Supply-side policy instruments for innovation in firms

Supply-side policies for innovation in firms aim at increasing firms’ incentives to invest in innovation by reducing costs. They include direct funding of firms’ R&D, fiscal measures, debt and risk sharing schemes, and technology extension services. One of the main rationales for supply-side instruments is that investments in innovative activities might not be undertaken as liquidity constrained caused by capital market imperfections can be substantial when it comes to innovation.

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What are supply-side policy instruments for innovation in firms?
Supply-side policies consist in offering support to firms undertaking R&D and innovation. These policies aim at increasing firms’ incentives to invest in innovation by reducing investment costs. Supply-side instrument include:

- Direct funding of firms’ R&D (see Direct funding of firms’ R&D [1]). Direct funding of business R&D projects by the government includes grants, subsidies, subsidized loans, and equity financing. It is normally offered on a competitive basis following a public call from which the funding agency selects the best project(s). It can be used to target specific projects with high potential social returns.
- Fiscal measures (see Fiscal measures [2]). Fiscal incentives for innovation in firms consist in a favorable tax treatment to R&D expenditure and may take the form of tax credits, accelerated depreciation on R&D equipment, tax holidays, import tariff exemptions on equipment and other research inputs, and exemption on social taxes for R&D employees.
- Debt and risk sharing schemes (see Debt and risk sharing schemes [3]). These instruments aim at reducing the risks faced by lenders/investors when financing firms’ innovation and favoring, thereby, the provision of financing to viable businesses that would be credit constrained otherwise. For instance, credit guarantee programs protect a part of the losses caused by the eventual default of the borrower.
- Technology extension services (see Technology extension services [4]). Technology extension services are services provided by government-funded programs to small and medium enterprises (SMEs). The main aim is not to develop new technology, but rather to expand the diffusion and adoption of already existing technology, and to contribute to increasing the absorptive capacity of targeted firms. Technology extension services usually comprise an assessment of the state of operation of the firm, followed by a proposal of an improvement plan and by assistance in their implementation.

What are the rationales for supply-side policy instruments in support to innovation in firms?

Beyond the market failure affecting R&D investment associated with R&D spillovers, the main rationale for supply-side instruments is the possibility that investments in innovative activities are liquidity constrained due to capital market imperfections. Capital markets can be inefficient and potentially profitable projects might not be financed.

Examples of supply-side policy instruments for innovation in firms

The table below provides a set of examples of supply-side policy instruments in support of innovation

<table>
<thead>
<tr>
<th>Policy instrument</th>
<th>Objective of the policy</th>
<th>Condition/Node</th>
<th>Rationale</th>
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<tr>
<td>Direct support to innovative firms through grants and subsidies</td>
<td>Facilitate access to finance</td>
<td>* Direct funding of firms R&amp;D (see Direct funding of firms’ R&amp;D [1]).</td>
<td>Capital market imperfections</td>
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### Supply-side policy instruments for innovation in firms

<table>
<thead>
<tr>
<th>Instrument</th>
<th>Description</th>
<th>Source</th>
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<tr>
<td>Competitive R&amp;D grants</td>
<td>Adopt market-friendly approaches that avoid “picking winners” and encourage competitive selection of investments that are likely to have the highest social return</td>
<td>Capital market imperfections</td>
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<td>Credit guarantees</td>
<td>Increase the incentive for banks to engage in innovative firm lending</td>
<td>Capital market imperfections</td>
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<td>Government subsidised loans</td>
<td>Reduce the cost of debt financing</td>
<td>Capital market imperfections</td>
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<td>Support of alternative types of debt finance such as convertible loans and subordinated loans through fiscal incentives to lenders and/or the partial coverage of losses in case of bankruptcy/liquidation</td>
<td>Increase the incentive for lenders to engage in innovative firm lending</td>
<td>Capital market imperfections</td>
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**Contributor:** OECD.

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