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Roula Inglesi-Lotz
University of Pretoria
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Department of Economics
University of Pretoria
0002, Pretoria
South Africa
Tel: +27 12 420 2413

Social Rate of Return to R&D on Various Energy Technologies: Where Should We Invest More? A Study of G7 Countries.

Roula Inglesi-Lotz

Department of Economics, University of Pretoria

Pretoria, South Africa

Abstract

The severity of investment in Research and Development (R&D) in the energy sector is undisputable especially considering the benefits of new technologies to sustainability, security and environmental protection. However, the nature and potential of various energy technologies that are capable to improve the energy and environmental conditions globally is a challenging task for governments and policy makers that have to make decisions on the allocation of funds in R&D. To do so, the optimal resource allocation to R&D should be determined by estimating the social rate of return for R&D investments. This paper aims to estimate the social rate of return of R&D on various energy applications and technologies such as energy efficiency, fossil fuels, renewable energy sources, and nuclear for the G7 countries. The results show that primarily R&D investment on Energy Efficiency technologies and Nuclear are the ones that yield high social benefits for all G7 countries while exactly the opposite holds for Fossil fuels.

1. Introduction

The severity of investment in Research and Development (R&D) in the energy sector is indisputable especially considering the benefits of new technologies to sustainability, security and environmental protection. Wong, Chang and Chia (2013) have shown that fossil fuel R&D drives economic growth in the OECD countries more than actually the fossil fuels consumption does. However, the nature and potential of various energy technologies that are capable to improve the energy and environmental conditions globally is a challenging task for governments and policy makers that have to make decisions on the allocation of funds in R&D. To do so, the optimal resource allocation to R&D should be determined by estimating the social rate of return for R&D investments.

Theoretical and empirical literature has illustrated the central role of R&D as a significant contributor to growth and development. Primarily empirical studies have estimated the rate of return to R&D in regressions of productivity growth on measures of R&D such as R&D intensity (Grilliches, 1994; Jones and Williams, 1998; Corderi and Cynthia Lin, 2011). Although, different studies accounted for various spillovers consensus has been reached that the social rate of return of R&D is positive, differs in size among countries and remains significantly above private rates. Tirole (2001) explain why the private rate of return diverge from the socially optimal rate of R&D: firstly the private sector might under-invest in R&D because there are positive spillovers included and secondly, when perfect price discrimination does not exist the social surplus from innovation is higher than the private one.

In the international context of climate change, fossil fuel dependence, high energy prices and lack of energy sustainability, there are good reasons to draw attention to the returns of R&D on energy technologies and innovations. Bointner (2014) argues that between the two major sources

of learning, namely learning by doing and learning by researching (Garrone and Grilli, 2010), the energy R&D is subject to the latter. He then continues in explaining the "four grand patterns of energy technological change" as discussed in Grubler et al. (2012): "…namely (a) clustering of related technologies and technology spillovers prevail over stand-alone technologies; (b) the ability to perform a novel energy service is more important than the cost of a new, immature technology; (c) energy supply follows demand, which is given by the available end-use applications; and (d) a low rate of technology diffusion" (Bointener, 2014). However, Sterlacchini (2012) stressed a staggering decline of energy R&D during the last two decades, due to reforms and restructuring of electricity markets.

It should be noted here that studies focusing on funding directed on energy R&D activities are rare and focusing primarily on developed economies. The reason for that is not only data availability but also, almost 85-90% of world's energy R&D is conducted in the world's richest nations (Breyer et al. 2010) Recently, Coderi and Cynthia Lin (2011) estimated the social rate of return to R&D in the energy manufacturing industry for a group of OECD countries. They quantified the impact of lagged R&D on total factor productivity (TFP) using a panel of data. Their results show that R&D had a positive and significant rate of return with a different magnitude for the various countries.

However, the R&D spending on energy is broad. The International Energy Agency (IEA) has classified the energy R&D in seven categories according to the technologies and innovations. Table 1 presents the share of these groups in each of the country's total R&D expenditures on energy. It can then be seen that the great majority of the energy R&D in all countries is spent on the nuclear sector, while the cross-country variation of the rest of the energy R&D groups is high.

Table 1: Share of the different R&D Categories to total Energy R&D (%)

Categories	Canada	France	Germany	Italy	Japan	UK	US
Group 1 Energy Efficiency	14.976	6.318	6.715	14.660	7.814	10.165	15.399
Group 2 Fossil fuels	29.858	10.675	7.742	2.985	9.543	10.442	15.292
Group 3 Renewable energies	8.185	4.400	23.834	12.312	4.855	20.149	10.512
Group 4 Nuclear	35.316	75.184	48.719	39.429	71.559	43.008	23.026
Group 5 Hydrogen and fuel cells	7.038	4.661	5.155	3.290	4.905	5.092	6.322
Group 6 Other power and storage technologies	4.252	0.562	3.736	13.938	2.841	3.838	4.073
Group 7 Other cross cutting technologies	5.151	1.032	7.597	15.622	1.935	10.760	29.665
Statistical differences	-4.776	-2.830	-3.498	-2.237	-3.452	-3.456	-4.290
Total	100	100	100	100	100	100	100

Source: International Energy Agency (IEA, 2014).

This paper aims to estimate the social rate of return of R&D on various energy applications and technologies such as energy efficiency, fossil fuels, renewable energy sources, and nuclear for the G7 countries (Canada, France, Germany, Italy, Japan, United Kingdom, United States) by using panel data estimations (primarily fixed effects). As used mostly in the literature, we will quantify the impact of lagged R&D intensity to TFP of the countries. Energy R&D Data will be derived from the IEA databases while economic data will be provided primarily by the OECD STAN database. All in all, this paper's purpose is to identify which of these energy technologies yield a higher social rate of return of R&D (if any) and make important policy recommendations.

2. Methods and data

A Cobb-Douglas production function is adopted in this analysis of the form:

$$Y_t = e^{\mu t} Z_{t-1}^{\gamma} K_t^{\alpha} L_t^{1-\alpha} \quad (1)$$

$$Z_t = R_t \quad (2)$$

Where Y is the output produced, Z is the R&D expenses, K is the capital, L is the labor and R is the expenditures in R&D. Equation (2) shows no depreciation of stock.

In a growth accounting exercise, we derive the relationship between TFP and R&D:

$$TFP_t = \frac{Y_t}{K_t^{\alpha} L_t^{1-\alpha}} \quad (3)$$

Equation (3) can finally be transformed in:

$$\Delta \ln(TFP_t) = \mu + \tilde{r} \frac{R_{t-1}}{Y_{t-1}} + \varepsilon_t \quad (4)$$

Where $\tilde{r} = \left(\frac{dY}{dZ}\right)$ is the rate of return to R&D. As can be shown in equation (4), TFP is regressed on the R&D share of output lagged by one period. As Jones and Williams (1998) mention, if the coefficient r is measured at the industry level, it represents the social rate of return.

The data used are derived primarily from the International Energy Agency (IEA) database "Energy Technology RD&D budgets", the OECD STAN database and the World Development Indicators of the World Bank for the G7 countries during the period from 1985 to 2012. The group of countries was selected because according to Coderi and Lin (2011) these countries conduct on average 88% of the energy R&D in the OECD countries.

Table 2 shows the gross domestic product (GDP) and R&D expenditures in the seven countries as well as their relative size to the group in percentages. In both indicators, it can be seen that US has the highest share in the sample while Japan follows suit in the group.

Table 2: Descriptive statistics

	US dollars millions, PPP, Constant prices 2005	**%**	**US dollars millions, PPP, Constant prices 2005**	**%**
	Size in terms of total R&D in energy	**Relative size to the group**	**Size in terms of GDP**	**Relative size**
Canada	520.024	4.844	982145.345	4.329
France	976.124	9.093	1687321.462	7.437
Germany	660.136	6.150	2454303.972	10.818
Italy	732.646	6.825	1547616.286	6.822
Japan	3470.010	32.326	3538803.193	15.598
UK	311.286	2.900	1757612.186	7.747
US	4064.117	37.861	10719327.596	47.248
Total	10734.342	100.000	22687130.041	100.000

3. Empirical results

The model specification has a regression equation of the form:

$$\Delta \ln(TFP_{it}) = \mu_i + \tilde{r}_i(RDint)_{it-1} + \beta Period_t + \varepsilon_{it} \quad (5)$$

Where TFP is the total factor productivity for each of the countries i in each growth rate (differenced natural logs); RDint is the R&D intensity (lagged 1 period) defined as the ratio of R&D expenditures to value added in each country; μ is the country fixed effects and εit is the error term which is assumed to be heteroskedastic (by country) and serially uncorrelated. The parameter $\tilde{r}_i$ is the one to be of interest here since it is denoting the country-specific social rate of return of each of the groups of energy R&D. Following Coderi and Lin (2011), "we used fixed effects rather than random effects panel estimation model since we believe that time –invariant country-level unobservables are potentially correlated with some of the regressors" (Coderi and Lin, 2011: 2782).

The dependent variable as seen in equation (5) is growth in total factor productivity and the regressor is the lagged R&D intensity. The White's robust error variance estimation procedure is used accounting for the possibility of heteroskedastic errors. Table 3 presents the social rate of return to the various groups of energy R&D[1].

[1] Appendix A presents the coefficient estimates with their t-statistics.

Table 3: Social rate of return estimates by country (percent)

	RD1	RD2	RD3	RD4	RD5	RD6	RD7
Canada	1.423	-0.635	-2.082	3.640	-25.259	-1.590	-0.777
France	1.122	-0.558	-0.271	4.861	2.216	1.035	1.136
Germany	1.125	-0.294	-7.780	3.571	65.884	-0.726	0.689
Italy	1.183	-0.204	-9.257	3.341	-2.560	-3.971	0.473
Japan	1.236	-0.693	1.480	5.603	10.685	1.775	0.405
UK	0.931	-0.487	1.299	2.611	-0.185	2.666	-0.588
US	1.234	-0.635	0.591	2.897	-3.837	0.723	-0.102

Note: in grey, the cells show estimates that were statistically significant

The first interesting fact that can be observed is that the coefficients for Groups 1 (Energy efficiency) and 4 (Nuclear) are all positive and statistically significant. In a sense, the results for Group 4 were expected as the majority of spending occur in that group. The results for Group 1 are showing how important is for the economics that betterment of the use of energy overall. Secondly, it is crucial to note that none of the coefficients for Group 2 (Fossil fuels) is either positive or statistically significant denoting that the society as a whole do not benefit by the investment in technologies for fossil fuels usage. The rest of the groups show a variety of results depending on the country. It is interesting to see that although US invests most than the other countries, it does not receive the same social return from the investment shows a statistically insignificant coefficient only for Groups 2 and 3 (Fossil fuels and Renewable energies).

4. Conclusions

In this paper we have estimated the social rate of return of R&D on various energy applications and technologies such as energy efficiency, fossil fuels, renewable energy sources, and nuclear for the G7 countries (Canada, France, Germany, Italy, Japan, United Kingdom, United States) by using panel data estimations (primarily fixed effects). Following the literature, the impact of lagged R&D intensity to TFP of the countries was quantified to do so. All in all, this paper's purpose was to estimate a lower limit for the social rate of return by using a narrow definition of spillover effects.

Following the approach used by Coderi and Lin (2011), our results yield a lower bound estimate of the social rate of return due to the assumptions and limitations of our approach. The primary focus is on contemporaneous within-country R&D spillovers, we do not account for R&D spillovers between industries, intertemporal or inter-country spillovers. Also, the way of measuring productivity here does not adjust for improvements in human capital.

The results show that primarily R&D investment on Energy Efficiency technologies and Nuclear energy are the ones that yield high social benefits for all G7 countries while exactly the opposite holds for Fossil fuels. There several policy implications of these results. The results show the variety of social benefits gained by various groups in various countries showing that not one policy fits all. Policy makers can count on promoting R&D in the fields of energy efficiency and nuclear in giving them high social returns. They should hence rethink on distinguishing the investment accordingly. By no means, the results suggest that R&D investment should be quit for all the other energy technologies apart from those that improve energy efficiency and nuclear production. It might on the contrary be argued that the lack of sufficient and properly directed R&D investment in other Groups of energy R&D is the main reason for the absence of social

returns. One should always keep in mind though that our estimates are lower bound estimates and the need for funding nationally and internationally as well as the need for incentives may be even greater.

Appendix A

Dependent variable: differenced total factor productivity													
	RD1		RD2		RD3		RD4		RD5		RD6		RD7	
Canada	0.014	**	-0.006		-0.021		0.036	**	-0.253	***	-0.016	***	-0.008	
	2.563		*0.426*		*-1.539*		*2.601*		*-3.043*		*0.000*		*0.186*	
France	0.011	**	-0.006		-0.003		0.049	**	0.022		0.010		0.011	
	2.193		*0.463*		*-0.413*		*2.436*		*0.275*		*0.327*		*0.667*	
Germany	0.011	**	-0.003		-0.078	***	0.036	**	0.659	***	-0.007		0.007	
	2.243		*0.647*		*-3.639*		*2.307*		*4.736*		*0.115*		*0.108*	
Italy	0.012	**	-0.002		-0.093	***	0.033	**	-0.026		-0.040	***	0.005	
	2.374		*0.726*		*-5.337*		*2.604*		*-1.514*		*0.000*		*0.223*	
Japan	0.012	**	-0.007		0.015		0.056	**	0.107	***	0.018	**	0.004	**
	2.036		*0.387*		*0.825*		*2.300*		*4.090*		*0.011*		*0.042*	
UK	0.009	**	-0.005		0.013	***	0.026	**	-0.002		0.027		-0.006	
	2.267		*0.323*		*2.833*		*2.411*		*-0.170*		*0.112*		*0.474*	
US	0.012	*	-0.006		0.006		0.029	**	-0.038		0.007		-0.001	
	1.915		*0.409*		*0.828*		*2.380*		*-0.681*		*0.644*		*0.764*	
Adjusted R-squared	0.985		0.987				0.986		0.993		0.986		0.985	
Observations	144		139				149		50		138		132	

Note: *(**)[***] denote 10%, 5% and 1% level of significance; the figures in italics are the t-statistics

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