Better, Faster, Stronger: Global Innovation and Trade Liberalization*

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Abstract

This paper estimates the effect of trade policy during the Great Liberalization of the 1990s on innovation in nearly 100 countries using international firm-level patent data. The empirical strategy exploits ex-ante differences in firms’ exposure to countries and industries, allowing us to construct firm-specific measures of tariff cuts. This provides a novel source of variation that enables us to establish the causal impact of trade policy on innovation. Our results suggest that trade liberalization has economically significant effects on innovation and, ultimately, technical change and growth. According to our estimates, a substantial share of global knowledge creation during the 1990s can be explained by trade policy reforms. Furthermore, we find that the increase in patenting reflects innovation, rather than simply more protection of existing knowledge. Both improved market access and more import competition contribute to the positive innovation response to trade liberalization.

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1 Introduction

Trade policy liberalization opens up new markets abroad while increasing the competitive pressure in the home market. Both mechanisms are likely to affect the innovation rate in the economy, as well as the rate of economic growth. In this paper we set out to estimate the net impact of trade policy on innovation, as well as to disentangle the impact of market access and import competition on innovation.

During the 1990s, tariffs in both developing and developed countries came down substantially, leading researchers to name the period the Great Liberalization of the 1990s (Estevadeordal and Taylor, 2013). Those reductions were predominantly a result of the GATT Uruguay Round, spanning the years 1986 to 1994 and phased in from 1995 to 2000, but also a result of regional trade agreements and unilateral liberalization. On average, developed country tariffs were cut from around 6 to 3 percent, while developing country tariffs were cut from almost 20 to 13 percent between 1990 and 2000 (Appendix D).

We use the Great Liberalization as a quasi-natural experiment and estimate the causal impact of diminishing tariffs on innovation by using firm-level variation in country and industry exposure prior to the tariff cuts. Intuitively, a firm $x$ located in Germany and selling to the U.S. and Mexico is affected differently than a Japanese firm $y$ selling to China and South Korea because tariff cuts vary across countries and industries. Furthermore, a German firm $z$ selling only to Germany is again affected differently because that firm does not immediately benefit from improved market access abroad but is potentially hurt by fiercer import competition in its home market.

The data requirements for this exercise are large; one would ideally need a firm-level panel data set on innovation over a long time period, along with detailed information on where firms are located and in which markets they sell in. To achieve this, we construct a global and comprehensive firm-level data set on patenting using PATSTAT from the European Patent Office.

In our data, we observe nearly every firm worldwide that files a patent, in which country (patent office) they file, along with their industry and home country affiliation, over four decades. We do not directly observe in which markets firms sell in, but instead we observe where firms are patenting. We therefore construct firm-level measures of country exposure by using patent information up until 1985, one year before the Uruguay negotiations started. As pointed out by Aghion et al. (2016), patent weights may be a better measure of exposure because they reflect the firms’ expectations of where their future profits will be. We also provide evidence that patent weights are strongly correlated with sales weights (Appendix F).
Our firm-level approach has a number of advantages. First, because ex-ante country exposure varies significantly within a country and within narrowly defined industries, we can sweep out all home country-industry trends in innovation by fixed effects. This is crucial because the likelihood of patenting depends on a host of factors such as the legal framework and technological characteristics of the industry. Second, because we observe aggregate patenting in all countries and industries, we can flexibly control for all other factors that are correlated with tariff cuts and also affect innovation. An example of this is market size. Being exposed to a high-tariff cut country may be correlated with innovation simply because this country grows faster (and market size fosters innovation). Controlling for aggregate patenting in the destination country will eliminate this concern. Third, our long time period allows us to perform placebo tests; to test if treated firms (exposed to high-tariff cut countries) typically always patent more.

Our results show that the Great Liberalization of the 1990s had a large positive net impact on innovation. Overall, our estimates can explain six percent of global knowledge creation over the period. The aggregate number masks considerable heterogeneity across countries and industries. For example, our estimates explain roughly one fifth of knowledge creation among firms in developing countries, which experienced much greater tariff cuts compared to firms in developed countries. While our data do not include other firm-level outcomes than patenting, other researchers have found an economically significant impact of patenting on firm-level productivity (Bloom and Van Reenen, 2002). Hence, our results suggest that innovation was one important channel by which trade policy liberalization improved global growth during this period. Furthermore, our decomposition exercise shows that both improved market access and tougher import competition have large and positive effects on innovation. The economic magnitude of the two mechanisms is similar.

One may question whether increased patenting reflects more innovation. The literature typically finds a strong correlation between patenting and research and development, and between patenting and other measures of innovation. We also find a strong positive correlation between patent counts and other innovation indicators in our own data (Appendix H). Moreover, our firm-level identification strategy ensures that all regulatory changes in the patent system, or differences across patent offices, are differenced out by fixed effects. But the concern remains that more trade could induce greater protection of intellectual property rights (IPR), i.e. that more patenting is simply a “lawyer effect”. To deal with this, we calculate citation counts for all firms in our data set to control for the quality of a patent, and check whether average citations are falling in response to trade liberalization. This would indeed be the case if import competition induced firms to take out more patents to protect marginal inventions. The data rejects this hypothesis, if anything, average citations are ris-
ing in response to trade liberalization. In addition we use alternative measures correlated with the economic value of patents to control for the quality of patents. This includes the breadth of a patent as well as the size of the research team behind the patent. The results mirror those obtained using citations.

The contributions of this paper are as follows. First, we develop a novel methodology that gives us broad and systematic evidence of the impact of trade policy on worldwide innovation over a decade with steep global tariff declines. This provides external validity compared to the current literature that has primarily focused on relatively narrow policy changes (e.g., Bustos 2011). Moreover, there is a large literature on the impact of trade policy on firm performance (e.g., TFP or labor productivity), but there is little evidence on observable output or input measures of innovation (e.g., patents and research and development, respectively). Third, we disentangle the import competition from the market access effect of trade policy, which not only informs the literature on trade policy but also the broader literature on the effects of competition on innovation (e.g. Aghion et al. 2005, Bloom et al. 2016 and Griffith et al. 2010) and market size on innovation (e.g. Acemoglu and Linn 2004). Fourth, we construct and analyze a novel, comprehensive and global firm-level patent data set that has so far not been applied in the context of international trade.

Our analysis thus speaks to different strands of literature. Our work is related to the empirical analyses of firm level data on the impact of tariffs on firm performance such as Amiti and Konings (2007), Goldberg et al. (2010) and Khandelwal and Topalova (2011). They all find that input tariffs cuts are associated with sizable measured productivity gains. Compared to our work, these papers focus on the impact of trade on firm performance but do not separately identify what are the channels that allow for the benign impact of trade on innovation.

Second, our work relates to the literature on complementarities between import competition, trade and technology adoption. Bloom et al. (2016) and Autor et al. (2016) analyze the effect of Chinese import competition on technology upgrading in Europe and the U.S., respectively, while Boler et al. (2015), Bustos (2011), Lileeva and Treffer (2010) analyze the complementarities between trade integration and technology choice. What distinguishes our paper from these contributions is the fact that: (i) we focus on the global impact of multilateral trade liberalization rather than on regional or industry-specific shocks, (ii) we disentangle the market access and competition mechanisms and (iii) we offer an entirely

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Goldberg et al. (2010) find that lower input tariffs are associated with increased R&D expenditures. Steinwender (2015) finds that productivity upgrades following increased export opportunities and stronger import competition are driven by higher R&D expenditures, patenting, and adoption of foreign technologies. Halpern, Koren, and Szeidl (2015) and Gopinath and Neiman (2013) also examine the link between firm performance and trade, but do not use variation in tariffs.
new identification strategy and provide external validity. Finally, our empirical approach is related to Aghion et al. (2016) and Calel and Dechezleprêtre (2016). Like us, they use PATSTAT data, but focus on very different questions, namely the impact of environmental policies on technical change.

The rest of the paper is organized as follows. Section 2 presents our economic framework. Section 3 describes the data, while Section 4 outlines the estimation details, highlights econometric issues and provides some descriptive statistics. Section 6 presents and discusses the empirical results and Section 7 concludes.

2 Economic Framework

We aim to investigate the effect of trade liberalization on firms’ innovation. To do so, we start by presenting a basic economic framework to support the analysis, and proceed by developing predictions for the relationship between trade and innovation.

2.1 Basic Setup

This section presents a simple reduced-form framework that will guide the econometric specification and yield testable empirical relationships. Consider the following global profit function of a firm $i$,

$$\pi_i = \sum_{n \in \Omega_i} \pi_{in} = z_i \sum_{n \in \Omega_i} \tau_n^{\beta_n} e_{in}, \quad (1)$$

where $z_i$ is productivity, $\tau_n$ is the iceberg-equivalent tariff in country $n$ (i.e., $\tau_n$ is one plus the ad-valorem tariff rate of country $n$), $\beta_n$ is an unknown parameter and $e_{in}$ is a residual capturing all other country-specific factors facing firm $i$ that determine profits, such as overall demand in country $n$. The set of countries where the firm $i$ has positive sales is given by $\Omega_i$. We obtain the firm’s global profits by summing across all countries in $\Omega_i$.

In this part of the paper, we abstract from the possibility of bilateral tariffs due to preferential trade agreements. Our empirical analysis will, however, take this into account. Similarly, to ease notation, we abstract from tariffs being industry-specific so that we can drop industry subscripts for $\tau_n$, but we shall exploit industry variation in $\tau_n$ in the empirical part of the paper.

The profit function captures two main ideas. First, profits increase with effective market size ($\sum_{n \in \Omega_i} \tau_n^{\beta_n} e_{in}$), either due to increased demand $e_{in}$ or by a change in market access $\tau_n$. Second, the impact of tariffs on profits may be heterogeneous across countries. In particular, a decline in home country tariffs may have a net negative impact on profits due to fiercer...
competition (i.e., $\beta_{Home} > 0$), while a decline in tariffs in export markets is expected to have a net positive impact due to better market access (i.e., $\beta_{Foreign} < 0$).

Note the similarity between our profit function and variable profits in benchmark trade models with monopolistic competition. In those models tariffs enter directly in the expression for variable profits in a market (the market access effect), but also indirectly through the price index term (the competition effect). For empirical tractability, we instead choose a specification where $e_{in}$ is calculated net of tariffs, but where $\beta_n$ is allowed to vary across countries. We clarify the correspondence between our reduced form and the structural expression for global profits in benchmark trade models with monopolistic competition in Appendix A.

The set of countries where the firm has positive sales, $\Omega_i$, is varying across firms but taken as exogenous. This is motivated by the empirical fact that there is a high degree of persistence in country-specific export participation, see e.g. [Moxnes (2010)], and that a dominant share of the variation across firms in market entry can be attributed to heterogeneity in firm efficiency, and efficiency is highly persistent over time [Eaton et al. (2011)]. Appendix F provides empirical evidence that $\Omega_i$ is remarkably persistent over time.

A firm’s productivity $z_i$ is proportional to its stock of knowledge $K_i$, $z_i = \xi K_i$. We discuss the measurement of $K_i$ in Sections 4.1 and 6.2. Gaining new knowledge is costly, and we assume that the cost of obtaining a stock of knowledge $K_i$ is $c(K_i) = \psi K_i^k$, where $\psi$ determines average innovation cost and $k > 1$ determines how quickly those costs rise with knowledge. The firm then chooses the optimal $K_i$ that maximizes net profits, $\pi_i - c_i$. This gives the first order condition

$$\xi \sum_{n \in \Omega_i} \tau_n^{\beta_n} e_{in} - \psi k K_i^{k-1} = 0,$$

or

$$K_i^* = \kappa \left( \sum_{n \in \Omega_i} \tau_n^{\beta_n} e_{in} \right)^{1/(k-1)},$$

where $\kappa$ is a positive constant.\(^2\)

The optimal knowledge stock, $K_i^*$, is a function of effective market size, $\sum_{n \in \Omega_i} \tau_n^{\beta_n} e_{in}$. Trade liberalization affects innovation through improved market access and through increased competition, and the magnitudes (and signs) of these effects are determined by the parameters $\beta_n$. Improved market access raises profits in a destination and will therefore give more innovation, suggesting a negative $\beta_n$. A more competitive marketplace may foster innovation due to an increased threat to monopoly rents, which may induce incumbent firms to inno-

\(^2\kappa \equiv (\xi/\psi k)^{1/(k-1)}$. The second order condition for profit maximization, $\partial^2 \pi_i / \partial K_i^2 - \psi k (k - 1) K_i^{k-2} = -\psi k (k - 1) K_i^{k-2} < 0$ is satisfied given that $k > 1$. 

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vate more in order to “escape” competition (see e.g. Aghion et al., 1997 and Aghion et al., 2005), also suggesting a negative $\beta_n$. On the other hand, the fundamental Schumpeterian force implies that competition lowers price-cost margins, thereby reducing the rents from innovation and the incentives to innovate (see e.g. Aghion and Howitt, 1992), suggesting a positive $\beta_n$.

Now consider a change in $\tau_n$ and $e_{in}$ from period $t = 0$ to $t = 1$. Using Jones’ hat algebra popularized recently by Dekle et al. (2008), we get

$$\hat{K}_i = \left( \sum_{n \in \Omega_i} \omega_{in} \hat{\beta}_n \hat{e}_{in} \right)^{1/(k-1)},$$

where $\omega_{in} \equiv \pi_{in0}/\pi_{i0}$ and the hat notation denotes the change from $t = 0$ to $t = 1$, $\hat{x} \equiv x_1/x_0$. The weights $\omega_{in}$ are simply the share of global profits generated in each country $n$ in the pre-period ($t = 0$). In Appendix B we show that equation (4) can be approximated by

$$\Delta \ln K_i = \sum_{n \in \Omega_i} \beta^*_{in} \omega_{in} \Delta T_n + \varepsilon_i,$$

where $T_n \equiv \tau_n - 1$ is the ad-valorem tariff, $\beta^* \equiv \beta_n / (k - 1)$ and $\varepsilon_i \equiv \sum_{n \in \Omega_i} \omega_{in} \Delta \ln e_{in} / (k - 1)$. We proceed with this approximation because it is empirically more convenient to work with.

### 2.2 Trade Liberalization and Innovation: Two Cases

The setup in Section 2.1 gave us a simple relationship between the growth in a firm’s knowledge stock and changes in ad-valorem tariffs. This section develops the final estimating equations. We consider two cases; first a symmetric model, $S$, with $\beta^*_n = \beta^*_m \equiv \beta^*$, so that the impact of lower tariffs in home and export markets is identical. Second, we employ an asymmetric model, $A$, where the impact of lower tariffs is allowed to differ across home and export markets, $\beta^*_H \neq \beta^*_E$, where $\beta^*_H$ is the home market impact and $\beta^*_E$ is the export market impact. In the first case, we can rewrite equation (5) to

$$\Delta \ln K_i = \eta_i + \beta^* \Delta \bar{T}_i + \varepsilon_i,$$

where

$$\Delta \bar{T}_i \equiv \sum_{n \in \Omega_i} \omega_{in} \Delta T_n$$

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is the weighted average of tariff changes across all of firm i’s markets including its home market, and where we introduce the variable $\eta_i$ to account for all other factors that may also affect the growth of a firm’s knowledge stock (i.e., a growth fixed effect that may be correlated with $\Delta \bar{T}i$ and $\varepsilon_i$). According to our framework, we expect that the knowledge stock is changing when weighted average tariffs decline or when weighted average demand ($\varepsilon_i$) rises. As demand shocks are unobserved in our data, $\varepsilon_i$ will enter into the regression residual.

In model A the change in knowledge stock is given by

$$\Delta \ln K_i = \eta_i + \beta^H \omega_i^H \Delta T_i^H + \beta^E (1 - \omega_i^H) \Delta \bar{T}i^E + \varepsilon_i,$$

(8)

where $\omega_i^H$ denotes the home market weight, $\Delta T_i^H$ is the home market tariff change, and the weighted average tariff change in foreign markets is given by

$$\Delta \bar{T}i^E \equiv \left[1/(1-\omega_i^H)\right] \sum_{n \in \Omega \setminus H} \omega_in \Delta T_n.$$

(9)

This specification allows us to separate the import competition effect from the market access effect of trade policy. Specifically, $\beta^H$ will be identified by firms with a high degree of home bias, while $\beta^E$ is identified by firms primarily exposed to foreign markets, and as such is mostly affected by the weighted average tariff $\bar{T}i^E$ in foreign markets. While both theory and empirical evidence suggest that better market access gives rise to more innovation, i.e. that $\beta^E$ is negative, as discussed above the sign of $\beta^H$ is theoretically ambiguous due to the undetermined net effect of increased competition on innovation. Note that $\beta^E$ will capture both improved market access and more competition in export markets, to the extent that other foreign firms also benefit from improved market access, while $\beta^H$ will only capture the competition effect in the home market.

3 Data

3.1 Patents

We use patents from PATSTAT to measure a firm’s innovation and knowledge stock. PATSTAT offers bibliographic data, family links and citations of 90 million applications of nearly

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3As described in the Section below, tariffs will be measured at the 3-digit industry-level, so that $T_i$ will vary both because firms are exposed to different markets and because firms belong to different industries.

100 countries. It contains the population of all patents globally since the mid 1960s. The patent documents as provided by PATSTAT are a rich source of information. We observe the name of the applicant and date of filing, publication and if and when the patent was granted. We know the geography of the patent in the sense that we have information on both source and destination country. Source country is the residence country of the applicant. Destination is the country of the patent authority (e.g. USPTO, EPO, JPO, etc). Appendix C provides more details on the construction of our data set, while Abramovsky et al. (2008) provides a thorough review of the PATSTAT data and the patenting process.

PATSTAT allows us to construct an international firm-level data set and to follow the patenting activity of a firm through time. To measure the innovation activity of a firm i in year t we use a count of patents by application/filing year (\( p_{it} \)).\(^5\) Patenting is known to be highly correlated with innovation and R&D, see e.g. Griliches (1990). In the Appendix H we document a close relationship between R&D expenditure and patenting for a subsample of our data set. We do however acknowledge that the advantages and limitations of patenting as a measure of innovation have been extensively discussed.\(^6\) For our purpose there is one major advantage of using patents. It is the only source of information that allows for a comprehensive firm-level analysis of innovation at a global scale. In Section 6.2 we use different measures to control for the quality of patents as innovation indicators.

In our analysis, a patent corresponds to a unique invention, i.e. filing the same patent in multiple locations does not inflate the patent count (\( p_{it} \)). Specifically, PATSTAT organizes patents into “patent families” that identify identical inventions filed in multiple countries.\(^7\) An additional advantage of PATSTAT is that names of applicants are harmonized over the entire sample period, alleviating the concern that slight differences in the spelling of firm names generate multiple firm IDs.\(^8\) Information about firms in PATSTAT is restricted to what can be retrieved from the patent applications. Our basic firm characteristics are industry affiliation (NACE Rev. 2 3-digit), home country of the firm, as well as in which countries the firm is patenting.\(^9\)

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\(^5\)Dating by application filing date is conventional in the empirical innovation literature as it is much more closely timed with when the R&D process took place than the patent publication and grant date. Patent applications are usually published 18 months after the first application.

\(^6\)See e.g. OECD (2009), Griliches (1990) and Nagaoka et al. (2010) for reviews and discussion of patent data as innovation indicators.

\(^7\)We use DOCDB patent family.

\(^8\)An applicant can be a firm or individual, but we will use the terminology firm when referring to an applicant.

\(^9\)Home country and industry affiliation are missing for a subset of firms. These observations are dropped from the dataset.
3.2 Tariffs

The main source of tariff data is the UNCTAD Trade Analysis and Information System (TRAiNS), which contains tariffs at the most disaggregated level of the Harmonized System (HS) for more than 150 countries. From this database we extract the average applied MFN industry-level tariff (NACE 3-digit) for the period 1992 to 2009. We use these to calculate firm-specific weighted average tariffs, $\bar{T}_i, T^E_i$ and $T^H_i$, which vary across firms, both because firms are exposed to different markets and because they belong to different industries. Appendix D describes the procedure followed to calculate industry-level tariffs, while Appendix E provides details about the historical background for tariff reductions during the 1990s.

In addition to UNCTAD TRAiNS data, we use information on regional trade agreements (RTAs) between pairs of countries. This allows us to take into account the fact that some countries are part of trade agreements, and as such cannot be treated as having the same level of protection as countries where such agreements are not in force. The information on RTAs for around 200 countries from 1948 to 2006 comes from the CEPII gravity data set.\(^\text{11}\)

4 Estimation Details

We use the Great Liberalization as a quasi-natural experiment and estimate the causal impact of tariffs on innovation by using firm-level variation in which countries firms were exposed to before the tariff cuts. This section provides details about the definition of the sample period, measurement of variables as well as the construction of the final sample and discusses econometric concerns.

4.1 Measurement and Baseline Periods

Pre-Liberalization period. According to the theoretical predictions outlined above, the impact of trade liberalization will depend on the change in weighted average tariffs. We calculate these weights based on patent data over the pre-period years 1965 to 1985. We use 1965 as the starting year because the number of patents in PATSTAT is limited in earlier years. 1985 is chosen as the final year because the Uruguay round negotiations started in 1986; hence the weights are not themselves affected by trade liberalization of the 1990s.

According to the models presented in Section 2.2, the weights should ideally reflect the relative importance of a country $n$ in the firm’s total profits. Profits and sales are unobserved.

\(^\text{10}\)Specifically, we add industry subscript $j$ to equation (7) as follows, $\bar{T}_i \equiv \sum_{n \in i} \omega_n T_{jn}$, where $j$ is the NACE 3-digit industry of firm $i$. We describe the weights $\omega_n$ in Section 4.1.

\(^\text{11}\)See Head et al. (2010) and Head and Mayer (2013).
in our data, but we do observe in which markets a firm is patenting. As pointed out by Aghion et al. (2016) a patent based weighting scheme may potentially be a superior measure because it reflects the firms’ expectations of where their future market will be. We follow Aghion et al. (2016) and calculate firm-specific weights as the share of patents issued in country $n$ relative to all the patents issued by the firm during the pre-period. Specifically, we define

$$\omega_{in} \equiv \frac{x_{in}}{\sum_k x_{ik}},$$

where $x_{in}$ is the number of patents issued by firm $i$ in market $n$ during the pre-period.

Seeking intellectual property rights in a country is typically motivated by (future) profits in that market. There is strong empirical support that patent weights are highly correlated with sales weights (see Aghion et al., 2016). We provide additional empirical evidence on this in Appendix F. The weights are also remarkably persistent over time, even over a period of 20 years, see Appendix G. This suggest that time-invariant firm and country characteristics (e.g. country-specific entry costs on the supply side or idiosyncratic taste differences on the demand side) are limiting where firms export goods and file patents.

Sample period. The years 1992 to 2000 are defined as our baseline sample period. Hence, the change in average tariffs facing firm $i$ is $\Delta T_i = T_{i2000} - T_{i1992}$ and the change in the knowledge stock of firm $i$ is $\Delta \ln K_i = \ln K_{i2000} - \ln K_{i1992}$. The choice of sample period is motivated by the fact that tariff reductions agreed upon during the Uruguay Round were gradually phased in from 1995 until 2000. Starting our sample in 1992 ensures that we capture the full impact of tariff reductions. Our data also confirms that the 1990s was unique: the overall reduction in tariffs was much greater during the latter half of the 1990s compared to both earlier and later periods. Finally, we choose to work with long differences 1992-2000 in our baseline specification because we want to allow for long time lags in the innovation response to trade liberalization. Long differences also eliminate serial correlation in the errors, since the averaging over periods ignores time-series information (see Bertrand et al., 2004).

Outcome variable. In the model presented above, the outcome variable $\Delta \ln K_i$ is the change in the log knowledge stock. Our empirical counterpart is the cumulative patent count of a firm until year $t$,

$$K_{it} \equiv \sum_{s=1965}^t p_{is},$$

where $p_{is}$ is the number of unique patents filed by firm $i$ in year $s$. The outcome variable $\Delta \ln K_{it} = \ln K_{i2000} - \ln K_{i1992}$ gives the change in the log cumulative patent count between 1992 and 2000 and provides a measure of the innovation that takes place during this time.
period. Focusing on the change in the stock over a long time period smooths out lumpiness and zeros in the $p_{it}$ variable. Indeed, in a given year the median $p_{it}$ is zero while the maximum $p_{it}$ is very large, suggesting that linear models are not adequate to model the data generating process at the annual level.

### 4.2 Final Sample of Firms

Our point of departure is a data set constructed on the basis of PATSTAT described in Section 3.1 and Appendix C, matched with the average applied MFN industry-level tariff from UNCTAD TRAINS. Given our sample period, 1992-2000, we treat the EU-15 countries as one country since the Single market was established in 1992. Our final sample consists of the following firms: First, it includes firms that applied for at least one patent over the sample period. Second, firms must be observed at least once in the pre-period (1965-1985) in order to be assigned weights $\omega_{in}$. Third, in some cases firms issue patents in countries with missing tariff data for their industry; these firms are dropped from the analysis.

The last column of Table 1 shows that we have roughly 133,000 firms in the final sample, filing about 1.8 million patents between 1992 and 2000. The initial sample of firms, which also includes firms without pre-period weights $\omega_{in}$, consists of almost 1.6 million firms filing about 6.1 million patents between 1992 and 2000. Hence, our final sample captures roughly one third of global patenting over the sample period.

Note that we cannot distinguish between firm exit and zero innovation in our data. For example, if we observe zero patenting from 1995 and onwards, then $p_{it}$ will be zero and $K_{it}$ will be constant for the remaining years of our sample. Hence, our baseline result will capture the overall innovation effect of trade policy, including the impact on firm exit. In Section 6.3 we perform a robustness where we estimate the model on a fully balanced panel of firms, i.e. firms that are patenting even after the end of the sample period (survivors).

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12 We drop firms that have positive weights $\omega_{in}$ for one or more countries with missing tariff data, i.e. if $T_{jnt}$ is missing when calculating $\bar{T}_{it}$ from equation 7.
Table 1: Initial versus final sample.

<table>
<thead>
<tr>
<th></th>
<th>Initial</th>
<th>Final</th>
</tr>
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<tbody>
<tr>
<td>$\sum_i \Delta K_{it}$</td>
<td>6,127,615</td>
<td>1,767,861</td>
</tr>
<tr>
<td>$\Delta K_{it}$</td>
<td></td>
<td></td>
</tr>
<tr>
<td>..mean</td>
<td>1.2</td>
<td>13.3</td>
</tr>
<tr>
<td>..median</td>
<td>0</td>
<td>1</td>
</tr>
<tr>
<td>..standard deviation</td>
<td>116.1</td>
<td>265.0</td>
</tr>
<tr>
<td>Number of firms</td>
<td>1,598,192</td>
<td>133,409</td>
</tr>
</tbody>
</table>

Note: The table shows the aggregate increase in the knowledge stock from 1992 to 2000 along with the mean, median and standard deviation of $\Delta K_{it}$ for the initial and the final sample of firms. The initial sample consists of all firms identified with a headquarter location and a NACE industry code that file at least one patent over the sample period. The final sample is described in Section 4.2.

4.3 Econometric Issues

Estimating the models $S$ and $A$ is challenging for a number of reasons. The first econometric concern is that the weighted average tariff reduction $\Delta \bar{T}_i$ may be correlated with unobservable firm characteristics $\eta_i$. For example, firms exposed to high-tariff reduction countries may innovate more even in the absence of trade liberalization. We solve this by including home country-industry pair fixed effects in the regressions as well as controlling for pre-period firm characteristics. Intuitively, we compare firms within the same industry, headquartered in the same country, and with similar observed characteristics during the pre-period, but that differ in terms of their exposure to international markets, and ask whether firms exposed to high tariff-cut countries innovate more than firms exposed to low tariff-cut countries.

An alternative way of solving this problem is by differencing out idiosyncratic firm trends. Specifically, we split the sample into our sample period, 1992-2000 ($t = 1$) and add a second period, 2000-2004 ($t = 2$), when the decline in tariffs was much smaller (see Figure 1 below), and estimate model $S$ by

$$\Delta \ln K_{i2} - \Delta \ln K_{i1} = \beta \left( \Delta \bar{T}_{i2} - \Delta \bar{T}_{i1} \right) + \varepsilon_i.$$  \hspace{1cm} (12)

Idiosyncratic growth trends in innovation, $\eta_i$, that may be correlated with $\Delta \bar{T}_i$, are then differenced out. We use a similar specification for the asymmetric model $A$. This is remi-

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13Industries are defined at the NACE 3 digit level. Pre-sample covariates are home weights $\omega_i^H$, the number of countries the firm is patenting in during the pre-period, $n_{i,Pre}$, and the log knowledge stock of the firm in 1985, $\ln K_{i,Pre}$. 

14Industries are defined at the NACE 3 digit level. Pre-sample covariates are home weights $\omega_i^H$, the number of countries the firm is patenting in during the pre-period, $n_{i,Pre}$, and the log knowledge stock of the firm in 1985, $\ln K_{i,Pre}$. 

15Industries are defined at the NACE 3 digit level. Pre-sample covariates are home weights $\omega_i^H$, the number of countries the firm is patenting in during the pre-period, $n_{i,Pre}$, and the log knowledge stock of the firm in 1985, $\ln K_{i,Pre}$. 

16Industries are defined at the NACE 3 digit level. Pre-sample covariates are home weights $\omega_i^H$, the number of countries the firm is patenting in during the pre-period, $n_{i,Pre}$, and the log knowledge stock of the firm in 1985, $\ln K_{i,Pre}$. 

17Industries are defined at the NACE 3 digit level. Pre-sample covariates are home weights $\omega_i^H$, the number of countries the firm is patenting in during the pre-period, $n_{i,Pre}$, and the log knowledge stock of the firm in 1985, $\ln K_{i,Pre}$. 

18Industries are defined at the NACE 3 digit level. Pre-sample covariates are home weights $\omega_i^H$, the number of countries the firm is patenting in during the pre-period, $n_{i,Pre}$, and the log knowledge stock of the firm in 1985, $\ln K_{i,Pre}$. 

19Industries are defined at the NACE 3 digit level. Pre-sample covariates are home weights $\omega_i^H$, the number of countries the firm is patenting in during the pre-period, $n_{i,Pre}$, and the log knowledge stock of the firm in 1985, $\ln K_{i,Pre}$. 

20Industries are defined at the NACE 3 digit level. Pre-sample covariates are home weights $\omega_i^H$, the number of countries the firm is patenting in during the pre-period, $n_{i,Pre}$, and the log knowledge stock of the firm in 1985, $\ln K_{i,Pre}$. 

21Industries are defined at the NACE 3 digit level. Pre-sample covariates are home weights $\omega_i^H$, the number of countries the firm is patenting in during the pre-period, $n_{i,Pre}$, and the log knowledge stock of the firm in 1985, $\ln K_{i,Pre}$. 

22Industries are defined at the NACE 3 digit level. Pre-sample covariates are home weights $\omega_i^H$, the number of countries the firm is patenting in during the pre-period, $n_{i,Pre}$, and the log knowledge stock of the firm in 1985, $\ln K_{i,Pre}$. 

23Industries are defined at the NACE 3 digit level. Pre-sample covariates are home weights $\omega_i^H$, the number of countries the firm is patenting in during the pre-period, $n_{i,Pre}$, and the log knowledge stock of the firm in 1985, $\ln K_{i,Pre}$. 

24Industries are defined at the NACE 3 digit level. Pre-sample covariates are home weights $\omega_i^H$, the number of countries the firm is patenting in during the pre-period, $n_{i,Pre}$, and the log knowledge stock of the firm in 1985, $\ln K_{i,Pre}$.
niscent of a triple differences model, as we compare the growth in the change in tariffs (two
differences) across firms (third difference).

A second econometric concern is that the error term \( \varepsilon_i \equiv \sum_{n \in \Omega_i} \omega_{in} \Delta \ln e_{in} \), which is a
weighted average of all other country-specific factors that determine innovation, may be cor-
related with trade liberalization. A case in point is the TRIPS agreement that strengthened
IPR among WTO members in the aftermath of the Uruguay round. A positive correlation
between tariff reductions and IPR strengthening could therefore produce biased estimates.\(^{14}\)

We solve this by using the fact that we observe aggregate patenting by industry and country,
and this measure is itself determined by the unobserved shocks \( e_{in} \). Specifically, we calculate
the aggregate knowledge stock by industry \( j \) and headquarters country \( h \), \( K_{hjt} = \sum_{i \in \Gamma_{hj}} K_{it} \),
where \( \Gamma_{hj} \) is the set of firms in industry \( j \) headquartered in \( h \), and construct the weighted
average

\[
\tilde{\varepsilon}_i \equiv \sum_{n \in \Omega_i} \omega_{in} \Delta \ln K_{nj},
\]

where \( \Delta \ln K_{nj} = \ln K_{nj2000} - \ln K_{nj1992} \). While headquarters-industry pair fixed effects
control for innovation trends in firm \( i \)'s home market, \( \tilde{\varepsilon}_i \) controls for innovation trends in
firm \( i \)'s destination markets. For example, if a US headquartered firm primarily exposed to
the Indian market is innovating more because the Indian market is growing quickly (high
\( \Delta \ln e_{India} \)), then including \( \tilde{\varepsilon}_i \) will control for this effect.\(^{15}\)

5 Descriptives on Patents and Tariffs

Weighted average trade barriers. To illustrate our identification strategy, we take a closer
look at the weighted average trade barriers, \( \bar{T}_{it} \) for our sample of firms. Figure 1 shows the
mean \( \bar{T}_{it} \) for firms headquartered in the U.S., Germany, Japan and the UK. There is a strong
decline during the latter half of the 1990s; the average firm experienced a decline in weighted
tariffs of around 3 percentage points during the 1990s. Also, the decline almost stops in the
year 2000, consistent with the fact that Uruguay Round concessions were phased in until
that year. The averages mask a considerable amount of heterogeneity: Figure 2 shows that
the whole distribution of weighted tariffs (\( \bar{T}_{it} \)) across firms shifts markedly to the left from

---

\(^{14}\)TRIPS established minimum and common standards of IP protection to be adopted by all WTO mem-
bers. While the institutions in the developed countries were little affected due to already strong IP protection,
developing countries had to reform and strengthen their IP protection system to comply with new WTO
rules.

\(^{15}\)Section 6.3 describes an alternative empirical strategy using fixed effects for each of firm \( i \)'s destination
markets.
Figure 1: Average Firm-Specific Tariffs, $\bar{T}_{it}$.

Note: The figure shows the annual average $\bar{T}_{it}$ across firms according to headquarters country.

Figure 2: Density of Firm-Specific Tariffs, $\bar{T}_{it}$, in 1992 and 2000.

Note: $\bar{T}_{it}$ is the weighted average import tariff in firm $i$’s markets, in 1992 and 2000. For expositional purposes the histogram is truncated at $\bar{T}_{it} = 20$. 

15
Figure 3: Patenting per firm. 1980-2004.

Note: The solid line shows the average number of patents filed per firm per year in the sample. The dotted lines show the 95 percent confidence interval associated with the mean.

Figure 4: Share of Firms by Country and Industry

Note: The figure shows share of firms by home country and NACE Rev. 2 2-digit industry for the period 1992-2000. Only the top 10 countries/industries are shown.
Patents. Figure 3 shows the development in the mean number of patents per firm by year in our sample \((p_t)\). We observe that the mean number of patents is steadily increasing from 1980 and onwards. Of course, these aggregate trends may not only reflect innovation, but also changes in firms’ behavior, legal trends and changes in the patent systems worldwide.

Figure 4 shows the distribution of patenting firms across home countries and industries (NACE 2-digit) in our sample. We note the dominance of Japan and the US and by the industries machinery and equipment (28), computers, electronic and optical products (26), and other manufacturing (32). Tables 10 and 11 in Appendix I provide more details on patent counts and patenting firms across industries and countries.

6 Results

6.1 Innovation and Trade Liberalization

We proceed by estimating the symmetric \((S)\) and asymmetric \((A)\) models presented in equations (6) and (8), as well as the alternative specification outlined in equation (12). As described in Section 4.3, all specifications include home country-industry (NACE 3-digit) pair fixed effects, which will control for aggregate (country and industry) trends in patenting. Columns (1) to (3) in Table 2 show the results for model \(S\) with various control variables included. Column (1) has only fixed effects and column (2) adds pre-sample firm characteristics (the home weight, \(\omega_{iH}\), the number of countries the firm is patenting in during the pre-period, \(n_{i,Pre}\), and log knowledge stock in 1985, \(\ln K_{i,Pre}\)), while column (3) also controls for aggregate destination trends \(\tilde{\varepsilon}_i\), as explained in Section 4.3. Column (4) shows the results for the model described in equation (12), where we difference out idiosyncratic firm trends. The results are highly significant and fairly similar across specifications, with an estimated coefficient in the range of \(-0.4\) to \(-0.5\).

A potential concern with using raw patent counts is that they are only weakly correlated with innovation. A typical solution in the literature is therefore to use citation-weighted patent counts instead (Harhoff et al., 1999). Section 6.2 below discusses various proxies for patent quality in detail. We therefore construct the citation-weighted knowledge stock as \(K^w_{it} = \sum_{s=1965}^{t} c_{is}p_{is}\), where \(c_{is}\) is the number of citations obtained by firm \(i\) for the patents filed in year \(s\).\footnote{As in Section 6.2, we use the citation rate three years after the patents were filed, in order to control for cohort effects.} We show the results when using \(\Delta \ln K^w_i\) instead of \(\Delta \ln K_i\) as the dependent variable in column (5). The point estimate of the semi-log elasticity is highly significant and greater than the point estimates in columns (1) to (4), suggesting that the quality-adjusted
knowledge stock is responding more strongly to trade liberalization. Note, however, that the number of firms in the sample also decreases, as roughly half the firms have portfolios of patents that are never cited.

A semi-log elasticity of -0.9 from column (5) implies that a one percentage point reduction in tariffs causes a 0.9 percent increase in the citation-weighted knowledge stock. Our data shows that over the period 1992 to 2000 the mean citation-weighted knowledge stock among firms globally grew by 44 percent (mean of $\Delta \ln K_{wi}$), while the mean reduction in the firm-specific tariff measure $\bar{T}_{it}$ was almost three percentage points (mean of $\Delta \bar{T}_i$). Hence, our results suggest that roughly 6 ($0.9 \times 3/44$) percent of the observed increase in the knowledge stock can be explained by trade policy reform. This overall number masks considerable heterogeneity across countries and industries. For example, among developing countries firm-specific tariffs fell seven percentage points on average, while the mean knowledge stock grew by 28 percent - suggesting that trade policy explains roughly one fifth of the increase in the knowledge stock ($0.9 \times 7/28$).

Table 2: Trade Policy and Knowledge Creation. Model S.

<table>
<thead>
<tr>
<th>Dep. variable:</th>
<th>$\Delta \ln K_i$</th>
<th>$\Delta \ln K_i$</th>
<th>$\Delta \ln K_i$</th>
<th>$\Delta \ln K_{12} - \Delta \ln K_{11}$</th>
<th>$\Delta \ln K_i^{E}$</th>
</tr>
</thead>
<tbody>
<tr>
<td>Change in average tariff ($\Delta \bar{T}_i$)</td>
<td>-0.48&lt;sup&gt;a&lt;/sup&gt;</td>
<td>-0.44&lt;sup&gt;a&lt;/sup&gt;</td>
<td>-0.42&lt;sup&gt;a&lt;/sup&gt;</td>
<td>-0.43&lt;sup&gt;a&lt;/sup&gt;</td>
<td>-0.87&lt;sup&gt;a&lt;/sup&gt;</td>
</tr>
<tr>
<td>Home country-industry FE</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>Firm controls</td>
<td>No</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>Destination market controls ($\bar{\epsilon}$)</td>
<td>No</td>
<td>No</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>Number of firms</td>
<td>133,409</td>
<td>133,409</td>
<td>133,402</td>
<td>133,402</td>
<td>67,955</td>
</tr>
</tbody>
</table>

Note: Standard errors clustered by home country-industry in parentheses. Pre-sample firm characteristics are the home weight, $\omega_{iH}$, the number of countries the firm is patenting in during the pre-period, $n_{i,Pre}$, and log knowledge stock in 1985, $\ln K_{i,Pre}$. <sup>a</sup> p < 0.01, <sup>b</sup> p < 0.05, <sup>c</sup> p < 0.1.

The symmetric model S masks the fact that trade liberalization in the home market can have a different effect than liberalization in export markets. Table 3 shows the results when we estimate the asymmetric model A, see equation [8], and disentagle the effect of home market tariffs $T_{i}^{H}$ and export market tariffs $T_{i}^{E}$. Columns (1) to (2) show the baseline model with and without the destination market control $\bar{\epsilon}_i$, column (3) uses the specification based on equation (12) to control for idiosyncratic firm trends, while column (4) uses the citation-weighted knowledge stock $K_{wi}$. The coefficient for $\omega_{i}^{H} \times \Delta T_{i}^{H}$ captures the differential

<sup>17</sup>Developing countries are defined according to the World Bank 1995 definition of high/low income countries.
impact of home tariffs depending on the firm’s home bias. The coefficients are negative and significant, indicating that firms with high exposure to the home market innovate more, relative to firms with less exposure to the home market, when home tariffs decline. Hence, our results suggest that unilateral liberalization raises innovation in the home market. The coefficient for \((1 - \omega^H_i) \times \Delta \bar{T}_IE\) captures the differential impact of export market tariffs depending on the firm’s export market bias. Again, we find a negative and significant number, suggesting that firms highly exposed to export markets innovate relatively more when export market tariffs decline.\(^{18}\)

<table>
<thead>
<tr>
<th>Dep. variable:</th>
<th>(\Delta \ln K_i)</th>
<th>(\Delta \ln K_i)</th>
<th>(\Delta \ln K_{i2} - \Delta \ln K_{i1})</th>
<th>(\Delta \ln K_{i}^{w})</th>
</tr>
</thead>
<tbody>
<tr>
<td>Home weight \times home tariff change ((\omega^H_i \times \Delta T_i^H))</td>
<td>-.23(^b)</td>
<td>-.21(^b)</td>
<td>-.51(^a)</td>
<td>-.90</td>
</tr>
<tr>
<td></td>
<td>(.09)</td>
<td>(.09)</td>
<td>(.14)</td>
<td>(.61)</td>
</tr>
<tr>
<td>Export weight \times foreign tariff change (((1 - \omega^H_i) \times \Delta \bar{T}_IE))</td>
<td>-.54(^a)</td>
<td>-.51(^a)</td>
<td>-.39(^a)</td>
<td>-.87(^b)</td>
</tr>
<tr>
<td></td>
<td>(.14)</td>
<td>(.14)</td>
<td>(.10)</td>
<td>(.40)</td>
</tr>
<tr>
<td>Home country-industry FE</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>Firm controls</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>Destination market controls ((\bar{\epsilon}))</td>
<td>No</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>Number of firms</td>
<td>133,409</td>
<td>133,409</td>
<td>133,409</td>
<td>67,955</td>
</tr>
</tbody>
</table>

Note: Standard errors clustered by home country-industry in parentheses. Firm controls are the home weight, \(\omega^H_i\), the number of countries the firm is patenting in during the pre-period, \(n_{i,Pre}\) and log knowledge stock in 1985, \(\ln K_{i,Pre}\). \(^a\) \(p< 0.01\), \(^b\) \(p< 0.05\), \(^c\) \(p< 0.1\).

Theory suggests that the market access effect of trade policy liberalization promotes innovation, while the import competition effect may encourage or discourage innovation, depending on the strength of escape-competition and Schumpeterian forces. Our results suggest that both the market size and import competition effect increase innovation, so that the net effect is unambiguously positive.

### 6.2 Is Patenting a Good Measure of Innovation?

As pointed to in Section 3.1, there is an ongoing discussion of the use of patenting as a measure of innovation. One may argue that patents are an imprecise measure of knowledge and innovation. Patenting is not the only way to protect innovations. Another problem

\(^{18}\)Note that the non-interacted variables \(\Delta T_i^H\) and \(\Delta T_i^E\) are not identified. For \(\Delta T_i^H\), this occurs because it is subsumed by the home country-industry fixed effect, while for \(\Delta T_i^E\) it occurs because \(\Delta T_i^E\) is not defined for non-exporters.
is that patent quality is highly heterogeneous. According to Nagaoka et al. (2010) roughly half of the patents owned by a firm are used either by them internally or licensed to others. The remaining patents are used for strategic reasons, e.g. attempts to block inventions by competitors. Hence, it is possible that firms take out more patents, without innovating more, in response to e.g. import competition. If this were the case, one would expect that firms are taking out patents on their marginal innovations, so that the average quality of their patent stock is decreasing.

To address this issue, we use three different proxies for patent quality: the number of citations, the size of the research teams behind a patent, and the number of technology areas (IPC codes) to which a patent is attributed (patent breadth). We use citations because high value inventions are more extensively cited than low value patents (Harhoff et al., 1999). We include the size of research teams since a set of studies have associated the number of inventors listed in a patent with the economical and technological value of the patent (OECD, 2009). Finally we include number of technical classes attributed to a patent application (patent breadth) which has been found to be a measure of the value of a patent portfolio (see e.g. Lerner, 1994).

We calculate average quality of the knowledge stock as follows. Let \( q_p \) denote the number of citations three years after a patent \( p \) was filed, or the number of inventors or the number of IPC codes associated with patent \( p \). The cumulative sum is then

\[
Q_{it} = \sum_{s=1965}^{t} \sum_{p \in \Xi_{is}} q_p,
\]

where \( \Xi_{is} \) is the set of firm \( i \)'s patents filed in year \( s \). The average quality of the knowledge stock is then calculated as \( \bar{Q}_{it} = Q_{it}/K_{it} \). We proceed by using \( \Delta \ln \bar{Q}_i = \ln \bar{Q}_{i,2000} - \ln \bar{Q}_{i,1992} \) as the dependent variable and estimate the symmetric model \( S \) in (6) again.

The results using all three proxies for quality are reported in columns (1)-(3) of Table 4. The results suggest that trade liberalization did not affect the quality of patents, i.e. there is no evidence of a “lawyer effect”. If anything, the point estimate for citations indicates that trade policy may have increased the quality of patents.

In addition to using different measures of patent quality, we also recognize that not all patent applications are successfully granted. A natural way to account for differences in quality is thus to limit the analysis to patents that are granted\(^{19}\). We therefore re-estimate equation (6) based on granted patents only. The results are reported in Column 4 of Table 4. Our finding that reduced trade barriers increases innovation proves to be strong and robust.

\(^{19}\)To be granted a patent, an innovation must satisfy three key criteria: it must be novel or new, it must involve an inventive step, and it must be industrially applicable.
Table 4: Trade Policy and Innovation Quality.

<table>
<thead>
<tr>
<th>Dep. variable: $\Delta \ln \bar{Q}_i$</th>
<th>Citations (1)</th>
<th>Research Team (2)</th>
<th>IPC codes (3)</th>
<th>Granted Patents (4)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Change in average tariff ($\Delta \bar{T}_i$)</td>
<td>-.61&lt;sup&gt;a&lt;/sup&gt;</td>
<td>-.03</td>
<td>-.10&lt;sup&gt;c&lt;/sup&gt;</td>
<td>-.38&lt;sup&gt;a&lt;/sup&gt;</td>
</tr>
<tr>
<td></td>
<td>(.24)</td>
<td>(.05)</td>
<td>(.06)</td>
<td>(.15)</td>
</tr>
<tr>
<td>Home country-industry FE</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>Firm controls</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>Destination market controls ($\tilde{\epsilon}$)</td>
<td>No</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>Number of firms</td>
<td>67,954</td>
<td>120,738</td>
<td>130,262</td>
<td>96,565</td>
</tr>
</tbody>
</table>

Note: Standard errors clustered by home country-industry in parentheses. <sup>a</sup> p < 0.01, <sup>b</sup> p < 0.05, <sup>c</sup> p < 0.1.

6.3 Robustness

Finally we examine the robustness of our results.

Falsification test. A potential concern is that firms being exposed to countries with high tariff cuts always have higher patent growth compared to other firms. To address this concern, we perform a placebo test and regress knowledge growth during the 1980s, $\ln K_{i1988} - \ln K_{i1980}$, on trade policy changes during the 1990s, $\Delta \bar{T}_{i2000} - \Delta \bar{T}_{i1992}$<sup>20</sup>. The results are shown in the first column of Table 5: the coefficient of interest becomes noisy and close to zero, suggesting that there are no differential pre-trends in patenting.

Country-level tariff data. Industry-level tariffs may not always be the relevant tariffs facing the firm, because it may also be exporting or importing products associated with other 3-digit NACE industries. We therefore test the sensitivity of our results using the simple average country tariff instead of industry specific tariffs. The results, shown in the second column of Table 5, confirm our main finding that a reduction of a firm’s tariffs increases innovative activity. The estimated effect is similar in magnitude to our main specification and economically significant.

Regional trade agreements. Our main measure of tariffs is the applied MFN ad-valorem rate. This masks the fact that many firms get preferential market access through regional trade agreements (RTAs). Recognizing this, we calculate a firm-level measure of how exposed a firm is to RTA’s. Specifically, we construct $R \bar{T}A_{it}$ in a similar way as the average tariff

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<sup>20</sup> The weighted average $\bar{T}_{it}$ is now calculated using weights $\omega_{in}$ based on a firm’s patent portfolio until 1980 (not 1985 as in the baseline). This is done in order to ensure that the weights $\omega_{in}$ are not themselves determined by the dependent variable $\ln K_{i1988} - \ln K_{i1980}$. 

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rate, $\bar{T}_i$ above as a weighted average of RTAs across all of firm $i$’s markets:

$$RTA_{it} \equiv \sum_{n \in \Omega_i} \omega_{in} RTA_{hn},$$

(15)

where $RTA_{hn} = 1$ if the home country $h$ and country $n$ have an RTA and zero otherwise\footnote{As a matter of convention, for the firm’s home country we set $RTA_{hh} = 1$.}. We then add $\Delta \bar{RT}_A_i = \bar{RT}_A_{2000} - \bar{RT}_A_{1992}$ to the symmetric model. The results in column (3) of Table 5 show that the RTA variable is insignificant while our main variable $\Delta \bar{T}_i$ continues to be highly significant and negative.

**Triadic patents.** Third, we restrict our sample to triadic patents. These are patents filed at the three main patent offices, namely the European Patent Office (EPO), the Japanese Patent Office (JPO) and the United States Patents and Trademark Office (USPTO)\footnote{See Dernis and Khan (2004) and Martinez (2010) for additional information about how triadic patent families are constructed.}. Triadic patents are commonly used in the literature to retain only highly valuable inventions and they provide a measure of innovation which is robust to administrative idiosyncrasies of the various patent offices. However, by limiting the analysis to triadic patents, the number of observations is reduced with around 94 percent. The results are shown in in column (4) of Table 5. We observe that the sample size is reduced from around 133,000 to around 3,500 observations and the standard errors become very large. The point estimate, however, has similar qualitative implications to our baseline results.

**Balanced panel.** In the baseline, we work with an ubalanced data set. This allows us to account for all innovation irrespective of whether the innovating firm remains, exits or is acquired by another firm as result of increased competition due to trade liberalization. As a robustness test we also estimate the symmetric model based on a balanced panel where our sample is limited to firms that file at least one patent between 2004 and 2014. Thus, by construction, all firms survive until the end of the sample period, i.e. year 2000. The estimated effect reported in column (5) of Table 5 is negative and highly significant and substantially bigger. This may suggest that trade liberalization did induce firm exit as well as M&As, although one would need data on actual exit and M&As to corroborate this.

**Destination country trends.** The variable $\tilde{\varepsilon}_i$ was included in the regressions to capture patenting trends in destination countries. An alternative empirical strategy is to include destination country fixed effects in the regressions. Specifically, we rewrite model $S$ in equation (6) to

$$\Delta \ln K_i = \eta_i + \beta \bar{T}_i + \sum_{n \in \Omega_i} \gamma_n + \varepsilon_i,$$

(16)
where $\gamma_n$ is a fixed effect for destination $n$, and we sum over all countries where the firm has non-zero weights during the pre-period (the set $\Omega_i$). As an example, if all firms exposed to the Indian market (but not necessarily headquartered in India) have high $\Delta \ln K_i$, then this will be controlled for by $\gamma_{\text{India}}$. Identification of $\beta$ then only comes from within-country, across-industry variation in tariffs, i.e. that among firms exposed to the Indian market, some firms experience greater tariff reductions because they belong to an industry getting large tariff cuts in India. Destination country trends will therefore control for the possibility that firms exposed to India may patent more because of unobserved factors specific to India (e.g., growth in market size or strengthening of IPR). The estimated coefficient in column (6) in Table 5 shows that $\beta$ is still highly significant, although the economic magnitude is lower than in the baseline specification.

### Table 5: Robustness.

<table>
<thead>
<tr>
<th>Dep. variable: $\Delta \ln K_{it}$</th>
<th>Placebo</th>
<th>Aggregate tariffs ($\Delta \bar{T}^I_i$)</th>
<th>Accounting for RTAs</th>
<th>Triadic Patents</th>
<th>Balanced Sample</th>
<th>Destination trends</th>
</tr>
</thead>
<tbody>
<tr>
<td>(1)</td>
<td>(2)</td>
<td>(3)</td>
<td>(4)</td>
<td>(5)</td>
<td>(6)</td>
<td></td>
</tr>
<tr>
<td>Change in average tariff</td>
<td>.14</td>
<td>-0.53$^a$</td>
<td>-0.42$^a$</td>
<td>-2.64</td>
<td>-0.82$^a$</td>
<td>-0.24$^b$</td>
</tr>
<tr>
<td></td>
<td>(0.13)</td>
<td>(0.13)</td>
<td>(0.12)</td>
<td>(2.15)</td>
<td>(0.12)</td>
<td>(0.14)</td>
</tr>
<tr>
<td>$\Delta RTA_i$</td>
<td>-0.00</td>
<td>-0.00</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Home country-industry FE</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>Firm controls</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>Destination market controls</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
<td>No</td>
</tr>
<tr>
<td>Destination country trends</td>
<td>No</td>
<td>No</td>
<td>No</td>
<td>No</td>
<td>No</td>
<td>Yes</td>
</tr>
<tr>
<td>Number of firms</td>
<td>61,777</td>
<td>129,042</td>
<td>131,308</td>
<td>3,410</td>
<td>72,374</td>
<td>133,402</td>
</tr>
</tbody>
</table>

Note: Standard errors clustered by home country-industry in parentheses. $^a$ p < 0.01, $^b$ p < 0.05, $^c$ p < 0.1.

### 7 Conclusions

We set out to analyze the impact of the global decline in tariffs during the 1990s on firms’ innovation. It is an issue that so far has not been the subject of rigorous analysis despite its relevance. Our results show that the Great Liberalization of the 1990s had a large positive net impact on innovation. Overall, our estimates suggest that six percent of innovation globally during this time period can be attributed to trade liberalization. Our findings underscore the importance of trade liberalization for firms’ long term performance and for aggregate economic growth and it points to large dynamic gains from trade; gains that are typically not observed and therefore neglected in empirical analyses.
Our estimates are robust to a set of econometric issues, and in particular we provide evidence in support of patents being a useful measure of innovation. Our methodology also allows for a decomposition of the import competition from the market access effect of trade policy, and we provide evidence that both market access and import competition matters for the innovation response. While the results are directly relevant for the analysis of trade policy, they also add to the broader literature on the effects of competition on innovation.
References


Appendix

A Global Profits in a Benchmark Trade Model

In this section, we show how the reduced-form expression for global variable profits in Section 2.1 corresponds to a structural expression for profits in a benchmark trade model with monopolistic competition.

We follow the assumptions of Chaney (2008). As in the main text, we focus on the case of MFN import tariffs, so that the iceberg-equivalent tariff is

\[ \tau_{mn} = \begin{cases} 
1 & \text{if } m = n \\
\tau_n & \text{if } m \neq n.
\end{cases} \]

Conditional on exporting to destination \( j \), variable profits associated with exports from \( m \) to \( n \) for a firm with productivity \( z \) are

\[ \pi_{mn}(z) = \frac{\lambda}{\sigma} \left( \frac{Y_n}{Y} \right)^{(\sigma-1)/\gamma} \left( \frac{\theta_n}{w_m \tau_{mn}} \right)^{\sigma-1} z^{\sigma-1}, \]

where \( \lambda \) is a constant, \( Y_n \) is income in \( n \), \( Y \) is world income, \( \sigma \) is the elasticity of substitution, \( \gamma \) is the Pareto shape parameter, \( w_m \) is the nominal wage in \( m \) and \( \theta_n \) is the multilateral resistance term:

\[ \theta_n = \left[ \sum_m \frac{Y_m}{Y} (w_m \tau_{mn})^{-\gamma} f_{mn}^{-(\gamma/\sigma-1)-1} \right]^{-1/\gamma} = (A_{nn} + \tau_n^{-\gamma} B_n)^{-1/\gamma}, \]

where \( A_{nn} = (Y_m/Y) w_m^{-\gamma} f_{mn}^{-(\gamma/\sigma-1)-1}, B_n = \sum_{m \neq n} A_{mn}, \) and \( f_{mn} \) is the bilateral fixed entry cost.

Global variable profits for a firm located in \( m \), associated with sales to the set of countries
\[ \Omega, \text{ can then be written} \]

\[
\pi_m(z) = \sum_{n \in \Omega} \pi_{mn}(z)
\]

\[
= \frac{\lambda}{\sigma} \left( \frac{z}{w_m} \right)^{\sigma-1} \sum_{n \in \Omega} \left( \frac{Y_n}{Y} \right)^{(\sigma-1)/\gamma} \left( \frac{\theta_n}{\tau_{mn}} \right)^{\sigma-1}
\]

\[
= \frac{\lambda}{\sigma} \left( \frac{z}{w_m} \right)^{\sigma-1} \left[ \left( \frac{Y_m}{Y} \frac{1}{A_{mm} + \tau_m^{-\gamma} B_m} \right)^{(\sigma-1)/\gamma} + \sum_{n \in \Omega \setminus m} \left( \frac{Y_n}{Y} \frac{\tau_n^{-\gamma}}{A_{nn} + \tau_n^{-\gamma} B_n} \right)^{(\sigma-1)/\gamma} \right].
\]

A reduction in home tariffs \(\tau_m\) has a negative impact on profits (as the home price index declines), while a reduction in foreign tariffs \(\tau_n\) has a positive impact on profits (as the direct positive impact on profits is greater than the indirect negative impact via the price index). This corresponds to the case with \(\beta_n > 0\) in the home market and \(\beta_n < 0\) in export markets in equation (1) in the main text.

**B Approximation of the Knowledge Production Function**

The expression \(\tilde{K}_i = (\sum_{n \in \Omega_i} \omega_{in} \hat{\tau}_{n}^{\beta_n} \hat{e}_{in})^{1/(k-1)}\) can be approximated by equation (5) in the main text, \(\Delta \ln K_i = \sum_{n \in \Omega_i} \beta_n \omega_{in} \Delta T_n + \sum_{n \in \Omega_i} \omega_{in} \Delta \ln e_{in}\).

*Proof.* The term

\[
\sum_{n \in \Omega_i} \omega_{in} \hat{\tau}_{n}^{\beta_n} \hat{e}_{in} = \sum_{n \in \Omega_i} \omega_{in} e^{\beta_n \Delta \ln \tau_n + \Delta \ln e_{in}}
\]

\[
\approx \sum_{n \in \Omega_i} \omega_{in} (1 + \beta_n \Delta \ln \tau_n + \Delta \ln e_{in})
\]

\[
= 1 + \sum_{n \in \Omega_i} \omega_{in} (\beta_n \Delta \ln \tau_n + \Delta \ln e_{in}),
\]

where we used the fact that \(\ln (1 + x) \approx x \iff 1 + x \approx e^x\) for \(x\) close to 0. Hence,

\[
\Delta \ln K_i = \frac{1}{k-1} \ln \left[ 1 + \sum_{n \in \Omega_i} \omega_{in} (\beta_n \Delta \ln \tau_n + \Delta \ln e_{in}) \right]
\]

\[
\approx \frac{1}{k-1} \sum_{n \in \Omega_i} \omega_{in} (\beta_n \Delta \ln \tau_n + \Delta \ln e_{in})
\]

\[
= \frac{1}{k-1} \left( \sum_{n \in \Omega_i} \beta_n \omega_{in} \Delta T_n + \sum_{n \in \Omega_i} \omega_{in} \Delta \ln e_{in} \right),
\]

29
where we used $\Delta \ln \tau_n = \Delta \ln (1 + T_n) \approx \Delta T_n$ for $T_n$ close to 0.

C PATSTAT

We use patents from PATSTAT to measure a firm’s knowledge stock. To construct our data set we need to deal with a set of issues:

Identify unique firms/patent holders. As described in the main text, for each patent application in PATSTAT we know the exact name of the patent applicant(s). However, patentee names that appear in patent documents may vary both within and across patent systems. Inconsistencies might be due to spelling mistakes, typographical errors, name variants, etc. In order to identify unique patent holders, we use the ECOOM-EUROSTAT-EPO PATSTAT Person Augmented Table (EEE-PPAT). This table was developed by EUROSTAT in collaboration with ECOOM (K.U.Leuven) and Sogeti, and provides harmonized patent applicants’ names obtained through an automated algorithm. These harmonized names have been included in PATSTAT TLS906_Person table since October 2011. We use the variable “HRM_L2_ID” from this table.

Patent families. To construct the knowledge stock variable we use patent counts. In principle, an applicant may decide to patent an invention in one or more countries, depending on where he seeks IP protection, and he can do so contemporaneously or at subsequent times after the first application. Therefore, simply counting the number of patent filings for each patentee would result in double counting the number of unique inventions belonging to each firm. To avoid this problem, we look at patent families. A patent family identifies and groups all subsequent patent filings originating from the same initial (priority) application; hence it comprises all patents protecting the same invention. An example can be helpful to clarify the main idea behind patent families. Suppose a German firm develops a new invention and patents it in Germany. Subsequently, it decides to seek protection for the same invention in US and in Japan and files the same patent to the USPTO and at the JPO. These three applications clearly protect the same invention and thus belong to the same patent family. For the purpose of our analysis these three applications are counted as one. Notice also that a patent family is a generic term: different definitions of how to group applications can be applied, depending on the specific purpose. Throughout our analysis we use DOCBD patent counts.

\footnote{For more information on the method developed to arrive at harmonized patentee names see \url{https://www.ecoom.be/nl/eee-ppat} and Magerman et al. (2006) and Peeters et al. (2009).}
\footnote{The OECD Patent Statistics Manual defines patent families as “the set of patents (or applications) filed in several countries which are related to each other by one or several common priority filings” (OECD, 2009, Ch.4, p.71).}
Assigning patents to firms. We identify the list of patent applicants from PATSTAT table TLS207_PERS_APPLN. Applicants have “APPLN_SEQ_NR” greater than 0. The same table provides the correspondence between each applicant and the patents he owns. We use this built in link to assign patents to firms. Technically, patentees can be private business enterprises, universities/higher education institutions, governmental agencies, or individuals, but for simplicity we call them firms throughout the paper. At this point, one clarification is required. It is possible that several applicants co-own the same patent. In this case we proceed by assigning the patent to every co-owner of the patent application.

Identify home country of firms. In order to identify the home country of a firm we use PERSON_CTRY_CODE from TLS906_PERSON in PATSTAT. One difficulty is that the information on the applicant’s country is not always reported. Firms without information on home country are dropped in what we refer to as the sample. Notice that a firm may be associated with more than one country. We have 42574 of such cases. When this is the case, we let home country be the one with the highest frequency in the data. We consider each applicant’s home country as its headquarter country.

EU and the Single market. The Single market was established in 1992. To account for this we treat all firms with home country among the EU 15 as if the belonged to one single country.

Identify the industry affiliation of a firm. PATSTAT assigns one or more industries \( j \) (NACE revision 2) to each patent application \( p \). Industries are given weights \( w_{pj} \) that sum to one for a given application (table TLS229). We let the industry affiliation of a firm be defined by the main industry of a firm being the industry that obtains the maximum weight across all of the firm’s applications, \( \max \sum_p w_{pj} \) during the pre-period.

D Tariff Data

The main source of tariff data is the UNCTAD Trade Analysis and Information System (TRAiNS), which contains tariffs at the most disaggregated level of the Harmonized System (HS) for more than 150 countries. From this database we extract the average ad-valorem industry-level tariff (NACE 3-digit) \( T_{njt} \) for industry \( j \), country \( n \), for year \( t \) over the period 1992 to 2009.

Details on construction. First, we convert 6-digit HS codes to a the 6-digit HS Combined

---

\[25\text{See also Dernis and Khan (2004) and Martinez (2010) for an overview of different types of patent families and how they are constructed.}\]
(HSC) nomenclature using a World Bank correspondence table.\footnote{20} In some cases, a 6-digit tariff line is missing in year $t$, but non-missing previous or later years; in these cases we interpolate to get a non-missing observation in year $t$. We also extrapolate tariffs in those cases where tariffs exist in 1995 but not in 1992-1994, or 1994 but not 1992-1993, or 1993 but not 1992. Tariff data for all EU member countries are also manually added to the database, as EU tariffs are not listed for individual EU countries in the raw data. Note, that as pointed out above, we control for the establishment of the Single market in 1992 by treating the EU 15, i.e. countries that were part of the EU before the Single market was established or became part of it right after, as one country. Second, we balance the raw data and drop all HSC-country combinations that are not available for all years 1992-2009. This is done to eliminate the possibility that average tariffs change simply due to sampling issues. Third, we aggregate the data to NACE revision 2 3-digit codes. To do so, we first aggregate to 4-digit ISIC revision 3.0 by using a correspondence table from the World Bank. This is then converted to 4-digit ISIC revision 3.1, then to 4-digit ISIC revision 4, which is again converted to NACE revision 2. The last three conversions use correspondences from the UN.\footnote{27} In cases where several ISIC revision 3.1 codes are associated with a single NACE revision 2 code, we take the simple average across the ISIC codes. In some cases, a firm has a missing industry code or a 2-digit code instead of a 3-digit code. In those cases, we use the simple average tariff across all industries, or across 3-digit codes within a 2-digit industry, $T_{nt} = (1/N) \sum_j T_{njt}$, instead.

The final tariff data set contains data for 96 countries, 128 3-digit industries and 12,174 country-industry combinations. Figure 5 shows average tariffs for high- and low income countries in our final tariff data set.

E Trade Policy During the 1990s

Launched in Punta del Este, Uruguay, on 20 September 1986, the Uruguay Round of Multilateral Trade Negotiations was formally concluded in Marrakesh, Morocco, on April 15 1994, when 125 Governments and the European Communities, accounting for more than 90 percent of world trade, concluded a historical agreement to reform international trade. As stated in the Marrakesh declaration,\footnote{28} the Uruguay Round achieved a global reduction by 40 percent of tariffs and wider market-opening agreements on goods. In addition, participation in the Uruguay Round was considerably wider than in any previous multilateral trade negotiation.

\footnotesize{\textsuperscript{20}http://wits.worldbank.org/product_concordance.html
\textsuperscript{27}http://unstats.un.org/unsd/cr/registry/rgot.asp?Lg=1
\textsuperscript{28}https://www.wto.org/english/docs_e/legal_e/marrakesh_decl_e.pdf}
Figure 5: Average Tariffs

Note: The figure shows average tariffs for high- and low income countries according to the World Bank 1995 definition, using our final tariff data set. Average tariffs are calculated as the simple average across countries. 3-digit NACE tariffs are aggregated to country level tariffs using simple averages.
and, in particular, developing countries played a notably active role in it. While only few developing countries took part in earlier GATT rounds, and trade barriers reduction was negligible, the Uruguay round achieved important tariff reductions in both developed and developing countries. The Uruguay Round implied commitments to cut and bind tariffs on the imports of goods. The tariff reductions agreed on were explicit on both the timing and magnitude in cut. The deadlines for cut ended in 2000.

The major results of the Uruguay Round were the individual commitments of the contracting parties to cut and bind their custom duty rates on imports of goods. It is important to note that the phase-in of tariff reductions were agreed on during the negotiations. This feature of the Marrakesh Agreement implies that tariff reductions were pre-determined and therefore unlikely to be correlated with contemporaneous shocks, or to be driven by political pressure arising from the effects of trade liberalization.

For non-agricultural products the agreed tariff reductions were implemented in five equal installments. The first cut was made on the date of entry into force of the WTO agreement, and the following four on 1 January of each subsequent year. Over the five years, this process led to a 40% tariff cut on average on industrial products in developed countries, from an average of 6.3% to and average of 3.8%.

In addition to tariff cuts, the number of “bound” tariffs increased significantly, from 78% to 99% in developed countries, from 21% to 73% in developing countries, and from 73% to 98% in transition economies.

F Patent and Sales Weights

This section provides empirical evidence that trade and patent weights are highly correlated.

Aggregate Evidence. We aggregate the patent data to the country-pair level, where the source country is the location of the applicant firm and the destination country is the location of the patent office. We calculate the share of patents filed in country $s$ that come from firms headquartered in country $r$, relative to all other foreign patents filed in country $s$, $\chi_{rst} = \frac{\text{Patents from } r \text{ to } s \text{ at time } t}{\sum_{k \neq s} \text{Patents from } k \text{ to } s \text{ at time } t}$ (17)

---

29 Exceptions are represented by the East Asian NICs.
30 Unless it is otherwise stated in a Member’s Schedule.
31 See Marrakesh Protocol to the General Agreement on Tariffs and Trade 1994 for additional information.
32 Bound tariffs are duty rates that are committed under WTO. Raising them above the bound rate is possible but hard: the process involves a negotiation with the most affected countries and it possibly requires a compensation for their loss of trade.
Similarly, by using trade data from CEPII, we calculate the import share $\psi_{rst}$ as the share of trade from $r$ to $s$ relative to $s$’ total imports,

$$\psi_{rst} = \frac{\text{Import from } r \text{ to } s \text{ at time } t}{\sum_{k \neq s} \text{Imports from } k \text{ to } s \text{ at time } t}$$ \hfill (18)

Figure 6 shows the import and patent inflow shares on the horizontal and vertical axis, respectively, on log scales, for four major economies, the U.S., Germany, Japan and Great Britain in year 2000. There is a high degree of overlap; typically the top three countries on the import side are also the top three countries on the patent side. In Figure 7 we plot all country pairs in our sample for the year 2000. We see that there is a strong log linear relationship between bilateral patenting and trade, with a linear regression slope of 0.80 (s.e. 0.02). Finally, we show that the patent flows adhere to a gravity model. Table 6 shows results when regressing the number of patents from $r$ filed in $s$ on distance and GDP in $r$ and $s$ (all in logs). Column (1) uses only the year 2000 cross-section sample, while column (2) uses all years from 1965 to 2006 and includes year and country-pair fixed effects. Just as for trade flows, bilateral patenting falls with distance and increases with the size of the home and destination country.

**Firm-Level Evidence.** We use survey data for European firms from EU-EFIGE/Bruegel-UniCredit data set (henceforth EFIGE) to calculate firm specific export shares to different
Figure 6: Import and Patents Shares.

Note: The vertical axis shows the share of patents filed in U.S./Germany/Japan/Great Britain belonging to firms headquartered in source country $r$ (log scales). The horizontal axis shows the share of total imports in U.S./Germany/Japan/Great Britain coming from source country $r$ (log scales). Year 2000.
Note: The figure shows the number of patents and total trade from headquarters country $r$ to destination country $s$ in year 2000 (both in logs). The solid line is the local polynomial regression fit and the gray area represents the 95% confidence bands. The linear regression slope is 0.80 (s.e. 0.02). The population of firms is all firms in PATSTAT with non-missing headquarters country information.

Note: The figure shows market exposure weights based on sales (2008) and patenting activity (1998 to 2008). The solid line is the local polynomial regression fit and the gray area represents the 95% confidence bands. The linear regression slope is 0.89 (s.e. 0.008).
country groups, and compare them to patent weights from PATSTAT.\textsuperscript{33} The EFIGE database consists of a representative sample of about 15,000 manufacturing firms (above 10 employees) across seven countries (Germany, France, Italy, Spain, United Kingdom, Austria, Hungary) and provides information on firms’ international activities. We use firms’ self-reported export shares for 2008 and for each firm we construct weights for market exposure based on the share of sales to eight groups of countries:\textsuperscript{34} EU 15 countries, other EU countries, other European countries not EU, China and India, other Asian countries, USA and Canada, Central and South America, and a residual category including all remaining countries.\textsuperscript{35}

We match the EFIGE data with firm level data from Amadeus, which in turn can be matched with PATSTAT using the patent application number of each patent owned.\textsuperscript{36} We calculate weights for market exposure based on firms’ patenting activity abroad that correspond to those we have calculated for exports using patent applications for the period of 1998 to 2008.\textsuperscript{37} Figure 8 shows a kernel-weighted local polynomial regression of patent shares on export shares for firms with at least one patent. Again we observe that there is a strong relationship between patent and trade weights. The corresponding linear regression slope is 0.89 (s.e. 0.008).

### G Persistence in Patent Weights

This section provides empirical evidence that patent weights $\omega_{in}$ are highly persistent over time. We calculate weights $\omega_{int}$ based on all patents filed during three non-overlapping time periods, $t = 0$: 1965-1985, $t = 1$: 1985-1995 and $t = 2$: 1996-2005. First, we calculate the likelihood of continuing to patent in a country conditional on patenting there in $t = 0$ (i.e., the extensive margin). We also calculate the likelihood of patenting in $t = 0$ and

\begin{itemize}
\item \textsuperscript{33}The EFIGE data set is described in Altomonte and Aquilante (2012).
\item \textsuperscript{34}Specifically, we use the answers to two questions. D4 asks: “Which percentage of your 2008 annual turnover did the export activities represent?” D13 asks: “If we assume that the total export activities equal to 100 which percentage goes to each of the following areas: 15 EU countries area, Other UE countries, Other European countries not UE (Switzerland, Norway, Russia, Turkey, Byelorussia, Ukraine, ...), China and India, Other Asian countries (excluded China and India), USA and Canada, Central and South America, and Other areas.
\item \textsuperscript{35}The weight for EU 15 is computed by summing a firm’s exports share to EU 15 area and the share of sales in its home market.
\item \textsuperscript{36}Specifically, from the variable patent application number in Amadeus we are able to construct the appln_nr_epodoc in PATSTAT, and to link each patent application in Amadeus to the same patent application in PATSTAT.
\item \textsuperscript{37}When the application authority is EPO, we assume that the patent was filed in at least one of the EU 15 countries, and include it in the EU 15 share. The motivation is that EPO filing is cost effective if the applicant wants to protect an invention in 4 or more countries, so there must be at least one application filed in one of the EU15 countries. If a firm does not have patents, then all its weights for all groups of countries are set to zero.
\end{itemize}
Conditional on patenting in the same country in \( t = 2 \). We limit the sample to firms that filed at least one patent after 2004, which ensures that all firms exist throughout the period in question. Table 7 reports the results. Even after 20 years, the likelihood of continuing to patent is high (44 percent). The same is true on the entry side; conditional on patenting in a market in \( t = 2 \), the likelihood of patenting in that market 20 years earlier is nearly 40 percent. These conditional probabilities are an order of magnitude higher than the unconditional probability of patenting in a market. The final row in the table shows that the unconditional probability is roughly 4 percent. Second, we calculate the correlation in weights conditional on patenting in that market in both \( t \) and \( t + 1 \) (i.e., the intensive margin). Figure 9 shows the expected weight in \( t = 1 \) and \( t = 2 \) conditional on a 1985 weight \( \omega_{\text{ino}} \). Even after 20 years there is a highly significant and positive correlation between the weights.

<table>
<thead>
<tr>
<th></th>
<th>(1) ( t = 0 )</th>
<th>(2) ( t = 1 )</th>
<th>(3) ( t = 2 )</th>
</tr>
</thead>
<tbody>
<tr>
<td>Conditional Probability of continuing ( P[p_{\text{int}}</td>
<td>p_{\text{ino}}] )</td>
<td>1</td>
<td>0.44</td>
</tr>
<tr>
<td></td>
<td></td>
<td>(.001)</td>
<td>(.001)</td>
</tr>
<tr>
<td>Conditional Probability of entry ( P[p_{\text{int}}</td>
<td>p_{\text{in2}}] )</td>
<td>0.37</td>
<td>0.39</td>
</tr>
<tr>
<td></td>
<td>(.001)</td>
<td>(.001)</td>
<td></td>
</tr>
<tr>
<td>Unconditional Probability of patenting ( P[p_{\text{int}}] )</td>
<td>.037</td>
<td>.033</td>
<td>.035</td>
</tr>
</tbody>
</table>

Note: Standard errors in parentheses. \( P[p_{\text{int}} | p_{\text{ino}}] \) depicts the share of firm-destinations with positive patenting in \( t = 0 \) and period \( t \) relative to all firm-destinations with positive patenting in \( t = 0 \). \( P[p_{\text{int}} | p_{\text{in2}}] \) depicts the share of firms-destinations with positive patenting in \( t = 0 \) and period \( t \) relative to all firm-destinations with positive patenting in \( t = 2 \).
Figure 9: Persistence in Patent Weights. Intensive Margin.

Note: The figure shows the kernel-weighted local polynomial regression of weights \( \omega_{int} \) in 1995 or 2005 (vertical axis) on weights in 1985 (horizontal axis). The two lines represent two separate regressions. Gray areas denote the 95 percent confidence bands. The sample includes all pairs \((\omega_{int}, \omega_{in,t+1})\) where both values are non-zero. The population of firms is described in Section 4.2.

H Patents as a Measure of Innovation

In this Section we examine the robustness of patenting as an indicator of innovative activity by looking at the correlation between patent applications and R&D expenditures. We rely on the EFIGE survey data referred to above and match these with Amadeus and PATSTAT. This leaves us with a sample of European manufacturing firms. EFIGE contains information of firms’ average investment in R&D activities as percentage of turnover for the period 2007-2009.\(^{38}\) Using turnover data from Amadeus we are able to calculate average R&D expenditures for the same period.

We proceed by calculating the correlation between firm level R&D expenditures (in logs) and the number of patent applications (in logs) for each firm. In order to account for the lag between the investment in R&D and the successful outcome of the R&D process and subsequent patent application, we calculate the average number of patents applied for per year by a firm by considering a window of six years. We include the survey period (2007-

\(^{38}\)Calculation is based on the question C21 in EFIGE that asks: “Which percentage of the total turnover has the firm invested in R&D on average in the last three years (2007-2009)?”
Table 8: R&D expenditures and patenting

<table>
<thead>
<tr>
<th>Dep. variable: Patenting</th>
<th>R&amp;D expenditure (1)</th>
<th>Log R&amp;D expenditures (2)</th>
</tr>
</thead>
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<tr>
<td>Patenting</td>
<td>3570.16&lt;sup&gt;a&lt;/sup&gt;</td>
<td>1.28&lt;sup&gt;a&lt;/sup&gt;</td>
</tr>
<tr>
<td></td>
<td>(584.17)</td>
<td>(0.06)</td>
</tr>
<tr>
<td>Observations</td>
<td>6204</td>
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</tbody>
</table>

Note: Standard errors in parentheses. <sup>a</sup> p< 0.01, <sup>b</sup> p< 0.05, <sup>c</sup> p< 0.1. The table shows a regression of R&D expenditures on a binary variable indicating whether the firm has any patent.

2009) and the three subsequent years, until 2012. On the intensive margin, higher R&D expenditures are strongly correlated with a higher number of patent applications. Figure 10 shows a kernel-weighted local polynomial regression of firms’ R&D expenditures on number of patent applications. The relationship between the number of patents filed by a firm and its investment in R&D is strong and positive. This relationship is not monotonic. We notice a drop for firms with very high numbers of patent applications; but only a minor number of firms file such a high number of patent applications per year. The corresponding linear regression slope is 0.68 (s.e. 0.05).

On the extensive margin, we find that firms with at least one patent application spend on average more on R&D than firms with no patents. We use firm level R&D expenditures and construct a binary variable, which equals one if the firm has applied for one or more patent on average in the period 2007-2012 period, and zero otherwise. Figure 11 shows the histogram of average R&D expenditures for firms with positive patent applications and for firms that didn’t file any patent. The shape of the distribution is very similar in the two groups, but for firms with patents the distribution is shifted to the right, suggesting a positive correlation between R&D expenditures and patenting. For high levels of R&D investments, there is a higher share of firms with at least one patent application. Conversely, for low levels of R&D, the share of firms with no patent applications is higher. We also run a correlation between firm level R&D expenditures and the binary variable indicating whether, on average, the number of patent applications per year in the 2007-2012 period is positive. We repeat the same exercise for both the level and the log of R&D expenditures. The results are reported in column one and two of Table 8 respectively. In both cases we find a positive and strong correlation between R&D expenditures and patent applications.
Note: The figure shows the average number of patent applications per year and average R&D expenditures per year (both in logs). R&D expenditures refer to the period 2007-2009, patent counts are calculated over a six year window, from 2007 to 2012. The solid line is the local polynomial regression fit and the gray area represents the 95% confidence bands. The linear regression slope is 0.68 (s.e. 0.05).

Note: The figure shows the distribution of firms’ R&D expenditures (in logs) for firms with (white) and without (gray) patent applications in the period 2007-2009.
## Additional Tables

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<th></th>
<th>Filed patents</th>
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<th>Citations (mean)</th>
<th>Inventors (mean)</th>
<th>IPC codes (mean)</th>
</tr>
</thead>
<tbody>
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The table shows the number of filed and granted patents and the average quality of patents as proxied by the number of citations, inventors and IPC class codes in the final sample of firms for the period 1992-2000. The first row displays overall statistics, the remaining part of the table shows statistics for the ten biggest economies (nominal GDP) in 2000.
The table shows the number of patents filed during the period 1992-2000 in the world and in the 10 biggest economies in terms of nominal GDP in 2000. The population consists of the final sample of firms described in the Section 4.2. Patent count is based on filed patent applications. Patents are only counted once in each industry and country: in Column 3 (World), patents owned by more than one firm and/or filed in more than one country are not counted twice; in Column 3-12 (Top 10 economies in 2000), patents with multiple ownership in the same country are only counted once, but patents owned by firms in more than one country and/or filed in more than one country, are counted once in each destination country. Nace Rev. 2 codes: 10 Manufacture of food products; 11 Manufacture of beverages; 12 Manufacture of tobacco products; 13 Manufacture of textiles; 14 Manufacture of wearing apparel; 15 Manufacture of leather and related products; 16 Manufacture of wood and of products of wood and cork, except furniture; manufacture of articles of straw and plaiting materials; 17 Manufacture of paper and paper products; 18 Printing and reproduction of recorded media; 19 Manufacture of coke and refined petroleum products; 20 Manufacture of chemicals and chemical products; 21 Manufacture of basic pharmaceutical products and pharmaceutical preparations; 22 Manufacture of rubber and plastic products; 23 Manufacture of other non-metallic mineral products; 24 Manufacture of basic metals; 25 Manufacture of fabricated metal products, except machinery and equipment; 26 Manufacture of computer, electronic and optical products; 27 Manufacture of electrical equipment; 28 Manufacture of machinery and equipment n.e.c.; 29 Manufacture of motor vehicles, trailers and semi-trailers; 30 Manufacture of other transport equipment; 31 Manufacture of furniture; 32 Other manufacturing; 62 Computer programming, consultancy and related activities; 99 Missing in data.
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The table shows the number of firms patenting in the world and in the 10 biggest economies in terms of nominal GDP in 2000. The population consists of the final sample of firms described in the Section 4.2. Nace Rev. 2 codes: 10 Manufacture of food products; 11 Manufacture of beverages; 12 Manufacture of tobacco products; 13 Manufacture of textiles; 14 Manufacture of wearing apparel; 15 Manufacture of leather and related products; 16 Manufacture of wood and of products of wood and cork, except furniture; manufacture of articles of straw and plaiting materials; 17 Manufacture of paper and paper products; 18 Printing and reproduction of recorded media; 19 Manufacture of coke and refined petroleum products; 20 Manufacture of chemicals and chemical products; 21 Manufacture of basic pharmaceutical products and pharmaceutical preparations; 22 Manufacture of rubber and plastic products; 23 Manufacture of other non-metallic mineral products; 24 Manufacture of basic metals; 25 Manufacture of fabricated metal products, except machinery and equipment; 26 Manufacture of computer, electronic and optical products; 27 Manufacture of electrical equipment; 28 Manufacture of machinery and equipment n.e.c.; 29 Manufacture of motor vehicles, trailers and semi-trailers; 30 Manufacture of other transport equipment; 31 Manufacture of furniture; 32 Other manufacturing; 62 Computer programming, consultancy and related activities; 99 Missing in data.