Zejan, 1994, Balasubramanyam, Salisu and Sapsford, 1996, Borensztein, Gregorio and Lee, 1998, Barrel and Pain, 1997). Governments have been pursuing policies (e.g. income tax, trade policies, and subsidies to foreign firms) to attract international investments.

This paper discusses and compares the growth effect of two most common types of incentives to innovation. In practice, a country often either offer favorable tax rate to attract FDI in R&D or provide a subsidy to R&D. Our focus here is, if a government has a limited possibility of promoting growth (in terms of the resources it can use to benefit a particular economic activity) should it subsidize research activity by national firms, or should it open the economy to foreign investment and offer a tax rate reduction in the R&D sector?

Under a R&D-based growth model, comparing these two most common policies, we expect to answer unambiguously which one is more economical and efficient in terms of accelerating the rate of innovation. The results of the model suggest that while foreign investors have lower or even equal costs of introducing new goods in the economy, the government need not provide as much benefits to accelerate the innovation rate under tax credit to foreign investor as under cost subsidies to national R&D.

Even if empirical studies do not always arrive to the same conclusions for the relationship between taxes and FDI, especially because it is sometimes difficult to isolate this single effect, usually the empirical studies point to a large sensitivity of the level and location of FDI to the tax treatment it receives (Gordon and Hines, 2002). In respect to R&D incentives, Grossman and Helpman (1991, Chapter 3) demonstrate that a subsidy to this activity has positive growth results. However, the economic literature on growth is more concerned with the effects of taxes than with the specific effect of a subsidy.

In the growth literature, the ideal tax rate on income has been indicated as being asymptotically zero (Judd, 1985, Chamley, 1986). Still for closed economies but in an endogenous growth models framework, Jones, Manuelli and Rossi (1993, 1997), Bull (2002) and Milesi-Ferretti and Roubini (1995), considering the existence of human capital accumulation, also conclude that the optimal long-run tax rates is zero. Judd (2002) finds that, in the presence of imperfect

¹Following a suggestion of Feenstra (1996), Reis (2001) shows for an economy with no taxes or subsidies that the welfare effect of foreign investment may be negative due to the transfer of profits to foreigners. This may dominate the positive effect of the increase in growth caused by a decrease in the cost of introducing new goods in the economy. On the other hand, Elberfeld, Götz and Stähler (2005), find that under free entry, FDI is welfare improving, since it entails a strong rationalizing effect, leading to a lower consumer price.

competition, the ideal tax may even be negative, thus may be a subsidy. As in Reis (2006) our results also suggest a negative tax rate, since the tax credit is higher than the tax rate itself. However, taxation is particularly important in endogenous growth models where externalities can be internalized by distortionary taxation, inducing an efficient allocation (Turnovsky, 1996).

The rest of the paper is structured as follows. Section 2 lays out the R&D-based growth model. Section 3 evaluates the impact on growth of a subsidy to R&D in a closed economy framework. Section 4 evaluates the effects on growth of a tax deduction with the aim to attract FDI into the R&D sector. Section 5 evaluates the effects on growth of a subsidy for national R&D firms that would be needed to undertake an optimal policy of incentives (tax cuts) to foreign investors. Section 6 compares the growth and welfare effects of these policies. Section 7 concludes.

2 The Model

The R&D-based model follows Grossman and Helpman (1991, Chapter 3), Reis (2006) and *de Mello-Sampayo, de Sousa-Vale and Camoes (2008)* but we go one step further comparing optimal with non-optimal R&D policies to accelerate the growth rate. The Government can attribute a subsidy to research in a closed economy or deduct taxes to profits in an open economy or attribute a subsidy to national R&D firms that would be needed to undertake an optimal policy of incentives (tax cuts) to foreign investors.

The utility of the representative household is:

$$U = \int_0^{\infty} e^{-\rho t} \log c_t dt, \quad (1)$$

where

$$c_t = \left(\int_0^{n_t} x_{c_j}^{\alpha} dj \right)^{1/\alpha}, \quad 0 < \alpha < 1. \quad (2)$$

x_c represents consumption of each good j and the total set of goods in the economy is given by the interval $[0, n_t]$. Maximizing Eq. (1), we obtain the growth rate of consumption:

$$\frac{\dot{c}}{c} = r - \rho, \quad (3)$$

where r is the real interest rate. The final good is assumed to be the numeraire. Total production, Y_t , takes into account how consumers' preferences combine the different varieties. The measure of total production is:

$$Y_t = \left(\int_0^{n_t} x_{p_j}^{\alpha} dj \right)^{1/\alpha}, \quad 0 < \alpha < 1, \quad (4)$$

where x_{p_j} is production of each good. From Eq. (4), the demand for each good is:

$$x_j = Y_t p_j^{-\varepsilon}, \quad (5)$$

where p_j is the price of the intermediate good and $\varepsilon = 1/(1 - \alpha)$ is the constant elasticity of substitution between any two varieties. A monopolist owns a patent for the production of a good x_j . Labor is the only factor employed in the production, being L_{x_j} the fraction used in the production of good j . The production function is then,

$$x_j = L_{x_j}. \quad (6)$$

Let w be the wage rate. From the maximization of profits the price of the good j is:

$$p_j = w/\alpha \quad \text{for all } j. \quad (7)$$

The wage rate is:

$$w_t = \alpha Q_t, \quad (8)$$

and profits become:

$$\Pi_j = (1 - \alpha) \frac{Y_t}{n_t}, \quad (9)$$

where Q_t is an index of knowledge in the economy, defined as $Q_t = n_t^{(1-\alpha)/\alpha}$.

To develop a new good x_j , the R&D sector needs a quantity a/n of labor. There are research spillovers as the cost of developing new goods depends inversely on the number of existing ones. When a researcher develops a new good owns the patent for producing it. Free-entry conditions in the R&D sector impose that the return of research for a new good must equal the cost of research. Thus,

$$v_t = aw_t/n_t \quad \text{for } g > 0, \quad \text{with } g = \dot{n}/n, \quad (10)$$

where v_t is the value of a patent. There exists a tax rate over profits, τ that is constant and known by all agents. This tax is transferred to consumers in the form of a lump-sum transfer. With taxes v_t is given by:

$$v_t = \int_t^\infty e^{-[R(s)-R(t)]} (1 - \tau) \Pi(\iota) d\iota, \quad \text{where} \quad R(t) = \int_0^t r(\iota) d\iota. \quad (11)$$

The equilibrium in the labor market is given by:

$$ag + \alpha Y_t/w_t = L. \quad (12)$$

In this equation, the first term represents labor used in R&D whereas the second term represents labor used in the production of all varieties of goods x and is obtained from Eqs. (5)-(7).

3 An Optimal Subsidy in a Closed Economy

We first consider the case where the government pursues a policy for promoting national R&D, and implements a proportional subsidy, s , for the cost of research. The cost of research is now given by $aw/n(1+s)$ with $0 < s < 1$. The new free-entry condition in the research sector is:

$$v_t = \frac{aw}{[n(1+s)]}. \quad (13)$$

With the subsidy, the productivity of the research sector augments from n/a to $n(1+s)/a$.

At the steady state g , the innovation growth rate, is constant. Then, from (12), the growth rate of production must equal the growth rate of the wage rate ($\dot{Y}/Y = \dot{w}/w$), which is given by $[(1-\alpha)/\alpha]g$. Substituting Eqs. (9) and (13) into Eq. (11), we get:

$$\frac{Y}{w} = \frac{a[r\alpha - (1-2\alpha)g]}{\alpha(1-\tau)(1-\alpha)(1+s)}. \quad (14)$$

Then, substituting Eq. (14) in the labor market equilibrium condition, we get a relationship between g_s and r as:

$$g_s = \frac{(1-\tau)(1-\alpha)(1+s)L/a - r\alpha}{\alpha - (1-\alpha)(\tau - s + s\tau)}. \quad (15)$$

This condition is valid for $g_s > 0$. From the labor market condition we know that we have to verify $g_s < L/a$ to have positive production. So, in equilibrium, $g_s < L/a$, which implies,

$$\frac{(1-2\alpha)L/a-\alpha r}{\alpha-(1-\alpha)(\tau-s+s\tau)} < 0 \quad \Longleftrightarrow \quad r > \frac{g(1-2\alpha)}{\alpha} \quad (16)$$

The equilibrium interest rate equals credit supply to credit demand. Our credit supply is given by Eq. (3) and because in this economy consumption is equal to production, we have:

$$r = \frac{\dot{c}}{c} + \rho = \left(\frac{1-\alpha}{\alpha} \right) g_s + \rho. \quad (17)$$

Now, using this last equation and Eq. (15) we can calculate the steady-state rate of innovation as a function of any subsidy to research:

$$g_s = \max \left\{ \frac{(1-\tau)(1-\alpha)(1+s)L/a - \alpha\rho}{1 - (1-\alpha)(\tau-s+s\tau)}, 0 \right\}. \quad (18)$$

Figure 1 provides a sensitivity analysis of the growth rate value, Eq. (18), with respect to the parameters of the model: ε and s . The simulation is performed against the Portuguese case (see Appendix for description of the data). It is revealed that g_s rises when s is high and ε moves towards one. Figure 1 also shows that g_s is much more sensitive to ε than to s . This is due to the fact that with a more elastic demand², a higher price dampens more the increase in profits, implying that the net increase in profits falls short of the entry of new firms in the R&D sector. Similarly, with a less elastic demand ($\varepsilon \rightsquigarrow 1$), a higher price dampens less the increase in profits, leading to more firms' entry into the R&D sector.

(Insert Figure 1 here)

Proposition 1 *For a closed economy, the optimal subsidy increases with the tax rate, τ , and with the labor force, L , and decreases with the innovation cost, a , with the intertemporal discount factor, ρ , and with α , $s = [L/a\rho + \tau - \alpha/(1-\alpha)] / (1-\tau)$.*

Proof. To determine the optimal subsidy, we have to calculate consumption in the closed economy using Eqs. (12) and (18):

$$c = \frac{w(L+a\rho)}{[1 - (1-\alpha)(\tau-s+s\tau)]}. \quad (19)$$

Now we use Eqs. (1), (8), (18) and (19) to obtain the utility function as

$$U_s = \frac{1}{\rho} \left[\log \frac{L+a\rho}{1 - (1-\alpha)(\tau-s+s\tau)} + \log \alpha Q_0 \right] + \frac{1}{\rho^2} \left(\frac{1-\alpha}{\alpha} \right) \frac{(1-\tau)(1-\alpha)(1+s)L/a - \alpha\rho}{1 - (1-\alpha)(\tau-s+s\tau)}, \quad (20)$$

and calculate the effect of the subsidy on welfare,

$$\frac{dU_s}{ds} = \frac{(1-\tau)(1-\alpha)}{\rho^2 [1 - (1-\alpha)(\tau-s+s\tau)]^2} [(1-\alpha)L/a + \rho(1-\alpha)(\tau-s+s\tau) - \alpha\rho]. \quad (21)$$

²Since a monopolist competitor operates on the part of the demand curve where demand is less elastic, it follows that it is reasonable to assume the elasticity of demand to be around two.

Thus, s is given by:

$$s = \frac{1}{1 - \tau} \left[\frac{L}{a\rho} + \tau - \frac{\alpha}{1 - \alpha} \right]. \quad (22)$$

The subsidy, s , as given by Eq. (22) is optimal only if it implies $g_s > 0$. Substituting Eq. (22) in Eq. (18) we obtain:

$$g(s) = \frac{L(1 - \alpha) - \alpha a \rho}{a(1 - \alpha)}. \quad (23)$$

The growth rate is positive if $L/a > \alpha\rho/(1 - \alpha)$, which implies that $s > 0$. ■

This result is in accordance with Grossman and Helpman (1991) since it implies that in the presence of externalities from R&D, the equilibrium growth rate will be higher with a policy that can internalize such spillovers. A subsidy may improve the private benefits of R&D motivating firms to enhance research.

4 Tax Deduction in an Open Economy

Consider a small economy, open to foreign investment and where foreign investors borrow in the international capital market. The interest rate is given by the international interest rate, $r = r^*$ and the supply of credit is infinitely elastic. The cost of innovation may be identical between national and foreign investors or may be smaller for foreign investors because they are introducing in our economy a set of new goods that have been developed and produced elsewhere. In any case, there will exist a unique production cost that will be equal to the international one.³ If $a^* < a$ all innovation will end up being done by foreign investors. Assume government allows for tax reduction, d , to foreigners in order to stimulate FDI and thus the innovation rate. The value of the patent, v_t , is now given by:

$$v_t = \int_t^\infty e^{-[R(s) - R(t)]} (1 - \tau + d) \Pi(\iota) d\iota, \quad \text{where} \quad R(t) = \int_0^t r(\iota) d\iota. \quad (24)$$

At the steady state the innovation rate, g_d , is again constant. The value of a patent becomes:

$$v_t = \frac{(1 - \tau + d)(1 - \alpha)Y_t/n_t}{r - \frac{1 - 2\alpha}{\alpha}g}. \quad (25)$$

The new labor market equilibrium condition for the open economy is given by:

$$a^*g_d + \alpha Y_t/w_t = L. \quad (26)$$

Substituting Eq. (25) and the free-entry condition in Eq. (26) we obtain the innovation growth rate as a function of the international interest rate,

$$g_d = \frac{(1 - \tau + d)(1 - \alpha)L/a^* - \alpha r^*}{\alpha - (\tau - d)(1 - \alpha)}. \quad (27)$$

Once again, Eq. (27) is valid for $g_d > 0$. From the labor market condition we know that $g_d < L/a^*$. So, in equilibrium we must verify that:

$$\frac{(1 - 2\alpha)L/a^* - \alpha r^*}{\alpha - (\tau - d)(1 - \alpha)} < 0. \quad (28)$$

³If international firms have the same production cost they may produce in the internal market and the innovation cost remains unchanged. In equilibrium, the set of goods produced in this economy will be produced by nationals and foreigners. If foreign investors have a smaller innovation cost they will replace the national firms and the cost of innovation will be determined by the foreign firms. In equilibrium all production will be done by foreign firms.

After opening to FDI, the credit supply function becomes⁴:

$$r^* = \frac{\dot{c}}{c} + \rho = \left(\frac{1 - \alpha}{\alpha} \right) g + \rho. \quad (29)$$

The steady state rate of innovation after the tax deduction, using Eqs. (27) and (29) is:

$$g_d = \max \left\{ \frac{(1 - \tau + d)(1 - \alpha)L/a^* - \alpha\rho}{1 - (\tau - d)(1 - \alpha)}, 0 \right\}. \quad (30)$$

The sensitivity analysis of the growth rate value, Eq. (30), with respect to the parameters⁵ of the model: ε and d , is illustrated in Figure 2. The simulation reveals that g_d rises when d is high and ε moves towards one. Comparing Fig. 1 with Fig. 2, the innovation rate is higher when the economy opens to FDI.

(Insert Figure 2 here)

Proposition 2 *Consider an economy open to foreign investment. Assume that*

$$r^* = \left(\frac{1 - \alpha}{\alpha} \right) \frac{L}{a^*}.$$

The optimal tax credit has to verify $d - \tau > 0$, which means that it is equivalent to a subsidy.

Proof. From Eqs. (26) and (30) consumption in the open economy is given by:

$$c = \frac{w(L + a^*\rho)}{1 - (\tau - d)(1 - \alpha)}. \quad (31)$$

Use Eqs. (1), (8), (30) and (31) to obtain the utility function:

$$U_d = \frac{1}{\rho} \left[\log \frac{L + a^*\rho}{1 - (\tau - d)(1 - \alpha)} + \log \alpha Q_0 \right] + \frac{1}{\rho^2} \left(\frac{1 - \alpha}{\alpha} \right) \frac{(1 - \tau + d)(1 - \alpha)L/a^* - \alpha\rho}{1 - (\tau - d)(1 - \alpha)}, \quad (32)$$

and derive the optimal tax deduction:

$$\frac{dU_d}{dd} = 0 \iff d - \tau = \frac{L}{a^*\rho} - \frac{\alpha}{1 - \alpha}. \quad (33)$$

Substituting this result in Eq. (30), we obtain

$$g(d) = \frac{(1 - \alpha)L - \alpha a^*\rho}{a^*(1 - \alpha)}. \quad (34)$$

The growth rate is positive if $L/a^* > \alpha\rho/(1 - \alpha)$, which implies that $d - \tau > 0$. ■

This result shows that to stimulate the rate of innovation, the government would have to give a subsidy to foreign investors in order to attract them into R&D sector. This is again the

⁴Since we are assuming that all the production is done by foreign investors we still verify that consumption is equal to production.

⁵The parameters are calibrated with the values shown in Table 1. of the Appendix. Here we use United States' innovation cost.

Grossman and Helpman (1991) result that states that government has to internalize research spillovers to augment growth.

de Mello-Sampayo et al. (2008) compared these two policies intended to stimulate the rate of innovation: one that subsidizes national R&D activity and a policy that offers a tax deduction to attract FDI in R&D. First, they compared a situation in which the foreign firms enter a small open economy with the same innovation costs as the national firms in the R&D sector. In this case, deducting taxes to foreign firms appears to be more efficient. Second, they considered the hypothesis of international firms having a smaller innovation cost and the results are reinforced by the fact that the national steady state growth rate becomes higher. Thus, if multinational enterprises have a lower innovation cost, the economy steady state growth rate is higher when opened to FDI than when closed, since the growth rate depends on the innovation cost.

National firms will produce

5 A Non-Optimal Subsidy

In previous sections we discussed and compared optimal policies, i.e. policies able to maximize welfare intertemporally. In this section, we study the effects on growth and welfare of a non-optimal R&D policy. we assume that pressure from national lobbies may lead the government to replace tax cuts attributed to foreign firms by subsidies attributed to domestic firms. This R&D policy will discourage foreign investors to locate their R&D activities in the home country, working as a barrier to FDI ⁶. Public authorities change their policy but only to the extent of their support to foreign firms. The given subsidy will correspond to a rate $s' = (1 - \tau)s$. In practice, the subsidy attributed to the innovators in the economy will be a share $1 - \tau$ of the optimal rate⁷. Under this assumption, we are assessing what the economy loses for not supporting foreign firms.

Under the above mentioned assumption, Eq. (18) becomes:

$$g_{s'} = \left\{ \frac{(1 - \tau)(1 - \alpha)[1 + (1 - \tau)s]L/a - \alpha\rho}{1 - (1 - \alpha)[\tau - (1 - \tau)^2s]}, 0 \right\} \quad (35)$$

with s given as in Eq. (22). In the optimal subsidy case, the equilibrium innovation growth rate is independent of the profits tax rate, whereas under this non-optimal policy the equilibrium growth rate depends on the tax rate. The derivative of the growth expression with respect to the tax rate indicates that the higher is the tax rate, the weaker will be the innovation rate.

Proposition 3 *Under a non-optimal subsidy, a tax cut will rise the steady state rate of innovation.*

Proof. Eq. (35) can be rewritten by replacing s as given in Eq. (22):

$$g(s') = \frac{(1 - \tau)(1 - \alpha)[1 + L/(a\rho) + \tau - \alpha/(1 - \alpha)] - \alpha\rho}{1 - (1 - \alpha)[\tau^2 - (1 - \tau)(L/(a\rho) - \alpha/(1 - \alpha))]}.$$

The derivative of $g(s')$ in order to τ is given by:

$$\frac{\partial g(sd)}{\partial \tau} = - \frac{(1 - \alpha)[2\tau + L/(a\rho) - \alpha/(1 - \alpha)]\alpha(1 + \rho)}{\{1 - (1 - \alpha)[\tau^2 - (1 - \tau)(L/(a\rho) - \alpha/(1 - \alpha))]\}^2},$$

which is negative given that $L/(a\rho) > \alpha/(1 - \alpha)$.

Therefore, as the tax rate rises, the innovation rate falls ■

This proposition has an immediate corollary. Since the subsidy does not correspond to an optimal value and the innovation rate decreases with the tax rate, a zero growth rate may prevail for some interval of values of the tax rate.

⁶ All production will be done by domestic firms and the cost of innovation will be determined by the domestic firms.

⁷ The new subsidy (s') would be optimal if the supported investment was the foreign one but will not be optimal for the national investment.

Corollary 4 Let $\theta \equiv \left[\sqrt{\left(\frac{L}{a\rho} + \frac{\alpha}{1-\alpha}\right)^2 + 4\left(1 - \frac{\alpha\rho a}{(1-\alpha)L}\right)} - \left(\frac{L}{a\rho} - \frac{\alpha}{1-\alpha}\right) \right] / 2$. The steady state rate of innovation is zero if the tax rate over profits is equal to or higher than θ .

Proof. The rate of innovation is positive if $(1 - \tau)(1 - \alpha)[1 + (1 - \tau)s]L/a > \alpha\rho$, which implies that:

$$\tau > - \left[\sqrt{\left(\frac{L}{a\rho} + \frac{\alpha}{1-\alpha}\right)^2 + 4\left(1 - \frac{\alpha\rho a}{(1-\alpha)L}\right)} + \left(\frac{L}{a\rho} - \frac{\alpha}{1-\alpha}\right) \right] / 2 \wedge$$

$$\tau < \left[\sqrt{\left(\frac{L}{a\rho} + \frac{\alpha}{1-\alpha}\right)^2 + 4\left(1 - \frac{\alpha\rho a}{(1-\alpha)L}\right)} - \left(\frac{L}{a\rho} - \frac{\alpha}{1-\alpha}\right) \right] / 2.$$

The first inequality holds, because the tax rate on profits cannot be negative, and the second inequality implies a boundary on τ that is higher than $\alpha/(1 - \alpha)$ (but that can be lower than 1, the highest value τ can assume), since positive optimal growth requires $\frac{\alpha\rho a}{(1-\alpha)L} < 1$ thus, the squared root expression must be a value above $\frac{L}{a\rho} + \frac{\alpha}{1-\alpha}$. Consequently, the innovation rate is positive as long as τ is below a given positive and lower than 1 threshold. On the contrary, the innovation rate being zero ($g_{s'} = 0$) is guaranteed for relatively high levels of the tax rate (for a value equal to or above such threshold) ■

(Insert Figure 3 here)

The sensitivity analysis of the growth rate value, Eq. (35), with respect to the parameters⁸ of the model: τ and s , is illustrated in Fig. 3. The simulation reveals that g'_s rises when s is high and τ is low. Further, Fig. 3 makes it clear that $g_{s'}$ decreases with τ ⁹.

Comparing Eqs. (35) and (18), we notice that eventhough Eq. (18) gives the growth rate that maximizes welfare, this does not necessarily mean that g_s must be always above $g_{s'}$. Nevertheless, we note that the non-optimal subsidy cannot produce a steady state rate of innovation higher than the one corresponding to the optimal subsidy, independently of the value of the tax rate.

Proposition 5 If the government chooses the non-optimal subsidy rate ($s' = (1 - \tau)s$), lower than the optimal subsidy rate (s), then the steady state innovation rate is smaller than the one respecting to the optimal case.

Proof. Given the optimal growth rate in Eq. (23), $g(s)$, the proposition states that $g(s) > g(s'), \forall \tau \in (0, 1)$. In fact, solving this inequality, we get the relation $\alpha(\rho + L/a) > 0$. Since all parameters in the expression are positive values, $g(s) > g(s')$ is a true condition and therefore $g(s)$ is always above $g(s')$ ■

Thus, the non-optimal R&D subsidy corresponds to the subsidy that would be needed to undertake an optimal policy of incentives (tax cuts) to foreign investors. Therefore, assuming that the cost of innovation is the same for national and foreign firms (as considered in *de Mello-Sampayo et al. (2008)*), figures 1, 2 and 3 also display a measure of inefficiency in the use of resources. Figure 2 respects to the rate of innovation if a tax deduction, d , is attributed to foreign

⁸The parameters are calibrated with the values shown in Table 1. of the Appendix. Here we use United States' innovation cost.

⁹ $g(s')$ can assume negative values for high levels of the tax rate (and therefore the innovation rate $g_{s'}$ becomes 0 for values of τ above a given threshold - in this case, a value around $\tau = 0.77$).

firms, Figure 3 corresponds to the rate of innovation when a same rate ($s' = d$) is the subsidy given to national innovators. Therefore, a same level of government funding to innovation can produce strikingly different outcomes, depending on who receives the support. This difference in outcomes is more pronounced the larger is the tax rate on profits.

6 The Welfare Effects

Finally, we analyse the effects on the welfare of these policies. Subsidy rate s is the one that allows for maximum welfare, whereas the subsidy rate $s' = (1 - \tau)s$ implies a lower level of welfare.

(Insert Figure 4 here)

(Insert Figure 5 here)

(Insert Figure 6 here)

Figures 4, 5 and 6 illustrate utility that the representative agent can get with the R&D policies: optimal R&D subsidy, optimal tax deduction and non-optimal R&D subsidy given by Eqs. (20), (32) and (36)¹⁰, respectively. The previous figures compare the effects of the three policies on welfare. Under optimal policies, welfare does not depend on the tax rate, whereas under non-optimal subsidy, welfare decreases with tax rate. Welfare increases with the innovation rate under any policy, however we note that the effect of the innovation rate on welfare is slower under the non-optimal subsidy than under the optimal policies.

The loss in welfare corresponds to the difference between the utility levels $U(s)$ and $U(s')$. The first one is given by Eq. (20) while the second is a similar expression with s replaced by s' . The result of this difference is,

$$\Delta U = U_s - U_{s'} = \frac{1}{\rho} \log \frac{1 + (1 - \alpha) [(1 - \tau)g(s)/\rho - \tau^2]}{1 + (1 - \alpha)g(s)/\rho} + \frac{1}{\rho^2} \left(\frac{1 - \alpha}{\alpha} \right) \left\{ \frac{(1 - \alpha)\tau(\tau + g(s)/\rho) [L/a + \alpha\rho - (1 - \alpha)(g(s)/\rho + \tau)(g(s)/\rho)]}{[1 + (1 - \alpha)g(s)/\rho][1 - (1 - \alpha)(\tau - (1 - \tau)(\tau - g(s)/\rho))]} \right\} > 0 \quad (36)$$

Eq. (36) was computed taking in consideration that $s = (\tau + g(s)/\rho)/(1 - \tau)$. Conclusions from Eq. (36) are not straightforward, given its complexity. However, we know that ΔU must be positive, since U_s represents the highest possible level of utility that the representative agent can get with a R&D subsidy, since s is optimal.

(Insert Figure 7 here)

(Insert Figure 8 here)

Figures 7 and 8 represent the increasing welfare loss that would occur if instead of assuming a subsidy rate s for national innovators, the government selected a subsidy rate of s' for nationals.

¹⁰The parameters are calibrated with the values shown in Table 1. of the Appendix.

7 Conclusion

Comparing the optimal R&D policies with a non-optimal R&D policy.

The non-optimal subsidy cannot produce a steady state rate of innovation higher than the one corresponding to the optimal policy.

The growth literature points to the importance of research and development as the engine of economic growth. Spillover effects of technology activities to the private ones are the main responsible for this positive growth effects, so economic policies should promote and internalize them. These technology developments can occur at the national level in private research laboratories that can have government subsidization or can be imported directly from abroad through international investments by multinational enterprises. Sometimes to attract these foreign firms governments have to pursue competitive fiscal policies like tax deductions.

In this paper, we compare two policies intended to stimulate the rate of innovation: one that subsidizes national R&D activity and a policy that offers a tax deduction to attract FDI in R&D. First, we compare a situation in which the foreign firms enter a small open economy with the same innovation costs as the national firms in the R&D sector. In this case, deducting taxes to foreign firms appears to be more efficient. Second, we consider the hypothesis of international firms having a smaller innovation cost. In this situation our results are reinforced by the fact that the national steady state growth rate becomes higher.

Under these policies, one has encountered the optimal rates of subsidy for national *R&D* and of tax deduction for foreign firms engaged in innovation activities on the national economy. One has also determined the steady state growth rate of the economy in both cases: the one in which *R&D* activities are developed by national firms and the case where foreign investment is allowed. The relevant conclusion is that, under equivalent innovation costs, foreign investment is preferable because a same growth rate is attained with a lower subsidy / tax cut.

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Appendix

Simulations

The simulations relate to the growth rates obtained in Eqs. (18), (30) and (35) and to the utility level obtained in Eqs (20), (32) and (36). These simulations are conducted with reference to the Portuguese case. The values of the parameters, as well as the ranges used in the simulations of growth rates, were drawn the European Commission, Economic and Financial Affairs, (AMECO Database) for the period 1998–2002 and from UIS Science and Technology database for the year 2000. Thus, the parameters from the equations of the growth rate are defined as:

τ : Tax rate is proxied by the Portuguese “current tax on income and wealth: corporations”, from AMECO database, for the period 1998–2002.

α : The parameter of the elasticity of substitution between any two products, ε , being $\varepsilon = 1/(1 - \alpha) > 1$, $0 < \alpha < 1$.

ρ : Discount rate is proxied by the United States “real long-term (5 years) interest rate, deflator GDP”, from AMECO database, for the period 1998–2002.

L : Labor force is proxied by the Portuguese “Total labor force”, from AMECO database, for the period 1998–2002.

a : Total gross domestic expenditure on R&D (GERD) $\times 1000$ / Full-time equivalent researchers \times GERD as % GDP, Portugal, from (UIS) database, for the year 2000.

a^* : Total gross domestic expenditure on R&D (GERD) $\times 1000$ / Full-time equivalent researchers \times GERD as % GDP, USA, from (UIS) database, for the year 2000.

s : Since the data on subsidies to innovation costs where not available, the value and the range of variation were picked arbitrarily.

d : Since the data on tax deduction to profits where not available, the value and the range of variation were picked arbitrarily.

Table 1: Parameter Values

	Mean	Maximum	Minimum
α	0.50	0.6	0.3
τ	0.16	0.20	0.12
ρ	0.04	0.05	0.016
a	68019	-	-
a^*	56108	-	-
L	5230.5	5407.8	5103.3
s	0.15	0.30	0.01
d	0.03	0.10	0.02

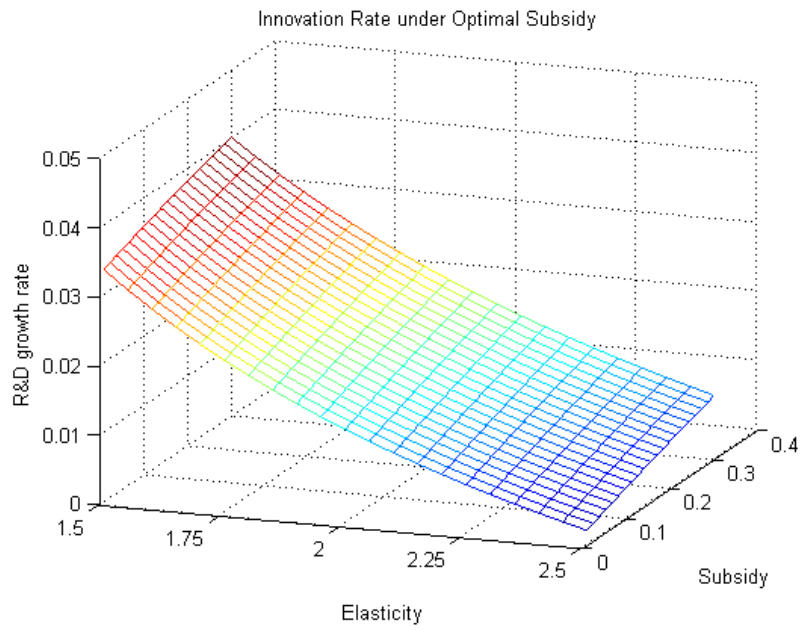


Figure 1: $\tau = 0.16$, $\rho = 0.04$, $a = 68019$, $L = 5230.5$

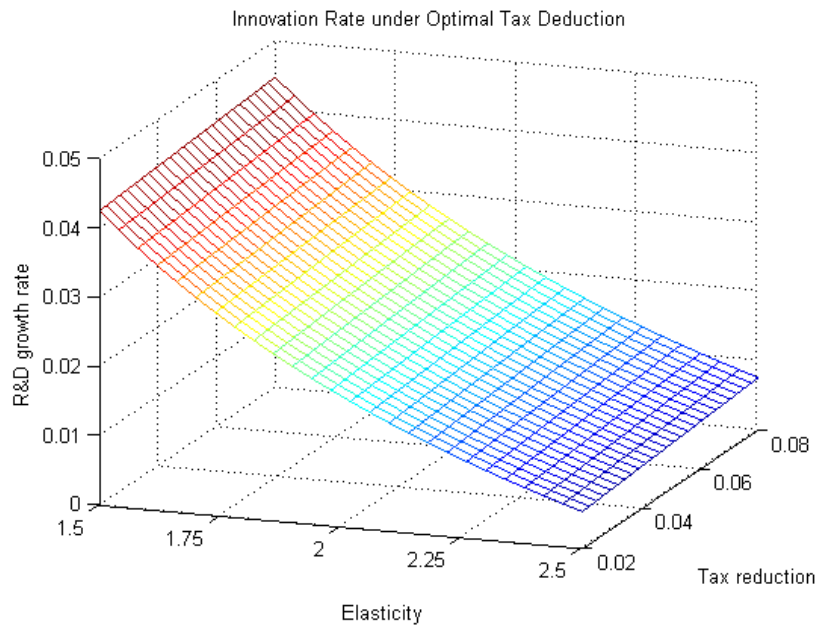


Figure 2: $\tau = 0.16$, $\rho = 0.04$, $a^* = 56108$, $L = 5230.5$

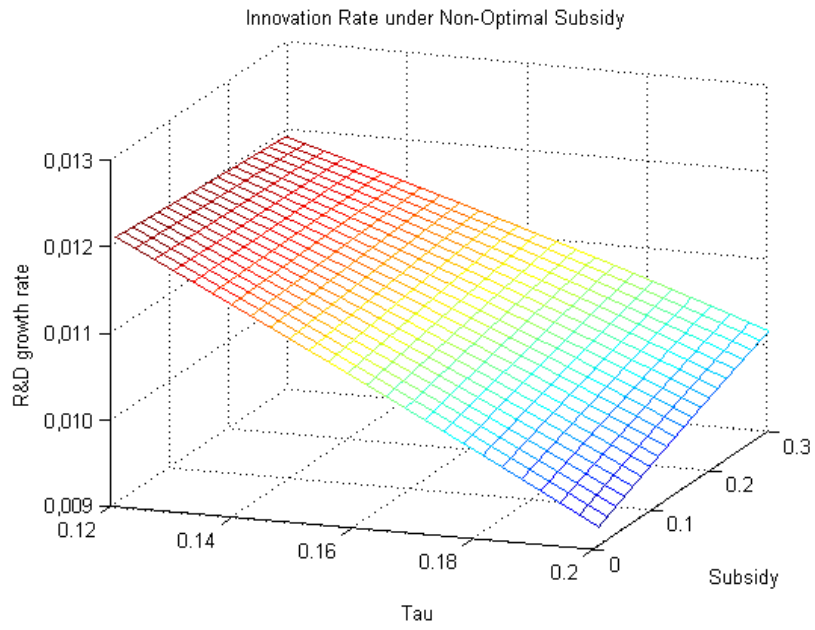


Figure 3: $\alpha = 0.05$, $\rho = 0.04$, $a = 68019$, $L = 5230.5$

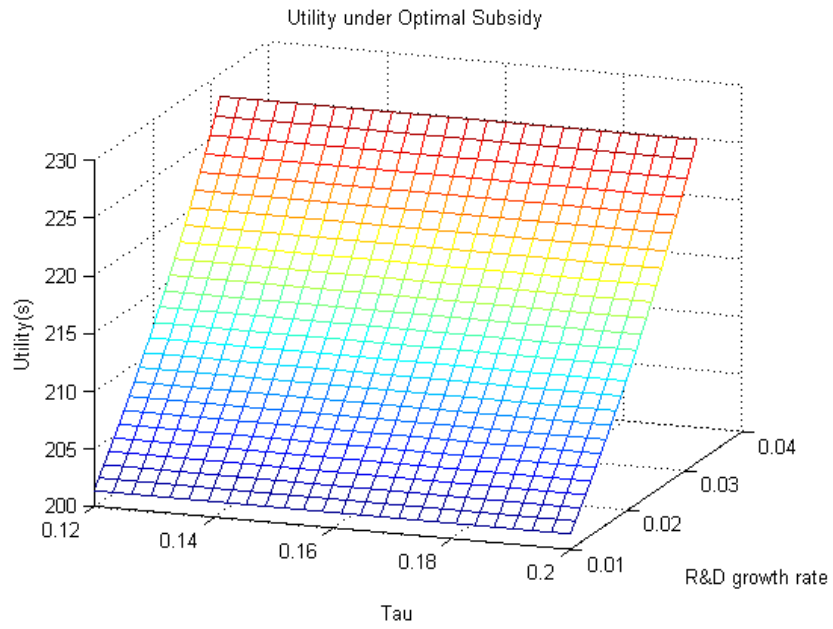


Figure 4: $\alpha = 0.05$, $s = 0.01$, $\rho = 0.04$, $a = 68019$, $L = 5230.5$

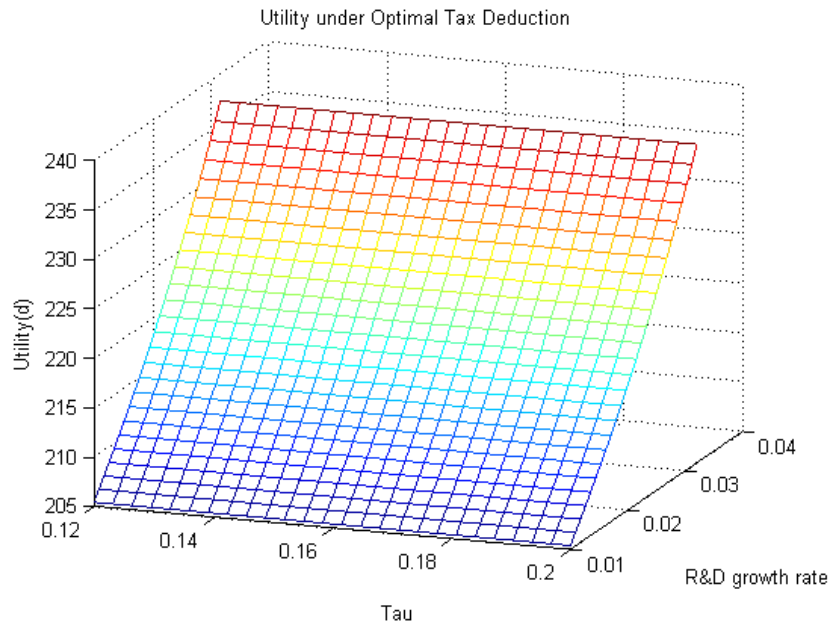


Figure 5: $\alpha = 0.05$, $d = 0.03$, $\rho = 0.04$, $a^* = 56108$, $L = 5230.5$

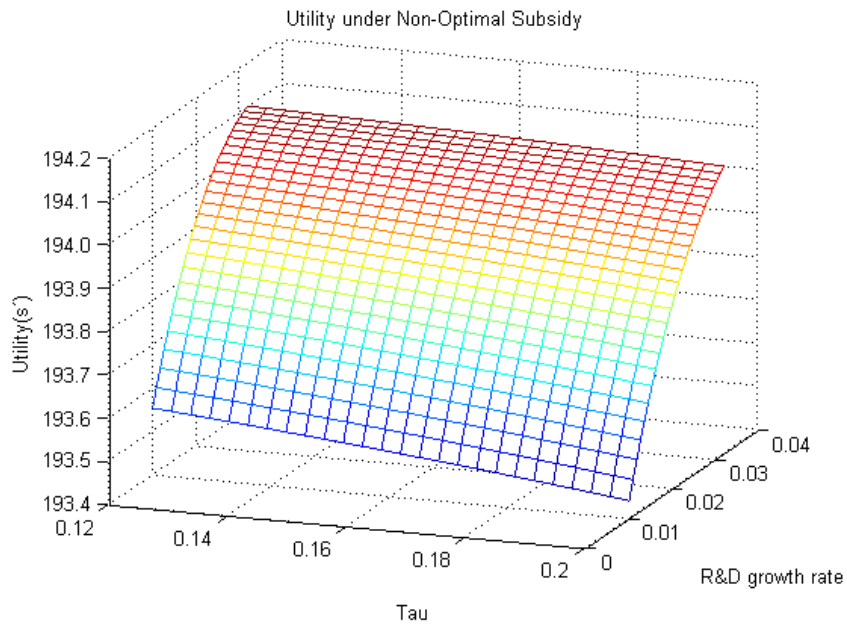


Figure 6: $\alpha = 0.05$, $s = 0.01$, $\rho = 0.04$, $a = 68019$, $L = 5230.5$

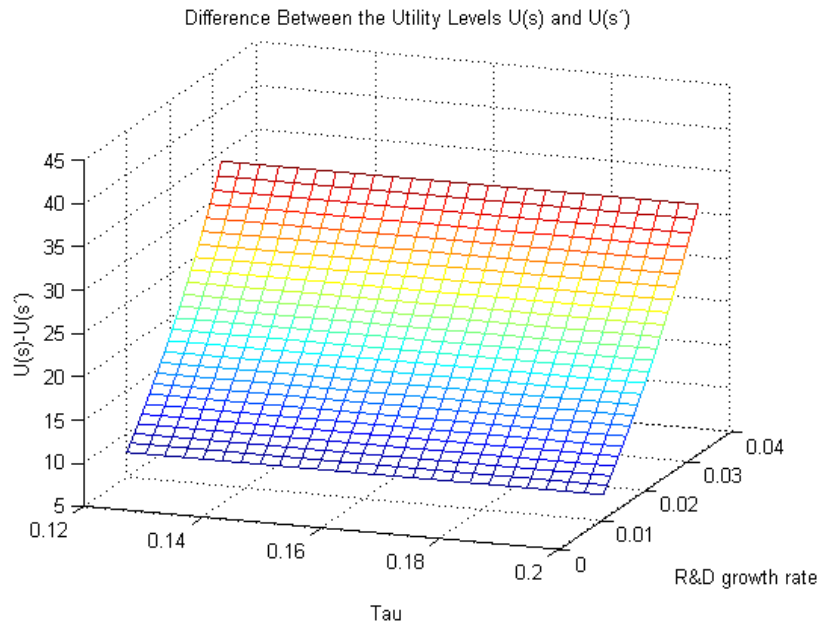


Figure 7: $\alpha = 0.05$, $s = 0.01$, $\rho = 0.04$, $a = 68019$, $L = 5230.5$

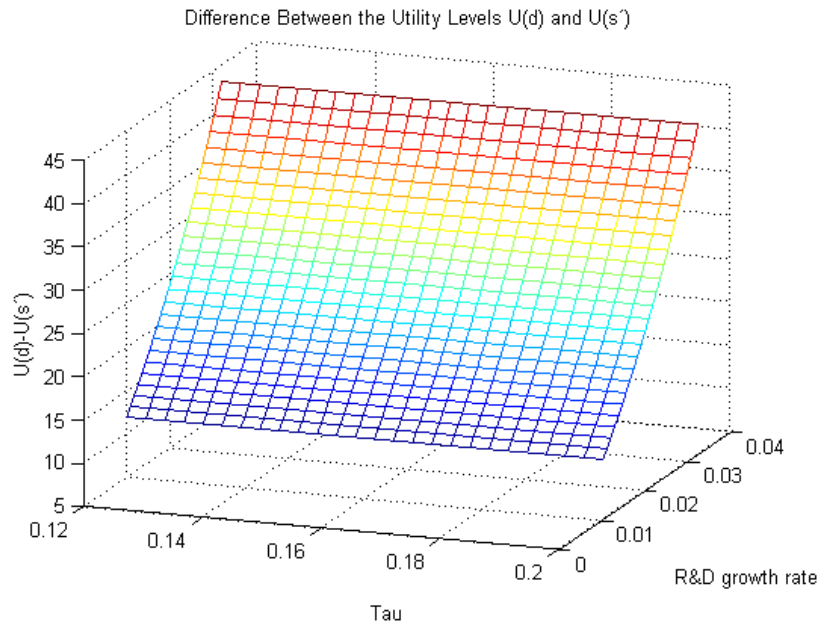


Figure 8: $\alpha = 0.05$, $s = 0.01$, $\rho = 0.04$, $a = 68019$, $a^* = 56108$, $L = 5230.5$