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The state as a pioneering customer: How public demand can drive private innovation

Especially in technology-intensive industries, demand from the state can expand private markets and create incentives for privately funded research and development, a new study by the Halle Institute for Economic Research (IWH) – Member of the Leibniz Association shows.

Research and development, and innovation are the ultimate drivers of productivity, and economic growth. Hence, in order to drive growth and innovation forward in Europe, the EU member states created the Lisbon Strategy in 2000, which called for an increase of research investment expenditure to 3% of the GDP. Two-thirds of the total should be coming from the private sector, potentially enhanced by way of subsidies and tax breaks. Ultimately, the effects fell far short of expectations as illustrated by the European Commission in their Final Report.

A recent paper by IWH researchers shows that government demand can stimulate private research activities. Public demand allows private companies to increase the return of their research and development expenditure by producing larger sales volumes. Hence, public demand may generate additional incentives for investing in developing new technologies. 'If the state increases demand, this can trigger research activity that otherwise wouldn't have been taken place,' says Victor Slavtchev, Head of the Research Group Innovation, Productivity, and Economic Dynamics at IWH. 'That is especially the case in technology-intensive sectors, because the uncertainty is much greater there. It is in exactly in such cases that the state can play a significant role as a pioneering customer.' The state is in a position to use its demand to guarantee sales and stimulate the so-called learning curve effect; in the early phases of the lifecycle of a product or technology, this allows market penetration and the development of market-ready technology to come to pass more quickly.

'However, the current governmental purchasing policies don't adequately account for these findings,' says Slavtchev. State commissioners often shelve ideas motivated by innovation policies, and instead prioritise conservative criteria, such as the lowest price. Even from a purely economic perspective, it is highly disputed whether concentrating only on the purchasing price will drive progress. This is because the usefulness and entire lifecycle cost of a service can't always be fully incorporated into profitability assessments. However, before the common way of

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thinking can change from being exclusively price-oriented to becoming more entrepreneurial, there are other aspects to be discussed, such as technological 'lock-ins' (whereby the state favours certain technologies), not discriminating in favour of or against certain private players (i.e. industries and companies), adaptive and/or paralysing effects on the part of the favoured company, as well as cost-benefit analyses in comparison with other possible funding instruments. 'The state's most important task is and always will be to safeguard its primary functions, i.e. allocating public assets. This task must continue to have the highest priority and should never be allowed to suffer in favour of other ventures,' said Slavtchev.

Publication

Slavtchev, Viktor; Wiederhold, S.: Does the Technological Content of Government Demand Matter for Private R&D? Evidence from US States, in: [American Economic Journal: Macroeconomics](#), Vol. 8 (2), 2016, 45-84.

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