

# Specialization in a Knowledge Economy

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## Abstract

Using firm-level data from the US Census Longitudinal Business Database (LBD), this paper exhibits novel evidence about a wave of specialization experienced by US firms in the 1980s and 1990s. Specifically: (i) Firms, especially innovating ones, decreased production scope, i.e., the number of industries in which they produce. (ii) Innovation and production separated, with small firms specializing in innovation and large firms in production. Higher patent trading efficiency and stronger patent protection are proposed to explain these phenomena. An endogenous growth model is developed with potential mismatches between innovation and production. Calibrating the model suggests that increased trading efficiency and better patent protection can explain 25% of the observed production scope decrease and 58% of the innovation and production separation. They result in a 0.64 percent point increase in the annual economic growth rate. Empirical analyses provide evidence of causality from pro-patent reforms in the 1980s to the two specialization patterns.

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**Keywords:** specialization, production scope, R&D, intellectual property rights, patent trade, endogenous growth

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# 1 Introduction

Profiting from innovation is vital for the survival of innovating firms and, therefore, economic growth. However, it is not easy to monetize innovation using a firm's own production. First, ideas are random and are not always matched with a firm's production.<sup>1</sup> Second, the firm may lack the ability to mass-produce its innovation output.<sup>2</sup> Strategies to solve these problems within the firm include: spanning a large number of industries to raise the opportunity of utilizing new inventions; doing innovation only when the firm can produce and commercialize new inventions.

Surprisingly, this paper finds deviations from the aforementioned strategies among US firms in the 1980s and 1990s using the Longitudinal Business Database (LBD) from the Census Bureau—there is novel evidence of specialization trends.<sup>3</sup> Specifically,

(i) US firms narrowed their production scopes, i.e., the number of industries in which they produce. The scope shrinkage was driven by innovating firms.

(ii) Innovation shifted from large firms (firms with mass production) to small firms.

This study then asks: What are the driving forces of the observed specialization, and how do they affect economic growth?

This paper proposes that higher patent trading efficiency and better patent protection contribute to the specialization patterns by allowing innovations to be traded and utilized by other firms. To assess this new hypothesis in explaining the specialization choices of US firms and economic growth, an endogenous growth model is built with potential mismatches between innovation and production and firm heterogeneity in the ability to monetize new inventions through production. Then, the model is calibrated to rich firm-level data from the LBD, R&D data from the Survey of Industrial Research and Development (SIRD), and patent data from the US Patent and Trademark Office (USPTO). The model suggests that increased patent trading efficiency and patent protection can jointly explain 25% of the production scope contraction and 58% of the shift of innovation activities. They lead to a 0.64 percent point increase in the annual economic growth rate.

Here is a complete summary of the hypothesis. Increased patent trading efficiency and patent protection made innovations more commodified and tradable. Trading of

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<sup>1</sup>Akcigit, Celik and Greenwood (2016) provides evidence that firms may generate new inventions that are far away from the firms' primary line of business. In this case, the inventions have less value to the firms.

<sup>2</sup>For example, RC Cola was a small beverage company that introduced the first cola in a can and the first diet cola. However, it quickly lost the advantage to Coca-Cola and Pepsi. De Havilland, the world's first commercial jet airliner, invented the Comet I jet 2 years before Boeing introduced the 707. However, de Havilland was not able to capitalize its early invention. For more examples, please see Teece (1986)

<sup>3</sup>The LBD covers all US firms with paid employees.

innovations on the patent market allowed firms to sell the new inventions that fell outside of their production scope and buy inventions that could be utilized by their production; thus, making firms' production scope contribute less to the value of their innovation. This explains why innovating firms sharply decreased production scope in the 1980s and 1990s (Fact i). Small firms often have limited ability to monetize innovation through their own production. Chances of selling innovation output on the patent market benefited them more and incentivized them to increase innovation efforts. Large firms could rely on small firms' innovation by purchasing patents on the market and therefore decreased innovation efforts. This explains why innovation activities shifted to small firms (Fact ii).

Two pieces of evidence provide direct support for the new hypothesis. First, the volumes of patent trading activities ballooned after the early 1980s. According to the Patent Assignment Dataset (PAD) from the USPTO, the share of patents ever traded increased from 30.9% at the beginning of the 1980s to 44.1% at the end of the 1990s. This increase shows that innovations have become more tradable. Second, the average matching rate between the technology class of a patent and its inventing firm's industry class declined from 3.8% in 1981 to 2.2% in 2000.<sup>4</sup> This decline suggests fewer innovations were utilized by the firms that invented them.

The 1980s and 1990s witnessed two major changes related to patent trading—the rise of information technology and a series of pro-patent reforms. Improvement in information technology allowed the USPTO to deploy the first automated search systems for trademarks and patents in the 1980s, which significantly raised search capability and reduced information frictions in trade. The pro-patent reforms include an extension of patentability to genetic engineering and software and the creation of the Court of Appeals for the Federal Circuit (CAFC) that vastly increased the winning opportunity of patent holders in legal disputes by lowering invalidation rates. On the one hand, these reforms incentivized firms to patent their inventions instead of hiding them as secrets, therefore, decreased information frictions in trading innovation. The effect of patent protection on patent trade through information disclosure is discussed in [Lamoreaux and Sokoloff \(2001\)](#) using historical data. On the other hand, those reforms allowed firms with new inventions to extract more value in the trading process since it was less likely that the potential buyers would use legal disputes to get the patent for free.

Other possible explanations are also considered for the observed specialization patterns. First, the US government introduced a R&D tax credit in 1981 as part of the strate-

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<sup>4</sup>The technology class of a patent is based on the 4-digit code of the International Patent Classification (IPC); the firms' industry class is based on the 6-digit NAICS code. This paper builds a concordance between the two using the method in [Silverman \(2002\)](#) and a link between the SIC and NAICS codes. [Silverman \(2002\)](#) bridges the patent technology classes with industries according to the usage of the technology.

gies to increase the competency of US firms in the global market. The effective federal subsidy rate increased from 5% before the 1980s to 24% in the 1990s, as documented in [Akcigit, Ates and Impullitti \(2018\)](#). Combined with the booming patent trading market, the R&D tax credit may have benefited small firms more as their R&D expense to domestic sales ratio grew to be higher than large firms' after 1985. Therefore, the tax credit may have amplified the shift of innovation to small firms.<sup>5</sup> Second, the cost structure of production may have changed over time that directly affected firms' production scope. Recent papers like [Hsieh and Rossi-Hansberg \(2019\)](#) and [De Ridder \(2019\)](#) argue that the rise of information technology increases the fixed cost for firms to enter new industries but decreases the marginal production cost after entry. This may explain the observed shrinkage of production scope.<sup>6</sup> Third, good ideas may be getting harder to find, as argued by [Bloom et al. \(2020\)](#). This may have pushed innovating firms to focus efforts on narrower fields of research and therefore production.

To evaluate the roles of the new hypothesis, as well as the aforementioned possible explanations in the specialization patterns and economic growth, a structural model is built with endogenous decisions of production scope and innovation effort. Distinct from existing theories about innovation (e.g., [Garcia-Macia, Hsieh and Klenow \(2019\)](#)) where the benefit from new ideas does not depend on production scope, the model in this paper takes into account potential mismatches between innovation output and production. A key tradeoff that an innovating firm faces when choosing its production scope is that larger scope raises the probability that the firm's innovation output is better matched with its production and, therefore, increases the firm's ability to monetize its inventions; but at the same time, larger scope increases the management cost of the firm. The patent trading market provides another channel for firms to benefit from their innovation besides production but is subject to search frictions. When the matching efficiency increases and the buyers' value at the disagreement point decreases (which, as will be shown, is equivalent to an increase in sellers' bargaining power,) the relative importance of production versus trading in monetizing innovation changes. The effects are heterogeneous for small and large firms. Small firms have limited production scope and benefit more from selling patents; large firms have broader scope and benefit more from buying patents. The model also entertains other explanations.

The developed model is first calibrated to an initial balanced growth path (1981-1985)

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<sup>5</sup>A further discussion of the optimal R&D taxation and subsidy policies can be found in [Akcigit, Hanley and Stantcheva \(2022\)](#).

<sup>6</sup>More specifically, their argument is that information technology makes production more scalable, but adopting it is costly. This incentivizes firms to specialize in a narrow set of sectors and expand production in their chosen sectors.

using the LBD, the SIRD, and the USPTO patent datasets. Key calibration targets include production scope, the R&D expense-to-domestic sales ratio of large and small firms, the share of patents traded, and the HP-filtered economic growth rate. Then, the model is recalibrated to fit an ending balanced growth path (1996-2000), allowing changes in parameters relevant to the new hypothesis and the three alternative explanations. A decomposition exercise is conducted to explore the contribution of each possible explanation by looking at the changes in the key moments due to each relevant parameter. The decomposition shows that higher patent trading efficiency and better patent protection can jointly explain 25% of the observed production scope decrease and 58% of the reallocation of R&D activities. The remaining part of specialization is primarily due to changes in the production cost structure. The increased efficiency and protection result in a 0.64 percent point increase in the annual growth rate, which makes them the main drivers of economic growth in the 1980s and 1990s.

Besides adjusting production scope, firms may also target their innovation to their production to improve matching between the two. One measure of the targeting behaviors of the innovation process is the share of basic research in total R&D spending. Since basic research is defined as “an activity aimed at acquiring new knowledge or understanding without specific immediate commercial application or use,” higher basic research share implies less targeted innovation.<sup>7</sup> Using the Survey of Industrial Research and Development (SIRD), this paper finds that basic research’s share increased in the period when firms’ production scope narrowed, implying that firms’ innovation activities became less targeted. To check whether the new hypothesis can explain this trend, the baseline model is extended to include two types of innovation, basic and applied research, that differ in R&D costs, the probability of matching a firm’s own production scope, and the importance of their output. Similar decomposition exercises are undertaken for the extended model. The result shows that the changes in patent trading efficiency and protection can explain nearly (101%) of the increase in the basic research share. The intuition is that basic research benefits more from patent trading as its output is harder to be utilized by the firm’s own production.

Finally, this study uses regional and sectoral differences in firms’ exposure to the patent policies to test whether the pro-patent policy reforms are causes of the contraction in firms’ production scope and the reallocation of R&D activities. The fraction of lawsuits invalidating the patents involved in legal disputes varied much across the twelve regional circuit courts before the establishment of the CAFC in 1982, as pointed out by (Henry and Turner (2006) and Han (2018)). The establishment of the CAFC significantly

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<sup>7</sup>This is the definition of basic research in the Survey of Industrial Research and Development (SIRD).

lowered the regional invalidation rates and made them more uniform. So, regions with a higher invalidation rate before the CAFC experienced a larger increase in the strength of patent protection. Using a difference-in-difference (DiD) approach, it is found that firms in regions with a higher pre-CAFC invalidation rate decreased production scope more. Using a triple difference (DDD) approach with firm sizes being another dimension of the difference, it is found that small firms in regions with a higher pre-CAFC invalidation rate increased R&D intensity more, while large firms decreased it more. Furthermore, genetic engineering and software were two of the most controversial fields of patentability in the 1970s. However, shortly before the establishment of the CAFC, the Supreme Court approved patentability in these two fields in two landmark cases, setting precedents for future cases. Therefore, these two fields experienced the most increase in patent protection strength and consistency in regional decisions. The share of firms' employment in these two fields before 1982 is used as a proxy for the exposure to the change in patent protection. With a Triple-Difference (DDD) approach, a finding is that firms with higher exposure were more likely to shrink production scope. These empirical results provide evidence of causality from the patent reforms to the two specialization patterns.

## **Related Literature**

This paper is closely related to the literature on the impacts of patent trading and intellectual property rights (IPR) protection. The structural model in this study is based upon [Akcigit, Celik and Greenwood \(2016\)](#), which analyzes how the propinquity between the technology class of a firm's new patent and its past patents affects the value of the new patent to the firm and how a patent trading market shortens the propinquity. This paper extends this work in a variety of directions to address the newly observed specialization patterns. First, the paper introduces (endogenous) production scope and highlights that mismatches between innovation and production are critical to firms' boundary choices. The interaction between innovation and production scope decisions is new to the literature. Second, the paper introduces heterogeneity in firm production ability (reflected by size), which matters for the impact of patent trading. Production ability affects the expected value the firm can extract from new ideas through production and determines whether a firm benefits more from buying or selling patents. Third, the paper links patent trading to a wide range of changes in the 1980s and 1990s, e.g., production scope, reallocation and targeting behaviors of R&D. These linkages are novel. Other literature about the trading of knowledge ([Eaton and Kortum \(1996\)](#), [Perla, Tonetti and Waugh \(2021\)](#)) studies the impact of technology adoption on firms' innovation and growth but not on firms' boundaries. Most discussions about the influence of IPR protection focus on the trade-



off between innovation incentives and inventors' monopoly power ([Mukoyama \(2003\)](#), [Acemoglu and Akcigit \(2012\)](#)). Some empirical studies suggest that the strength of the patent system facilitates the disintegration of the innovation industries by allowing trade in knowledge ([Arora and Ceccagnoli \(2006\)](#), [Gans, Hsu and Stern \(2008\)](#), [Han, Liu and Tian \(2020\)](#)).<sup>8</sup> However, as mentioned by [Hall and Harhoff \(2012\)](#), research in this area is still limited. There are few systematic theoretical and quantitative analyses about the role of IPR protection in firms' specialization decisions.

Theoretically, this paper contributes to the specialization literature by incorporating a new form of friction that determines firm boundaries between innovation and production. According to [Coase \(1937\)](#), a comparison between market transaction costs and firms' internal organization costs determines the scope of a firm. The literature about specialization has studied various forms of external and internal costs. [Williamson \(1985\)](#) considers problems of incomplete contracts. [Grossman and Hart \(1986\)](#) and [Costinot, Oldenski and Rauch \(2011\)](#) emphasize the role of contractual frictions in determining firms' boundary.<sup>9</sup> [Atalay, Hortaçsu and Syverson \(2014\)](#) studies the determinants and effect of vertical integration and diversification. [Grossman and Helpman \(2002\)](#), [Boehm and Oberfield \(2020\)](#), and [Bostanci \(2021\)](#) discuss factors that affects firms' outsourcing decisions. Some papers ([Chiu, Meh and Wright \(2017\)](#), [Baslandze \(2016\)](#), [Han \(2018\)](#)) focus on frictions in the innovating sectors, but none of these papers considers how mismatches between innovation and production affect specialization.

Empirically, this research is related to the recent debates about US business dynamism. [Hsieh and Rossi-Hansberg \(2019\)](#) find that the gap between the number of industries of a top firm and that of an average firm is smaller in 2013 compared to 1977. They explain these changes by introducing a new technology that raises the fixed costs but lowers the marginal costs of production in the service industry. Related arguments about technological changes are in [Aghion et al. \(2019\)](#), [De Ridder \(2019\)](#) and [Autor et al. \(2020\)](#). Inspired by their research, the current study explores the specialization patterns more thoroughly by looking at the number of industries per firm for all years from 1978 to 2016. Findings are that all firms experienced a drop in the number of industries, and this drop was mostly driven by firms that performed R&D activities. The quantitative analysis of this paper supports the roles of both the increased tradability of intellectual properties and the change in the production cost structure. Besides, the observation of scope shrinkage with nearly constant average employment among the US firms in the 1980s and 1990s complements the findings that the aggregate concentration of the US firms was stable ([White](#)

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<sup>8</sup>A summary of the relationship between patents and innovation can be found in [Moser \(2013\)](#).

<sup>9</sup>A summary of the literature on firms' boundary can be found in [Holmstrom and Roberts \(1998\)](#).

(2002)), but the within-industry concentration increased ([Autor et al. \(2020\)](#)).

This paper is also related to papers about growth slowdown after the 2000s (e.g., [Ak-cigit and Ates \(2019\)](#) and [Olmstead-Rumsey \(2019\)](#)) by explaining why there was high growth in the 1980s and 1990s. Consistent with a series of counterbalancing patent policies after 1999, the specialization patterns found in this paper also stabilized or reversed after the 2000s.<sup>10</sup> This may suggest that patent protection policies in the 1980s and 1990s were good for economic growth.

The rest of the paper is organized as follows. Section 2 presents the specialization patterns. Section 3 introduces the pro-patent policies. Section 4 shows evidence of a rising patent trading market and a declining matching rate between firms' innovations and production scope. Section 5 constructs an endogenous growth model with potential mismatches between innovation and production. Section 6 calibrates the model and evaluates the contribution of each possible explanation. Section 7 extends the model to include basic and applied research. Section 8 shows evidence of causality from the patent reforms to the specialization patterns. Section 9 concludes.

## 2 Specialization Patterns

This section exhibits the trends of production scope and R&D activities of US firms. The datasets involved are the Longitudinal Business Database (LBD) constructed by the US Census Bureau;<sup>11</sup> the Survey of Industrial Research and Development (SIRD) collected by the US Census Bureau and the National Science Foundation (NSF); the Patent Data Project (PDP) collected and cleaned by the NBER; the Compustat Historical Segments and Fundamentals Annual.

The LBD covers the universe of business establishments with paid employees in the U.S. It has a consistent 6-digit NAICS code constructed by [Fort, Klimek et al. \(2016\)](#) for each establishment and each year. This study uses the firm ID variable that identifies the ownership of each establishment to aggregate the number of the 6-digit NAICS codes of each firm and defines it as the production scope of a firm. Information about firms' patenting activities comes from the PDP. It records all patents issued by the U.S. Patent and Trademark Office from 1976 to 2006. A firm is classified as an innovating firm if it

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<sup>10</sup>For example, the American Inventor Protection Act in 1999 required patent applications to be made public 18 months after being filed, regardless of whether patents were granted. This increased the risk of patent infringement. In 2006, Justice Kennedy of the US Supreme Court cast aspersions on business method patents, and the attitudes of the court system towards those patents became negative afterward.

<sup>11</sup>Description of this dataset can be found in [Jarmin and Miranda \(2002\)](#).



has ever been granted a patent between 1976 and 2006.<sup>12</sup> The SIRD provides R&D information of a nationally representative sample of for-profit R&D-performing firms. Using the sample weights in the survey, the Census Bureau and the NSF calculate countrywide statistics each year and publish them on the Industrial Research and Development Information System (IRIS). The Compustat datasets are used in robustness checks.

## 2.1 Production Scope

Since NAICS is constructed on a production-oriented framework and defines industries according to the similarity in the technology used to produce goods and services, the production scope captures the number of technologies a firm uses in production.<sup>13</sup> Figure 1 shows the average production scope of US firms with paid employees from 1978 to 2006 by whether they have ever issued a patent recorded by the PDP (innovating firms vs. others).<sup>14</sup> The scale for innovating firms is shown on the left y-axis, while the scale for other firms is shown on the right. Innovating firms produced in 3.07 6-digit NAICS industries on average at the beginning of the 1980s. This number experienced a sharp decrease by one-third to around 2.05 at the end of 1990s and then rebounded slightly after 2000. Other firms' production scope also decreased, but to a much lesser extent.<sup>15</sup>

This paper does two checks. First, it looks at the trend of production scope with firm-size controlled and finds that innovating firms had a larger drop in scope than non-innovating firms of the same size.<sup>16</sup> Second, the paper deletes the auxiliary establishments (establishments that perform management and support services to other establishments) and repeats the exercises above. The results are very similar.<sup>17</sup>

## 2.2 Innovation Activities

Figure 2a shows the ratio of total R&D spending by large firms to total R&D spending by small and medium firms. Here, a firm is regarded as small or medium if it has no more

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<sup>12</sup>Although patenting is not the perfect measure of innovation activities, it is the best proxy in the data that covers all US firms.

<sup>13</sup>NAICS is not market-oriented and thus does not capture the number of products produced by the same technology. For more information about NAICS, see [https://www.census.gov/naics/reference\\_files\\_tools/2022\\_NAICS\\_Manual.pdf](https://www.census.gov/naics/reference_files_tools/2022_NAICS_Manual.pdf)

<sup>14</sup>The data point for the year 2002 is omitted because, in the version of the LBD data available to the author of this paper, there is a problem in the scope statistics in 2002. Economists from the Census Bureau confirm that the newest version does not have the problem.

<sup>15</sup>Note that the average number of establishments per firm increased in the same period. So, the decrease in the number of industries was not due to firms having fewer establishments.

<sup>16</sup>Section A.1 of the Appendix describes the methods and plots the trend in Figure 8.

<sup>17</sup>Figures of production scope after deleting auxiliary establishments are available upon request.

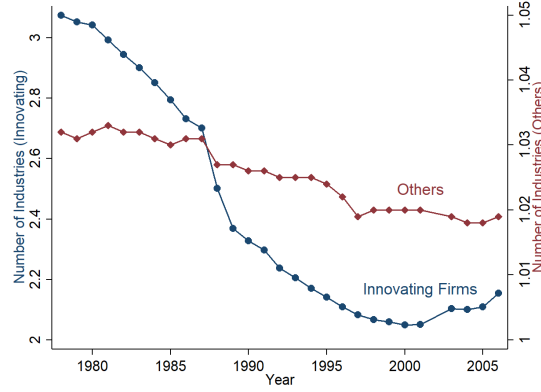


Figure 1: Trend of Production Scope by Innovating Activities

*Notes:* This figure shows the average number of 6-digit NAICS codes owned by US firms by year and innovating activities. The blue curve shows the trend for firms that have ever issued patents in the sample years; the red curve shows the trend of firms that have never issued patents.

*Sources:* Longitudinal Business Database (LBD); the Patent Data Project (PDP).

than 999 employees, while a large firm has at least 1000 employees. This ratio started to drop after the early 1980s and stabilized after 2000, indicating that US R&D activities have shifted from large to small and medium firms. To look at the intensive margin, Figure 2b displays the R&D intensity of US R&D performing firms by size. The R&D intensity is defined by the ratio of the aggregate R&D cost (excluding the federally funded part) of R&D performing firms to the net domestic sales of those firms. As shown in Figure 2b, the R&D expense-to-domestic sales ratio of small and medium firms started to surge after 1980, and the rising trend stopped after 2000.<sup>18</sup> In the same period, the ratio of large firms slightly decreased. These diverging trends suggest that small and medium firms became more focused on innovation, while large firms more focused on non-innovation activities. To address the potential misreporting problem of R&D expenses, this paper checks another measure—the ratio of the number of citation-weighted patents to the number of employees for large and small/medium firms with patents in the LBD. The trend is shown in Figure 9 of the Appendix A.2, and the implications are very similar. According to Baumol (2002) and Akcigit and Kerr (2018), small firms has a comparative advantage in creating new ideas, while large firms are better at exploiting values from innovations through production and commercialization. The two panels of Figure 2, therefore, suggest that firms spent more efforts on areas where they had comparative advantage.<sup>19</sup> This paper also looks at R&D intensity by firm age and finds that the diverging patterns are

<sup>18</sup>The increase in the R&D expense-to-domestic sales ratio was more salient for smaller firms (e.g., firms with less than 100 employees or less than 50 employees).

<sup>19</sup>In the following sections, this paper will call all the non-innovation activities as production. Therefore, production indicates all activities that are complementary to innovation.

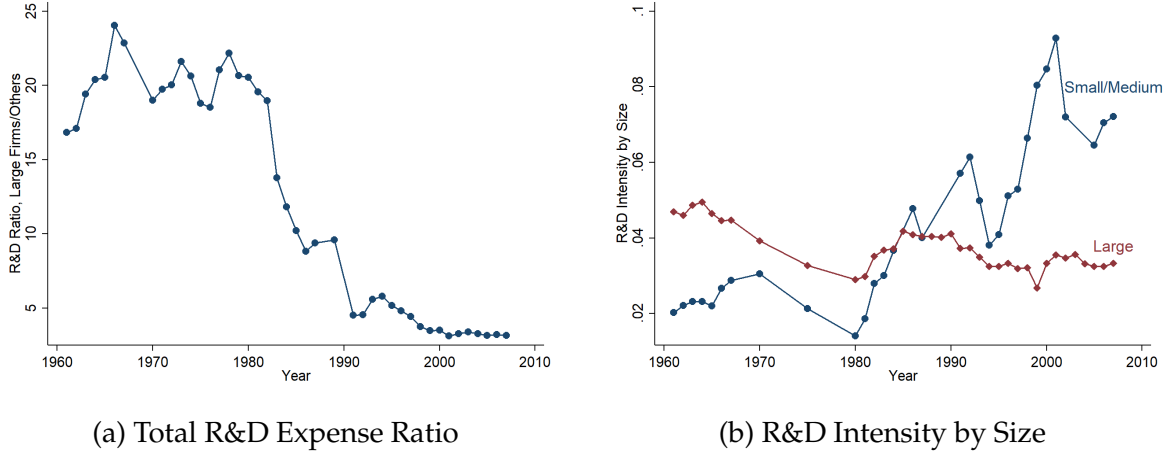


Figure 2: Trends of R&D Activities

*Notes:* This figure shows R&D spending by firm size. Panel (a) displays the ratio of total R&D spending by large firms to total R&D spending by small and medium firms. Panel (b) displays the R&D-spending-to-domestic-sales ratios by firm size.

*Source:* Survey of Industrial Research and Development (SIRD).

not as salient as the trends by size, showing that firm size is the main force behind the divergence in R&D intensity.

## 2.3 Robustness Checks

Several concerns arise over the specialization patterns generated by the Census data. First, the LBD only documents establishments located inside the US. The production scope shrinkage in Figure 1 may only reflect the increasing offshoring activities of US firms. Besides, patenting may not be the perfect measure of innovation activities. Second, the increase in R&D intensity of small firms may be the results of the exploding VC activities in the 1990s that invest heavily in small private firms. Third, the two specialization patterns may only concentrate in sectors where offshoring or VC activities are the most active. Therefore, the general specialization trends may be driven by the expansion of the specialized sectors.

To address these concerns, this paper checks the existence of specialization patterns in the Compustat data. The Compustat data covers all the publicly listed firms in the US, and therefore, is less affected by VC or other private equity investments. Its Historical Segments data documents both domestic and foreign industry segments reported by the firm in the SEC filing. Measuring production scope by counting the number of different industry segments take into account the firms' offshoring activities. The Compustat Annual Fundamentals records the R&D spending and sales of each firm, thus, provides a

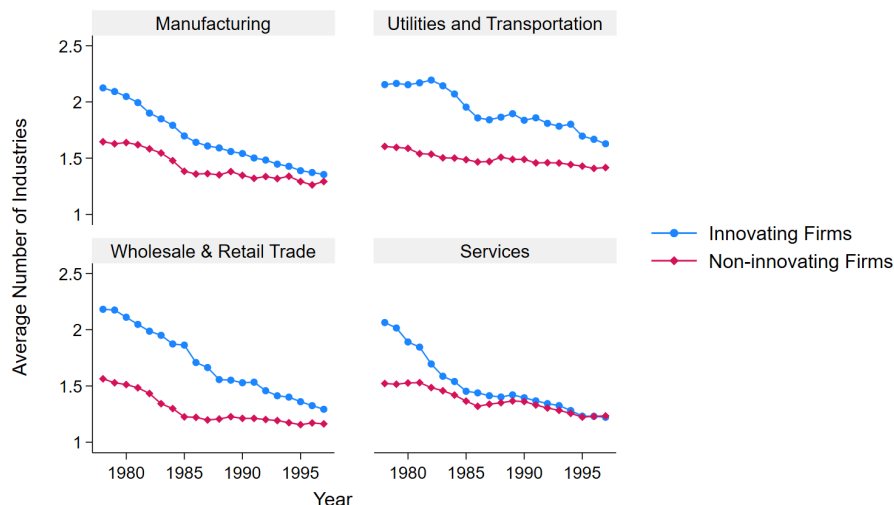


Figure 3: Trend of Production Scope by Innovating Activities and Industry

*Notes:* This figure shows the average number of 4-digit SIC codes owned by US public firms by year, the firm's main industry, and the firm's innovating activities. The blue curve shows the trend for firms that have positive R&D spending or have issued patents in the sample years; the red curve shows the trend of other firms.

*Sources:* Compustat Historical Segments; Compustat Fundamentals Annual.

direct measure of innovation activities.

Figure 3 shows the number of different industry segments of US public listed firms by the firms' main activities from 1978 to 1997. The industry segment is defined as the 4-digit SIC code of each segment, and the main activities of each firm is based on the firm's major SIC code in the Fundamentals Annual.<sup>20</sup> The innovating firms are defined as firms with positive R&D spending or patents granted in the sample period. The cutoff at 1997 is due to a significant change in segment reporting since that year. This figure indicates that the reduction in production scope is a general phenomenon for all major industries and is robust to offshoring activities. Still, it is driven mostly by innovating firms.

Figure 4 shows the R&D expense to firms' total sales ratio in the Compustat Fundamental Annual by firm size. The threshold for distinguishing small and large firms remains at 1000 employees. The sample includes all the innovating firms in the Compustat. These firms either have positive R&D spending or have issued patents in the sample period. This figure indicates that the shift of R&D from large to small firms is a general phenomenon for all major industries and is robust to private equity investment.

<sup>20</sup>The classification of the main industry is the same as in Autor et al. (2020) but combining retail and whole trade to be "Wholesale and Retail Trade," and combining finance and services to be "Services" to ensure sufficient number of observations.

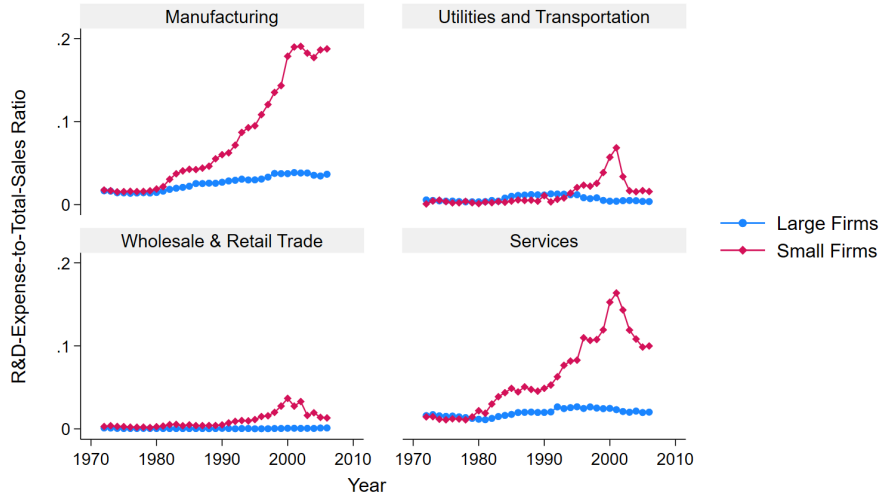


Figure 4: Trends of R&D Intensity by Firm Size and Industry

*Notes:* This figure shows the R&D expense to firms' total sales ratio in the Compustat Fundamentals Annual by year and the firm's main industry for innovating firms. The blue curve shows the trend for firms that have more than 1000 employees; the red curve shows the trend of other firms.

*Sources:* Compustat Fundamentals Annual.

### 3 Driving Forces

The two decades (the 1980s and 1990s) that witnessed the specialization wave described in the previous section also experienced important technological improvement and policy reforms in the United States. These changes have significantly affected the patent market.

#### 3.1 Technological Improvement

The rise of the information technology enabled the USPTO to transit from a paper search system to an automated search system for US patents and trademarks in the 1980s. According to the USPTO report, before the transition, a searcher needed to "look at the daily updated Patent Locator to identify the Patent Search Room stack location(s) of the respective class(es)/subclass(es)" and then "remove all the paper copies of the patents in a class/subclass to be searched from the stack location and take them to a desk and look through them."<sup>21</sup> The availability of an electronic system largely facilitated the search process. Since potential buyers in patent trading needs to attain sufficient information about the focal patent, the transition of the search system reduced the frictions in patent trade.

<sup>21</sup>The full version of the report, "Report to Congress on the Removal of Classified Paper From the USPTO's Public Search Facilities," can be found on the USPTO website.

## 3.2 Policy Reforms

In the 1970s, the innovation activities in the U.S. were thought to fall behind other industrialized countries ([Meador \(1992\)](#)), so a series of policies were adopted to stimulate innovation and boost economic growth. Besides introducing the R&D tax credits at the federal level in 1981, the US government adopted a series of pro-patent reforms starting at the beginning of the 1980s that strengthened the protection of intellectual property rights. The US legal environment towards patents became increasingly positive in the following two decades until some counterbalancing new policies came out at the end of the 1990s. This paper will describe two major pro-patent policies starting in the 1980s.<sup>22</sup>

**Extension of Patentability to Genetic Engineering and Software.** The US Supreme Court's decision in 1980 in the case between *Diamond* and *Chakrabarty* approved the patentability of genetically engineered bacteria. The 1981 decision in *Diamond v. Diehr* affirmed patent protection of software. Bioengineering and software became two heavily patented areas then. The overall patent applications and issuances both doubled between 1980 and 2000 after a long stable phase before 1980.

**Creation of the Court of Appeals for the Federal Circuit.** Before 1982, legal disputes of patents were heard at district courts or regional appellate courts, which did not have consistent enforcement of the patent law across regions. The establishment of the Court of Appeals for the Federal Circuit (CAFC) in 1982 provided centralized patent jurisdiction. More importantly, it largely decreased the patent invalidation rates in legal disputes ([Henry and Turner \(2006\)](#), [Han \(2018\)](#)). The fraction of lawsuits that invalidated the patents involved plummeted from around 55% to 28% after the change in the court system.<sup>23</sup> The legal disputes of patents usually arise because one party is not willing to pay for using the patents another party (the patent holder) created. The party that wants the patents then sues the patent holder by claiming its patents are invalid. The invalidation rates of the court therefore captures the probability that the plaintiff wins the case and uses the patent for free. A lower invalidation rate indicates the court has stronger protection toward the patent holders' benefit.<sup>24</sup>

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<sup>22</sup>A thorough description of the policy changes can be found in [Gallini \(2002\)](#).

<sup>23</sup>The full trend of the invalidation rates is shown by Figure 10a in Appendix A.3.

<sup>24</sup>The ratio of the number of patent-related circuit court decisions to the number of patents-in-force have remained constant since 1980 ([Marco et al. \(2015\)](#)), showing that there was no clear change in the propensity of litigation (through circuit court decisions) after the reform.



## 4 Trading of Innovations and Matching with Production

Following the technological and policy changes, the patent trading market experienced a rapid growth, a signal that innovations became more tradable. Combining the Patent Assignment Dataset (PAD) with the LBD,<sup>25</sup> this paper calculates the citation weighted fraction of patents granted to US firms in each year that have ever been traded through sales or merger & acquisitions (M&As).<sup>26</sup> M&As constituted around 10% of the total transactions and had very similar trends to patent sales. So, in this paper, M&As are treated the same as patent sales. As shown in Figure 5a, in the early 1980s, only about 30.9% of patents had been transacted. This fraction climbed to around 44.1% at the end of the 1990s and plateaued after 2000.<sup>27</sup> Besides patent transactions, patent licensing activities also ballooned after 1980, as indicated by the rising trends of licensing fees and royalties presented in [Arora and Gambardella \(2010\)](#). Therefore, the increase in patent transactions shown in Figure 5a should be viewed as a lower bound of the estimation for the increase in trading activities of innovations. Regarding who traded the patents, the main argument of this paper is consistent with the finding by [Akcigit and Ates \(2019\)](#) that a larger share of patents were traded from small firms to large firms.

Accompanied by a more vibrant patent trading market was a declining trend in the matching rate between patents' technology classes and their inventing firms' production scope. The matching rate is defined as the ratio of the (citation weighted) number of newly granted patents with technology classes matching their inventors' industry classes to the (citation weighted) number of all newly granted patents each year.<sup>28</sup> As shown in Figure 5b, in 1981, 3.8% of new patents fell inside of their inventing firms' production scope, while in 2000, the ratio decreased to 2.2%.<sup>29</sup> This trend implies that a firm's production has become less of a restriction to the usage of its innovations.<sup>30</sup>

The increased trading of innovations and decreased matching rate between a firm's innovation and production show that the market provides another channel for firms to monetize their R&D output.

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<sup>25</sup>The PAD is collected by the USPTO. It maintains as much as possible a complete history of claimed interests in a patent. [Marco et al. \(2015\)](#) has an introduction and shows various statistics of this dataset.

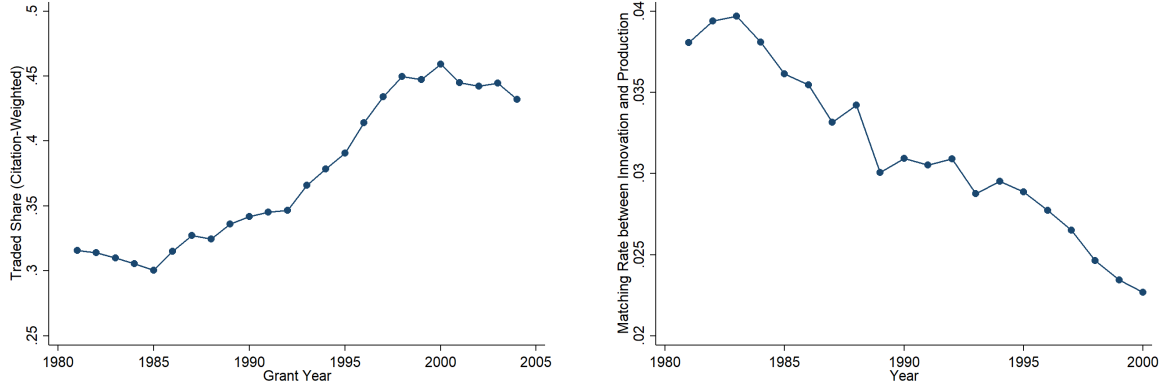
<sup>26</sup>The graph of the fraction not weighted by citations delivers very similar patterns.

<sup>27</sup>This rise was primarily due to increasing transactions at an early stage, as shown by Figure 10b in Appendix A.4. This is another evidence of increased patent trading efficiency.

<sup>28</sup>The definitions of the technology and industry classes are shown in Footnote 4.

<sup>29</sup>The unweighted ratio has the same trend and is available upon request.

<sup>30</sup>The decrease in the matching rate should not be due to changes in definitions of technology classes and industries over time versus the invariant concordance used. The concordance built by [Silverman \(2002\)](#) is based on the technology classes and industries in the early 1990s. So, if the invariant concordance used has any effect, we should predict the matching rate to be the highest in the early 1990s.



(a) Fraction of Patents Involved in Trading

(b) Trend of the Matching Rate

Figure 5: Trading of Innovations and Matching with Production

*Notes:* This figure shows supporting evidence for the new hypothesis. Panel (a) displays the share of patents issues in each year that has ever been traded through sales or M&A. Panel (b) displays the average likelihood that a firm's innovation output matches its production in each year.

*Source:* Patent Assignment Dataset (PAD); Longitudinal Business Database (LBD).

## 5 Model

To explore the driving forces of the observed specialization phenomena and their effects on economic growth, a model is constructed in this section. In the model, there are potential mismatches between a firm's innovations and its production. Firms endogenously choose their production scope, R&D intensity, and whether to buy or sell innovation output on the patent market. The patent market is subject to search frictions, the efficiency of which and the bargaining power between buyers and sellers depend on the legal environment towards patents. There are two types of production ability, which reflect firms' comparative advantage in innovation or production. Firms with a high production ability can extract higher value from new inventions through production and, on average, have larger size. Decisions of different types of firms are affected differently by patent trading, R&D tax credit rates, production cost structure, as well as the cost of new ideas.

### 5.1 Setup

There is a unit measure of firms in this economy, and each is exogenously and uniformly centered at a point on the industry circle shown in Figure 6. The industry circle contains all the industries in the economy and is assumed to have a radius of  $\frac{1}{2\pi}$ . At the beginning of each period, a firm chooses its production scope ( $\omega$ )—the set of industries in which it will produce goods and services. Figure 6 shows an example of a firm that is centered at

the top of the circle and chooses the arc  $\omega$  as its production scope.<sup>31</sup> The absolute value of  $\omega$ ,  $|\omega|$ , stands for the number of industries the firm produces in and will be used in the following analysis. As the model only focuses on the symmetric equilibrium, the location of the center turns out to be irrelevant to firms' decisions.

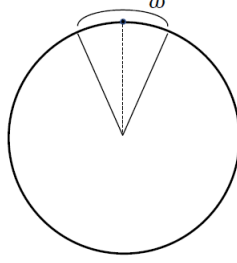


Figure 6: Schematic Diagram of the Industry Circle and Production Scope

A firm goes through two major stages of operation after the scope is determined: innovation and production.<sup>32</sup> The key assumptions of the model are twofold. First, the location of the innovation output cannot be entirely controlled by the firm, and therefore it may not necessarily fall inside the firm's production scope. Second, the firm cannot adjust its scope after the innovation stage and can only utilize the innovation output that matches its production scope. Between the two stages, firms can trade innovations on the patent market subject to a search and matching process. They can sell the innovation that is useless to them and buy patents that match their production scope. There are two exogenous changes in the search and matching process. (i) The matching efficiency increases. (ii) The buyers' value at the disagreement point decreases, which, as will be shown later, is equivalent to a rise in the bargaining power of the patent sellers.

Each firm in this economy is characterized by production ability ( $m$ ) and an innovation level ( $z$ ). The production ability has two statuses, high ( $m_H$ ) and low ( $m_L$ ). The transition of statuses across periods is subject to a Markov process,  $Q_{mm'} = \begin{bmatrix} q_{HH} & q_{HL} \\ q_{LH} & q_{LL} \end{bmatrix}$ . In the stationary distribution, the shares of firms that have high and low production ability are respectively  $\alpha_H$  and  $\alpha_L$ . The innovation level is updated in each period according to the law of motion,

$$z' = z + \gamma(\mathbb{1}_{(RD \in \omega)} + \mathbb{B})z, \quad (1)$$

<sup>31</sup>Whether the set of industries is connected is not assumed ex-ante, but will be solved from the model based on assumptions that will be unfolded later.

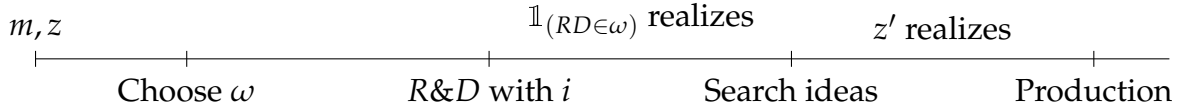
<sup>32</sup>The model can add a non-innovating sector whose productivity is dragged by the innovating sector, as what is done for the non-VC sector in [Greenwood, Han and Sanchez \(2022\)](#). The non-innovating sector captures firms that only adopt existing technology (they do not need to buy patents since most of the technology they use has passed the patent term.) The results in this paper will not change.

where  $\mathbb{1}_{(RD \in \omega)}$  is an indicator of whether the firm's innovation output falls inside of its production scope;  $\mathbb{B}$  is an indicator of whether the firm buys a patent that matches its scope. It is assumed that: (i) At most one idea can be implemented in each period, so  $\mathbb{1}_{(RD \in \omega)}$  and  $\mathbb{B}$  are exclusive. (ii) Regardless of a firm's production ability, an idea generates higher value to a firm if it falls inside of the firm's production scope compared to outside. This implies that whenever a firm has an in-scope innovation, the firm uses it in its own production.<sup>33</sup>  $\gamma$  is a constant lock-step growth of the innovation level.  $\mathbf{z}$  is the employment-weighted average innovation level of the economy, defined by,

$$\mathbf{z} = \frac{\int \int mzdF(m, z; \mathbf{z})}{\alpha_H m_H + \alpha_L m_L}, \quad (2)$$

where  $F(m, z; \mathbf{z})$  is the joint distribution of production ability and innovation levels among all firms at the end of the previous period.

The timing of events in each period is shown as follows:



A firm starts a period with the newly realized production ability ( $m$ ) and the innovation level ( $z$ ) inherited from the end of the previous period. The value of the firm at this stage is denoted as  $V(m, z; \mathbf{z})$ . The firm chooses the production scope  $\omega$  according to an increasing and convex management cost function in the number of industries,

$$C^e(\omega; \mathbf{z}) = \mu |\omega|^{1+\iota} \mathbf{z}^{\zeta/(\zeta+\lambda)} / (1 + \iota), \quad \iota > 0. \quad (3)$$

where  $\mu$  and  $\iota$  capture the shape of the cost function and are exogenous.  $\zeta$  and  $\lambda$  are respectively the profit and labor share in the production function, as will be shown later.

After the scope is chosen, the firm begins to do R&D. This innovation process has a success rate of  $i$ , which is endogenously determined by the firm and also subject to an increasing and convex cost function,

$$C^i(i; \mathbf{z}) = \chi i^{1+\rho} \mathbf{z}^{\zeta/(\zeta+\lambda)} / (1 + \rho), \quad \rho > 0. \quad (4)$$

<sup>33</sup>This is captured by a weak mathematic condition, shown in the proof of Proposition 5.1 in Appendix B.1. A more general setting that allows firms with an in-scope innovation to search on the patent market with the intention to sell is available upon request. Whether the firm decides to search depends on the production ability difference between the high- and low-type firms. Calibrating the more general setting with the same classification of high- and low-type firms as in Section 6.1 shows that firms with an in-scope innovation always use it and do not search.

where  $\chi$  and  $\rho$  capture the shape of the cost function and are exogenous. Both the management and innovation cost functions rise with the economy-wide innovation level,  $\mathbf{z}$ .

Whether the innovation process succeeds realizes then, together with the location of the output. The output is useful to the firm's own production only if it locates inside the scope. Firms that fail to innovate search on the patent market as potential buyers. At the same time, firms that successfully innovate, but the innovation output is useless, also search on the market, as both potential buyers and sellers. They want to sell the useless patent at hand and buy a patent that matches their production scope. It is assumed that each seller and buyer have one unit of search effort. Sellers spend their whole effort searching at the location of their patents; buyers evenly distribute their effort over their production scope. For any arc,  $d$ , on the industry circle, this paper denotes the total search effort on the arc by sellers and by buyers respectively as  $n_s(d)$  and  $n_b(d)$ . The total number of matches on the arc is subject to,

$$M(n_s(d), n_b(d)) = \phi n_s(d)^\nu n_b(d)^{1-\nu}, \quad (5)$$

where  $\phi$  represents the matching efficiency, which is subject to exogenous changes.  $\nu$  is the exponent. The odds of a successful match for a potential seller can be expressed as

$$s = \lim_{|d_0| \rightarrow 0} \phi \left( \frac{n_b(d_0)}{n_s(d_0)} \right)^{1-\nu}. \quad (6)$$

where  $d_0$  is the neighborhood that spans symmetrically around the location of the seller's patent. Since the model will only focus on the symmetric equilibrium, the location of the patent is not tracked. The odds of a successful match for a potential buyer depend on a function of the arc it searches over (its production scope,  $\omega$ ),

$$b(\omega) = \phi \left( \frac{n_s(\omega)}{n_b(\omega)} \right)^\nu. \quad (7)$$

Finally, the new innovation level of the firm realizes according to the law of motion in (1). At the production stage, a firm maximizes its overall profit by choosing capital and labor in each industry within its production scope. The production function exhibits decreasing return-to-scale with regard to capital and labor. The profit, capital, and labor shares sum up to 1 ( $\zeta + \eta + \lambda = 1$ ). Capital is hired at the rental rate  $\tilde{r}$ , and labor is hired at the wage rate  $w$ . It is assumed that goods in different industries are perfect substitutes and industries are symmetric. Denote the capital and labor in each industry as  $k$  and  $l$ .

The firm's optimization problem at the production stage is

$$\pi(\omega, m, z'; \mathbf{z}) = \max_{k, l} (mz')^{\frac{\eta}{\zeta}} (|\omega|k)^{\eta} (|\omega|l)^{\lambda} - \tilde{r}(|\omega|k) - w(|\omega|l). \quad (8)$$

The production function suggests that firms with a higher production ability ( $m$ ) get more profit at any given innovation level.

## 5.2 Consumer Preference

A representative household in this economy maximizes the lifetime utility,

$$\sum_{t=0}^{\infty} \beta^t \frac{c(t)^{1-\epsilon}}{1-\epsilon}.$$

where  $c(t)$  is consumption in period  $t$ ,  $\beta$  is the discount rate of the future, and  $\epsilon$  is the degree of risk aversion of the household. The household owns and rents capital to all the firms in this economy, which generates both a profit and a risk-free rate of capital return,  $\frac{1}{r}$ , in each period. The depreciation rate of capital is  $\delta$ . So, the rental rate of capital,  $\tilde{r}$ , is  $\frac{1}{r} - 1 + \delta$ . The household also provides one unit of labor to firms, from which it earns a wage rate  $w(t)$ . The government levies a lump-sum tax,  $T$ , on the household to sponsor the R&D subsidy.

## 5.3 Firm Decisions

This section solves firms' decisions in backward order. At the final production stage, the first-order condition derives

$$k(\omega, m, z'; \mathbf{z}) = \frac{mz'}{|\omega|} \left( \frac{\eta}{\tilde{r}} \right)^{1+\frac{\eta}{\zeta}} \left( \frac{\lambda}{w} \right)^{\frac{\lambda}{\zeta}}; \quad (9)$$

$$l(\omega, m, z'; \mathbf{z}) = \frac{mz'}{|\omega|} \left( \frac{\eta}{\tilde{r}} \right)^{\frac{\eta}{\zeta}} \left( \frac{\lambda}{w} \right)^{1+\frac{\lambda}{\zeta}}. \quad (10)$$

It is straightforward that the total amount of capital  $|\omega|k(\omega, m, z'; \mathbf{z})$  and the total amount of labor  $|\omega|l(\omega, m, z'; \mathbf{z})$  a firm hires do not depend on the production scope. So does the total profit, which equals to

$$\pi(m, z'; \mathbf{z}) = mz' (1 - \eta - \lambda) \left( \frac{\eta}{\tilde{r}} \right)^{\frac{\eta}{\zeta}} \left( \frac{\lambda}{w} \right)^{\frac{\lambda}{\zeta}}. \quad (11)$$



The independence of total input and output on the production scope implies that firms either span a wide range of industries but only touch on each of them, or focus on a narrow range of industries and deepen production in them. This independence is consistent with observations in the data, that US firms deepened production in fewer industries without changing much the total employment. The average employment of US firms was similar between the beginning of the 1980s and the end of the 1990s, even though the average number of industries was much lower at the latter period.<sup>34</sup>

The decision of R&D expenses is equivalent to determining the success rate ( $i$ ) of innovation, as there is a one-to-one mapping between the two. Denote the value of a firm before the R&D decision as  $D(\omega, m, z; \mathbf{z})$ , taking the production scope as given. Then,

$$\begin{aligned}
D(\omega, m, z; \mathbf{z}) = & \max_i \{ iX(\omega) \underbrace{[\pi(m, z'; \mathbf{z}) + r\mathbb{E}V(m', z'; \mathbf{z}')]_{\text{Innovate within } \omega}} \\
& + (1 - iX(\omega)) \underbrace{[b(\omega)(\pi(m, z'; \mathbf{z}) - p_b(m, z; \mathbf{z}) + r\mathbb{E}V(m', z'; \mathbf{z}'))]_{\text{Buy an idea within } \omega}} \\
& + (1 - iX(\omega)) \underbrace{[(1 - b(\omega))(\pi(m, z; \mathbf{z}) + r\mathbb{E}V(m', z; \mathbf{z}'))]_{\text{No idea within } \omega}} \\
& + i(1 - X(\omega)) \underbrace{sp_s}_{\text{Sell an idea}} - (1 - \sigma)C^i(i; \mathbf{z}) \}, \tag{12}
\end{aligned}$$

where the function  $X(\omega)$  is the probability that the firm's innovation output falls inside its production scope,  $\omega$ . It is assumed that (i) the closer an industry is to the firm's core business (center), the larger the probability the firm's inventions match that industry and generate value to the firm.<sup>35</sup> (ii)  $X(|\omega|) = \xi|\omega|^\psi$  with  $\xi > 0$  and  $0 < \psi < 1$  if  $\omega$  spans symmetrically around the firm's center.<sup>36</sup> In the following analysis,  $X(|\omega|)$  will denote the relationship between the within-scope probability and the length of the production arc, given that the arc is symmetric around the center.

$D(\omega, m, z; \mathbf{z})$  consists of five components, the first four of which describe the benefit of innovation in four different scenarios, while the last one of which is the innovation cost when the R&D tax credit rate equals to  $\sigma$ . The first scenario happens when the firm's innovation is successful, and the output falls within the firms' production scope. So, the probability of this scenario is  $iX(\omega)$ . The firm then updates its innovation level according

<sup>34</sup>To be more specific, the average employment of US firms first decreased in the 1980s and then rebounded in the 1990s. The levels at the start and the end were similar.

<sup>35</sup>This assumption is supported by the empirical findings in [Akcigit, Celik and Greenwood \(2016\)](#) that the propinquity between a patent's technology class and the firm's main line of business positively affects the value of the patent to the firm.

<sup>36</sup>As shown in Table 15 in Appendix D.2, the empirical estimation of  $X(|\omega|)$  confirms this assumption.

to the law of motion described in (1).  $\pi(m, z'; \mathbf{z})$  is the profit in the current period with the updated innovation level ( $z'$ ).  $rEV(m', z'; \mathbf{z}')$  is the discounted future value of the firm at the beginning of the next period. The second and third scenarios happen when the firm does not develop useful innovation output through its own R&D process, either because the innovation fails or because the innovation output does not match the firm's production scope. The firm then searches on the patent market as a potential buyer. With probability  $b(\omega)$ , the firm matches with a patent seller. It buys the patent at a price  $p_b(m, z; \mathbf{z})$  and updates its innovation level with the patent, as captured by the second scenario. With probability,  $1 - b(\omega)$ , the firm cannot find a seller, and therefore, its innovation level is not updated, as captured by the third scenario. The fourth scenario happens when the firm's R&D process succeeds, but the output falls outside the firm's own production scope. In this case, the firm searches on the patent market as a potential seller. With probability  $s$ , the firm matches with a buyer and sells its innovation output at a selling price denoted as  $p_s$ . The model assumes that the patent expires in one period. So, the firm that does not sell its patent in the current period have to dump it and earn nothing from its innovation.

The determination of the buying price of a patent, also the transaction price, is through Nash bargaining, which can be described as follows,

$$p_b(m, z; \mathbf{z}) = \arg \max_{p_b} p_b^\theta [\pi(m, z'; \mathbf{z}) + rEV(m', z'; \mathbf{z}') - p_b - (\pi(m, z; \mathbf{z}) + rEV(m', z; \mathbf{z}'))]^{1-\theta}. \quad (13)$$

The buyer and seller choose the transaction price ( $p_b$ ) to maximize the product of their surplus. The surplus of the seller is simply the price, as the seller will earn nothing if the patent is not sold. The surplus of the buyer is the difference between the firm value with the updated innovation level minus the payment and the value with the original innovation level.  $\theta$  denotes the bargaining power of the seller in the transaction. Note that the surplus of the buyer depends on the buyer's type, and therefore, so does the transaction price.

At the R&D stage, firms do not know what type of buyers they will meet if they have a useless innovation to themselves and want to sell it on the market. So,  $p_s$  should be the expected price in transactions with all potential buyers. The distribution of types of potential buyers on the market is denoted as  $G(m, z; \mathbf{z}')$  and will be determined endogenously in the equilibrium. The selling price can be expressed as

$$p_s(\mathbf{z}) = \int \int p_b(m, z; \mathbf{z}) dG(m, z; \mathbf{z}). \quad (14)$$

The decision of the production scope at the beginning of each period is based on the tradeoff between the benefit and cost. The production scope, on the one hand, affects the ability that a firm monetizes its innovation output, and on the other hand, determines the management difficulty. The optimal scope solves,

$$V(m, z; \mathbf{z}) = \max_{\omega} D(\omega, m, z; \mathbf{z}) - C^e(\omega; \mathbf{z}), \quad (15)$$

where  $C^e(\omega; \mathbf{z})$  is the management cost function as introduced in the model setup.

The government budget constraint can be expressed as the following,

$$T = \sigma \int \int C^i(i(\omega(m, z; \mathbf{z}), m, z; \mathbf{z}); \mathbf{z})) dF(m, z; \mathbf{z}). \quad (16)$$

## 5.4 Equilibrium

This paper focuses on a symmetric-balanced-growth-path (SBGP) equilibrium, where the employment-weighted average growth rate of the innovation level in the economy and the ratio of the average innovation level of firms with high production ability to that of firms with low production ability are constants. The variables in this equilibrium can be expressed as functions of the model parameters and are displayed in the following proposition. The proof is unfolded in Appendix B.1.

**Proposition 5.1** (Symmetric Balanced Growth Path). *There exists a symmetric balanced growth path of the following form:*

1. *The employment-weighted growth rate of the aggregate innovation level,  $g$ , and the ratio of the average innovation level of firms with high production ability to that of firms with low production ability,  $o$ , defined respectively by*

$$g = \frac{\int \int m' z'' dF(m', z') / \int \int m' dF(m', z')}{\int \int m z' dF(m, z) / \int \int m dF(m, z)}; \quad o = \frac{\int z' dF(m, z)|_{m=m_H}}{\int z' dF(m, z)|_{m=m_L}},$$

*are constants.*

2. *The interest factor  $r = \beta / g^{\epsilon \zeta / (\zeta + \lambda)}$ ; the rental rate on capital  $\tilde{r} = g^{\epsilon \zeta / (\zeta + \lambda)} / \beta - 1 + \delta$ .*
3. *The odds of a successful match for a potential buyer,  $b(\omega)$ , and for a potential seller,  $s$ , only depend on the total number of patent buyers and sellers, i.e.,  $b(\omega) = \phi(\frac{n_s}{n_b})^\nu$ ,  $s = \phi(\frac{n_b}{n_s})^{1-\nu}$ .*
4. *The production scope of each firm spans symmetrically around the center, and the length of the scope depends only on the production ability of the firm, i.e.,  $|\omega(m, z; \mathbf{z})| = \Omega(m)$ .*
5. *The R&D success rate does not depend on the firm's innovation level,  $z$ , or the economy-wide innovation level,  $\mathbf{z}$ , i.e.,  $i(\omega, m, z; \mathbf{z}) = i(\omega, m)$ .*

6. The government budget constraint is,

$$T = \sigma(\alpha_H C^i(i(\Omega(m_H), m_H)) + \alpha_L C^i(i(\Omega(m_L), m_L))).$$

7. The value function  $V(m, z; \mathbf{z})$  is linear in  $\tilde{z}$  and  $\tilde{\mathbf{z}}$ , i.e.,  $V(m, z; \mathbf{z}) = v_1(m)\tilde{z} + v_2(m)\tilde{\mathbf{z}}$ , where  $\tilde{z} = z/\mathbf{z}^{\lambda/(\zeta+\lambda)}$ ,  $\tilde{\mathbf{z}} = \mathbf{z}^{\zeta/(\zeta+\lambda)}$ .

8. The number of buyers of both types ( $n_{bH}$ ,  $n_{bL}$ ) and the number of sellers ( $n_s$ ) are

$$n_{bH} = \alpha_H(1 - i^*(\omega^*(m_H), m_H)X(\omega^*(m_H))), \quad n_{bL} = \alpha_H(1 - i^*(\omega^*(m_L), m_L)X(\omega^*(m_L)));$$

$$n_s = \alpha_H i^*(\omega^*(m_H), m_H)(1 - X(\omega^*(m_H))) + \alpha_L i^*(\omega^*(m_L), m_L)(1 - X(\omega^*(m_L))).$$

9. The buying price and the expected selling price of a patent is

$$p_b(m, z; \mathbf{z}) = \theta(Am + \frac{r}{g^{\lambda/(\lambda+\zeta)}}\mathbb{E}[v_1(m')|m])\gamma\tilde{\mathbf{z}};$$

$$p_s(\mathbf{z}) = \frac{n_{bH}}{n_b}p_b(m_H, z; \mathbf{z}) + \frac{n_{bL}}{n_b}p_b(m_L, z; \mathbf{z}),$$

where  $A$  is a constant.

The intuition of the matching rate of a potential buyer only depending on the total number of buyers and sellers is that firms are endowed with the same unit of search effort and have to dilute their effort at each point of the arc they search over. Therefore, although firms with different production scope have different chances of getting an in-scope idea if their innovation succeeds, they have equal opportunities to get an idea on the market. Besides, the matching rate of a potential seller is also the same for all firms, as on each point of the industry circle, there are equal number of buyers and sellers.

The R&D success rate does not rely on individual and aggregate innovation levels because both the benefit and the cost of R&D depend only on the aggregate innovation level of the economy and the aggregate level cancels out in the calculation. The irrelevance of the R&D success rate with the innovation levels results in the production scope only relying on firms' production ability.

## 5.5 Relevant Parameters for Specialization

According to the analysis in the previous section, changes in the patent trading environment, the R&D tax credit rate, the production cost structure, and the difficulty in finding good ideas may be potential reasons for the observed specialization patterns. Parameters in the model that correspond to these changes are listed here.

The matching efficiency of the patent market,  $\phi$ , reflects information frictions in the trading process. Technologies that reduce the search cost and policies that make inventions more visible on the market are predicted to raise the matching efficiency. The bargaining power of patent sellers,  $\theta$ , reflecting protection towards patent holders, directly correlates with the invalidation rate of patents. As shown in Section 3, the invalidation rate captures the probability that a buyer gets a patent for free from a seller through legal disputes, which affects the value of the buyer at the disagreement point. Denote the invalidation rate as  $f$ , then the actual Nash bargaining problem becomes

$$p_b(m, z; \mathbf{z}) = \arg \max_{p_b} p_b^\theta \{ \pi(m, z'; \mathbf{z}) + rEV(m', z'; \mathbf{z}') - p_b - [f(\pi(m, z'; \mathbf{z}) + rEV(m', z'; \mathbf{z}')) + (1 - f)(\pi(m, z; \mathbf{z}) + rEV(m', z; \mathbf{z}'))] \}^{1-\theta}. \quad (17)$$

Upon disagreement, the buyer can sue the seller in court, and with probability  $f$ , it wins the case and can update its innovation level for free. The solution to this problem is  $\theta(1 - f)$  times the difference between the buyer's value with and without the updated innovation level.  $\theta(1 - f)$  can be viewed as the new bargaining power of the seller. Therefore, a lower invalidation rate is equivalent to higher sellers' bargaining power. A partial equilibrium analysis of the effect of  $\phi$  and  $\theta$  is in Appendix C.

The R&D tax credit is directly captured by  $\sigma$ . A higher fixed cost of entering new industries corresponds to a larger scale and elasticity parameters in the management cost function ( $\mu$  and  $\iota$  in equation (3)). As the production function at the final stage is DRS to total production factors, and the total factors are the product of the number of industries and factors in each industry, decreasing the number of industries raises the marginal benefit of scaling production in each industry. This indirectly captures the decreasing marginal cost of production in an industry after entry, as proposed in the previous literature. Finally, the difficulty of finding good ideas is captured by the step size of new inventions ( $\gamma$ ) and the parameters ( $\chi$  and  $\rho$ ) in the R&D cost function.

## 6 Quantitative Analysis

The main goal of this section is to quantify the relative importance of the key drivers of the specialization patterns and their effects on economic growth. In particular, this study focuses on the four possible explanations: increased tradability of innovations (through both higher trading efficiency and better patent protection), the rise in the R&D tax credit rate, changes in the production cost structure, and changes in the difficulty of finding ideas. The quantitative analysis is undertaken in the following steps. First, the parame-

ters in the model are set to fit data moments in the initial balanced growth path period, 1981-1985. This is the period of the paper search system used by the USPTO and the beginning of the policy reforms. Then, the relevant parameters as analyzed in Section 5.5 are changed to make the model fit the moments in the ending balanced growth path period, 1996-2000, with other parameters fixed in this process. This is the period when the electronic search system was widely used, occurring before the implementation of counterbalancing patent policies in the early 2000s. Untargeted moments are used to check the quality of the calibration. Finally, changes in firms' specialization decisions and the economic growth rate are decomposed into the contribution of each relevant explanation.

## 6.1 Calibration

There are eighteen parameters,  $\{\eta, \lambda, \epsilon, \beta, \delta, \alpha_H, \alpha_L, \chi, \sigma, m_H, m_L, v, \gamma, \rho, \theta, \mu, \iota, \phi\}$ , a transition matrix  $Q_{mm'}$ , and a function,  $X(\omega)$ , to be calibrated in the model. They are grouped into three categories. The first category comes from a priori information, as shown in Table 1. The capital and labor share ( $\eta$  and  $\lambda$ ) are set respectively to be 0.28 and 0.57 (1/3 and 2/3 multiplied by a return to scale factor of 0.85). The profit share ( $\zeta$ ) is then 15%, which is consistent with the discussion in [Guner, Ventura and Xu \(2008\)](#). The degree of risk aversion for households ( $\epsilon$ ) is taken to be 2, a standard value in the literature. The discount factor ( $\beta$ ) is set as 0.99, such that the interest rate of the model economy is 7.5%, a reasonable estimate for the early 1980s in the United States. The depreciation rate of capital ( $\delta$ ) is chosen to be 0.07, consistent with the US National Income and Product Accounts. The paper defines firms of high production ability as those at the top 10% of the production ability distribution; firms of low production ability as the rest. This division is to make the two types of firms respectively represent the large and small firms defined earlier. Among all innovating firms between 1981 and 2000, around 9.1% are large firms (firms with more than 1000 employees). 55.1% of large firms turned out to be of high production ability, while only 5.5% of small and medium firms have high production ability. Therefore, in the following analysis, firms of high and low production ability largely correspond to large and small firms. The scale parameter in the R&D cost function ( $\chi$ ) is normalized to be 1, which is irrelevant to the quantitative results, as the calibrated step size of innovation ( $\gamma$ ) will adjust to any changes in  $\chi$ . The R&D tax credit rate ( $\sigma$ ) is set at the effective level before 1980 as calculated by [Akcigit, Ates and Impullitti \(2018\)](#).

Parameters in the second category are pinned down by direct estimation from the data, as presented in Table 2. The sample used for estimation is all the firms in the Longitudinal Business Database (LBD) that have ever been granted a patent recorded in the



Table 1: Parameter Values from a Priori Information

Parameter	Description	Value	Identification
$\eta$	Capital Share	0.25	Guner et al. (2008)
$\lambda$	Labor Share	0.60	Guner et al. (2008)
$\epsilon$	CRRA Parameter	2.00	Standard
$\beta$	Discount Factor	0.99	Interest Rate
$\delta$	Depreciation Rate	0.07	NIPA
$\alpha_H$	Share of High Type	0.10	Imposed
$\alpha_L$	Share of Low Type	0.90	Imposed
$\chi$	R&D Cost, Scale	1.00	Normalization
$\sigma$	R&D Tax Credit Rate	0.05	Akcigit et al. (2018)

Notes: The division of firm types ( $\alpha_H, \alpha_L$ ) to a large extent overlaps the division of firm size in Figure 2.

Patent Data Project (PDP). Therefore, it is all the innovating firms. The sample spans from 1981 to 2000. Estimation of firms' production ability is based upon the solution of employment decisions in the model,  $l(m, z') = m z'[(\alpha_h m_h + \alpha_l m_l)z']^{-1}$ . By taking the natural logarithm of both sides, it can be shown that the logarithm of a firm's employment equals the summation of the logarithm of its production ability, the logarithm of the innovation level, and aggregate factors. This study uses the accumulated citation-weighted patent stock as a proxy for a firm's innovation level and uses the time and industry fixed effects as proxies for the aggregate factors. Then, the firm's production ability is backed out from the residual term of the regression,

$$\ln(emp_{ijt}) = \beta_1 \underbrace{\ln(patentstock_{ijt})}_{\ln(z')} + \beta_0 + u_t + v_j + \underbrace{residual_{ijt}}_{\ln(m)}. \quad (18)$$

The production ability of the high type ( $m_H$ ) and low type ( $m_L$ ) are respectively estimated by the average production ability of firms at the top 10% and bottom 90% of the sample distribution. The transition matrix of production ability ( $Q_{mm'}$ ) is derived from a maximum likelihood estimation.

The elasticity parameter ( $v$ ) in the matching function is estimated by running panel regressions of the number of patent transactions on the number of potential sellers and potential buyers in different layers of industries (i.e., different numbers of digits of the NAICS code). Taking the natural logarithm of both sides of the matching function derives

$$\ln(match\_num_{jt}) = \alpha_0 + v \ln(seller\_num_{jt}) + (1 - v) \ln(buyer\_num_{jt}) + u_t + v_j + e_{jt},$$

where  $seller\_num$  is the number of firms whose patent has a technology class that does not match any of the firm's 6-digit NAICS industries.  $buyer\_sum$  is the number of firms

Table 2: Parameter Values from Direct Estimations

Parameter	Description	Value	Identification
$m_H$	Prod. Ability of High Type	24.43	Regression
$m_L$	Prod. Ability of Low Type	0.70	Regression
$Q_{mm'}$	Type Transition Matrix	$\begin{bmatrix} 0.872 & 0.128 \\ 0.017 & 0.983 \end{bmatrix}$	MLE
$\nu$	Matching Function, Exponent	0.70	Regression
$X(\omega)$	Within-scope Probability	$e^{-4.443} *  \omega ^{0.7643}$	Regression

Notes: The transition matrix reported is rounded to three decimal points to comply with the Census disclosure requirement.

that do not have an in-scope patent.<sup>37</sup> Whether the technology class of a patent matches the firm's industries is based on the concordance developed by Silverman (2002).<sup>38</sup> The results are shown in Table 14 in Appendix D.1. The value of  $\nu$  is taken to be the average of the estimates.

The within-scope probability function ( $X(\omega)$ ) is estimated as follows. Since it is optimal for firms to produce in industries close to its main line of business (center), this paper assumes all firms do so and only estimates the relationship between a patent's within-scope probability and the number of industries of its inventor. The function form is assumed to be  $X(|\omega|) = \zeta|\omega|^\psi$ . This paper groups firms with patents in the LBD by the number of industries and regress the logarithm of the average fraction of patents that match their firms' production scope in each group on the logarithm of the industry number.  $\zeta$  and  $\psi$  are estimated to be  $e^{-4.443}$  and 0.7643.<sup>39</sup>

The third group of parameters is disciplined by minimizing the sum of squares of the distance between key moments in the data and the model-predicted values jointly in the initial balanced growth path (1981-1985). The economic growth rate, after removing the cyclical components through the HP filter, is primarily affected by the step size of growth driven by innovations ( $\gamma$ ). The R&D cost-to-domestic sales ratio of innovating firms with high and low production ability are informative of both the elasticity of the R&D cost function ( $1 + \rho$ ) and the bargaining power of sellers on the patent transaction market ( $\theta$ ). The average industry numbers of innovating firms with high and low production ability are directly determined by the scale ( $\mu$ ) and elasticity ( $1 + \iota$ ) parameters in the management cost function. They are also indirectly influenced by sellers' bargaining power ( $\theta$ ).

<sup>37</sup>The potential buyers may also include non-innovating firms. Including them in the regression will not change the results much.

<sup>38</sup>Silverman's concordance links the International Patent Classification (IPC) system to the U.S. Standard Industrial Classification (SIC) system. This study further links the SIC with the North American Industry Classification System (NAICS).

<sup>39</sup>The full regression results are shown in Table 15 of Appendix D.2.

Table 3: Parameter Values from the Minimum Distance Estimation

Parameter	Description	Value	Identification
$\gamma$	Step Size of Innovation	1.72	Growth Rate
$1 + \rho$	R&D Cost Elasticity	1.79	R&D Cost/Sales
$\theta$	Bargaining Power	0.16	Ratio (H and L)
$\mu$	Management Cost, Scale	1.5E-4	Avg. Number of
$1 + \iota$	Management Cost, Elasticity	3.31	Industries (H and L)
$\phi$	Matching Function, Scale	0.19	Patent Traded Share

*Notes:* Parameters in this table are jointly calibrated to minimize the distance between the model and data moments in the initial balanced growth path (1981-1985).

The share of patents ever transacted is closely linked with the scale parameter ( $\phi$ ) in the matching function. The estimated values of the relevant parameters are shown in Table 3. It is worth noting that both the R&D cost and management cost functions are convex, as assumed by the model, although no restrictions are imposed in the estimation process. The model predicted moments are almost the same as in the data, as shown by Table 4, attesting that the model fits the initial balanced growth path well.

Table 4: Model Fit for Key Moments in the Initial Balanced Growth Path

Targets	Data	Model
Economic Growth Rate (1981-1985)	3.05%	3.05%
R&D Cost/Sales of H Firms (1981-1985)	3.62%	3.62%
R&D Cost/Sales of L Firms (1981-1985)	2.83%	2.83%
Avg. Number of Industries of H Firms (1981-1985)	11.81	11.81
Avg. Number of Industries of L Firms (1981-1985)	1.92	1.92
The Share of Patents Transacted (1981-1985)	30.9%	30.9%

*Notes:* The model and data moments in the initial balanced growth path are almost the same, showing the model fits the data well.

## 6.2 Recalibration to the Ending Balanced Growth Path

As pointed out in Section 5.5, the set of parameters,  $\{\phi, \theta, \sigma, \mu, \iota, \gamma, \rho\}$ , corresponds to the possible explanations for the specialization patterns. To match the ending balanced growth path, this paper sets the new R&D tax credit rate as the actual effective rate, 24%, in the 1990s. Other parameters in this set are recalibrated to make the model fit the economic growth rate, the R&D cost-to-domestic sales ratio, the average industry numbers of innovating firms with high and low production ability, and the fraction of patents ever transacted in 1996-2000. The value of parameters out of this set is fixed in the recalibration process. The performance is displayed in Table 5, showing a good match between

Table 5: Model Fit for Key Moments in the Ending Balanced Growth Path

Targets	Data	Model
Economic Growth Rate (1996-2000)	3.34%	3.34%
R&D Cost/Sales of H Firms (1996-2000)	3.15%	3.15%
R&D Cost/Sales of L Firms (1996-2000)	6.71%	6.71%
Avg. Number of Industries of H Firms (1996-2000)	6.31	6.31
Avg. Number of Industries of L Firms (1996-2000)	1.61	1.61
The Share of Patents Transacted (1996-2000)	44.1%	44.1%

*Notes:* The model and data moments in the ending balanced growth path are almost the same, showing the model fits the data well.

Table 6: Model Fit for Untargeted Moments

Moments	Data	Model
Within-scope Prob. of H Firms (1981-1985)	6.65%	7.76%
Within-scope Prob. of L Firms (1981-1985)	2.92%	1.94%
Within-scope Prob. of H Firms (1996-2000)	3.79%	4.81%
Within-scope Prob. of L Firms (1996-2000)	2.25%	1.69%
Ratio of Bargaining Power	1.60	1.53

*Notes:* The model successfully captures the trend and magnitude of the within-scope probability of innovations for the two types of firms. The ratio of bargaining power implied by the model is close to the actual value. These moments are not targeted in calibration.

the model and data.

### 6.3 Untargeted Moments

To further check the quality of the calibration, this paper compares the model-predicted values with the real values of some untargeted moments. First, the within-scope probabilities for the two types of firms in the model ( $X(\omega_H)$  and  $X(\omega_L)$ ) are compared with the average matching rates between the firms' industry classes and their patents' technology classes. As shown in Table 6, they are very close in both periods. This suggests that parameters estimated from changes in production scope and innovation intensity successfully capture the declining matching rate between innovation and production. Second, the ratio of the sellers' bargaining power after the reform to the power before the reform is compared with the ratio of (1-patent invalidation rate) after the reform to the counterpart before the reform.<sup>40</sup> The underlying assumption is that nothing else that determines the bargaining power has changed over the period. As shown in Table 6, the ratio predicted by the model is close to the actual value.

<sup>40</sup>Section 5.5 shows a mapping between the sellers' bargaining power and 1-patent invalidation rate.

Table 7: Changes of Parameter Values

	Old BGP	New BGP	Interpretation
$\phi$	0.19	0.27	Matching efficiency increase
$\theta$	0.16	0.22	Sellers' bargaining power increase
$\mu$	1.5E-4	1.7E-4	Higher costs of large scope
$1 + \iota$	3.31	3.93	More DRS to scope
$\gamma$	1.72	1.73	Goods ideas rely more on
$1 + \rho$	1.79	1.56	R&D investment

*Notes:* This table compares the calibrated values of key parameters in the two balanced growth paths. The last column interprets the parameter value change between the two BGPs.

## 6.4 Changes in Key Parameter Values

Comparison between the initial and ending values of the parameters are displayed in Table 7. Although the direction of changes of these parameters is not restricted in the recalibration process, it turns out to be consistent with the original predictions. There is an increase in the matching efficiency,  $\phi$ , of the patent market and the bargaining power,  $\theta$ , of patent sellers, confirming decreasing market frictions and stronger protection towards patent holders. The scale and elasticity parameters in the management cost function ( $\mu$  and  $\iota$ ) are larger, implying that the cost of producing in multiple industries is higher. The very slight change in  $\gamma$  shows the value of a successful R&D output remains nearly the same, while the decrease in  $\rho$  suggests that the success rate of R&D relies more on investment, reflecting that the generation of good ideas is more investment intensive. <sup>41</sup>

## 6.5 Decomposition

To gauge the contribution of each possible explanation, this paper sets the parameters that govern each explanation at the ending balanced-growth-path value while others at the initial steady-state value. Hypothetical moments about specialization and economic growth are derived in each case. Then the paper compares the hypothetical moments with the moments in the initial balanced growth path. The difference between them measures the effect of each mechanism. The decomposition process uses the formula,

$$\frac{M_i(\Theta_{81-85}, \kappa_{96-00}) - M_i(\Theta_{81-85}, \kappa_{81-85})}{D_{i,96-00} - D_{i,81-85}}, \quad (19)$$

where  $M_i$  is the  $i$ th moment in the model and  $D_i$  is the corresponding value in the data.  $\kappa$  is the set of key parameters that correspond to each explanation.  $\Theta$  represents all pa-

<sup>41</sup>The elasticity of the R&D success rate with respect to investment can be expressed as  $\frac{1}{1+\rho}$ .

rameters in the model except for  $\kappa$ . This formula isolates the contributions of the key parameters.<sup>42</sup>

Table 8 presents the decomposition results. The first row displays the direction of changes in the data regarding the average production scope, the R&D intensity of firms with high and low production ability, the share of patents traded, and the economic growth rate. The direction of changes predicted jointly by higher matching efficiency and better patent protection, is consistent with the direction of all the real changes.<sup>43</sup> Quantitatively, the new hypothesis can jointly explain 25% of the decrease in production scope of innovating firms; 232% of the decrease in R&D intensity for firms with high production ability and 58% of the increase in R&D intensity for firms with low production ability. It is responsible for the bulk of (90%) the rise in the trading share of patents and 221% of the rise in economic growth. Since the annual economic growth rate increases by 0.29 percentage points between the two periods, changes in invention tradability lead to a 0.64 percentage points increase in growth. This study lists the respective contribution of the matching efficiency and sellers' bargaining power, finding that the former is the main driving force. The R&D tax credit has little explanatory power for the specialization patterns but significantly contributes to a higher growth rate. Most of the remaining part of specialization is explained by the change in the production cost structure, although it has little effect on the patent trading activities and contributes negatively to growth. Increased difficulty in finding good ideas contributes to a significant part of the decrease in firms' scope but is muted in explaining other dimensions of specialization. The subsections below will discuss the effects of each mechanism in detail.

### 6.5.1 Increased Tradability of Innovations

The effect of this mechanism on the specialization patterns is mostly driven by the rise in the matching efficiency of the patent trading market. Both the buyers and sellers get higher matching rates on the market. Higher chances of trading decrease R&D incentives for potential buyers while increase R&D incentives for potential sellers. Since firms with high production ability benefit more from buying patents on the market, the force that decreases R&D intensity dominates. Firms with low production ability benefit more from selling patents to other firms. Therefore, the force that increases R&D intensity dominates.

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<sup>42</sup>Another decomposition method sets the parameters that govern each explanation at the initial balanced-growth-path value while others at the ending steady-state value. The hypothetical moments constructed in this way are compared with the data moments in the initial balanced growth path. The decomposition results are similar and are available upon request.

<sup>43</sup>Starting from the second row, positive numbers mean the predicted change is consistent with the direction of the actual change; negative numbers mean otherwise.



Table 8: Effects of Key Parameters

	Prod. Scope	R&D(H)	R&D(L)	Patent Trade	Growth
Data	-	-	+	+	+
Patent Market ( $\phi, \theta$ )	25%	232%	58%	90%	221%
Efficiency ( $\phi$ )	26%	220%	15%	100%	151%
Bargaining Power ( $\theta$ )	-8%	11%	37%	-6%	45%
Tax Credit ( $\sigma$ )	7%	-265%	12%	-8%	137%
Production Cost ( $\mu, \iota$ )	63%	287%	25%	3%	-180%
Rare Good Ideas ( $\gamma, \rho$ )	43%	-273%	-32%	12%	-27%

*Notes:* The first row shows the actual direction of changes in the data. In the second to seventh rows, positive values indicate that the direction of changes due to the corresponding parameters is consistent with the actual direction.

The effect of the matching efficiency on production scope also has two sides. On the one hand, the trading channel makes the scope less critical in determining the value of a firm's innovation output, so there is a tendency to narrow the scope. On the other hand, the scope becomes more important if the firm increases R&D intensity due to the efficiency change. For firms with high production ability, the overall effect is unambiguous because they decrease R&D intensity. For firms with low production ability, as it turns out, the former force dominates. The fraction of patents traded is directly linked to the matching efficiency, therefore, explained to a large extent.

The contribution of higher bargaining power mainly lies in the increase in the R&D intensity of firms with low production ability. This is because higher bargaining power increases the transaction prices of patents. A higher price raises the value of both in-scope and out-of-scope innovation output and therefore increases R&D incentives. The slight decrease of R&D intensity of firms with high production ability is mainly due to a general-equilibrium effect.

Higher economic growth comes from two sources. First, fewer ideas are wasted as out-of-scope innovations can be utilized through trade. Second, innovation activities are reallocated to firms with a comparative advantage.

### 6.5.2 R&D Tax Subsidy

An increase in the R&D tax credit boosts the R&D intensity of both types of firms since the innovation cost is lower. The effect on firms with high production ability turns out to be more significant because these firms can better monetize innovation output through their own production. Higher R&D intensity has a strong positive effect on economic growth.

### 6.5.3 Changes in the Production Cost Structure

Changes in the production cost structure can mainly explain the remaining part of the specialization patterns. A higher cost of producing in multiple industries directly shrinks firms' production scope. Smaller production scope reduces the likelihood of matches between innovation and production, thus disincentivizing firms to do R&D. This explains the decline in high-type firms' R&D intensity. The slight increase in low-type firms' R&D intensity is mainly due to the general-equilibrium effect. This mechanism alone has minimal effects on patent trading activities. It negatively affects growth as mismatches between innovation and production increase, and more inventions are wasted.

### 6.5.4 Good Ideas are Harder to Find

As innovation becomes more investment intensive, there is a direct decrease in the incentive to do R&D. Then, successful R&D output becomes scarcer and more valuable. So, firms with higher production ability (the ones that benefit more from R&D output) invest more in innovation. This predicts a shift of R&D activities to firms good at production, contradictory to the trend in the 1980s and 1990s. The decrease in firms' production scope is mostly driven by a significant decrease in the scope of firms with low production ability. This is because those firms sharply reduce their R&D effort and get lower benefits from expanding production scope. The change in the R&D cost function contributes negatively to growth as idea generation is more costly than before.

## 7 Discussion and Extension

Quantification of the baseline model shows that increased tradability of innovations can explain a sizable share of the decrease in production scope and the reallocation of R&D activities. However, this new hypothesis may be subject to several challenges. First, the direction of causality is not clear. It is possible that the more vibrant patent trading activities are the result of narrower production scope of firms, i.e., firms produce in fewer industries due to changes in the cost structure and then have to depend on the market for monetizing innovation as it becomes harder to match innovation output with their own production. Second, the potential mismatch between innovation output and production may not play an important role. Intellectual products may be similar to other goods in the sense that the inventing process requires ingredients from other intellectual properties. Alleviation of the incomplete contract problem in the ingredient trading process may also lead to more patent transactions and shrinkage in production scope.

To check whether the new hypothesis holds in front of these challenges, this paper looks at changes in the targeting behaviors of firms' R&D activities. If the reverse causality is true, it should be predicted that R&D becomes more targeted as the firm spans fewer industries. If there is no mismatch between innovation and production, but only the incomplete contract problem in the ingredient trading process for new inventions, the targeting behaviors of innovation will increase with patent trade since firms no longer need to invent every ingredient. On the contrary, the new hypothesis in this study predicts the R&D activities to be less targeted, as the type of R&D that is less likely to match the firm's own production benefits more from the trade of intellectual properties.

## 7.1 Data Patterns

The targeting behavior of the innovation process can be measured by the expense shares of different R&D types—basic research, applied research, and development. They differ in the probability of being applied to a specific production process.<sup>44</sup> This study uses the ratio of basic research to basic plus applied research expenses (the red curve) and the ratio of basic research to total R&D expenses (the blue curve) as proxies for firms' targeting behaviors in R&D. A higher share implies less targeting and broader R&D scope. Figure 7 shows the two ratios over the years.<sup>45</sup> They both picked up at the beginning of the 1980s, and the rising trends continued in the following two decades—the same period when the patent market grew. The pattern of widening R&D scope in the 1980s and 1990s is also supported by [Akcigit and Ates \(2019\)](#), in which the authors use the average length of patent claims as a measurement of the R&D scope. This pattern suggests that the reverse causality and the ingredient trading theory are insufficient to address the newly found specialization wave.

## 7.2 Model Extension

The baseline model is extended to study the impact of the new hypothesis on firms' targeting behaviors in the innovation process. Now, firms choose the success rates (equivalent to expense) of two types of research at the innovation stage—(a)ppplied and (b)asic

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<sup>44</sup>In the Survey of Industrial Research and Development (SIRD), basic research is defined as "the activity aimed at acquiring new knowledge or understanding without specific immediate commercial application or use;" applied research is "the activity aimed at solving a specific problem or meeting a specific commercial objective;" development is "the systematic use of research and practical experience to produce new or significantly improved goods, services, or processes." Therefore, basic research has the broadest targets.

<sup>45</sup>Only data before 1998 is shown because statistics for 1998 and later years are not directly comparable to statistics for 1997 and earlier years, according to the statement made by the SIRD.

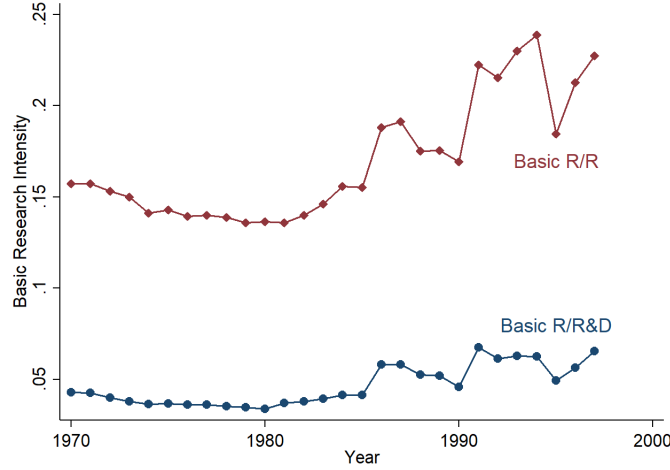


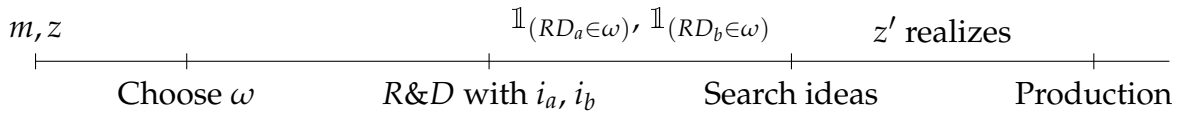
Figure 7: Share of Research Spending on Basic Research

research. The two types of research differ in three dimensions: (i) the scale and elasticity parameters in the R&D cost function. (i.e.,  $\chi^b \neq \chi^a$ ,  $\rho^b \neq \rho^a$ ), (ii) the probability of the innovation output falling inside the firm's own production scope (i.e.,  $X^b(\cdot) \neq X^a(\cdot)$ ), and (iii) the step size of successful inventions coming from basic research and from applied research (i.e.,  $\gamma^b \neq \gamma^a$ ). Each firm is endowed with two units of search effort—one for basic research output and the other for applied research output. The innovation level of a firm is updated in each period according to the following law of motion,

$$z' = z + \sum_{j \in \{a,b\}} \gamma^j (\mathbb{1}_{(RD \in \omega)}^j + \mathbb{B}^j) \mathbf{z}, \quad (20)$$

where  $\mathbb{1}_{(RD \in \omega)}^j$  is an indicator of whether the firm's type- $j$  (applied or basic) research output falls inside its production scope.  $\mathbb{B}^j$  is an indicator of whether the firm can buy a type- $j$  (applied or basic) patent that matches its scope.

The new timeline is shown as follows.



The following proposition holds. Characterization and proof of Proposition 7.1 are presented in Appendix B.2 and B.3.

**Proposition 7.1** (Symmetric Balanced Growth Path). *There exists a symmetric balanced growth path in the extended model.*

Table 9: Effects of Key Parameters

	Basic Research	Prod. Scope	R&D (H)	R&D (L)	Patent Trade	Growth
Data	+	-	-	+	+	+
Patent Market ( $\phi, \theta$ )	101%	29%	205%	55%	93%	227%
Efficiency ( $\phi$ )	26%	29%	194%	10%	102%	149%
Bargaining Power ( $\theta$ )	56%	-6%	7%	39%	-5%	51%
Tax Credit ( $\sigma$ )	32%	7%	-257%	12%	-6%	132%
Production Cost ( $\mu, \iota$ )	-17%	66%	223%	20%	2%	-155%
Harder Ideas ( $\{\gamma^j, \rho^j\}_{j \in \{a,b\}}$ )	-35%	23%	-168%	-17%	9%	-82%

### 7.3 Quantification of the Extended Model

Table 9 presents the explanatory power of the four mechanisms in the targeting behaviors of innovation and the other moments shown in the baseline calibration.<sup>46</sup> As shown by the first column, increased tradability of innovations is responsible for all (101%) of the increase in the share of basic research. The R&D tax credit also contributes to part of the increase. In contrast, changes in production cost structure make innovation more targeted. The reason is that as firms span fewer industries due to higher fixed costs, they also narrow R&D scope to improve matching between innovation and production. The increased difficulty of finding good ideas also leads to a contraction in R&D scope. The impacts of the mechanisms on other moments are very similar to the results in the baseline model, confirming the robustness of the previous conclusions.

In sum, the rise in the share of basic research spending provides evidence of the important role of potential mismatches between innovation and production in explaining the observed specialization wave.

## 8 Empirical Analysis

This section empirically tests whether there is causality from the pro-patent reform to the specialization patterns. The main idea is to exploit the regional and sector differences in the exposure to policy changes and check whether they lead to different extents of the drop in scope and reallocation of innovation and production.

<sup>46</sup>The calibration process of the extended model is shown in Appendix D.3.

Table 10: Patent Invalidation Rates in District Courts under Different Circuit Courts

Circuit Court	Invalidation rate		Circuit Court	Invalidation rate	
	Before	After		Before	After
Boston	0.64	0.18	Chicago	0.54	0.30
New York	0.58	0.28	St.Louis	0.49	0.33
Philadelphia	0.74	0.32	San Francisco	0.51	0.29
Richmond	0.47	0.26	Denver	0.27	0.22
New Orleans	0.36	0.20	Atlanta	0.41	0.28
Cincinnati	0.60	0.30	DC	0.59	—

*Notes:* A higher invalidate rate before the establishment of CAFC means a more negative attitude towards patent holders. The circuit court of DC has too few observations after the CAFC era, so the invalidation rate is omitted.

## 8.1 Institutional Background

The US federal court system has three main layers: district courts, circuit courts, and the Supreme Court of the United States. All patent-related cases are heard initially at one of the ninety-four district courts across the country. If there are challenges to the decisions, the case can be appealed to one of the circuit courts. Since the Supreme Court rarely hears patent-related cases, the circuit courts usually have the final say on those cases.

Before 1982, twelve circuit courts divided the country into different regions. Attitudes towards patents in the circuit courts had a significant discrepancy. Therefore, decisions of district courts under different circuit courts varied much in the first place. The second and fifth columns of Table 10 shows the fraction of lawsuits invalidating the involved patents in district courts of different regions from 1940 to September 1982. The legal environment towards patents was stable in this period.

In October 1982, Congress created the Court of Appeals for the Federal Circuit (CAFC). It has nationwide jurisdiction to hear appeals involving patent laws. So, decisions of district courts can be appealed to not only the twelve regional circuit courts but also the CAFC. The CAFC was more positive towards patents and had a much lower invalidation rate in its final decisions. Therefore, the decisions of district courts became lower and more uniform across different regions in the first place, as shown in the third and sixth columns of Table 10. Regions that had a higher patent invalidation rate before 1982 were more strongly affected by the CAFC.<sup>47</sup>

Precedents of court decisions in patent-related legal disputes often determine the patentability of similar objects afterward. Genetic engineering and software are two of the most controversial fields of patentability in the 1970s. In 1980, the Supreme Court

<sup>47</sup> Although there are forum shopping behaviors, firms are more likely to bring their lawsuits to the district court where they are located due to home-field advantage (Moore (2001)).

ruled in the case between Diamond and Chakrabarty that genetically engineered bacteria involved in the case could be patented. This ruling was viewed as a turning point for the biotechnology industry in the following decades. In 1981, the decision of the Supreme Court in the dispute between Diamond and Diehr that software was not precluded from patentability also had a profound impact on court decisions afterward. These two landmark cases happened just before the establishment of the CAFC, making these two used-to-be controversial fields experience the most reduction of inconsistency among different regions. This leads to another dimension of difference in firms' exposure to policy shocks.

## 8.2 Estimation Strategy

The following Difference-in-Difference (DiD) regression explores whether regional differences in the change of patent protection led to different extents of contraction in firms' production scope,

$$\ln(ind_{ist}) = \alpha_i + \beta * inval_{c,pre} * post_t + \gamma X_{ist} + \mu_t + \epsilon_{ist}, \quad (21)$$

where the dependent variable,  $ind_{ist}$ , is the number of 6-digit NAICS industries of the firm  $i$  in the LBD.  $s$  is the state of its headquarters before the year of the CAFC establishment. The headquarter is measured by the state where the firm has the most employment.  $t$  is the year of the observation. The main explanatory variable is an interaction between  $inval_{c,pre}$ , the patent invalidation rate of the circuit court,  $c$ , that the state,  $s$ , belongs to prior to the CAFC era, and a dummy variable,  $post_t$ , that indicates whether the year is before or after the establishment of the CAFC. The control variables,  $X_{ist}$ , include the log of firm's employment, the effective federal and state corporate income tax rates, and R&D tax credit rates calculated by [Wilson \(2009\)](#), and the log of state-level real GDP. Firm-fixed effects,  $\alpha_i$ , and year-fixed effects,  $\mu_t$ , are also included in the regression to exclude permanent cross-firm and time differences. The coefficient,  $\beta$ , captures the relationship between the different changes in firms' production scope and the different changes in patent protection strength across regions.

Sectoral differences add another dimension of difference in the exposure to patent protection. The following Triple-Difference (DDD) regression tests whether firms with a higher exposure decreased production scope more,

$$\ln(ind_{ist}) = \alpha_i + \beta_1 * high\_treat_i * inval_{c,pre} * post_t + \beta_2 * inval_{c,pre} * post_t + \beta_3 * high\_treat_i * post_t + \gamma X_{ist} + \mu_t + \epsilon_{ist}, \quad (22)$$



where  $high\_treat_i$  is the firm's share of employment in the NAICS code 541710 (Research and Development in the Physical, Engineering, and Life Sciences)<sup>48</sup> and 511210 (Software Publishers) prior to the CAFC. The rest of the variables are the same as defined earlier. The other interaction terms are omitted in the fixed effects.  $\beta_1$  captures the differential impact of the change in patent protection for firms in the two most controversial industries versus others;  $\beta_2$  shows whether the effect of the CAFC concentrates in the two industries or stretches to more general industries.

To check whether regional differences in the change of patent protection resulted in diverging trends of R&D activities by small and large firms, this paper designs the following regression,

$$RD\_to\_sales_{ist} = \alpha_i + \beta_1 * small_i * inval_{c,pre} * post_t + \beta_2 * inval_{c,pre} * post_t + \beta_3 * small_i * post_t + \gamma X_{ist} + \mu_t + \epsilon_{ist}, \quad (23)$$

where  $RD\_to\_sales_{ist}$  is the the firm's R&D expenses to domestic sales ratio, measuring R&D intensity.  $small_i$  is a dummy variable indicating whether the firm had less than 1000 employees prior to the CAFC. The rest of the variables are the same as defined earlier.  $\beta_2$  captures the impact of the change in patent protection on large firms' R&D intensity;  $\beta_1 + \beta_2$  captures the impact on small firms.

The standard errors are clustered at the circuit court region by the post dummy level in all specifications.

### 8.3 Sample Description

The sample of the regression analysis for production scope is the innovating firms in the LBD that existed before or in 1982, the year of the establishment of the CAFC. The sample of the regression analysis for R&D intensity is all the firms in the SIRD that existed before or in 1982. The requirement of existence before the reform is to avoid endogeneity issues induced by changes in firms' headquarters due to the policy change. To be representative for all the innovating firms, the R&D intensity regression is weighted by the sample weight assigned to each observation in the SIRD. The sample period for all regressions is from 1976 to 1989, 7 years before and after the reform.<sup>49</sup> Summary statistics of the main variables are presented in Table 19 in Appendix E.1. The number of observations

<sup>48</sup>Bioengineering is embodied in this code.

<sup>49</sup>1976 is the earliest year of the LBD, so the longest period this study can explore before the establishment of the CAFC is seven years. This study also runs the same regressions on the samples of six years and five years before and after the reform. The results are very similar.

Table 11: DiD Regression Results on Production Scope

Dependent Variable	Ln(Number of Industries)			
	(1)	(2)	(3)	(4)
Invalidation Rate*Post	-0.0326** (0.014)	-0.0326** (0.014)	-0.0332** (0.014)	-0.0281** (0.013)
Ln(Employment)	0.0888*** (0.007)	0.0899*** (0.007)	0.0893*** (0.007)	0.0894*** (0.007)
Real GDP	NO	YES	NO	YES
Tax Rates	NO	YES	NO	YES
R&D Tax Credits	NO	YES	NO	YES
Post Dummy	YES	YES	NO	NO
Year-fixed Effects	NO	NO	YES	YES
Firm-fixed Effects	YES	YES	YES	YES
Observations	268000	268000	268000	268000
R-squared	0.944	0.944	0.944	0.944

*Notes:* The dependent variable is the logarithm of the number of 6-digit NAICS codes owned by the firm. The four columns have different control variables. Standard errors are clustered by circuit court regions  $\times$  the post dummy. The number of observations is rounded to the nearest 1000 to comply with the disclosure requirement of the Census Bureau.

and the common control variables in the two samples (weighted for the SIRD sample) are comparable in magnitude.

## 8.4 Regression Results

Table 11 displays the regression results of Equation (21) that exploits regional differences on production scope. The first two columns insert the *post* dummy in the regression instead of the year-fixed effects; the last two columns control the year-fixed effects. Columns (2) and (4) control the state-level characteristics while columns (1) and (3) do not. In all of the columns, there are negative and significant coefficients of the interaction term, implying that firms located in regions with a larger change in patent protection strength experience a larger drop in production scope.

Table 12 displays estimation of Equation (22) that includes sectoral differences. The different controls across columns are the same as in Table 11. The negative and significant coefficient of the triple interaction term suggests that firms in the highly treated industries (bioengineering and software) are more affected by the CAFC. The coefficient of *Invalidation Rate \* Post* is still significantly negative, showing that the impact of the CAFC is not limited to the two highly treated industries.

The average magnitude of the interaction term coefficient ( $-0.032$ ) in Table 11 suggests that the decrease in the patent invalidation rates ( $55\% - 28\%$ ) resulted in  $0.86\%$

Table 12: DDD Regression Results on Production Scope

Dependent Variable	Ln(Number of Industries)			
	(1)	(2)	(3)	(4)
High_treat*Invalidation Rate*Post	-0.134* (0.069)	-0.132* (0.069)	-0.132* (0.069)	-0.128* (0.069)
Invalidation Rate*Post	-0.0301** (0.014)	-0.0301** (0.014)	-0.0307** (0.014)	-0.0257* (0.013)
High_treat*Post	0.0840** (0.040)	0.0833* (0.041)	0.0833** (0.040)	0.0829* (0.040)
Ln(Employment)	0.0888*** (0.007)	0.0899*** (0.007)	0.0893*** (0.007)	0.0894*** (0.007)
Real GDP	NO	YES	NO	YES
Tax Rates	NO	YES	NO	YES
R&D Tax Credits	NO	YES	NO	YES
Post Dummy	YES	YES	NO	NO
Year-fixed Effects	NO	NO	YES	YES
Firm-fixed Effects	YES	YES	YES	YES
Observations	268000	268000	268000	268000
R-squared	0.944	0.944	0.944	0.944

Notes: The dependent variable is the logarithm of the number of 6-digit NAICS codes owned by the firm. The four columns have different control variables. Standard errors are clustered by circuit court regions  $\times$  the post dummy. The number of observations is rounded to the nearest 1000 to comply with the disclosure requirement of the Census Bureau.

decrease in firms' production scope. The average sum of the triple and double interaction term coefficients in Table 12 ( $-0.16$ ) suggests that for firms fully exposed to the bioengineering and software industries, the decrease in the patent invalidation rates ( $55\% - 28\%$ ) resulted in 4.32% decrease in firms' production scope. Since the overall decrease of firms' production scope is 11.8% in the period of the regression sample, the invalidation rate decrease alone can explain 7.3% of the scope shrinkage for general firms and 36.7% for firms in the bioengineering and software industries.

Table 13 displays estimation of Equation (23) that explores effect of the policy change on the R&D intensity of small and large firms. The different controls across columns are the same as in Table 11. The positive and significant coefficient of the triple interaction term suggests that small firms increases R&D intensity relative to large firms due to the establishment of the CAFC. The coefficient of *Invalidation Rate \* Post* is negative, although not significant, showing that the CAFC decreases the R&D intensity of large firms.

The average magnitude of the coefficient of *InvalidationRate \* Post* ( $-0.036$ ) in Table 13 suggests that the decrease in the patent invalidation rates ( $55\% - 28\%$ ) resulted in 0.97 percentage points decrease in large firms' R&D intensity. The average sum of the *Small \* InvalidationRate \* Post* and *InvalidationRate \* Post* coefficients in Table 13

Table 13: DDD Regression Results on R&amp;D Intensity

Dependent Variable	R&D Expenses to Domestic Sales Ratio			
	(1)	(2)	(3)	(4)
Small*Invalidation Rate*Post	0.266*** (0.091)	0.223** (0.105)	0.267*** (0.093)	0.223** (0.105)
Invalidation Rate*Post	-0.0456 (0.036)	-0.0215 (0.055)	-0.0544 (0.035)	-0.0215 (0.055)
Small*Post	-0.177*** (0.057)	-0.111* (0.066)	-0.136** (0.058)	-0.111* (0.066)
Ln(Employment)	-0.0049 (0.024)	-0.00189 (0.022)	-0.00121 (0.022)	-0.00189 (0.022)
Real GDP	NO	YES	NO	YES
Tax Rates	NO	YES	NO	YES
R&D Tax Credits	NO	YES	NO	YES
Post Dummy	YES	YES	NO	NO
Year-fixed Effects	NO	NO	YES	YES
Firm-fixed Effects	YES	YES	YES	YES
Observations (Weighted)	220000	220000	220000	220000
R-squared	0.719	0.72	0.72	0.72

*Notes:* The dependent variable is the firm's R&D-expenses-to-domestic-sales ratio. The four columns have different control variables. Standard errors are clustered by circuit court regions  $\times$  the post dummy. The number of observations is rounded to the nearest 1000 to comply with the disclosure requirement of the Census Bureau.

(0.21) suggests that the decrease in the patent invalidation rates resulted in 5.67 percentage points increase in small firms' R&D intensity. These numbers are comparable to the overall changes in the large and small firms' R&D intensity.

Placebo tests show there are no pre-trends for the observed regional and sectoral differences. Appendix E.2 describes details about the tests.

## 9 Conclusion

This study finds novel patterns of firm specialization in the 1980s and 1990s in the US Census data. (i) Firms, especially innovating ones, narrowed down their production scope. (ii) Innovation activities shifted from large to small firms.

A new hypothesis is proposed to explain the observed phenomena—higher patent trading efficiency and better patent protection increased the tradability of intellectual properties, making production scope less critical in determining the value of a firm's innovations. Three major conclusions can be drawn in this paper. First, increased tradability of innovations accounts for 25% of the production scope decrease and 58% of the reallocation of innovation activities. Second, increased tradability of innovations leads to

a 0.64 percent point increase in growth rates. Third, there is evidence of causality from the pro-patent reforms to the two specialization patterns.

This paper also finds in the data that the R&D activities of US firms became less targeted in the 1980s and 1990s. The baseline model is then extended to include two types of research that differ in the probability of matching the inventor's production scope. Quantitative results of the extended model show that increased tradability of innovations can explain 101% of the decrease in the R&D targeting behavior.

Using the regional and sectoral differences in the exposure to patent policy changes in the early 1980s, this paper provides empirical support for causality from the pro-patent reform to contraction in firms' production scope and the shift of innovation activities.

The findings of this paper suggest that innovation and production become more separate when patent trade is more prevalent. A potential extension is to allow firms to endogenously choose their production ability at some costs. Mirroring the result that firms with high production ability choose to do less innovation, it is predicted that firms with high innovation levels will spend fewer resources improving their production ability. This may provide a new explanation for the phenomenon found in [Pugsley, Sedlacek and Sterk \(2019\)](#) that high-growth startups ("gazelles") have grown less rapidly in size since the mid-1980s.

An important policy implication of this paper is that stronger intellectual property rights protection has an impact that is often neglected—reducing mismatches between innovation and production through a market approach. It spurs specialization and provides a strong engine for economic growth. Specialization resulting from patent trade should be considered when optimizing the IPR protection policies.

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## For Online Publication

### A More Empirical Evidence

#### A.1 Production Scope with Firm Size Controlled

To control the firm size, a regression of firms' production scope is run each year on a dummy variable of whether the firm is innovating or not, employment, and their interaction. Then the predicted production scope of innovating and other firms is calculated based on the estimated parameters when fixing the employment level at 20 and 1000, respectively. As shown in the two panels of Figure 8, at both employment levels, innovating firms shrank production scope more than other firms.

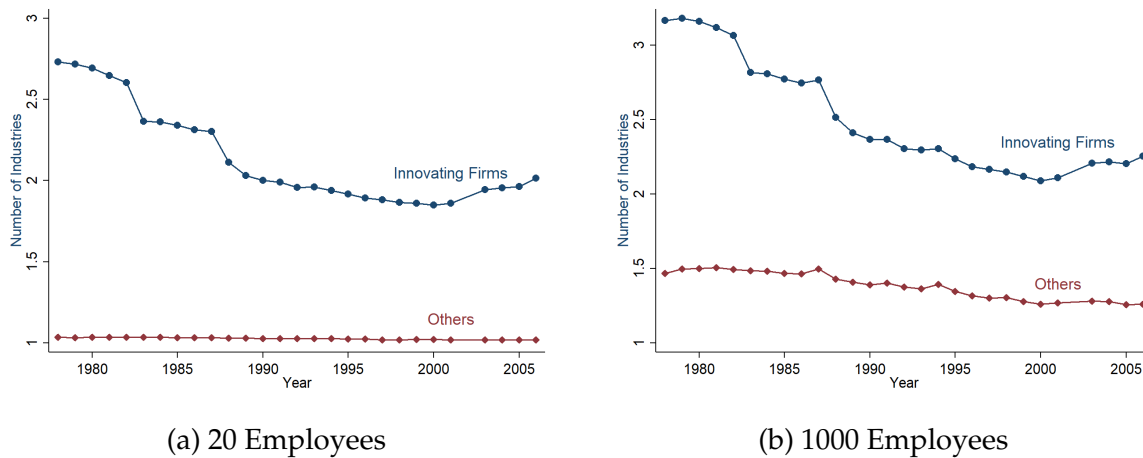


Figure 8: Trends of Production Scope with Fixed Firm Size

*Notes:* This figure shows the average number of 6-digit NAICS codes owned by US firms when controlling firm size. This is created by running regressions of firms' production scope each year on a dummy variable of whether the firm is innovating or not, employment, and their interaction. Panel (a) shows predictions of a firm's production scope if the firm has 20 employees. Panel (b) shows predictions of a firm's production scope if the firm has 1000 employees.

*Sources:* Longitudinal Business Database (LBD); the Patent Data Project (PDP).

#### A.2 Another Measure of Innovation Intensity

Figure 9 shows the (citation-weighted) number of patents per employee for small/medium firms and large firms. They both increased starting from the early 1980s, but the increase was more salient for small/medium firms. The rising trends are partly due to the extension of patentability, but the different slopes of them reflect that small/medium firms engaged in more R&D activities.

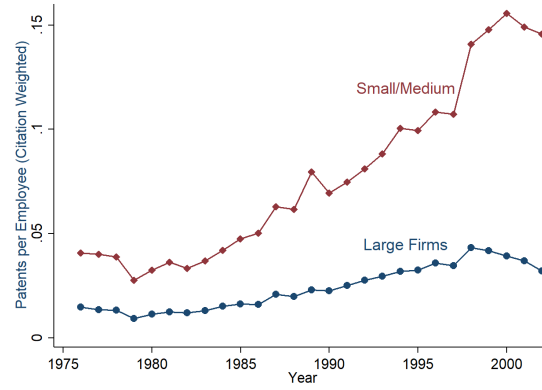


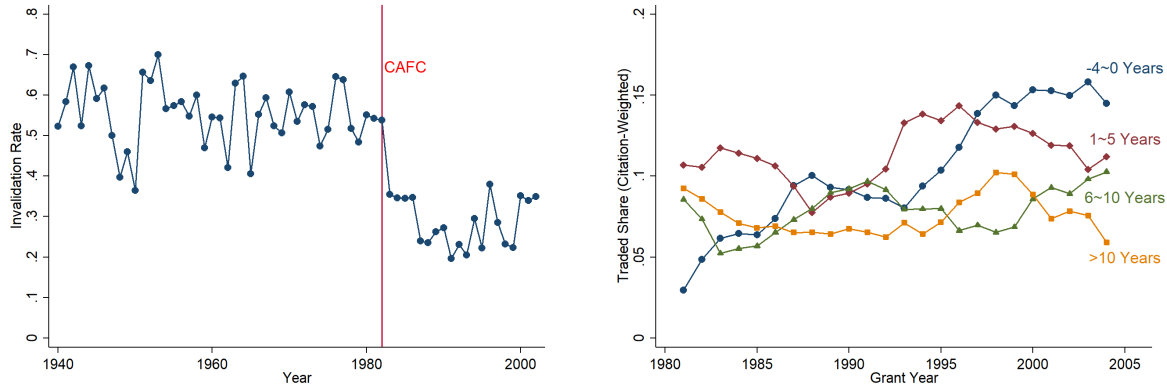
Figure 9: Patents per Employee by Size

*Notes:* This figure shows the ratio of the number of citation-weighted patents to the number of employees for large and small/medium firms with patents in the LBD. This provides another measure of R&D intensity by firm size that avoids the misreporting issue.

*Sources:* Longitudinal Business Database (LBD); the Patent Data Project (PDP).

### A.3 Patent Invalidation Rates

As shown by 10a, the invalidation rates of patents in legal disputes experienced a sharp decrease after the establishment of the CAFC in 1982.



(a) Patent Invalidation Rates in Lawsuits

(b) Patent Trade by Gaps from the Grant Year

*Notes:* Panel (a) displays the average patent invalidation rates of the regional circuit courts by year. The red vertical line indicates the year of CAFC establishment. Panel (b) displays the share of patents traded at different time windows.

*Sources:* Henry and Turner (2006); Patent Assignment Dataset (PAD).

### A.4 Timing of Patent Trade

Figure 10b shows the timing of the patent trade. The blue, red, green, and yellow curves display, respectively the fraction of patents (citation-weighted) traded within four years

before issuance, one to five years after issuance, six to ten years after issuance, and more than ten years after issuance. It should be noted that the descending trend of the yellow curve after 2000 is due to the right censoring issue. A comparison of the four curves suggests that most of the increase happened between 1980 and 2000, consistent with the timing of the pro-patent reforms; earlier transactions occurred more often, evidence that the patent market has become more efficient.

## B Proof of the Theory

### B.1 Proof of Proposition 5.1

*Proof.* Denote the distribution of production ability and innovation levels among all firms at the end of the current period as  $F(m, z'; \mathbf{z})$ . Equation (10) implies that the labor market clearing condition can be written as

$$\left(\frac{\eta}{\tilde{r}}\right)^{\frac{\eta}{\zeta}} \left(\frac{\lambda}{w}\right)^{1+\frac{\lambda}{\zeta}} \int \int m z' dF(m, z'; \mathbf{z}) = 1. \quad (24)$$

Equation (24) can be transformed to

$$\left(\frac{\eta}{\tilde{r}}\right)^{\frac{\eta}{\zeta}} \left(\frac{\lambda}{w}\right)^{1+\frac{\lambda}{\zeta}} (\alpha_H m_H \mathbf{z}'_H + \alpha_L m_L \mathbf{z}'_L) = 1, \quad (25)$$

where  $\mathbf{z}'_H$  and  $\mathbf{z}'_L$  are, respectively, the average innovation level of firms with high and low production ability at the end of this period. They are defined by

$$\mathbf{z}'_H = \frac{1}{\alpha_H} \int z' dF(m_H, z'; \mathbf{z}); \quad (26)$$

$$\mathbf{z}'_L = \frac{1}{\alpha_L} \int z' dF(m_L, z'; \mathbf{z}). \quad (27)$$

The economy-wide average innovation level at the end of the previous period,  $\mathbf{z}$ , can then be expressed as

$$\mathbf{z} = \frac{\alpha_H m_H \mathbf{z}'_H + \alpha_L m_L \mathbf{z}'_L}{\alpha_H m_H + \alpha_L m_L}. \quad (28)$$

Assume  $\mathbf{z}$  grows at a constant rate,  $g$ , across periods. Then, the labor market clearing condition can be further transformed to

$$\left(\frac{\eta}{\tilde{r}}\right)^{\frac{\eta}{\zeta}} \left(\frac{\lambda}{w}\right)^{1+\frac{\lambda}{\zeta}} (\alpha_H m_H + \alpha_L m_L) g \mathbf{z} = 1. \quad (29)$$

The wage rate,  $w$ , can then be expressed as

$$w = \lambda \left(\frac{\eta}{\tilde{r}}\right)^{\frac{\eta}{\zeta+\lambda}} [(\alpha_H m_H + \alpha_L m_L) g \mathbf{z}]^{\frac{\zeta}{\zeta+\lambda}}, \quad (30)$$

which implies that it grows at a rate of  $g^{\frac{\zeta}{\zeta+\lambda}}$ . The total output and capital of the economy also grow at  $g^{\frac{\zeta}{\zeta+\lambda}}$ , since

$$\int \int Y(m, z'; \mathbf{z}) dF(m, z'; \mathbf{z}) = \left(\frac{\eta}{\tilde{r}}\right)^{\frac{\eta}{\zeta}} \left(\frac{\lambda}{w}\right)^{\frac{\lambda}{\zeta}} (\alpha_H m_H + \alpha_L m_L) g \mathbf{z}; \quad (31)$$

$$\int \int K(m, z'; \mathbf{z}) dF(m, z'; \mathbf{z}) = \left(\frac{\eta}{\tilde{r}}\right)^{1+\frac{\eta}{\zeta}} \left(\frac{\lambda}{w}\right)^{\frac{\lambda}{\zeta}} (\alpha_H m_H + \alpha_L m_L) g \mathbf{z}, \quad (32)$$

where  $w$  grows at the rate  $g^{\frac{\zeta}{\zeta+\lambda}}$ ,  $\mathbf{z}$  grows at the rate,  $g$ , and all the other parameters are fixed.

A firm with production ability  $m$  and an innovation level  $z$  at the beginning of the period may or may not update its innovation level through R&D or trade. If it updates the innovation level, the profit of the current period is

$$\pi(m, z'; \mathbf{z}) = \zeta m \left(\frac{\eta}{\tilde{r}}\right)^{\frac{\eta}{\zeta}} \left(\frac{\lambda}{w}\right)^{\frac{\lambda}{\zeta}} (z + \gamma \mathbf{z}). \quad (33)$$

Otherwise, the profit is

$$\pi(m, z; \mathbf{z}) = \zeta m \left(\frac{\eta}{\tilde{r}}\right)^{\frac{\eta}{\zeta}} \left(\frac{\lambda}{w}\right)^{\frac{\lambda}{\zeta}} z. \quad (34)$$

Denote  $\tilde{z} = \frac{z}{\mathbf{z}^{\frac{\lambda}{\zeta+\lambda}}}$ ,  $\tilde{\mathbf{z}} = \frac{\mathbf{z}}{\mathbf{z}^{\frac{\lambda}{\zeta+\lambda}}}$ . Plugging the expression of  $w$  in (30) into (33) and (34) derives

$$\pi(m, z'; \mathbf{z}) = A m (\tilde{z} + \gamma \tilde{\mathbf{z}}), \quad \pi(m, z; \mathbf{z}) = A m \tilde{z}, \quad (35)$$

where  $A = \zeta \left(\frac{\eta}{\tilde{r}}\right)^{\frac{\eta}{\zeta+\lambda}} [(\alpha_H m_H + \alpha_L m_L) g]^{-\frac{\lambda}{\zeta+\lambda}}$ . So, the difference of firm profit with the updated and non-updated innovation levels is  $A m \gamma \tilde{\mathbf{z}}$ , which is not a function of the firm's current innovation level,  $z$ .

Next, a guess-and-verify procedure is used to derive the value of the firm at the

beginning of the period,  $V(m, z; \mathbf{z})$ . Conjecture

$$V(m, z; \mathbf{z}) = v_1(m)\tilde{z} + v_2(m)\tilde{\mathbf{z}}. \quad (36)$$

Then, the surplus of the firm if being a buyer in the Nash bargaining problem (13) is

$$[\pi(m, z'; \mathbf{z}) + r\mathbb{E}V(m', z'; \mathbf{z}')] - [\pi(m, z; \mathbf{z}) + r\mathbb{E}V(m', z; \mathbf{z}')] = [Am + r\mathbb{E}(v_1(m'))g^{-\frac{\lambda}{\zeta+\lambda}}]\gamma\tilde{\mathbf{z}}, \quad (37)$$

which is not a function of the firm's innovation level,  $z$ , either. Denote this surplus as  $\Delta\psi(m; \mathbf{z})$  and use  $B(m)$  as an abbreviation for  $[Am + r\mathbb{E}(v_1(m'))g^{-\frac{\lambda}{\zeta+\lambda}}]$ . We have

$$\Delta\psi(m; \mathbf{z}) = B(m)\gamma\tilde{\mathbf{z}}. \quad (38)$$

The price this firm has to pay to buy a patent can be expressed as (Point 9)

$$p_b(m; \mathbf{z}) = \theta\Delta\psi(m; \mathbf{z}) = \theta B(m)\gamma\tilde{\mathbf{z}}, \quad (39)$$

i.e., the buying price is the bargaining power of the seller times the trading surplus of the buyer. It only depends on the production ability of the buyer and the aggregate innovation level. The expected price a firm gets if selling a patent on the market depends on the shares of searching effort from high-type buyers and low-type buyers. Since we focus on a symmetric equilibrium, the shares are constants on any arc of the technology circle, i.e.,

$$\frac{n_{bH}(d)}{n_b(d)} = \frac{n_{bH}}{n_b}, \quad \forall d, \quad (40)$$

where  $\frac{n_{bH}}{n_b}$  and  $\frac{n_{bL}}{n_b}$  are the share of potential buyers with high and low production ability. The expected selling price can be expressed as

$$p_s = \theta \int \int \Delta\psi(m; \mathbf{z}) dG(m, z; \mathbf{z}) = [\frac{n_{bH}}{n_b}B(m_H) + \frac{n_{bL}}{n_b}B(m_L)]\theta\gamma\tilde{\mathbf{z}}. \quad (41)$$

To solve firms' optimal innovation intensity, it is necessary to derive the expressions of  $s$  and  $b(\omega)$  in problem (12). Consider any arc on the circle. Without loss of generality, Figure 10 shows an arc  $d$  with length  $|d|$ . The total search effort by potential sellers on  $d$  equals to the number of potential sellers that have a patent located inside  $d$ . On a symmetric balanced growth path, sellers' patents are evenly distributed on the circle. So,  $n_s(d) = |d|n_s$ .

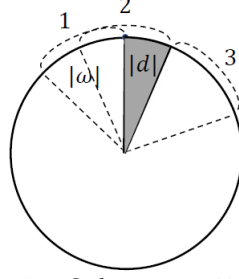


Figure 10: Schematic Diagram

Potential buyers that spend effort searching on  $d$  may have various scope. I classify these buyers according to the length of their scope. For potential buyers with scope length equal to  $|\omega|$ , their locations may span from 1 to 3. Buyers at location 1 or 3 spend measure 0 of search effort on  $d$ , while buyers at location 2 spend measure  $\frac{|d|}{|\omega|}$  of search effort on  $d$ . The total measure of search effort on  $d$  conditional on the buyer having  $|\omega|$  as the scope length is an integral of effort from location 1 to 3, which can be expressed as

$$\int_0^{|d|} \frac{i}{|\omega|} di + \int_{|d|}^{|\omega|} \frac{|d|}{|\omega|} di + \int_{|\omega|}^{|d|+|\omega|} \frac{|d| + |\omega| - i}{|\omega|} di = |d|, \forall |\omega|, |d|. \quad (42)$$

This conditional measure does not rely on the scope length. So, the unconditional total measure of search effort on  $d$  is  $d$  times the total number of potential buyers, i.e.,  $n_b(d) = |d|n_b$ .

The number of matches on the arc  $d$  equals to

$$M(s(d), b(d)) = |d|\phi n_s^\nu n_b^{1-\nu}, \forall d. \quad (43)$$

Potential buyers with scope  $\omega$  will only search within its scope, so, the probability of meeting a seller is

$$b(\omega) = \frac{M(n_s(\omega), n_b(\omega))}{n_b(\omega)} = \phi \left( \frac{n_s}{n_b} \right)^\nu \equiv b, \quad (44)$$

which is a constant and does not depend on the scope of the buyer. The probability for a potential seller to meet a buyer is

$$s = \lim_{|d_0| \rightarrow 0} \frac{M(n_s(d_0), n_b(d_0))}{n_s(d_0)} = \phi \left( \frac{n_b}{n_s} \right)^{1-\nu}, \quad (45)$$

which is also a constant (Point 3). Plugging the matching probabilities  $b(\omega)$  and  $s$  into



problem (12) derives the solution of firms' R&D success rate.

$$i^*(\omega, m) = \left\{ \frac{\gamma}{(1-\sigma)\chi} [X(\omega)(1 - (1-\theta)b)B(m) + (1 - X(\omega))s\theta(\sigma_H B(m_H) + \sigma_L B(m_L))] \right\}^{\frac{1}{\rho}}, \quad (46)$$

which only depends on the firm's production scope and production ability (Point 5).

The firm's value at the innovation stage,  $D(\omega, m, z; \mathbf{z})$  is then

$$D(\omega, m, z; \mathbf{z}) = B(m)\tilde{z} + \left[ \frac{(1-\sigma)\rho}{1+\rho} \chi i^*(\omega, m)^{1+\rho} + b(1-\theta)B(m)\gamma + r\mathbb{E}v_2(m')g^{\frac{\zeta}{\zeta+\lambda}} \right] \tilde{\mathbf{z}}. \quad (47)$$

$D(\omega, m, z; \mathbf{z})$  is larger when  $\omega$  is closer to the center for any given length of  $\omega$  if the following condition is fulfilled,

$$(1 - (1-\theta)b)B(m) - s\theta(\sigma_H B(m_H) + \sigma_L B(m_L)) > 0, \quad (48)$$

i.e., the value of a within-scope patent is larger than an out-of-scope patent.<sup>50</sup> Firms will always choose to span symmetrically around their center. The length of the firm's production scope ( $|\omega|$ ) is determined by problem (15),

$$i^*(\omega, m)X'(|\omega|)[(1 - (1-\theta)b)B(m) - s\theta(\sigma_H B(m_H) + \sigma_L B(m_L))]\gamma = \mu|\omega|^l. \quad (49)$$

The solution to (49) is only a function of  $m$ , i.e.,  $|\omega^*(m, z; \mathbf{z})| = \Omega(m)$  (Point 4).

Plugging in the solution of  $i^*(\omega, m)$  and  $\omega^*(m, z; \mathbf{z})$  into the government budget constraint derives (Point 6)

$$T = \sigma(\alpha_H C^i(i(\Omega(m_H), m_H)) + \alpha_L C^i(i(\Omega(m_L), m_L))). \quad (50)$$

The number of buyers of each type,  $(n_{bH}, n_{bL})$ , are the share of firms in each type that do not get an innovation output matching their production scope. The total number of buyers is the summation of the buyers of the two types. They are expressed as (Point 8)

$$n_{bH} = \alpha_H(1 - i^*(\omega^*(m_H), m_H)X(\omega^*(m_H))); \quad (51)$$

$$n_{bL} = \alpha_H(1 - i^*(\omega^*(m_L), m_L)X(\omega^*(m_L))); \quad (52)$$

$$b_b = n_{bH} + n_{bL}. \quad (53)$$

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<sup>50</sup>The calibrated model confirms that this condition is satisfied.

The number of sellers is the share of firms that successfully innovate, but the output falls outside of their own production scope,

$$n_s = \alpha_H i^*(\omega^*(m_H), m_H)(1 - X(\omega^*(m_H))) + \alpha_L i^*(\omega^*(m_L), m_L)(1 - X(\omega^*(m_L))). \quad (54)$$

The value of the firm at the beginning of the period,  $V(m, z; \mathbf{z})$ , can be expressed as

$$V(m, z; \mathbf{z}) = D(\Omega(m), m, z; \mathbf{z}) - C^e(\omega; \mathbf{z}) \equiv v_1(m)\tilde{z} + v_2(m)\tilde{\mathbf{z}}, \quad (55)$$

where

$$v_1(m) = B(m); \quad (56)$$

$$v_2(m) = \left[ \frac{\rho}{1+\rho} \chi i^*(\Omega(m), m)^{1+\rho} + b(1-\theta)B(m)\gamma + r\mathbb{E}v_2(m')g^{\frac{\zeta}{\zeta+\lambda}} - \frac{\mu|\Omega(m)|^{1+\iota}}{1+\iota} \right]. \quad (57)$$

Since both  $v_1(m)$  and  $v_2(m)$  are only functions of  $m$ , the value function,  $V(m, z; \mathbf{z})$ , is consistent with the conjecture (Point 7).

The representative household's problem can be expressed as

$$\begin{aligned} W(a; \mathbf{z}) &= \max_{c, a'} u(c) + \beta W(a'; \mathbf{z}) \\ \text{s.t.}, c + a' &= \frac{1}{r}a + \Pi, \end{aligned}$$

where  $a$  is the asset holding of the household in the current period;  $\frac{1}{r}$  is the capital return rate, where its relationship with the capital cost,  $\tilde{r}$ , is  $\tilde{r} = \frac{1}{r} - 1 + \delta$ ;  $\Pi$  is the total profit of firms in this economy. Because all firms are owned by the household, the total profit is a part of the household's income. Solving the problem derives the following relationship on consumption across periods,

$$\frac{c'}{c} = \left( \frac{\beta}{r} \right)^{\frac{1}{\epsilon}}. \quad (58)$$

Since consumption grows at the same rate,  $g^{\frac{\zeta}{\zeta+\lambda}}$ , as the total output, and the interest rate is fixed over time, we have (Point 2)

$$r = \frac{\beta}{g^{\epsilon\zeta/(\zeta+\lambda)}}. \quad (59)$$

The growth rate of the employment-weighted average innovation level of the econ-

omy,  $g$ , can be expressed by the following equation according to the definition,

$$g \equiv \frac{\alpha_H m_H \mathbf{z}_H' + \alpha_L m_L \mathbf{z}_L'}{\alpha_H m_H \mathbf{z}_H + \alpha_L m_L \mathbf{z}_L}. \quad (60)$$

In the balanced growth path equilibrium, the ratio of the innovation level of firms with high production ability to that of the firms with low production ability should be stable across periods, i.e.,

$$\frac{\mathbf{z}_H'}{\mathbf{z}_L'} = \frac{\mathbf{z}_H}{\mathbf{z}_L} \equiv o, \quad (61)$$

where  $o$  is a constant. Then (60) implies that

$$g = \frac{\mathbf{z}_H'}{\mathbf{z}_H} = \frac{\mathbf{z}_L'}{\mathbf{z}_L}. \quad (62)$$

Equations in (62) show that the growth rate in the innovation level of the aggregate economy is the same as the growth rate of firms across types.

The change in the average innovation levels of high- and low-type firms consists of two components.

- (i) There is a reshuffling of firms at the beginning of each period because of the transition of production ability.
- (ii) Firms update their innovation level through R&D or trade of patents.

The average innovation level of each type of firms after the transition of production ability but before the innovation stage in this period can be expressed as follows,

$$\mathbf{z}_{Hr} \equiv \frac{\alpha_H q_{HH} \mathbf{z}_H + \alpha_L q_{LH} \mathbf{z}_L}{\alpha_H q_{HH} + \alpha_L q_{LH}}; \quad (63)$$

$$\mathbf{z}_{Lr} \equiv \frac{\alpha_L q_{LL} \mathbf{z}_L + \alpha_H q_{HL} \mathbf{z}_H}{\alpha_L q_{LL} + \alpha_H q_{HL}}. \quad (64)$$

Firms update their innovation level in the R&D or trading process following the law of motion in (1). So, the growth rate of each type of firms in this process (denoted as  $g_H$  and  $g_L$ ) depends on the share of them that successfully create an invention that matches their scope and the share that successfully buy a patent on the market.

$$g_H \equiv \frac{\mathbf{z}_H'}{\mathbf{z}_{Hr}} = 1 + [i^*(\omega^*(m_H), m_H) X(\omega^*(m_H)) + (1 - i^*(\omega^*(m_H), m_H) X(\omega^*(m_H)) m_b)] \gamma \frac{\mathbf{z}}{\mathbf{z}_{Hr}}; \quad (65)$$

$$g_L \equiv \frac{\mathbf{z}_L'}{\mathbf{z}_{Lr}} = 1 + [i^*(\omega^*(m_L), m_L)X(\omega^*(m_L)) + (1 - i^*(\omega^*(m_L), m_L)X(\omega^*(m_L))m_b)]\gamma \frac{\mathbf{z}}{\mathbf{z}_{Lr}}. \quad (66)$$

Using the relationship  $\mathbf{z}_H' = g_H \mathbf{z}_{Hr}$  and plugging equations (61), (63), (64), (65) and (66) into the first equation in (62) derive the solutions for  $g$  and  $o$  through the following system of equations,

$$g = \frac{g_H(\alpha_H q_{HH} + \alpha_L q_{LH} \frac{1}{o})}{\alpha_H q_{HH} + \alpha_L q_{LH}}; \quad (67)$$

$$o = \frac{g_H(\alpha_H q_{HH} o + \alpha_L q_{LH})}{\alpha_H q_{HH} + \alpha_L q_{LH}} \frac{\alpha_L q_{LL} + \alpha_H q_{HL}}{g_L(\alpha_L q_{LL} + \alpha_H q_{HL} o)}. \quad (68)$$

Since all of the other variables and parameters are fixed in the equation system, the solutions of  $g$  and  $o$  are indeed both constants (Point 1).  $\square$

## B.2 Characterization of Proposition 7.1

There exists a symmetric balanced growth path of the form:

1. The employment-weighted growth rate of the aggregate innovation level,  $g$ , and the ratio of the average innovation level of firms with high production ability to that of firms with low production ability,  $o$ , defined by,

$$g = \frac{\int \int m' z'' dF(m', z') / \int \int m' dF(m', z')}{\int \int m z' dF(m, z) / \int \int m dF(m, z)}; \quad o = \frac{\int z' dF(m, z)|_{m=m_H}}{\int z' dF(m, z)|_{m=m_L}},$$

are constants.

2. The interest factor  $r = \beta / g^{\epsilon \zeta / (\zeta + \lambda)}$ ; the rental rate on capital  $\tilde{r} = g^{\epsilon \zeta / (\zeta + \lambda)} / \beta - 1 + \delta$ .
3. The odds of a successful match for a potential buyer,  $b^j(\omega)$ , and for a potential seller,  $s^j$ , on the market of each type (basic or applied) of patents, only depend on the total number of patent buyers and sellers on that market, i.e.,  $b^j(\omega) = \phi(\frac{n_s^j}{n_b^j})^\nu$ ,  $s^j = \phi(\frac{n_b^j}{n_s^j})^{1-\nu}$ , where  $j \in \{a, b\}$ .
4. The production scope of each firm spans symmetrically around the center, and the length of the scope depends only on the production ability of the firm, i.e.,  $|\omega(m, z; \mathbf{z})| = \Omega(m)$ .
5. The success rates of applied and basic research do not depend on the firm's innovation level,  $z$ , or the economy-wide innovation level,  $\mathbf{z}$ , i.e.,  $i^j(\omega, m, z; \mathbf{z}) = i^j(\omega, m)$ ,  $j \in \{a, b\}$ .

6. The government budget constraint is,

$$T = \sigma \sum_{j \in \{a, b\}} (\alpha_H C^{ij}(i^j(\Omega(m_H), m_H)) + \alpha_L C^{ij}(i^j(\Omega(m_L), m_L))).$$

7. The value function  $V(m, z; \mathbf{z})$  is linear in  $\tilde{z}$  and  $\tilde{\mathbf{z}}$ , i.e.,  $V(m, z; \mathbf{z}) = v_1(m)\tilde{z} + v_2(m)\tilde{\mathbf{z}}$ , where  $\tilde{z} = z/\mathbf{z}^{\lambda/(\zeta+\lambda)}$ ,  $\tilde{\mathbf{z}} = \mathbf{z}^{\zeta/(\zeta+\lambda)}$ .

8. The number of buyers of both types ( $n_{bH}^j, n_{bL}^j$ ) and the number of sellers ( $n_s^j$ ) for  $j$  ( $j \in \{a, b\}$ ) type of patents are

$$n_{bH}^j = \alpha_H(1 - i^{j*}(\omega^*(m_H), m_H)X^j(\omega^*(m_H))), \quad n_{bL}^j = \alpha_H(1 - i^{j*}(\omega^*(m_L), m_L)X^j(\omega^*(m_L)));$$

$$n_s^j = \alpha_H i^{j*}(\omega^*(m_H), m_H)(1 - X^j(\omega^*(m_H))) + \alpha_L i^{j*}(\omega^*(m_L), m_L)(1 - X^j(\omega^*(m_L))).$$

9. The buying price and the expected selling price of a  $j$ -type ( $j \in \{a, b\}$ ) patent is

$$p_b^j(m, z; \mathbf{z}) = \theta(Am + \frac{r}{g^{\lambda/(\lambda+\zeta)}}\mathbb{E}[v_1(m')|m])\gamma^j\tilde{\mathbf{z}};$$

$$p_s(\mathbf{z}) = \frac{n_{bH}^j}{n_b^j}p_b^j(m_H, z; \mathbf{z}) + \frac{n_{bL}^j}{n_b^j}p_b^j(m_L, z; \mathbf{z}),$$

where  $A$  is a constant.

### B.3 Proof of Proposition 7.1

*Proof.* The proof is very similar to that of Proposition 5.1. One difference is that the profit of each type of firms now have four possible cases. (i) The firm gets both applied and basic R&D output (either through own innovation or purchasing them from the market). The profit in this case is  $\pi(m, z^{ab}; \mathbf{z}) = Am(\tilde{z} + \gamma^a\tilde{\mathbf{z}} + \gamma^b\tilde{\mathbf{z}})$ . (ii) The firm gets only applied R&D output. The profit is  $\pi(m, z^a; \mathbf{z}) = Am(\tilde{z} + \gamma^a\tilde{\mathbf{z}})$ . (iii) The firm gets only basic R&D output. The profit is  $\pi(m, z^b; \mathbf{z}) = Am(\tilde{z} + \gamma^b\tilde{\mathbf{z}})$ . (iv). The firm gets neither R&D output. The profit is  $\pi(m, z; \mathbf{z}) = Am(\tilde{z})$ .  $A = \zeta(\frac{\eta}{\tilde{r}})^{\frac{\eta}{\zeta+\lambda}}[(\alpha_H m_H + \alpha_L m_L)g]^{-\frac{\lambda}{\zeta+\lambda}}$  for all the four cases.

Then, from the Nash bargaining problem between the buyer and the seller, it can be derived that for a  $j$ -type patent ( $j \in \{a, b\}$ ), the buying price can be expressed as

$$p_b^j(m; \mathbf{z}) = \theta B(m)\gamma^j\tilde{\mathbf{z}}, \quad (69)$$

where  $B(m) = [Am + r\mathbb{E}(v_1(m'))g^{-\frac{\lambda}{\zeta+\lambda}}]$ . The selling price is then

$$p_s^j = [\frac{n_{bH}^j}{n_b^j}B(m_H) + \frac{n_{bL}^j}{n_b^j}B(m_L)]\theta\gamma^j\bar{\mathbf{z}}. \quad (70)$$

The optimal success rate of the  $j$ -type R&D ( $j \in \{a, b\}$ ) is

$$i^{j*}(\omega, m) = \left\{ \frac{\gamma^j}{(1-\sigma)\chi^j} [X^j(\omega)(1 - (1-\theta)b^j)B(m) + (1 - X^j(\omega))s^j\theta(\sigma_H^jB(m_H) + \sigma_L^jB(m_L))] \right\}^{\frac{1}{\rho}}, \quad (71)$$

which also only depends on the firm's production scope and production ability.

The length of the firm's production scope is determined by,

$$\sum_{j \in \{a, b\}} i^{j*}(\omega, m) X^{j'}(|\omega|) [(1 - (1-\theta)b^j)B(m) - s^j\theta(\sigma_H^jB(m_H) + \sigma_L^jB(m_L))] \gamma^j = \mu|\omega|^t. \quad (72)$$

The solution to the equation above is still only a function of  $m$ .

The growth rates of each type of firms in the R&D and search and matching stages are respectively

$$g_H \equiv \frac{\mathbf{z}_H'}{\mathbf{z}_{Hr}} = 1 + \sum_{j \in \{a, b\}} [i^{j*}(\omega^*(m_H), m_H) X^j(\omega^*(m_H)) + (1 - i^{j*}(\omega^*(m_H), m_H) X^j(\omega^*(m_H)) m_b^j)] \gamma^j \frac{\mathbf{z}}{\mathbf{z}_{Hr}}; \quad (73)$$

$$g_L \equiv \frac{\mathbf{z}_L'}{\mathbf{z}_{Lr}} = 1 + \sum_{j \in \{a, b\}} [i^{j*}(\omega^*(m_L), m_L) X^j(\omega^*(m_L)) + (1 - i^{j*}(\omega^*(m_L), m_L) X^j(\omega^*(m_L)) m_b^j)] \gamma^j \frac{\mathbf{z}}{\mathbf{z}_{Lr}}. \quad (74)$$

Still, the growth rate in the social innovation level and the ratio of the innovation levels between high- and low-type firms are constants and equal to

$$g = \frac{g_H(\alpha_H q_{HH} + \alpha_L q_{LH} \frac{1}{o})}{\alpha_H q_{HH} + \alpha_L q_{LH}}; \quad (75)$$

$$o = \frac{g_H(\alpha_H q_{HH} + \alpha_L q_{LH})}{\alpha_H q_{HH} + \alpha_L q_{LH}} \frac{\alpha_L q_{LL} + \alpha_H q_{HL}}{g_L(\alpha_L q_{LL} + \alpha_H q_{HL} o)}. \quad (76)$$

□

## C Partial Equilibrium Analysis

How do the two parameters related to the new hypothesis, matching efficiency ( $\phi$ ) and sellers' bargaining power ( $\theta$ ), affect firms' R&D intensity and production scope? Partial equilibrium analysis of the model sheds light on the directions and channels.

### C.1 Impacts of the Matching Efficiency

According to the model solution (see proof of Proposition 5.1 in Appendix B.1), the success rate of innovation given production scope can be expressed as

$$i^*(\omega, m) = \left\{ \frac{\gamma}{(1-\sigma)\chi} [X(|\omega|) \underbrace{(1 - (1-\theta)b)B(m)}_{-} + (1 - X(|\omega|)) \underbrace{s\theta(\sigma_H B(m_H) + \sigma_L B(m_L))}_{+}] \right\}^{\frac{1}{\rho}}. \quad (77)$$

where  $B(\cdot)$  is a function of production ability with constants and aggregate variables. An increase in the matching efficiency ( $\phi$ ) increases the matching rate of both potential buyers ( $b$ ) and potential sellers ( $s$ ). Easier trading of patents for buyers decreases firms' R&D intensity as they can rely more upon other firms to do R&D (the first term in Equation (77)). On the other hand, firms can better monetize their innovation output when it falls outside of their own scope and therefore have a stronger incentive to do R&D (the second term in Equation (77)). The final direction of the effect will depend on which force dominates.

Firms' production scope is determined by the following equation,

$$X'(|\omega|) \underbrace{i^*(\omega, m)}_{+/-} \underbrace{[(1 - (1-\theta)b)B(m) - s\theta(\sigma_H B(m_H) + \sigma_L B(m_L))]}_{-} \gamma = \mu|\omega|^t. \quad (78)$$

The right-hand side is the marginal cost of production scope, which is not affected by the efficiency change. The left-hand side is the marginal benefit of production scope, which is a product of the marginal within-scope probability, the R&D success rate, and the difference in the values between within-scope and out-of-scope successful R&D output. On the one hand, an increase in  $\phi$  has a direct negative effect through rises in  $b$  and  $s$ , capturing that easier patent trading makes scope less relevant in determining the value



of a firm's successful invention (the second term in Equation (78)). On the other hand,  $\phi$  also indirectly affects the marginal benefit by changing the success rate of innovation. The direction of this indirect effect is ambiguous according to the discussion on R&D intensity (the first term in Equation (78)). So, the overall effect of the market efficiency on production scope is ambiguous but is positive only if there is a large increase in the R&D intensity.

## C.2 Impacts of Sellers' Bargaining Power

Unlike the matching efficiency, an increase in sellers' bargaining power benefits the seller at the cost of the buyer. Higher bargaining power of the seller increases the value of in-scope innovation output (the first term in Equation (79)) because it becomes more costly to buy patents from other firms. At the same time, it also increases the value of out-of-scope innovation output (the second term in Equation (79)) because it is more rewarding to sell patents to other firms. In both cases, firms are more encouraged to do R&D.

$$i^*(\omega, m) = \left\{ \frac{\gamma}{(1-\sigma)\chi} [X(|\omega|) \underbrace{(1 - (1-\theta)b)B(m)}_{+} + (1 - X(|\omega|)) \underbrace{s\theta(\sigma_H B(m_H) + \sigma_L B(m_L))}_{+}] \right\}^{\frac{1}{\rho}} \quad (79)$$

Higher bargaining power of sellers leads to higher transaction prices of patents, which has an ambiguous direct effect on the production scope (the second term in Equation (80)). On the one hand, firms want to increase the likelihood that their innovation output matches their production as buying patents is expensive. On the other hand, having a smaller scope is beneficial as out-of-scope innovation output can be sold at a higher price. As for the indirect effect, the increase in the R&D success rate due to higher bargaining power of the seller raises the benefit of having a larger scope (the first term in Equation (80)). The overall effect is ambiguous, depending on which force dominates.

$$X'(|\omega|) \underbrace{i^*(\omega, m)}_{+} \underbrace{[(1 - (1-\theta)b)B(m) - s\theta(\sigma_H B(m_H) + \sigma_L B(m_L))]}_{+/-} \gamma = \mu |\omega|^\iota \quad (80)$$

Table 14: Estimation of the Elasticity in the Matching Function

	Ln(Number of Matches)					
	(1)	(2)	(3)	(4)	(5)	(6)
		Raw		Citation-Weighted		
Ln(Num. of Sellers)	0.598 (0.006)	0.693 (0.012)	0.780 (0.049)	0.604 (0.006)	0.694 (0.012)	0.821 (0.050)
Ln(Num. of Buyers)	0.0713 (0.008)	0.105 (0.018)	0.291 (0.089)	0.0698 (0.008)	0.102 (0.018)	0.222 (0.090)
Observations	20000	5700	500	20000	5700	500
R-squared	0.873	0.936	0.984	0.871	0.935	0.983

*Notes:* The dependent variable is the logarithm of the number of matches at different level of sectors. The numbers are at the 6-digit NAICS code level in columns (1) and (4); at the 4-digit NAICS code level in columns (2) and (5); at the 2-digit NAICS code level in columns (3) and (6). Columns (1)-(3) use raw numbers, while columns(4)-(6) use patent citation-weighted numbers. The number of observations is rounded to the nearest 100 to comply with the disclosure requirement of the Census Bureau.

## D Calibration

### D.1 Estimation of the Matching Elasticity

Table 14 displays the estimation results of the elasticity in the matching function of the patent trading market. The first three columns use raw numbers, while the last three columns use patent citation-weighted numbers. The numbers are summed at the 6-digit NAICS code level in columns (1) and (4); at the 4-digit NAICS code level in columns (2) and (5); at the 2-digit NAICS code level in columns (3) and (6). In most columns, the summation of the two coefficients is not far from 1, suggesting that the matching function is close to being constant-return-to-scale. The coefficient of the number of sellers, which corresponds to the matching elasticity( $\nu$ ), is in the range of 0.598-0.821. The calibration then sets the value of  $\nu$  as 0.70.

### D.2 Estimation of the Within-scope Probability Function

Table 15 shows the estimation of the within-scope probability function ( $X(\omega)$ ). To avoid disclosure of the information of specific firms, firms are grouped by the number of 6-digit NAICS codes they have. Then the average likelihood that firms' patents match their production is calculated for each group. Then,  $X(\omega)$  is estimated by running regressions of the likelihood on the number of industries. The high R-squared confirms that the function form assumed in the model can capture the actual relationship.

Table 15: Relationship between the Within-Scope Probability and the Number of Industries

VARIABLE	Log(Within-Scope Probability)
Ln(Num. of Industries)	0.7643 (0.0134)
Constant	-4.443 (0.0370)
Observations	150
R-squared	0.9547

*Notes:* Firms are grouped by the number of 6-digit NAICS codes they have. The dependent variable is the average likelihood that firms' patents match their production in each group. The independent variable is the logarithm of the number of 6-digit NAICS codes in each group. The number of observations is rounded to the nearest 50 to comply with the disclosure requirement of the Census Bureau.

### D.3 Calibration of the Extended Model

This paper calibrates the newly added parameters,  $\{\chi^j, \rho^j, \gamma^j\}$ , and the two probability functions,  $X^j(\cdot)$ , where  $j$  is an indicator of basic or applied research, in the following way. The ratio of the step sizes,  $\frac{\gamma_b}{\gamma_a}$ , is set to be consistent with [Akcigit, Hanley and Serrano-Velarde \(2021\)](#). The within-scope probability functions are estimated by the same method as the estimation of  $X(\cdot)$  in the baseline model, except that the regression is run on two separate samples—patents from basic research and patents from applied research or development in the SIRD. The scale parameter of the applied research cost function ( $\chi^a$ ) is normalized to be 1. The scale parameter of the basic research cost function ( $\chi^b$ ), the step size of applied research ( $\gamma_a$ ), and the two elasticities ( $\rho^a, \rho^b$ ) are pinned down together with  $\{\phi, \theta, \mu, \iota\}$  in the calibration. Two additional moments are added—the share of basic research expense in total R&D expense, respectively, for firms with high and low production ability. All the other parameters are disciplined by the method used to calibrate the baseline model, and the decomposition method is the same as before. Table 16 shows the results. The estimated within-scope probability functions suggest that when the industry number of a firm is not too large, it is harder for basic research output to match the firm's production compared to applied research. In the calibration, the annual growth rate is mostly affected by  $\gamma_a$ ; the basic research share and the R&D cost to domestic sales ratio of firms with high and low production ability are mostly governed by  $\chi_b$ ,  $1 + \rho_a$ , and  $1 + \rho_b$ .

The extended model is calibrated to both the initial and the ending balanced growth paths. In this process, parameters corresponding to the four mechanisms,  $\{\phi, \theta, \sigma, \mu, \iota, \gamma_a,$

Table 16: Parameter Values of the Extended Model

Parameter	Description	Value	Identification
<b>Priori Info.</b>			
$\frac{\gamma_b}{\gamma_a}$	Step Size Ratio	1.6	Akcigit et al. (2021)
$\chi_a$	Applied R Cost, Scale	1	Normalization
<b>Estimation</b>			
$X^a(\omega)$	Applied R, Within-Scope Prob.	$e^{-3.837} *  \omega ^{0.602}$	Regression
$X^b(\omega)$	Basic R, Within-Scope Prob.	$e^{-4.944} *  \omega ^{0.932}$	Regression
<b>Model</b>			
$\gamma_a$	Applied R Step Size	1.46	Growth Rate
$\chi_b$	Basic R Cost, Scale	5.33	Basic Research Share,
$1 + \rho_a$	Applied R Cost, Elasticity	1.90	R&D Cost/Sales
$1 + \rho_b$	Basic R Cost, Elasticity	1.29	Ratio (H and L)

Notes: The newly added parameters are calibrated by a priori information, direct estimation, and minimizing the distance between the model and data moments. When calculating the minimized distance, the new parameters are jointly calibrated with the old parameters in Table 3.

Table 17: Model Fit for Key Moments in the Initial Balanced Growth Path

Targets	Data	Model
Economic Growth Rate(1981-1985)	3.05%	3.05%
R&D Cost/Sales of H Firms(1981-1985)	3.62%	3.62%
R&D Cost/Sales of L Firms(1981-1985)	2.83%	2.83%
Basic R Share of H Firms(1981-1985)	4.20%	4.20%
Basic R Share of L Firms(1981-1985)	3.73%	3.73%
Avg. Number of Industries of H Firms(1981-1985)	11.81	11.81
Avg. Number of Industries of L Firms(1981-1985)	1.92	1.92
The Share of Patents Transacted(1981-1985)	30.9%	30.9%

Notes: The model and data moments in the initial balanced growth path are almost the same, showing the model fits the data well.

$\chi_b, \rho_a, \rho_b\}$ , are changed to match the data moments in the two periods.

The model fit of the two balanced growth paths are shown respectively in Table 17 and Table 18. Overall, the model matches the data well.

## E Supplementary Materials for Empirical Analysis

### E.1 Summary Statistics

Panel A and B in Table 19 respectively show summary statistics of the regression samples for production scope and R&D intensity.<sup>51</sup> The number of industries per firm experiences

<sup>51</sup>The number of observations is rounded to the nearest 1000 to comply with the disclosure requirement of the Census Bureau.

Table 18: Model Fit for Key Moments in the Ending Balanced Growth Path

Targets	Data	Model
Economic Growth Rate(1996-2000)	3.34%	3.34%
R&D Cost/Sales of H Firms(1996-2000)	3.15%	3.15%
R&D Cost/Sales of L Firms(1996-2000)	6.71%	6.71%
Basic R Share of H Firms(1996-2000)	4.61%	4.61%
Basic R Share of L Firms(1996-2000)	11.46%	11.46%
Avg. Number of Industries of H Firms(1996-2000)	6.31	6.31
Avg. Number of Industries of L Firms(1996-2000)	1.61	1.61
The Share of Patents Transacted(1996-2000)	44.1%	44.1%

Notes: The model and data moments in the ending balanced growth path are almost the same, showing the model fits the data well.

a decrease after the CAFC (Post=1), while the average employment remains at nearly the same level. The average share of employment in the two highly treated industries is around 2%. The overall R&D intensity increases after the CAFC (Post=1). The common control variables are comparable in magnitude in the two panels. The average invalidation rate across different regions is around 54%.<sup>52</sup> There is a drop in the federal corporate income tax rate and a rise in both the federal and state-level R&D tax credits.

## E.2 Placebo Tests

It is possible that the differential changes in the number of industries and R&D intensity across regions and firms are due to pre-trends instead of the policy impact. To check whether there are pre-existing trends, this study runs the same regressions in Equation (21)–(23) on the pre-CAFC sample (1976-1982). All variables are defined as the same as before, except the *post* dummy. Now, the *post* dummy (written as *post2*) equals zero if the observation year is before or in 1979; equals one if after 1979.<sup>53</sup> If there are pre-trends in production scope,  $\beta$  in Equation (21) and  $\beta_1$  and  $\beta_2$  in Equation (22) should still be significantly negative. However, as shown in Table 20 and Table 21, they are either positive or tiny in absolute magnitude. None of them is significant, showing that the differential changes in production scope are not due to pre-existing trends.

If there are pre-trends in the R&D intensity,  $\beta_1$  in Equation (23) should be still positive while  $\beta_2$  still negative. However, as shown in Table 22, their signs are flipped, showing that the differential changes in R&D intensity are not due to pre-existing trends. Therefore, the empirical results in section 8.4 can be viewed as evidence of causality from the

<sup>52</sup>There is very little change in this rate before and after the CAFC because both of them are at the pre-CAFC level.

<sup>53</sup>This study also tries other ways of segmenting the pre-CAFC sample. The results are similar.

Table 19: Summary Statistics of the Regression Sample

Sample	All	Mean		Standard Deviation		
		Post=0	Post=1	All	Post=0	Post=1
<u>Panel A</u>						
Observations	268000	131000	136000	268000	131000	136000
Number of Industries	3.066	3.074	3.058	6.722	6.952	6.494
Employment	1187	1187	1187	9670	10780	8467
Highly Treated Share	0.02101	0.01987	0.0221	0.1337	0.129	0.138
Pre-CAFC Invalid. Rate	0.5375	0.5381	0.5369	0.1082	0.1082	0.1083
Real GDP	144000	127200	160200	115000	95460	129100
Effective Federal Tax Rate	0.4105	0.4335	0.3883	0.0434	0.01645	0.04934
Effective State Tax Rate	0.07406	0.07325	0.07484	0.02676	0.0279	0.02558
Federal R&D Tax Credits	0.01443	0.004603	0.02388	0.01145	0.007372	0.004747
State R&D Tax Credits	0.0006073	0.0001753	0.001023	0.003604	0.002553	0.004343
<u>Panel B</u>						
Observations	41000	20000	21000	41000	20000	21000
Sum of Weight	220000	100000	120000	220000	100000	120000
R&D Intensity	0.1268	0.06814	0.176	0.9789	0.4915	1.247
Employment	1355	1094	1574	13570	9913	16000
Small Firm Share	0.8989	0.8956	0.9017	0.3014	0.3058	0.2977
Pre-CAFC Invalid. Rate	0.5387	0.5446	0.5338	0.1103	0.1089	0.1113
Real GDP	146500	129300	161000	121600	99300	135900
Effective Federal Tax Rate	0.4068	0.4339	0.3839	0.04653	0.01692	0.05101
Effective State Tax Rate	0.07348	0.07321	0.0737	0.02763	0.02926	0.02617
Federal R&D Tax Credits	0.01473	0.004456	0.02336	0.01114	0.007208	0.004627
State R&D Tax Credits	0.0006286	0.0001987	0.0009896	0.002836	0.002718	0.002883

*Notes:* Panel A shows the summary statistics of the regression sample for production scope. The sample contains the innovating firms in the LBD that existed before or in 1982, the year of the establishment of the CAFC. Panel B shows the summary statistics of the regression sample for R&D intensity. The sample contains all the firms in the SIRD that existed before or in 1982. the R&D intensity regression is weighted by the sample weight assigned to each observation in the SIRD. The sample period for all regressions is from 1976 to 1989, 7 years before and after the reform. The number of observations is rounded to the nearest 1000 to comply with the disclosure requirement of the Census Bureau.

policy reforms to firms' shrinkage in production scope and reallocation of R&D activities.

Table 20: Placebo Test-DiD Regression on Production Scope

Dependent Variable	Ln(Number of Industries)			
	(1)	(2)	(3)	(4)
Invalidation Rate*Post2	0.00196 (0.013)	0.0206 (0.014)	0.000678 (0.013)	-0.00194 (0.012)
Ln(Employment)	0.0539*** (0.003)	0.0529*** (0.003)	0.0526*** (0.003)	0.0527*** (0.003)
Real GDP	NO	YES	NO	YES
Tax Rates	NO	YES	NO	YES
R&D Tax Credits	NO	YES	NO	YES
Post Dummy	YES	YES	NO	NO
Year-fixed Effects	NO	NO	YES	YES
Firm-fixed Effects	YES	YES	YES	YES
Observations	131000	131000	131000	131000
R-squared	0.97	0.97	0.97	0.97

*Notes:* The dependent variable is the logarithm of the number of 6-digit NAICS codes owned by the firm. The four columns have different control variables. Standard errors are clustered by circuit court regions  $\times$  the post dummy. The number of observations is rounded to the nearest 1000 to comply with the disclosure requirement of the Census Bureau.

Table 21: Placebo Test-DDD Regression on Production Scope

Dependent Variable	Ln(Number of Industries)			
	(1)	(2)	(3)	(4)
High_treat*Invalidation Rate*Post2	0.00965 (0.038)	0.00894 (0.038)	0.011 (0.038)	0.0121 (0.039)
Invalidation Rate*Post2	0.00177 (0.012)	0.0204 (0.014)	0.000479 (0.012)	-0.00213 (0.012)
High_treat*Post2	-0.0094 (0.020)	-0.00877 (0.020)	-0.00935 (0.020)	-0.00908 (0.020)
Ln(Employment)	0.0539*** (0.003)	0.0530*** (0.003)	0.0526*** (0.003)	0.0527*** (0.003)
Real GDP	NO	YES	NO	YES
Tax Rates	NO	YES	NO	YES
R&D Tax Credits	NO	YES	NO	YES
Post Dummy	YES	YES	NO	NO
Year-fixed Effects	NO	NO	YES	YES
Firm-fixed Effects	YES	YES	YES	YES
Observations	131000	131000	131000	131000
R-squared	0.97	0.97	0.97	0.97

*Notes:* The dependent variable is the logarithm of the number of 6-digit NAICS codes owned by the firm. The four columns have different control variables. Standard errors are clustered by circuit court regions  $\times$  the post dummy. The number of observations is rounded to the nearest 1000 to comply with the disclosure requirement of the Census Bureau.

Table 22: Placebo Test-DDD Regression on R&amp;D Intensity

Dependent Variable	R&D Expenses to Domestic Sales Ratio			
	(1)	(2)	(3)	(4)
Small*Invalidation Rate*Post2	-0.0467 (0.048)	-0.057 (0.052)	-0.0417 (0.048)	-0.057 (0.052)
Invalidation Rate*Post2	0.0772* (0.039)	0.0994** (0.049)	0.0734* (0.039)	0.0994** (0.049)
Small*Post2	0.042 (0.028)	0.0584* (0.031)	0.0497* (0.029)	0.0584* (0.031)
Ln(Employment)	0.00197 (0.024)	0.0045 (0.025)	0.00435 (0.025)	0.0045 (0.025)
Real GDP	NO	YES	NO	YES
Tax Rates	NO	YES	NO	YES
R&D Tax Credits	NO	YES	NO	YES
Post Dummy	YES	YES	NO	NO
Year-fixed Effects	NO	NO	YES	YES
Firm-fixed Effects	YES	YES	YES	YES
Observations (Weighted)	100000	100000	100000	100000
R-squared	0.853	0.853	0.853	0.853

*Notes:* The dependent variable is the firm's R&D-expenses-to-domestic-sales ratio. The four columns have different control variables. Standard errors are clustered by circuit court regions  $\times$  the post dummy. The number of observations is rounded to the nearest 1000 to comply with the disclosure requirement of the Census Bureau.