R&D and Economic Growth

——— Panel Data Analysis in ASEAN+3 Countries

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Abstract: Most literature suggests that roughly half of cross-country differences in economic growth are driven by differences in Total Factor Productivity, generally associated with technological progress. This study investigates the long-run relationship between R&D expenditure and economic growth using a panel data set comprising of 8 ASEAN+3 economies, over the period of 1994 to 2003. First, Begin with the Cobb-Douglas production function; we focuses on the contribution of R&D by estimating the social rates of return to R&D. Then, we develop the patterns of the evolution of R&D expenditure over the course of economic growth. In the last part, we use the PLS model to explores the determinants of R&D for every ASEAN+3 members.

Keywords: R&D expenditure   economic growth   ASEAN+3

Introduction

Facing with the trends of unprecedented rapid technological advances, accelerating globalization and regional integration will serve as the basic framework for the formation of the global economic order in the new era. The “ASEAN+3” bringing together ASEAN, Korea, Japan and China with a view to promoting regional economic cooperation in East Asia is now truly under way. With ample natural resources and economic cooperation, “ASEAN+3” countries are closing the gap with the developed countries. However, it is a painful fact that with the exception of Japan, these countries as a whole were slow to wake up to industrialization, and therefore failed to become developed countries. Enhancing competitiveness (according to the World Economic Forum, is a nation’s ability to achieve sustained high rates of growth in per capita income as measured by per capita Gross Domestic Product in constant prices.) is still great challenges for “ASEAN+3” countries.
A large theoretical and empirical literature has suggested that R&D plays a core role as an engine of growth. However, recent work in innovation also stresses that adopting existing technology is not without cost. Countries need to develop an “absorptive” or “national learning” capacity which, in turn, are hypothesized to be functions of spending on R&D.

The purpose of this study is to provide a view to understanding the link between the R&D and economic growth in ASEAN+3 countries over the 1994-2003 period. The major questions it addresses are the following:

— What is the contribution of technology to productivity growth in ASEAN+3 countries?
— Do ASEAN+3 countries engage in too much or too little R&D?
— What are the determinants of R&D across countries and over time?
— To what extent do these determinants influence cross-country differences in R&D?

The rest of the paper is organized as follows. Section 2 focuses on the contribution of R&D by estimating the social rates of return to R&D. Section 3 then develop the patterns of the evolution of R&D expenditure over the course of economic growth. To explain cross-country differences in R&D, Section 4 uses the PLS model to explores the determinants of R&D for every ASEAN+3 members. Section 5 summarizes the main findings.

The rate of return to R&D

There are different types of R&D and the effect of R&D on productivity may take various channels. In order to capture the links between R&D and productivity it is necessary to take these aspects into account. R&D performed by business results in new goods and services, in higher quality of output and in new production processes. These are factors of productivity growth at the firm level and at the macroeconomic level. Government and university research have a direct effect on scientific knowledge and public missions, they generate basic knowledge. To avoid the measurement problem of the R&D capital stock, we estimate the rate of return to the R&D to measure the
contribution of R&D to productivity.

Based on the above framework, we estimate the contribution of technical change to productivity growth. We distinguish the two sources of technical change: business and public sources. We also take into account business-cycle effects that strongly influence productivity in the short run. The model on which the estimated equation is based is a simple Cobb-Douglas production function.

\[
Y_{it} = \exp(\phi_i + \varphi_t + \varepsilon_{it})L^{\lambda_L} K^{\lambda_K} BRD^{\lambda_{BRD}} PRD^{\lambda_{PRD}} U^{\lambda_U}
\]

The variables (for country \(i\) and time \(t\)) are defined as follows:

- \(Y\) is the level of output
- \(K\) is the level of physical capital
- \(L\) the labor stock
- \(BRD\) is the business performed R&D capital stock
- \(PRD\) is total public R&D capital stock implemented in the higher education and public laboratories.

A range of control variables is included in all the regressions, \(U\) is intended to capture the business cycle effect: it is equal to 1 minus the unemployment rate.

- \(\phi_i\) is an individual country fixed effect,
- \(\varphi_t\) is a sample-wide time effect, and
- \(\varepsilon_{it}\) is a country and time specific effect.

The model can be rewritten as:

\[
d \ln(Y_{it}) = r_x(I/Y)_{it} + r_{BRD}(BRD/Y)_{it-1} + r_{PRD}(PRD/Y)_{it-1} + \lambda_x d \ln(L_{it}) + \lambda_{BRD} d \ln(U_{it}) + \phi_i + \varphi_t + \varepsilon_{it}
\]

by using the fact that

\[
\lambda_x d \ln(X) = r_x \left( \frac{\dot{X}}{Y} \right) = r_x(x)
\]

Here \(r_x\) is the rate of return on factor \(X\), \(x\) is the share of investment in \(X\) over \(Y\), \(\lambda_x\) is the output elasticity of factor \(X\).

One important type of omitted variable bias might be induced by the correlation of unobserved country-specific factors and the variables of interest; \(E(\phi_i, x_{it})\) may be large. Casselli, Esquivel and Lefort (1996), for instance, pointed out that the difference with respect to the highest level of income in the sample of countries acts as a proxy of the
country-specific effect in cross sectional regressions, and thus the resulting estimates are inconsistent. Here we use the lagged dependent variable (the initial level of GDP per capita) as instrument for endogenous variables. Nevertheless, if the lagged dependent variable is included in the model to account for endogeneity between variables, the coefficients obtained from the fixed effects analysis are no longer consistent. The GMM estimator takes into account both country fixed effects and the endogeneity problem by using the first differences of the variables and including the lagged dependent variable as an instrument in the analysis.

Table 1 presents estimated returns to R&D for the panel of countries that had sufficient consecutive observations (at least three) required for the GMM system estimator.

<table>
<thead>
<tr>
<th>Table 1 Returns to R&amp;D</th>
</tr>
</thead>
<tbody>
<tr>
<td>Dependent Variable: Growth of GDP (PPP)</td>
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<tr>
<td></td>
</tr>
<tr>
<td>Explanatory Variable</td>
</tr>
<tr>
<td>Ln(gdp per capita)t-1</td>
</tr>
<tr>
<td></td>
</tr>
<tr>
<td>Investment /GDP</td>
</tr>
<tr>
<td></td>
</tr>
<tr>
<td>Labor growth</td>
</tr>
<tr>
<td></td>
</tr>
<tr>
<td>BRD/GDPt-1</td>
</tr>
<tr>
<td></td>
</tr>
<tr>
<td>PRD/GDPt-1</td>
</tr>
<tr>
<td></td>
</tr>
<tr>
<td>Control Variable</td>
</tr>
<tr>
<td>ln(Unemployment)</td>
</tr>
<tr>
<td></td>
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<tr>
<td>R-squared</td>
</tr>
<tr>
<td>Observations</td>
</tr>
<tr>
<td>Countries</td>
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</tbody>
</table>

The conclusions from table 1 are that:

Compared with physical capital, the expenditures on R&D have more contribution to economic growth.
Comparing the returns to R&D of All Countries, ASEAN+3, EU and G7, we find that ASEAN+3 is the most attractive region for Investment, either in R&D capital or in physical capital.

In contrast to other regions, R&D implemented by governments has more contribution to economic growth than R&D implemented by businesses in ASEAN+3 countries. The coefficient of PRD is 4.1391, while the coefficient of BRD is only 0.7328.

The control variable (for the business cycle) is of the expected sign and is significant. The employment rate has a large impact on GDP growth.

As a whole, for ASEAN+3 countries, technological effort (measured by R&D) is one of the most important drivers to upgrade their competitiveness. Furthermore, it is urgent for these countries to exert more indigenous technological effort (proxied by Business R&D).

To learn more about the R&D behavior of the ASEAN+3 members, we have a look at their innovation trajectories.

**Innovation Trajectories**

Following Daniel Lederman and William F. Maloney (2003), we develop the patterns of the evolution of R&D expenditure over the course of economic growth using the panel data set including 8 ASEAN+3 countries constructed by IMD (1994-2003). We use OLS and Fixed Effects model to estimate the regression of the ratio of total R&D expenditures to GDP on log GDP per capita and its squared term. The estimated coefficients are presented in the Table 2.

<table>
<thead>
<tr>
<th>Table 2</th>
<th>innovation trajectory</th>
</tr>
</thead>
<tbody>
<tr>
<td>Dependent Variable</td>
<td>R&amp;D/GDP</td>
</tr>
<tr>
<td>Estimation Method</td>
<td>OLS</td>
</tr>
<tr>
<td>Explanatory Variables:</td>
<td></td>
</tr>
<tr>
<td>Log GDP per capita</td>
<td>-6.2995 (-6.047)</td>
</tr>
<tr>
<td>Log GDP per capita squared</td>
<td>0.3898 (6.834)</td>
</tr>
<tr>
<td>Adjusted R-squared</td>
<td>0.4553</td>
</tr>
<tr>
<td>F-test of Significance of No Fixed-Effects(p-value)</td>
<td></td>
</tr>
</tbody>
</table>
It is shown, from OLS and FEONE estimated results, that there is a positive relationship between R&D effort and log GDP per capita and the rate of increase also rises with GDP per capita in ASEAN+3 countries. The fixed effects estimates indicate that, though the R&D effort is partly a function of the log transformation of GDP per capita within countries, there is not an exclusive feature of the cross-country variations (for the F-test of significance of No-Country-Fixed-Effects less than 0.0001).

Figure 1 plots the observed levels of R&D as a share of GDP as function of the log GDP per capita for 8 ASEAN+3 countries (including Korea, Japan, Singapore, Malaysia, Thailand, Indonesia, Philippines and China) and compares these innovation trajectories with the so-called “general innovation trajectory” generated by a panel data set of all countries. Impressively, through depicting the specific trajectories of 8 ASEAN+3 countries, we classify these countries into five categories:

- High Growth and High R&D: Japan and Korea
- High growth but Low R&D: Singapore
- Medium growth but Low R&D: Malaysia and Thailand
- Low growth but High R&D: China
- Low growth and Low R&D: Indonesia and Philippines

What is immediately striking is Korea and Japan show substantial “take offs” relative to the “general innovation trajectory”. And China appear to be a follower in the footsteps of the “take offs”.
Figure 1 provides us with another way (more explicit) to tell the same story: the level of development is not the only reason to explain the R&D expenditure, there are some other reasons to determine the R&D expenditure for a country.

**Determinants of R&D Propensity**

There are very few studies of the determinants of R&D across countries. Two such studies (Varsakelis 2001; Bebczuk 2002) suffer from small samples and, as result, inconsistent estimates due to inability to deal with country-specific effects and endogeneity of the explanatory variables. And Daniel Lederman and William F. Maloney (2003) apply the GMM system estimator to their larger sample. Here we want to use PLS (partial least squares) regression to explain why there is various on R&D expenditure among ASEAN+3 countries. PLS regression is a recent technique that generalizes and combines features from principal component analysis and multiple regression. It is particularly useful when we need to predict a set of dependent variables from a (very) large set of independent variables.

As to determinates of R&D expenditure, there are some views as follows (Daniel Lederman and William F. Maloney 2003):
First, we imply the real interest rate which we presume reflects the opportunity cost of investment as well as other factors pertaining to the investment climate.

Second, we include a measure of credit market depth measured as index of credit flows easily from banks to businesses to proxy for the availability of credit at the reported interest rate.

Third, to capture risk associated with long term investments, we include the variance of GDP growth which he found correlated with physical investment.

Fourth, we also include a measure of intellectual property rights that would also affect the expected quasi rents derived from innovation. Although the impact of IPR is theoretically ambiguous (Horstmann et. al 1985), Arora, Ceccagnoli and Cohen (2003) using US manufacturing survey data find that patent protection stimulates R&D across almost all industries.

Fifth, for the fact that we are using a series of total R&D expenditures, which includes private and public financing of R&D, we include a measure of overall government spending over GDP as a measure of the government’s capacity to mobilize resources.

Sixth, as possible further constraints on investment, we include measures of the availability of complementary innovation-related institutions that may also put binding constraints on new R&D projects. We include the subjective indicators on the quality of research institutions (universities, public research centers, etc.) and the extent to which these collaborate effectively with the private sector. These considerations may also constrain the number of national innovation projects.

Finally, we include as control variables GDP growth to capture cyclical or accelerator effects, and the log of GDP/capita which we know from section 2 is positively associated with the R&D effort.

Based on the above framework, we specificity the model to explore the determines of R&D propensity:
### Table 3  Determinants to R&D: PLS regress results

<table>
<thead>
<tr>
<th>country</th>
<th>Control Variable</th>
<th>Response Variable</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Coef. VIP</td>
<td>x1</td>
</tr>
<tr>
<td>Philippine</td>
<td>Coef. VIP</td>
<td>0.04</td>
</tr>
<tr>
<td>Korea</td>
<td>Coef. VIP</td>
<td>-0.25</td>
</tr>
<tr>
<td>Malaysia</td>
<td>Coef. VIP</td>
<td>0.07</td>
</tr>
<tr>
<td>Japan</td>
<td>Coef. VIP</td>
<td>0.36</td>
</tr>
<tr>
<td>Thailand</td>
<td>Coef. VIP</td>
<td>-0.16</td>
</tr>
<tr>
<td>Singapore</td>
<td>Coef. VIP</td>
<td>-0.21</td>
</tr>
<tr>
<td>Indonesia</td>
<td>Coef. VIP</td>
<td>0.00</td>
</tr>
<tr>
<td>China</td>
<td>Coef. VIP</td>
<td>0.39</td>
</tr>
</tbody>
</table>

Note: all coefficients are significant at 10%
VIP means variable importance for projection

Here:

- $x_1$-log(GDP per capita), $x_2$- GDP growth, $x_3$-Real Interest Rate, $x_4$-Credit Index, $x_5$-Sd Growth, $x_6$-IPR Index, $x_7$-Gov.Cons./GDP, $x_8$-Quality of Edu., $x_9$-Collaboration

For Philippine, Malaysia, Japan, Indonesia and China, column 3 and 4 shows level of development and the GDP growth variable, positive and significant. The negative coefficient in Korea, Thailand and Singapore imply that there are some reduction on R&D expenditure relative to the GDP level.

The real interest rate (column 5) has the expected negative sign in all but Singapore and Indonesia. Following investment literature (see Serven 2003), the overall impression is that higher borrowing costs do lead to lower investment in R&D.

Credit Index (column 5) for 8 ASEAN+3 countries enters with the predicted positive sign indicating that deeper capital markets facilitate R&D investments. Among the measures of risk (column 6), the standard deviation of growth enters with the expected negative sign. For 8 ASEAN+3 countries, the IPR protection index (column 7) has the expected positive and very significant coefficient. Excepting Singapore and Indonesia, the government's ability
to mobilize resources (column 8) has positive contribution to R&D effort.

Both measures of complementary research capacity (column 9 and 10) enter strongly significantly and with predicted sign in 8 ASEAN+3 countries.

Figure 2 provides us with benchmark on important of determinants for every country.

**Figure 2  Benchmark for VIP of determinants to R&D: 8 ASEAN+3 Countries**

The top 3 determinants have been arranged based on their contribution to R&D

Philippine: Gov.Cons./GDP, Credit Index, Collaboration
Korea: Gov.Cons./GDP, Quality of Edu, IPR Index
Malaysia: Gov.Cons./GDP, Collaboration, IPR Index
Japan: Quality of Edu, Gov.Cons./GDP, Real Interest Rate
Thailand: Gov.Cons./GDP, Collaboration, Credit Index
Singapore: Gov.Cons./GDP, IPR Index, Real Interest Rate
Indonesia: IPR Index, Credit Index, Quality of Edu
China: Sd Growth, Gov.Cons./GDP, Collaboration

**Summary**

Through the preceding three sections, we found that there is an interactive relationship between R&D expenditure and economic growth. Focusing on the ASEAN+3 countries, R&D expenditure plays a more efficient role than that of other regions. By tracing the innovation trajectory of these countries, it is illustrated that R&D expenditures mainly depend on the level of their development, but the deviation from the “general innovation trajectory” implies it is also affected by several other elements. In the last section, we attempted to lay out these elements and found that Government ability to mobilize resources, credit market depth, and technological cooperation have more effect on R&D for ASEAN+3 countries.

Every country, which aims to upgrade their competitiveness (sustainable economic growth), should increase their R&D expenditure.

**Reference:**

7. Examples Using the PLS Procedure. SAS/SATA.