NOTCHING R&D INVESTMENT WITH CORPORATE INCOME TAX CUTS IN CHINA

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Working Paper 24749
http://www.nber.org/papers/w24749

We are very grateful for comments from Manuel Adelino, Ashish Arora, Pierre Bachas, Michael Best, Wesley Cohen, Dhammika Dharmapala, Michael Devereux, Rebecca Diamond, Liran Einav, Bronwyn Hall, Jim Hines, Damon Jones, Henrik Kleven, Ben Lockwood, Jill Popadak, Jim Poterba, Nirupama Rao, Mark Roberts, Joel Slemrod, Stefanie Stantcheva, John Van Reenen, Mazhar Waseem, Shang-Jin Wei, Daniel Wilson, and Eric Zwick as well as seminar participants at ASSA, CEPR, Chicago (Booth & Becker Friedman), Cornell, Drexel, Duke (Fuqua & Econ), FRB Minneapolis, FRB Philadelphia, FRB San Francisco, Hitotsubashi University, Hong Kong University, IIPF, LSE, MIT, National School of Development (PKU), NBER (Dev, Ent, China, CCER), NTA, Oxford University, Penn State, Stanford (SIEPR & Econ), Toronto, UCLA, UCSD (Econ & Bunching Conference), University of Alberta, University of Maryland, University of Melbourne, Warwick University, and ZEW MaTax. Dan Garrett, Yuxuan He, and Matt Panhans provided outstanding research assistance. This project is funded by NSF grant #17300024 and Suárez Serrato is also grateful for funding from the Kauffman Foundation. All errors remain our own. The views expressed herein are those of the authors and do not necessarily reflect the views of the National Bureau of Economic Research.

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ABSTRACT

We study a Chinese policy that awards substantial tax cuts to firms with R&D investment over a threshold, or notch. Quasi-experimental variation and administrative tax data show that firms significantly increase reported R&D, and that relabeling of expenses accounts for 30% of this increase. Accounting for relabeling is crucial to obtain unbiased estimates of the productivity effects of real R&D and to quantify the fiscal costs of stimulating R&D. We estimate a 9.8% productivity-to-R&D elasticity using a structural model of investment and relabeling. Policy simulations show that selection into the program and relabeling costs determine the cost-effectiveness of stimulating R&D.
1 Introduction

The belief that innovation is crucial for economic growth inspires governments around the world to encourage R&D investment through tax incentives. While these incentives are meant to stimulate real R&D expenditures, firms can also respond by relabeling other expenses as R&D. Relabeling raises important questions for how tax incentives affect productivity growth. To what extent is reported R&D real or relabeled? How does relabeling affect estimates of the productivity effects of R&D? How should governments incentivize R&D taking relabeling behavior into account?

We answer these questions using a novel administrative dataset of corporate tax returns of Chinese firms as well as sharp and changing tax incentives. The tax incentive we study—China’s InnoCom program—provides substantial corporate income tax cuts to firms that report R&D investment over a given threshold, or “notch.” Before 2008, firms with an R&D intensity (R&D investment over revenue) above 5% could qualify for a special status as high-tech firms that was accompanied by a lower average tax rate of 15%—a large reduction from the statutory rate of 33%. After 2008, the government established three thresholds at 3%, 4%, and 6% for firms of different size categories. By changing average tax rates—as opposed to marginal incentives—the program generates very large incentives for firms to increase reported R&D.

Our empirical analysis starts by using tax data and a bunching estimator to document a significant increase in reported R&D in response to the policy. We then use two complementary empirical strategies to detect relabeling and to quantify the real component of reported R&D. We first use a reduced-form approach that leverages the detailed cost breakdown in our administrative data to quantify the effects of the policy on relabeling. As a second empirical strategy, we specify and estimate a model of R&D investment and relabeling. The model matches the joint of distribution of R&D and firm productivity as well as the bunching response to the notch. We find consistent results using both approaches: one third of the reported R&D increase is relabeled.

We then show that accounting for relabeling is important when estimating the productivity effects of R&D. Because relabeled expenses do not impact firm productivity, relabeling behavior lowers the measured effect of reported R&D on productivity. By accounting for relabeling, the model finds that real R&D raises the productivity of Chinese firms and estimates a productivity elasticity of real R&D of 9.8%.

Lastly, we study how governments can best incentivize R&D in the presence of relabeling. We show that the effectiveness of the policy at stimulating R&D depends on relabeling and how firms select into the program. Targeting the program to larger, more productive firms, and to those with weaker incentives for relabeling increases the effectiveness of the program. We also compare the InnoCom program to a more standard R&D tax credit. We find that governments may prefer to deviate from standard incentives in the presence of relabeling (e.g., Best et al., 2015). Specifically, an InnoCom-style program can focus monitoring efforts on fewer firms, limit
relabeling, and stimulate R&D at a lower fiscal cost.

Overall, this paper shows that relabeling affects the measurement of actual R&D expenses, the contribution of R&D to TFP growth, and how tax incentives translate fiscal costs to economic growth. The decision to invest in R&D or relabel also depends on firms’ underlying productivity as well as on limits to their technological opportunities. Accounting for the relabeling behavior of heterogeneous firms is crucial when designing tax incentives for R&D.

China is the perfect laboratory to study fiscal incentives for R&D. Figure 1 shows that China has experienced an explosive growth in R&D investment even relative to its rapid GDP expansion. As China’s development through industrialization reaches a mature stage, the government is fostering technology-intensive industries as a source of future economic growth. One concern is that these R&D investments will not translate into improved firm performance if the private return to R&D is low. Our results show that the seemingly low return to reported R&D is an artifact of relabeling (König et al., 2018). Finally, tax incentives for R&D may be particularly costly in emerging economies where the corporate tax is imperfectly enforced (Cai et al., 2018).

We begin our analysis by showing graphically that tax notches have significant effects on the distribution of reported R&D intensity and that part of this response may be due to relabeling. We show that a large number of firms choose to locate at tax notches and that introducing the tax cut led to a large increase in R&D investment. Using a group of firms that was unaffected prior to 2008, we show that the bunching patterns are driven by the tax incentive and are not a spurious feature of the data. We then analyze relabeling responses by exploiting the fact that, under Chinese Accounting Standards, R&D is reported as a subcategory of administrative expenses. Using our detailed tax data to separate R&D from other administrative expenses, we provide graphical evidence that firms may relabel non-R&D expenses as R&D in order to qualify for the tax cut. We also study other forms of manipulation—including relabeling of other expenses as well as re-timing of sales—and we do not find evidence of manipulation along these margins.

We then develop a model of R&D investment and relabeling. Firms’ decisions to invest or relabel depend on tax incentives, the effect of R&D on productivity, the costs of relabeling, as well as on heterogeneous productivity and adjustment costs. The model shows that, as long as firm productivity and adjustment costs are smoothly distributed, the InnoCom program leads to excess bunching at the R&D notch relative to a tax system without a notch (e.g., Saez, 2010; Kleven and Waseem, 2013). The main parameters of the model—the productivity elasticity of R&D and the cost of relabeling—are informed by the bunching response in reported R&D and the joint distribution of R&D and productivity. These parameters are also related to the effects of the notch on relabeling and future productivity. Our empirical analysis combines these complementary predictions to estimate the productivity effects of real R&D investment as well relabeling costs.

Using the bunching estimator, we quantify the percentage increase in R&D investment that is due to the tax notch. We find large increases in R&D investment of 31% for large firms, 21%
for medium firms, and 11% for small firms in 2011. Our bunching estimates are supported by a number of robustness checks. We use a set of firms that were not affected by the program to inform the estimate of the counterfactual density and we find very similar results. In addition, these estimates are robust to excluding firms with extensive margin responses, state-owned enterprises, and to different specifications of the bunching estimator or the exclusion region, in addition to other robustness checks.\(^1\) The striking graphical evidence and the robustness of the bunching estimates provide strong evidence that firms responded to the InnoCom program by reporting higher levels of R&D.

We follow two complementary approaches to deciphering whether the estimated bunching response corresponds to real behavior, or whether the bunching is driven by relabeling. We first estimate the effects of the InnoCom program on relabeling and productivity using methods developed by Diamond and Persson (2016). This estimator recovers the average effect of the program for the set of firms that could have responded to the notch. The identifying assumption is that we can use data on firms that were not affected by the program to extrapolate how average outcomes would vary with R&D over the excluded region. Combined with the estimated counterfactual density from the bunching analysis, we obtain a counterfactual average outcome for firms in the excluded region, and therefore the treatment effect of the policy. The benefit of this approach is that it does not place any restrictions on the distributions of productivity and adjustment frictions. Using this estimator, we find that about 37% of the reported R&D increase is due to the relabeling of administrative expenses. Even though a significant fraction of the response is consistent with relabeling, we find statistically significant effects of the InnoCom program on future productivity. Between 2009 and 2011, the program increased the average productivity of the firms exposed to the incentive by 1.2%. These results show that firms respond to the notch by increasing both real R&D and by relabeling.

As a complement to these estimates, we propose a simulated method of moments approach to estimate the structural parameters of our model. The structural model recovers the productivity-elasticity-of-real-R&D and the extent of relabeling by combining information from the bunching estimation and the joint distribution of R&D intensity and firm productivity. By specifying the distributions of fixed and adjustment costs, the model also characterizes how firms select into the program, which allows us to study the effects of alternative policies. The estimates from our structural model are very consistent with the reduced-form estimates, which is a valuable cross-validation of both approaches. We further combine the structural and treatment effects approaches by incorporating the treatment effects into the structural estimation. Using all available moments,

\(^1\)Specifically, we obtain very similar results when we exclude SOEs, firms that had extensive margin responses during our sample period, low profitability firms, or low tech firms. We also obtain similar estimates of the counterfactual distribution when we use a set of firms that were not affected by the InnoCom program, when using different parametric choices for the density or the exclusion region, or when we estimate the counterfactual density using only data from the right tail of the distribution.
we estimate that, on average, 30% of the reported R&D investment is due to relabeling, and that a 100% increase in real R&D would increase TFP by 9.8%. These results show that accounting for relabeling is necessary to obtain an unbiased estimate of the returns to R&D. Finally, because our model is consistent with the reduced-form estimates of the policy, it provides a solid foundation for investigating the effects of alternative policies.

The final step of our analysis uses the estimated model to study the fiscal effectiveness of alternative policies. We first study the effects of changing the size of the tax cut and the location of the notch. Policies with a larger tax cut and those with a notch at a lower R&D intensity select firms with lower productivity, higher adjustment costs, and with greater motives for relabeling. Firm selection into the program plays a crucial role in determining the economic effects of the program and the fiscal cost of incentivizing real R&D. Finally, we compare the fiscal effectiveness of the InnoCom program to those of a linear tax credit. In a setting where firms have low incentives to relabel, a linear tax credit is more effective at stimulating R&D. However, a notch may be more effective than a linear tax credit when firms can relabel. The key intuition is that, under a linear tax credit, the government’s monitoring efforts are spread across many firms, which lowers firms’ relabeling costs. By focusing monitoring efforts on fewer firms, an InnoCom-style program can raise the cost of relabeling and incentivize real R&D at a lower fiscal cost.

This paper contributes to several literatures. First, this paper is related to a large literature analyzing the effects of tax incentives for R&D investment. Hall and Van Reenen (2000) and Becker (2015) survey this literature. Hall and Van Reenen (2000) find a dollar-for-dollar effect of tax credits on R&D investment. The empirical evidence is concentrated in OECD countries, where micro-level data on firm innovation and tax records have become increasingly available. While earlier work relied on matching and panel data methods, there is an emerging literature that explores the effects of quasi-experimental variation in tax incentives for R&D. Examples include Agrawal et al. (2019), Dechezlepretre et al. (2016), Einiő (2014), Guceri and Liu (2015), Akcigit et al. (2018), and Rao (2016). To our knowledge, this is the first paper to analyze R&D tax incentives in a large emerging economy such as China. It is also one of the first studies to use administrative tax data to study the link between fiscal incentives, R&D investment, and firm-level productivity.\footnote{As noted in the literature, optimal policies for R&D investment rely on estimates of the social returns to R&D investment (e.g., Bloom et al., 2013), in addition to the firm-level effects of R&D. Our results characterize the costs to the government of increasing R&D through fiscal incentives, which can be used to evaluate policies given an estimate of spillovers from R&D.}

Second, a previous literature has long documented relabeling as an important challenge to identifying the real impact of tax incentives for R&D (Eisner et al., 1984; Mansfield and Switzer, 1985). This is a salient issue for policymakers in developed countries (GAO, 2009; Bloom et al., 2019) and is likely a more severe problem in developing economies (Bachas and Soto, 2019; Best et al., 2015). Our paper exploits unique data on firm expenditures to jointly model and estimate firms’ R&D bunching and relabeling decisions. Our policy simulations also improve our
understanding of the effectiveness of different policies when firms may engage in evasion, as in Best et al. (2015).

Third, although there has been a dramatic increase in innovation activities in China, researchers and policymakers are concerned that innovation resources could be misallocated. Wei et al. (2017) show that state-owned firms produce significantly fewer patents-per-yuan of investment than foreign or private domestic firms. In a closely related paper, König et al. (2018) compare the effects of R&D on productivity growth in Taiwan and mainland China, and find that R&D investments are significantly less effective in mainland China. They conjecture that misreported R&D in China may explain this discrepancy. Our paper validates this conjecture by using detailed micro-level data to examine an important policy that can lead firms to misreport R&D investment.

Finally, our paper is related to a recent literature that uses bunching methods to recover estimates of behavioral responses to taxation by analyzing the effects of sharp economic incentives, such as kinks or notches in tax schedules.\(^3\) While most of the literature studies kinks or notches in taxable income, the notch in the InnoCom program targets a particular action: R&D investment. We exploit this feature to estimate treatment effects of the program on R&D investment, relabeling, and productivity, as in Diamond and Persson (2016). Finally, we develop a simulated method of moments estimation approach that uses estimates from the bunching estimators to recover structural parameters. The model clarifies the interpretation of reduced-form estimates as suggested by Einav et al. (2017).\(^4\) Our model quantifies the extent of misreporting, measures the returns to real R&D, and simulates the effects of alternative policies. The model also also clarifies how selection and relabeling determine the effectiveness of a notch-based policy.\(^5\)

The rest of the paper is organized as follows. Section 2 describes the fiscal incentive for R&D investment and discusses the potential for relabeling of R&D expenses in China. Section 3 discusses the data and provides descriptive evidence of the effects of the tax incentive on R&D investment and relabeling. Section 4 develops a model of R&D investment that links traditional estimates of productivity with bunching estimators. Section 5 describes our results on the real and relabeling responses to the InnoCom program. Section 6 culminates by estimating the structural model and by simulating counterfactual policies; Section 7 concludes.

\(^3\)These methods, pioneered by Saez (2010), have been used by researchers analyzing a wide range of behaviors. Kleven (2016) provides a recent survey. Our project is most related to a smaller literature analyzing firm-level responses (Devereux et al., 2014; Patel et al., 2016; Liu et al., 2019; Almunia and Lopez-Rodriguez, 2018; Bachas and Soto, 2019) as well as to papers analyzing the effect of constraints to optimizing behavior (Kleven and Waseem, 2013; Best and Kleven, 2017; Gelber et al., 2019). Blomquist and Newey (2017) and Bertanha et al. (2018) show that variation in incentives helps identify bunching estimators from notches. We use changes in the location of the notch and a set of unaffected firms to confirm that our bunching patterns are due to the policy. In robustness checks, we obtain similar estimates when we use unaffected firms to estimate the counterfactual density.

\(^4\)Lockwood (2018) also notes that reduced-form effects from bunching in notches are not sufficient to analyze the effects of changes in policy. This result motivates the use of a structural model for policy analysis.

\(^5\)Blinder and Rosen (1985) discuss selection patterns under which notches can be desirable and Slemrod (2013) discusses administrative costs as a motivation for notches. Gordon and Li (2009) discuss broader motivations for why tax policies in developing countries may differ from standard optimal tax models when firms can evade taxes.
2 Fiscal R&D Incentives and the Chinese Corporate Income Tax

China had a relatively stable Enterprise Income Tax (EIT) system from 2000-2007. During this period, the EIT ran on a dual-track scheme with a base tax rate of 33% for all domestic-owned enterprises (DOE) and a preferential rate for foreign-owned enterprises (FOE) ranging from 15% to 24%. The government implemented a major corporate tax reform in 2008 that eliminated the dual-track system based on domestic/foreign ownership and established a common rate of 25%.6

This paper analyzes the InnoCom program, which targets qualifying high tech enterprises (HTE) and awards them a flat 15% income tax rate. Since a firm’s average tax rate can fall from 33% to 15%, this tax incentive is economically very important and may lead firms to invest in projects with substantial fixed costs. This program is most important for DOE, including both state- and privately-owned enterprises, as they are not eligible for many other tax breaks.

Table 1 outlines the requirements of the program and how they changed as part of the 2008 reform. A crucial requirement of the program is that firms must have an R&D intensity above a given threshold. The reform changed the threshold from a common R&D intensity of 5%, to a size-dependent threshold with a lower hurdle for medium and large firms, 4% and 3% respectively, and a larger hurdle of 6% for small firms. This requirement is a large fiscal incentive to invest above these thresholds, and the reform generates quasi-experimental variation across firms of different size and ownership categories. Specifically, because the reform eliminated preferential tax rates for foreign firms, their incentive to qualify for the InnoCom program grew after the reform.

In addition to increasing R&D intensity, the InnoCom program requires firms to employ college-educated workers and to sell “high tech” products. Unlike the R&D intensity requirement, these guidelines—such as which products are classified as “high tech”—are easily influenced. It is also hard for tax authorities to verify the employment composition of a given firm. While these requirements are not sharp incentives, they increase the cost of participating in the program. Importantly, these costs may even prevent some firms from bunching at the notch despite having an R&D intensity immediately below the notch. To capture this cost of participating in the program, our model in Section 4.3 assumes that firms differ by an unobserved fixed cost of certification.

As a final program requirement, firms have to actively apply for the program and undergo a special audit. The reform improved enforcement of the program by changing the certifying agency from the Local Ministry of Science and Technology to a joint effort between the National Ministry of Science and Technology, the Ministry of Finance, and the National Tax Bureau. By focusing enforcement efforts on fewer firms, the InnoCom program increased the cost of relabeling R&D relative to a more standard setting where all firms are able to claim an R&D tax credit.7

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6 We discuss details of other preferential tax policies in Appendix A.
7 The original government regulations also require that firms operate in a number of selected state-encouraged
Table 1: Requirements of the InnoCom Program

<table>
<thead>
<tr>
<th>Requirement</th>
<th>Before 2008</th>
<th>After 2008</th>
</tr>
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<tbody>
<tr>
<td>R&amp;D Intensity</td>
<td>5%</td>
<td>6% if sales &lt; 50M</td>
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<tr>
<td></td>
<td></td>
<td>4% if sales &gt; 50M &amp; sales &lt; 200M</td>
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<tr>
<td></td>
<td></td>
<td>3% if sales &gt; 200M</td>
</tr>
<tr>
<td>Sales of High Tech Products</td>
<td>60% of total sales</td>
<td></td>
</tr>
<tr>
<td>Workers with College Degree</td>
<td>30% of workforce</td>
<td></td>
</tr>
<tr>
<td>R&amp;D Workers</td>
<td>10% of workforce</td>
<td></td>
</tr>
<tr>
<td>Certifying Agency</td>
<td>Local Ministry of</td>
<td>Ministries of Science &amp; Technology, Science &amp; Technology Finance and National Tax Bureau</td>
</tr>
</tbody>
</table>

NOTES: Size thresholds in Millions of RMB, where 50 M RMB ≈ 7.75 M USD and 200 M RMB ≈ 30 M USD.

Potential for Evasion and Relabeling

One concern is that firms’ reported R&D investment is contaminated by evasion or relabeling. Relabeling of other expenses as R&D is a significant concern for policymakers (GAO, 2009) and for academics studying the effects of R&D investment (Eisner et al., 1984; Mansfield and Switzer, 1985). In our setting, the institutional environment limits some forms of evasion and suggests that the most likely form of relabeling is the mis-categorization of administrative expenses as R&D.

The hypothesis that the entirety of the response is due to evasion is likely ruled out by the requirements of the InnoCom certification.\(^8\) A second hypothesis is that firms manipulate their reported R&D intensity by reporting “phantom expenses” or by manipulating sales. China relies on a value-added tax (VAT) system with third-party reporting, and China’s State Administration of Tax (SAT) keeps records of transaction invoices between a given firm and its third-party business partners. As in other settings (e.g., Kleven et al., 2011), this type of third-party reporting limits the degree to which firms can completely make up “phantom” R&D expenses.

From conversations with the State Administration of Tax as well as with corporate executives, we recognize that the most likely source of manipulation is the mis-categorization of expenses. This is a natural channel for relabeling since, in the Chinese Accounting Standard, R&D is categorized under “Administrative Expenses,” which includes various other expenses related to general management.\(^9\) Thus, firms may relabel non-R&D administrative expenditures as R&D in order industries. Due to the breadth and vagueness of these industry definitions, this requirement does not constitute a substantial hurdle. In addition, after the reform, the state authorities further require that firms meet all these criteria in the previous three accounting years, or from whenever the firm is registered, in case the firm is less than three years old.

\(^8\)Part of this certification includes an audit of the firm’s tax and financial standings. In addition, the Chinese State Administration of Tax, together with the Ministry of Science and Technology, conducts regular auditing of the InnoCom HTE firms.

\(^9\)Examples include administrative worker salary, business travel expenses, office equipment, etc. While we interpret changes in administrative expenses as relabeling, they may also be consistent with reallocating resources from other expenses towards R&D, or with more precise accounting of previously-undercounted R&D expenses. In
to over-report their R&D intensity. These types of expenses are easily shifted, and it may be hard to identify relabeling in any given audit. Relabeling may also be a way for firms to reach the R&D intensity threshold when it is hard for them to perfectly forecast their sales. A firm with unexpectedly high sales, for instance, might choose to characterize administrative expenses as R&D in order to meet the InnoCom requirement for a given year. Our empirical strategy to detect relabeling leverages these institutional features and exploits the detailed cost reporting in our administrative tax data, which contains information on the breakdown of operating expenses and R&D expenses.

3 Descriptive Evidence of Firms’ Responses to Tax Notches

We now describe our data and provide evidence that the R&D investment of Chinese manufacturing firms responds to the InnoCom program. We then show that part of this response may be due to relabeling. Specifically, we document stark bunching patterns precisely above the tax notches, and we show that the ratio of administrative expenses to sales drops sharply at the notch.

3.1 Data and Summary Statistics

Our main data come from the Chinese State Administration of Tax (SAT). The SAT is the counterpart to the IRS in China and is in charge of tax collection and auditing. Our data are comprised of administrative enterprise income tax records for years 2008–2011 (Appendix B discusses our data sources). These panel data include information on firms’ total production, sales, inputs, and R&D investment. The detailed cost breakdowns allow us to measure different subcategories of administrative expenses. We use these data to construct residualized measures of firm productivity (see Appendix C for details). The SAT’s firm-level records of tax payments contain information on tax credits, such as the InnoCom program, as well as other major tax breaks. This allows us to precisely characterize the effective tax rate for individual manufacturing firms. We supplement these data with the relatively well-studied Chinese Annual Survey of Manufacturing (ASM), which extends our sample to years 2006–2007.

Table 2 reports descriptive statistics of the firms in our analysis sample. In panel A, we report summary statistics of our tax data for all surveyed manufacturing firms from 2008 to 2011. Our data are comprised of around 1.2 million observations, with about 300,000 firms in each year. 8% of the sample reports positive R&D. Among firms with positive R&D, the ratio of R&D to sales ratio, i.e. R&D intensity, is highly dispersed. The 25th, 50th, and 75th percentiles are 0.3%, 1.5%, 10While we recognize that it is possible for firms to relabel R&D intensity through other means, we do not find systematic evidence for this hypothesis. In Section 3 we show sales are not manipulated around the R&D thresholds. Similarly, we do not find evidence of manipulation of other expenses.}

Section 6 we explore how this interpretation affects our estimates.
and 4.3%, respectively. The administrative expense to sales ratio, which is a potential margin for relabeling, is close to 5.8% at the median. While our measure of residualized TFP is normalized by construction, the distribution of productivity has a reasonable dispersion with an interquartile range of 0.8 log points.

Panel B of Table 2 reports summary statistics of Chinese manufacturing firms with R&D activity in the ASM for years 2006–2007. We have a similar sample size of around 300,000 firms per year. Firms in the ASM sample are noticeably larger than those in the SAT sample, and the difference is more pronounced when we look at lower quartiles (i.e. 25th percentile) of the distribution of sales, fixed assets, and the number of workers. This is consistent with the fact that the ASM is weighted toward medium and large firms. The fraction of firms with positive R&D is slightly larger than 10%, and R&D intensity ranges from 0.1% to 1.7% at the 25th and 75th percentiles of this sample.

### 3.2 Bunching Response

We first analyze data from the post-2008 period since the multiple tax notches based on firm size generate rich variation in R&D bunching patterns. Figure 2 plots the empirical distribution of the R&D intensity of Chinese firms in 2011. We limit our sample to firms with R&D intensity between 0.5% and 15% to focus on firms with non-trivial innovation activities. The first panel in Figure 2 shows the histogram of overall R&D intensity distribution. There are clear bunching patterns at 3%, 4%, and 6% of R&D intensity, which correspond to the three program thresholds. This first panel provides strong prima-facie evidence that fiscal incentives provided by the InnoCom program play an important role in firms' R&D investment choices.

To further validate that these R&D bunching patterns are motivated by this specific policy, the remaining panels of Figure 2 plot the histograms of R&D intensity for the three different size categories. For firms with annual sales below 50 million RMB, we find clear bunching at 6%, and we find no evidence of bunching at other points. Similarly, for firms with annual sales between 50 million and 200 million RMB, we only find bunching at 4%, while for firms with more than 200 million RMB in annual sales, we only observe bunching at 3%. These patterns are consistent with the size-dependent tax incentive in the InnoCom program.

We now compare bunching patterns before and after the 2008 tax reform. Figure 3 compares the R&D intensity distribution for large FOEs before and after 2008. Large FOEs have no clear pattern of bunching before 2008. This is consistent with the fact that FOEs had a very favorable EIT treatment before the reform, which severely reduced the appeal of the InnoCom program. In comparison, Figure A.1 plots the empirical distribution of R&D intensity in the ASM for years 2006–2007. The tax incentive of the InnoCom was not size-dependent before 2008, and kicked-in uniformly at a 5% R&D intensity. It is reassuring that we observe the R&D intensity bunching solely at 5%, and no significant spikes at 3%, 4%, and 6%.

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\[\text{In comparison, Figure A.1 plots the empirical distribution of R&D intensity in the ASM for years 2006–2007. The tax incentive of the InnoCom was not size-dependent before 2008, and kicked-in uniformly at a 5% R&D intensity. It is reassuring that we observe the R&D intensity bunching solely at 5%, and no significant spikes at 3%, 4%, and 6%.}\]
contrast, FOEs start behaving like DOEs after 2008, when the InnoCom program becomes one of the most important tax breaks for FOEs. Their R&D intensity distribution shows a clear bunching pattern at 3% after the reform, which is the exact threshold required for these firms to qualify as HTEs. The figure demonstrates that the change in the EIT system had a large impact on firm behavior.\(^\text{12}\)

### 3.3 Detecting Relabeling of R&D Investment

We now explore the degree to which the bunching response may be due to expense mis-reporting. Figure 4 explores how the ratio of non-R&D administrative expenses to sales is related to R&D intensity. For each size group, this figure groups firms into bins of R&D intensity and plots the mean non-R&D administrative expense-to-sales ratio for each bin. We report the data along with an estimated cubic regression of the expense ratio on R&D intensity with heterogeneous coefficients above and below the notches. The green squares are for large firms, red diamonds for medium firms, and blue dots for small firms. There is an obvious discontinuous jump downward at the notch for each size category. This suggests that some firms that report R&D intensity at the notch may partly relabel non-R&D expenses as R&D to comply with the policy. Once firms get farther away from the bunching threshold, there is no systemic difference in the administrative expense-to-sales ratio. This pattern is consistent with the hypothesis that firms mis-categorize non-R&D expenses into R&D when they get close to the bunching thresholds.\(^\text{13}\)

The structural breaks in Figure 4 are statistically significant for all three groups (see Table A.1). As we discuss in Section 5.2, however, these estimates do not have a causal interpretation. Nonetheless, they present strong descriptive evidence that firms may respond to the InnoCom program by relabeling non-R&D expenses.\(^\text{14}\)

### Lack of Sales Manipulation

The stark bunching patterns in Figure 2–3 raise the concern that firms may also manipulate their sales. There are two ways firms may do this. First, since the incentives of the InnoCom program are stated in terms of R&D intensity (R&D/Sales), firms could increase their R&D intensity by under-reporting sales. Panel A in Figure 5 plots firms’ log sales relative to their R&D intensity. Panel A in Figure 5 plots firms’ log sales relative to their R&D intensity.

\(^{12}\) Consistent with the intent of the program, firms’ bunching patterns are persistent over time. Specifically, 76% of firms that report an R&D intensity greater than the notch in 2011 also bunched in 2010. For this reason, our model considers the choice of R&D as a medium-term investment plan.

\(^{13}\) The existence of different thresholds across size groups also allows us to rule out other explanations for these discontinuities. In particular, we find that when we impose the “wrong” thresholds of the other size groups, there is no observable discontinuity. In Appendix D, we explore whether firms adjust other costs that are not in the administrative cost category, and we show that firms do not respond to the program by manipulating other expenses.

\(^{14}\) We also conduct a similar set of analysis focusing on the ratio of R&D to total administrative expenses. In this case, expense mis-categorization would result in discontinuous increases in this ratio at the notch. This is confirmed in Table A.3 and in Figure A.2.
For each group of firms, we report average log sales for small bins of R&D intensity as well as an estimated cubic regression that is allowed to vary below and above each threshold. If firms under-reported sales in order to achieve the target, we might expect a sudden drop in sales to the right of each threshold. In contrast, this figure shows that both the data and the estimated polynomial regressions are remarkably stable at each notch.¹⁵

Second, if a firm wants to be categorized as a larger firm, it may over-report sales in order to qualify for a lower R&D intensity threshold. Panels B and C in Figure 5 show the histogram of firms around the size thresholds. Since larger firms face lower R&D intensity thresholds, we might expect firms to bunch on the right of the size threshold. These figures show that firms are not responding to the incentives by manipulating their size.¹⁶ Overall, it does not appear firms mis-report sales in order to comply with the InnoCom program. One reason for this result is that, in addition to the limits placed by third-party reporting in the VAT system, firm managers may not want to mis-report sales as this is seen as a measure of their job performance.

Figures 2-4 provide strong visual evidence that firms actively respond to the incentives in the InnoCom program by increasing reported R&D investment and by relabeling administrative costs as R&D. Our quantitative analysis focuses on measuring the size of the change in R&D investment, analyzing the degree to which the response is due to relabeling, and studying how relabeling may influence the effect of R&D on productivity.

4 A Model of R&D Investment and Corporate Tax Notches

This section develops a model of R&D investment where firms may respond to notches in the corporate income tax schedule in China by investing in R&D and by relabeling non-R&D expenses. The model has three objectives. First, the model shows that a standard model of firm investment and relabeling may produce the patterns described in Section 3. Second, the model motivates a bunching estimator for the increase in R&D investment, as in Saez (2010) and Kleven and Waseem (2013), as well as an treatment effects estimator for relabeling and productivity, as in Diamond and Persson (2016). Finally, the model shows how to relate bunching estimates to structural parameters, which we use to study the effectiveness of alternative tax incentives.

4.1 Model Setup

We start with a simple model. We then develop extensions that account for relabeling, fixed costs of certification, and adjustments costs. Appendix E discusses the model in detail.

¹⁵Table A.2 reports estimates of the structural breaks at these notches, which are statistically insignificant.
¹⁶In our estimations, we further restrict our sample to exclude firms that are close to the size threshold and this does not affect our estimates.
Consider a firm $i$ with a unit cost function $c(\phi_{it}, w_t) = c(w_t) \exp\{-\phi_{it}\}$, where $w_t$ is the price of inputs.\(^{17}\) $\phi_{it}$ is log-TFP and has the following law of motion:

$$\phi_{i,t} = \rho \phi_{i,t-1} + \varepsilon \ln(D_{i,t-1}) + u_{it}, \quad (1)$$

where $D_{i,t-1}$ is R&D investment and $u_{it} \sim$ i.i.d. $N(0, \sigma^2)$. Because our empirical analysis focuses on firms with non-trivial R&D, this law of motion applies to firms with $D_{i,t-1} > 0$.\(^{18}\) This setup is consistent with the R&D literature where knowledge capital depreciates over time (captured by $\rho$) and is influenced by R&D expenditures (captured by $\varepsilon$).

We assume the firm faces a demand function with a constant elasticity: $\theta > 1$. This setup implies that we can write expected profits as follows:

$$\mathbb{E}[\pi_{it}] = \tilde{\pi}_{it} D_{i,t-1}^{(\theta-1)\varepsilon},$$

where $\tilde{\pi}_{it} \propto \mathbb{E}[\exp\{(\theta-1)\phi_{it}\}|\phi_{i,t-1}]$ measures the non-R&D expected profitability of the firm.

**R&D Choice Under A Linear Tax**

Consider first how firms' R&D investment decisions would respond to a linear income tax. We analyze the firm’s inter-temporal problem as a two-period investment decision:\(^{19}\)

$$\max_{D_{i1}} (1 - t_1)(\pi_{i1} - D_{i1}) + \beta(1 - t_2)\tilde{\pi}_{i2} D_{i1}^{(\theta-1)\varepsilon}.$$  

The optimal choice of $D^*_i$ is given by:\(^{20}\)

$$D^*_i = \left[ \frac{\beta(1 - t_2)(\theta - 1)\varepsilon}{1 - t_1} \right] \tilde{\pi}_{i2}.$$  

The choice of R&D depends on potentially-unobserved, firm-specific factors $\phi_{i1}$, as they influence expected profits, $\tilde{\pi}_{i2}$. We can recover these factors by inverting the first order condition and writing $\tilde{\pi}_{i2}$ as a function of $D^*_i$:

$$\tilde{\pi}_{i2} = \frac{1}{(\theta - 1)\varepsilon} \frac{1 - t_1}{\beta(1 - t_2)} (D^*_i)^{1-(\theta-1)\varepsilon}. \quad (2)$$

We now write the value of the firm, $\Pi(D^*_i|t_2)$, as a fraction of firm sales, $\theta \pi_{i1}$, by substituting Equation 2 into the objective function:

$$\frac{\Pi(d^*_i|t_2)}{\theta \pi_{i1}} = (1 - t_1) \left[ \frac{1}{\theta} + d^*_i \left( \frac{1}{(\theta - 1)\varepsilon} - 1 \right) \right]. \quad (3)$$

\(^{17}\)Note that any homothetic production function with Hicks-neutral productivity admits this representation.

\(^{18}\)If firms do not engage in R&D, we assume that their productivity process is $\phi_{it} = \rho \phi_{i,t-1} + u_{it}$.

\(^{19}\)Firms commit to a medium-term set of R&D investments in order to participate in the InnoCom program (see Section 2). For this reason, we view the relevant margin for firms as a medium-term decision that we characterize in a two-period context.

\(^{20}\)As we discuss in Appendix E, we assume $(\theta - 1)\varepsilon < 1$ in order to ensure a well-behaved second order condition.
Equation 3 expresses the firm’s problem in terms of the choice of R&D intensity, \(d_{i1}^* = \frac{D_{i1}^*}{\theta \pi_{i1}}\), as in the InnoCom program.\(^{21}\)

**A Notch in the Corporate Income Tax**

Assume now that the tax in the second period has the following structure, modeled after the incentives in the InnoCom program:

\[ t_2 = \begin{cases} t_{2LT} & \text{if } d_{i1} < \alpha \\ t_{2HT} & \text{if } d_{i1} \geq \alpha \end{cases} \]

where \(t_{2LT} > t_{2HT}\), and where \(LT/HT\) stands for low-tech/high-tech. This tax structure induces a notch in the profit function at \(d_{i1} = \alpha\), where \(\alpha\) is the R&D intensity required to obtain the high-tech certification. Figure 6 presents two possible scenarios following this incentive. Panel A shows the example of a firm that finds it optimal to choose a level of R&D intensity below the threshold. At this choice, the first order condition with a linear tax holds and the optimal value of the firm is given by Equation 3. In this panel, a range of R&D intensity below the threshold is dominated by the threshold \(\alpha\). Panel B shows another firm that is indifferent between the internal solution and “bunching” at the notch. This firm is the marginal buncher and is characterized both by Equation 2 and by having an equal firm value at R&D intensities \(d_{i1}^*\) and \(\alpha\).

Let \(\Pi(\alpha |t_{2HT}) / \theta \pi_{i1}\) be the value-to-sales ratio of the firm conditional on bunching at the notch. Using Equation 2, we can write this equation as:

\[
\Pi(\alpha |t_{2HT}) / \theta \pi_{i1} = (1 - t_1) \left[ \frac{1}{\theta} + \alpha \left( \frac{d_{i1}^*}{\alpha} \right)^{1-(\theta-1)\varepsilon} \left( \frac{1 - t_{2HT}}{1 - t_{2LT}} \right) \frac{1}{(\theta - 1)\varepsilon - 1} \right].
\]

Compared to Equation 3, this equation shows a larger R&D intensity (since \(d_{i1}^* < \alpha\)), which increases the cost of investment. The additional investment results in higher profits because of the productivity effect from the additional investment in R&D, \(\left( \frac{d_{i1}^*}{\alpha} \right)^{-(\theta-1)\varepsilon} > 1\), and because of the tax benefit, \(\left( \frac{1 - t_{2HT}}{1 - t_{2LT}} \right) > 1\).

A firm will bunch at the notch if \(\Pi(\alpha |t_{2HT}) / \theta \pi_{i1} \geq \Pi(d_{i1}^* |t_{2HT}) / \theta \pi_{i1}\), which occurs when:

\[
\left( \frac{d_{i1}^*}{\alpha} \right)^{1-(\theta-1)\varepsilon} \left( \frac{1 - t_{2HT}}{1 - t_{2LT}} \right) \frac{1}{(\theta - 1)\varepsilon - 1} \geq \frac{d_{i1}^*}{\alpha} \left( \frac{1}{(\theta - 1)\varepsilon - 1} \right).
\]

For firms that were already close to the notch \(d_{i1}^* \approx 1\), bunching has small costs and productivity benefits, but the tax cut \(\left( \frac{1 - t_{2HT}}{1 - t_{2LT}} \right) > 1\) incentivizes firms to bunch. For firms farther from the notch

\(^{21}\)Firm value is given by \(\Pi(D_{i1}^* |t_2) = (1 - t_1) \left[ \pi_{i1} + D_{i1}^* \left( \frac{1}{(\theta-1)\varepsilon} - 1 \right) \right]\), where we substitute Equation 2 into the firm’s objective function.
(as \(d_{i1}^*\) decreases from \(\alpha\)), the additional investment costs increase faster than the productivity benefits, which reduces firms’ incentive to bunch.

Let \(d^{*-}\) be the marginal firm such that Equation 4 holds with equality, as in panel B of Figure 6. In this simple model, firms with \(d_{i1}^* \in (d^{*-}, \alpha)\) would decide to bunch at the notch, since the difference between the left- and right-hand-sides of Equation 4 is increasing in \(d_{i1}^*\). It can also be shown that \(d^{*-}\) is decreasing in both \((\theta - 1)\varepsilon\) and \(\left(\frac{1-t_2^{HT}}{1-t_2^{LT}}\right)\), so that we would observe more bunching if firms have a higher valuation of R&D, or if the tax incentive is larger.

### 4.2 Real and Relabeled R&D Investment Under Tax Notch

This section extends the model by allowing for firms to misreport their costs and shift non-R&D costs to the R&D category. We show that the interpretation of the reported bunching response is now a combination of real and relabeled activity.

Denote a firm’s reported level of R&D spending by \(\tilde{D}_{i1}\). The expected cost of misreporting to the firm is given by \(h(D_{i1}, \tilde{D}_{i1})\), which represents the likelihood of being caught and the punishment from the tax authority. We assume that the cost of mis-reporting is proportional to the reported R&D and depends on the percentage of misreported R&D, \(\delta_{i1} = \frac{\tilde{D}_{i1} - D_{i1}}{\tilde{D}_{i1}}\), so that:

\[
h(D_{i1}, \tilde{D}_{i1}) = \tilde{D}_{i1} \tilde{h}(\delta_{i1}).
\]

We also assume that \(\tilde{h}\) satisfies \(\tilde{h}(0) = 0\) and \(\tilde{h}'(\cdot) \geq 0\). Finally, define \(\Pi(D_{i1}, \tilde{D}_{i1}|t)\) as the value function of a firm’s inter-temporal maximization problem when the firm invests \(D_{i1}\) on R&D, declares investment of \(\tilde{D}_{i1}\), and faces tax \(t\) in period 2.

Firms qualify for the lower tax whenever \(\tilde{D}_1 \geq \alpha \theta \pi_1\). Notice first that if a firm decides not to bunch at the level \(\alpha \theta \pi_1\), there is no incentive to misreport R&D spending as it does not affect total profits or the tax rate. However, a firm might find it optimal to report \(\tilde{D}_1 = \alpha \theta \pi_1\), even if it actually invested a lower level of R&D.

Consider now the optimal relabeling strategy of a firm conditional on bunching. The first order condition for relabeling implies the following condition:

\[
\left(\frac{d_{i1}^*}{\alpha (1 - \delta_{i1}^*)}\right)^{1-(\theta-1)\varepsilon} \times \left(\frac{1 - t_2^{HT}}{1 - t_2^{LT}}\right) = \frac{\left((1 - t_1)^{-\tilde{h}'(\delta_{i1}^*)}\right)}{\alpha (1 - t_1)}.
\]

where we use Equation 2 to express the first order condition in terms of the interior optimum R&D intensity, \(d_{i1}^*\). When deciding how much to relabel, the firm trades-off lower productivity gains and increased costs of relabeling with the decrease in investment costs. This equation features the

\[\text{Productivity Loss from Relabeling} \quad \text{Reduction in Investment Cost and Increase in Relabeling Cost}\]

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\textsuperscript{22}Our formulation of \(\tilde{h}(\cdot)\) is consistent with general features of evasion cost functions in the literature (Slemrod, 2001). We assume that the mis-reporting cost depends on \(\delta\) (the percentage of mis-reported R&D) because the InnoCom program is based on R&D intensity rather than total R&D expenditures.
“avoidance-facilitating” effect whereby real R&D lowers the marginal cost of relabeling (Slemrod and Gillitzer, 2013).

The firm decides to bunch if the profits from the optimal relabeling strategy are greater than when the firm is at the optimal interior solution, which occurs when:

\[
\left( \frac{d^*_i}{\alpha(1 - \delta^*_i)} \right)^{1 - (\theta - 1)\varepsilon} \times \frac{(1 - \delta^*_i)}{(\theta - 1)\varepsilon} \times \left( \frac{1 - t_H}{1 - t_L} \right) - (1 - \delta^*_i) \geq \frac{\bar{h}(\delta^*_i)}{\alpha(1 - t_1)} \times \left( \frac{1}{(\theta - 1)\varepsilon} - 1 \right) .
\]

Equations 4 and 6 are very similar and are identical in the case when \( \delta^*_i = 0 \)—i.e., when there is no relabeling. When \( \delta^*_i > 0 \), the cost of investment and the productivity gains are smaller, but the firm also incurs a cost of relabeling.

Since firms can elect to report truthfully (\( \delta = 0 \)), firms’ profits from bunching in the case with relabeling are greater than in the case without relabeling. However, since the relative profit from not bunching has not changed, this implies that misreporting allows more firms to bunch than in the case without relabeling. Panel C of Figure 6 shows this intuition graphically. It depicts a firm that would not bunch absent the ability to relabel R&D. With relabeling, the firm reports an R&D intensity of \( \alpha \), while real R&D intensity is \( (1 - \delta^*_i)\alpha \geq d^*_i \). Thus, when relabeling is possible, the marginal firm (such that Equation 6 holds with equality) will have a lower threshold \( d^*_i \). This implies that we should see more bunching when firms can misreport R&D, and that the observed bunching patterns combine real increases in R&D with increases in relabeling.

4.3 Adjustment Costs of Investment and Fixed Certification Cost

We now enrich the model to allow for adjustment costs of R&D and fixed certification costs.

Consider first the role of adjustment costs of R&D investment. In a world without the InnoCom program, our model would predict a deterministic relationship between R&D and TFP. In reality, the distribution of R&D investment in China has large variability even conditional on firm TFP. This variability reflects the fact that firms face different costs of installing new equipment and also have different opportunities to improve their technology. We incorporate these real-world features by assuming that firms face heterogeneous adjustment frictions of conducting R&D. We follow the investment literature and adopt a quadratic formulation for adjustment costs that is governed by: \( b \times \frac{\theta_i}{2} \left[ \frac{D_i}{\theta_i} \right]^2 \). Intuitively, the law of motion for TFP allows for strong returns to scale, as it implies that increasing R&D will have a proportional increase in the TFP of all units of production within a firm. Since the adjustment costs are proportional to firm size, they limit the returns to scale in R&D investment.

Now consider the costs of obtaining the InnCom certification. Our initial model predicts that all firms with \( d \in (d^*, \alpha) \) would bunch at the notch. However, firms with high R&D intensity may not participate in the program due to constraints that prevent them from hiring the sufficient
number technical employees, if they do not obtain a significant fraction of their sales from high-tech products, or due to compliance and registration costs. We model these constraints by assuming that firms pay a fixed cost of certification: \( c \times \alpha \theta \pi_1 \). These costs imply that some firms will not be able to bunch despite being very close to the notch—i.e., the region immediately below the notch will not be empty.

With fixed costs and adjustment costs, the decision to bunch is similar to that described by Equation 6. In this case, however, the identity of the marginal firm depends on a given set of values \( b \) and \( c \). We denote the marginal firm as \( d_{b,c}^- \). As expected, we find that \( d_{b,c}^- \) is increasing (smaller bunching response) with both adjustment, \( b \), and fixed, \( c \), costs. As before, for a given set of values \( b \) and \( c \), \( d_{b,c}^- \) is decreasing (larger bunching response) in the profitability elasticity of R&D, \( (\theta - 1)\varepsilon \), and increasing in the relabeling cost. Finally, we now redefine \( d^* = \min_{b,c} d_{b,c}^- \) as the smallest R&D intensity for which there is a marginal firm.\(^23\)

### 4.4 Empirical Implications for Bunching on R&D

We now describe how we use the model to quantify the distributional patterns described in Section 3. Figure 7 provides the intuition for this procedure. Panel A plots \( h_0(d) \): the counterfactual distribution of R&D intensity under a linear tax. Panel A demonstrates the effect of the notch on the distribution of R&D intensity in a world of unconstrained firms. In this case, the range \((d^*, \alpha)\) is dominated by the threshold \( \alpha \), as shown by the density of R&D intensity with a notch, \( h_1(d) \). Denote \( B \) as the missing mass relative to the counterfactual distribution over this range. To see how the model relates to the extent of bunching, note that a larger value of \( \varepsilon \) or a lower relabeling cost will result in a larger missing mass \( B \) and a lower value of \( d^* \)—i.e., the marginal bunching firm has a lower R&D intensity.

The prediction in panel A of Figure 7 is quite stark in that no firms are expected to locate in the dominated interval. The presence of fixed and adjustment costs constrains some firms from responding to the incentives in the InnoCom program. For given values of \((b, c)\), a firm will be constrained from responding if \( d < d_{b,c}^- \), an event that we denote by \( \mathbb{I}[d < d_{b,c}^-] \). The fraction of constrained firms at a given value of \( r \) in the range \((d^*, \alpha)\) is given by

\[
\mathbb{P}_r(\text{Constrained}|r) = \int_{b,c} \mathbb{I}[r < d_{b,c}^-]h_0(r, b, c)d(b, c) = h_1(r),
\]

where \( h_0(r, b, c) \) is the joint density of R&D intensity, fixed costs, and adjustment costs, and where the second equality notes that we observe this fraction of firms in the data. It follows from this expression that measures of \( \mathbb{P}_r(\text{Constrained}|r) \) are informative of the distributions of \( b \) and \( c \).

---

\(^23\)Appendix J discusses alternative models that allow for heterogeneous returns to R&D, \( \varepsilon \), across firms.
Panel B of Figure 7 describes graphically how random adjustment and fixed costs affect the predicted bunching pattern. In particular, the area $B$ can now be computed as follows:

\[
B = \int_{d^* - b, c}^\alpha \int \mathbb{I}[r \geq d_{b, c}^\alpha] h_0(r, b, c) d(b, c) dr = \int_{d^* - b, c}^\alpha \int (1 - \mathbb{I}[r < d_{b, c}^\alpha]) h_0(r, b, c) d(b, c) dr
\]

\[
= \int_{d^* -}^\alpha (h_0(r) - \mathbb{P}_r(\text{Constrained}|r)) dr = \int_{d^* -}^\alpha (h_0(r) - h_1(r)) dr.
\]

The first line shows that $B$ depends on the distribution of fixed and adjustment costs. The second line shows that frictions result in a smaller bunching mass $B$ by subtracting the fraction of constrained firms. The observed degree of bunching $B$ is therefore a function of $\varepsilon$, relabeling costs, adjustment costs, and certification costs.

This discussion highlights how bunching estimates inform the parameters of the model. Specifically, the model predicts that lower fixed and adjustment costs will result in larger values of $B$, lower values of $d^* -$, and lower values of $\mathbb{P}_r(\text{Constrained}|d)$. To separate the role of fixed and adjustment costs, we use the fact that firms below $d^* -$ and significantly above $\alpha$ are not affected by the program. For this reason, the observed density $h_1(d)$ away from the notch is independent of the distribution of $c$ but is informative of the distribution of $b$. Conditional on fixed and adjustment costs, lower relabeling costs and a higher values of $\varepsilon$ also predict larger values of $B$ and lower values of $d^* -$. In order to disentangle how $\varepsilon$ and relabeling costs affect bunching, we use the fact that, since firms have no incentive to misreport R&D outside of the bunching region, the joint distribution of $d_{1, i}$ and $\phi_1$ informs the value of $\varepsilon$ separately from the role of relabeling costs. The structural estimation leverages these insights to recover structural parameters. These estimates quantify the fraction of reported R&D that is due to relabeling, how relabeling affects the measured effects of reported R&D on TFP, and how firms respond to alternative tax policies.

4.5 Model Implications for Relabeling and Productivity

We now discuss an alternative and complementary approach to quantifying the effects of the InnoCom program on relabeling and productivity. Our model predicts that firms that bunch may relabel R&D and that their future TFP will increase to the extent that reported R&D constitutes real investment. Because firms select into the program by manipulating R&D, comparing firms that participate in the program to those that do not can result in biased estimates of the effects of the program. To obtain unbiased estimates, we follow a treatment effects approach that compares the (observed) average outcome of firms that could have participated in the program to a counterfactual average without the InnoCom program.
Diamond and Persson (2016) develop an estimator that formalizes this comparison and quantifies the average effect of the program on a given outcome $Y$:\footnote{Bachas and Soto (2019) implement a similar approach to analyze the effects of notches on other outcomes.}

\[ ITT^Y = E[Y|\text{Notch}, d \in (d^{*-}, d^{*+})] - E[Y|\text{No Notch}, d \in (d^{*-}, d^{*+})], \tag{8} \]

where we define the manipulated region $(d^{*-}, d^{*+})$ to include all firms that could have responded to the program. While $d^{*+} = \alpha$ in theory, in practice firms bunch in a neighborhood above $\alpha$, as can be seen in Figure 2.\footnote{Section 5.2 discusses the econometric approach to estimating $E[Y|\text{No Notch}, d \in (d^{*-}, d^{*+})]$, including $d^{*-}$ and $d^{*+}$. Note that $E[Y|\text{Notch}, d \in (d^{*-}, d^{*+})]$ is directly observed in the data.}

Equation 8 compares the average potential outcome of firms in the region $(d^{*-}, d^{*+})$, which includes firms that do not respond to the program, as well as firms whose R&D intensity would be above the notch without the program. For this reason, we interpret this quantity as an intent-to-treat (ITT).\footnote{Conceptually, we can partition the firms in the region $(d^{*-}, d^{*+})$ into compliers, never-takers, and always-takers. In our setting, never-taker firms are firms below the notch that are constrained from responding to the policy. Always-taker firms are firms that are already above the notch without the program. By assuming that there are no defier firms, we can show that Equation 8 has the interpretation of an intent-to-treat. See Appendix F for a detailed discussion.}

Our model has intuitive predictions for the intent-to-treat effects on R&D, relabeling through administrative costs (ADM), and TFP. If some of the reported R&D intensity is real activity, our model would predict that $ITT^{TFP} \geq 0$. According to our model for the evolution of TFP in Equation 1, we would find larger values of $ITT^{TFP}$ for larger values of the parameter $\varepsilon$. We expect to find $ITT^{ADM} < 0$ if a fraction of the reported R&D is due to relabeling of administrative costs. Intuitively, if firms over-report R&D by under-reporting administrative costs, the average $ADM$ over the excluded region would be artificially low. Our model predicts small values of $ITT^{ADM}$ if firms face large costs of relabeling. Finally, consider the case where the outcome of interest is reported R&D intensity. In this case, $ITT^d$ only depends on the counterfactual density $h_0(d)$. Our model predicts a larger fraction of compliers if $\varepsilon$ is large or if relabeling costs are low.

This discussion shows that this treatment effects approach can also quantify the extent of relabeling and the effects of the InnoCom program on productivity. In addition, estimates of Equation 8 complement the model-based approach by providing additional moments that can inform the parameters of the model.

## 5 Effects on Investment, Relabeling, and Productivity

The model shows that the effects of the program on the distribution of R&D intensity and on firm-level relabeling and TFP can improve our understanding of the effectiveness of tax incentives for R&D. In Section 5.1, we use a bunching estimator to quantify the increase in reported R&D in response to the program. We present estimates of treatment effects of the program on relabeling
5.1 Bunching Estimates of Investment Response

We follow the literature (e.g., Kleven, 2016) by using a flexible polynomial to estimate the counterfactual density of R&D intensity, \( h_0(\cdot) \). We first group the data into bins of R&D intensity and then estimate the following regression:

\[
c_j = \sum_{k=0}^{p} \beta_k \cdot (d_j)^k + \gamma_j \cdot 1 \left[ d^- \leq d_j \leq d^+ \right] + \nu_j,
\]

where \( c_j \) is the count of firms in the bin corresponding to R&D intensity \( d_j = \frac{D_j}{\theta \pi_1} \), and where \((d^-, d^+)\) is the region excluded in the estimation.\(^{27}\) An estimate for \( h_0(\cdot) \) is now given by

\[
\hat{c}_j = \sum_{k=0}^{p} \hat{\beta}_k \cdot (d_j)^k.
\]

We obtain counterfactual estimates for \( h_0(\cdot) \) and \( B \) as follows:

\[
\hat{h}_0(\alpha) = \sum_{k=0}^{p} \hat{\beta}_k \cdot (\alpha)^k \quad \text{and} \quad \hat{B} = \sum_{d_j=d^-}^{d^+} \left( \sum_{k=0}^{p} \hat{\beta}_k \cdot (d_j)^k - c_j \right).
\]

Intuitively, a larger missing mass \( B \) is related to a larger increase in R&D intensity. Indeed, we can quantify the effect of the program on R&D investment as follows:

\[
\Delta d \equiv \frac{\mathbb{E}[d|\text{Notch}, d \in (d^-, d^+)] - \mathbb{E}[d|\text{No Notch}, d \in (d^-, d^+)]}{\mathbb{E}[d|\text{No Notch}, d \in (d^-, d^+)]} \approx \frac{B}{2\alpha h_0(\alpha)}. \quad (9)
\]

\( \Delta d \) is a reduced-form estimate of the percentage increase in R&D over the region \((d^-, d^+)\). Because it measures the effect for all firms that could have participated in the program, we interpret \( \Delta d \) as an estimate of the intent-to-treat relative to the counterfactual.

To present estimates that are comparable to the literature (e.g., Kleven and Waseem, 2013), we report two additional quantities. First, we report the percentage increase in R&D intensity for the marginal buncher relative to the notch:

\[
\Delta D^* \approx \frac{B}{\alpha h_0(\alpha) \left( 1 - \mathbb{P}(\text{Constrained}) \right)}. \quad (10)
\]

In practice, we estimate the fraction of constrained firms at an R&D intensity \( \alpha^- \) such that firms would be willing to jump to the notch even if R&D had no effects on productivity.\(^{28}\) In addition,

\(^{27}\)Our setting avoids two common issues that arise when estimating counterfactual densities. First, we do not observe bunching at round numbers since our running variable is a ratio. Second, the density above the notch can potentially reflect intensive margin responses, which could shift the density to the right. Because the density is very flat in this region, adjusting for this shift does not affect our estimates.

\(^{28}\)Appendix F contains details of these approximations. The “money-burning” point is easy to compute. Note that the tax benefit is given by \( \text{Profits} \times (t^{HT} - t^{LT}) \) and the cost of jumping to the notch is \( \text{Sales} \times (\alpha - \alpha^-) \), which implies that \( \alpha^- = \alpha - (t^{HT} - t^{LT}) \times \text{Profits} \). Using the average net profitability ratio in our data of 7\%, this implies that firms in the range \((\alpha - 0.07 \times (t^{HT} - t^{LT}), \alpha)\) are not able to respond to the incentives of the InnoCom program. For the case of the large firms we have \((\alpha^-, \alpha) = (2.3\%, 3\%)\).
we also estimate the fraction of constrained firms at \( \alpha^- \) relative to the counterfactual density:

\[
a^*(\alpha^-) = \frac{\Pr(\text{Constrained}|\alpha^-)}{h_0(\alpha^-)} = \frac{c_{\alpha^-}}{\sum_{k=0}^{p} \hat{\beta}_k \cdot (\alpha^-)^k}.
\]

To implement the bunching estimator, we need to choose the polynomial degree, \( p \), and the bounds of the excluded region, \((d^-*, d^+*)\). We use a data-based approach to selecting these parameters by cross-validating the choice of these values such that the missing mass below the notch equals the excess match above the notch.\(^{29}\) Finally, we obtain standard errors by bootstrapping the residuals from the original regression, generating 5000 replicates of the data, and re-estimating the parameters.

Figures 8-9 display the results of the bunching estimator for the three different notches for 2009 and 2011. The red line with diamond markers displays the observed distribution of R&D intensity \( h_1(\cdot) \), the vertical dashed lines display the data-driven choices of the omitted region, and the blue line displays the estimated counterfactual density \( h_0(\cdot) \). These graphs also report the fraction of firms that are constrained below the notch point, \( a^*(\alpha^-) \), the overall percentage increase in R&D intensity in the excluded region, \( \Delta d \), the increase in R&D intensity for the marginal firm, \( \Delta D^* \), as well as the p-value of the test that the missing mass equals the excess mass.

Panel A of Figure 8 shows a percentage increase in R&D over the excluded region of \( \Delta d = 5.6\% \) for small firms in 2009. This small increase is due to the fact that many firms are not able to respond to the program, \( a^*(\alpha^-) = 74\% \). As these are small firms, many firms may be constrained in their ability to increase investment to a significant degree or to develop a new product. In addition, a higher failure rate among small firms implies that a long process of certification may never pay off in lower taxes. However, the marginal firm sees a significant increase in reported R&D, since \( \Delta D^* = 38\% \). The specification test shows that using the missing mass or the excess mass results in statistically indistinguishable estimates.

Panels B and C show larger responses for medium and large firms in 2009. These counterfactual densities imply an increase in R&D intensity of 13.3\% for medium firms and of 14.9\% for large firms. However, marginal firms see larger increases of 78.2\% and 69.4\% for medium and large firms, respectively. These graphs show that a significant fraction of firms are constrained from responding to the program (66\% for medium and 57\% for large firms). These patterns show that even large and medium firms may be unable to satisfy some of the requirements of the program. Using the missing mass and the excess mass results in statistically indistinguishable estimates of the increases in R&D for both types of firms.

\(^{29}\)This procedure ensures that we do not overfit the data with an overly flexible polynomial and provides an objective approach to selecting the excluded region. Given the monotonically decreasing shape of the R&D intensity distribution, we restrict the estimated \( \hat{\beta}_k \)'s to result in a decreasing density. We describe this procedure in detail in Appendix G.
Figure 9 shows similar patterns for 2011. We find larger increases in R&D of 31% for large firms, 21% for medium firms, and 11% for small firms. The increase in R&D is partly driven by a smaller fraction of constrained firms in all cases. These effects are estimated with a high degree of precision as standard errors are often an order of magnitude smaller than the estimates.

We now explore the robustness of our estimates. First, we show in panel A of Figure 10 that our estimator is able to recover a null effect in the absence of the policy. This panel estimates the effect of a non-existent notch on the distribution of R&D intensity of large foreign firms before 2008, which were not subject to the incentives of the InnoCom program, and finds a small and insignificant estimate of $\Delta d$. Second, we explore the potential for firms’ extensive margin responses to bias our estimates. If the bunching we observe is driven by firms who previously did not perform any R&D, the missing mass would not equal the excess mass. This would lead us to underestimate both the excess mass and $\Delta d$. In panel B of Figure 10 we use data for large firms in 2011 and we restrict the sample to firms that had positive R&D in 2009 and 2010. This panel shows that we obtain a very similar estimate of $\Delta d$ when we rule out extensive margin responses. Finally, we show that our results are robust to using data from large foreign firms before 2008 who were not subject to the incentives of the InnoCom program in order to inform the shape of the density in the excluded region. Panel C of Figure 10 shows that using these data results in very similar estimates of both the counterfactual density and $\Delta d$. Appendix H explores further robustness checks. First, as we show in Figure A.5, our results are not sensitive to excluding state-owned enterprises, low-tech firms, or low-profitability firms in the estimation. Across these different robustness checks, the estimates of $(d^{*-}, d^{*+})$ are very precise, which shows that our results are not sensitive to the estimated excluded region. Additionally, as we show in Figure A.6, we obtain similar estimates when we vary the choices of $(p, d^{*-}, d^{*+})$ and we even obtain similar estimates when we only rely on data above $d^{*+}$ to estimate the counterfactual density.

Overall, estimates from the bunching analysis consistently show that firms respond to the InnoCom program by increasing their reported R&D intensity. In Section 6, we use estimates of $\Delta d$, $d^{*-}$, $d^{*+}$, and the counterfactual density $h_0(d)$ to construct moments that inform the key parameters of the model.

5.2 ITT Estimates on Productivity, Relabeling, and Tax Revenue

We now use an estimator of treatment effects developed by Diamond and Persson (2016) to estimate the effects of the InnoCom program on productivity, relabeling, and on fiscal costs. The intuition of the estimator is to compare the observed aggregate mean outcome for firms in the excluded region to a suitable counterfactual. For a given outcome $Y_{it}$, such as TFP, R&D or

30As discussed in Blomquist and Newey (2017), variation in non-linear incentives can help in identifying responses when using bunching approaches. We combine this un-manipulated density with the density in 2011, $h_1(d)$, by ensuring that the combined density is continuous at the boundaries of the excluded region, $d^{*-}$ and $d^{*+}$.
administrative costs, the estimate is given by:

\[
\hat{ITT} = \mathbb{E}[Y_t|\text{Notch}, d_{t_1} \in (d_{t_1}^-, d_{t_1}^+)] - \mathbb{E}[Y_t|\text{No Notch}, d_{t_1} \in (d_{t_1}^-, d_{t_1}^+)]
\]

\[
= \left[ \frac{1}{N^{\text{Exc.}}} \sum_{d_{t_1} \in (d_{t_1}^-, d_{t_1}^+)} Y_{it} \right] - \left[ \int_{d_{t_1}^-}^{d_{t_1}^+} \hat{h}_0(r) \mathbb{E}[Y_{it}|d_{t_1} = r, \text{No Notch}] dr \right]. \tag{11}
\]

When \(Y_t\) is R&D or administrative costs, we estimate contemporaneous effects, so that \(t = t_1\). For the case when \(Y_t\) is TFP, we study the effect of the program in time \(t_1\) on future TFP (\(t > t_1\)). As we discuss in Section 4.5, we interpret this estimate as an intent-to-treat (ITT). \(^{31}\) For example, the ITT on \(Y = \ln d\) measures the percentage increase in R&D intensity over the excluded region, \(\Delta d\), without imposing the approximation of Equation 9.

The first quantity in Equation 11 is the observed average value of a given outcome \(Y_{it}\) over the excluded region. The second quantity is a counterfactual average value of \(Y_{it}\). We construct this counterfactual by combining the counterfactual density of R&D intensity we estimated as part of the bunching analysis (\(\hat{h}_0(\cdot)\)) with an estimated average value of the outcome conditional on a given value of R&D. We estimate \(\mathbb{E}[Y_{it}|d_{t_1}, \text{No Notch}]\) using a flexible polynomial regression of \(Y_{it}\) on R&D intensity over the same excluded region used to estimate \(\hat{h}_0(\cdot)\): \(^{32}\)

\[
Y_{it} = \sum_{k=0}^{p} \beta_k \cdot (d_{it_1})^k + \gamma \cdot \mathbbm{1}[d_{it}^* \leq d_{it_1} \leq d_{it}^+] + \delta Y_{it_1} + \phi_s + \nu_{it},
\]

where we exclude observations in the manipulated region, and control for industry fixed effects \(\phi_s\) and lagged outcomes \(Y_{it_1}\) when \(t > t_1\). Armed with an estimate of \(\mathbb{E}[Y_{it}|d_{t_1}, \text{No Notch}]\), we then compute the counterfactual average value for firms in the excluded region by integrating \(\mathbb{E}[Y_{it}|d_{t_1}, \text{No Notch}]\) relative to the counterfactual density \(h_0(d)\).

The interpretation of Equation 11 as a treatment effect relies on two assumptions. First, that we can consistently estimate the counterfactual density \(h_0(d)\), as in the previous section. Second, that the InnoCom program does not change the relationship between R&D intensity and a given outcome outside the excluded region. This assumption allows us to uncover the relationship between an outcome and the running variable. We can then use this relationship to approximate \(\mathbb{E}[Y_{it}|d_{t_1}, \text{No Notch}]\) inside the excluded region. Given a consistent estimate of \(h_0(d)\),

\(^{31}\)As detailed in our model, firms self-select into the treatment depending on whether they face fixed or adjustment costs that prevent them from obtaining the high-tech certification. This selection implies that we cannot use data just beneath the threshold as a control group for firms above the threshold. Our procedure does not rely on such comparisons across firms, but instead relies on the assumption that \(\mathbb{E}[Y_{it}|d_{t_1}, \text{No Notch}]\) is smooth around the notch, and that it may be approximated with data outside the excluded region that, by definition, is not subject to a selection problem.

\(^{32}\)Note that this regression is not causal. Its role is purely to predict the outcome over the excluded region. We obtain standard errors for ITT estimates in Equation 11 by bootstrapping this equation as well as the estimates of the counterfactual density.
this assumption holds trivially for the case where $Y = \ln d$. When we estimate the effect on TFP growth, this assumption implies that the only effect of the program on TFP growth is through real R&D investment. This assumption is consistent with the model in the previous section. A similar argument applies to the case of relabeling through administrative costs. Finally, note that this approach has the advantage that it places no restrictions on the distributions of fixed costs, adjustments costs, and productivity, and does not rely on functional form assumptions for relabeling costs and the effects of R&D on firm-level productivity.

Panel A of Table 3 presents estimates of ITT effects of the InnoCom program on several outcomes. We focus on large firms since they account for more than 90% of all R&D investment (see Figure A.4). We find that R&D investment for firms in the excluded region increased by 14.6% in 2009, which is very close to the bunching estimate of $\Delta d$ of 14.9%. We also find a decrease in the administrative cost ratio of 9.6%. When compared with the average value of this ratio, we find that administrative costs decreased by 0.33% of firm sales. We use this estimate to construct an approximation to the fraction of R&D investment that was relabeled. Compared to the implied increase in R&D intensity, this would imply that $(0.33\% / 0.89\%) \approx 0.37$ of the increase in R&D intensity was due to relabeling.\(^{33}\) Note that this approximation is imperfect because it assumes that all firms engage in the same relabeling activity. As our model in Section 4.2 shows, the fraction of relabeling may vary across firms depending on their distance from the notch. The structural model in Section 6 relaxes this strong assumption. Nonetheless, this estimate would imply that the real increase in R&D investment was closer to 9%. Finally, we study how the decision to invest in R&D in 2009 affects productivity in 2011. We find that between 2009 and 2011, the policy led to an increase in TFP of 1.2%. These results shows that, while the policy induces relabeling, it also leads to real R&D investment and productivity gains.\(^{34}\)

To relate our estimates to the existing literature, we obtain estimates of the elasticity of R&D investment to the user cost of capital (UCC). Panel A of Table 3 shows that the policy lowered the UCC in 2009 by 7.1%.\(^{35}\) The second panel of Table 3 presents estimates of user cost of capital elasticities by taking the ratio of the ITT on R&D to the ITT on the UCC, along with bootstrapped confidence intervals. The first row shows that reported R&D increased by 2% for every 1% decrease in the user cost. When we use the approximation above to obtain an estimate of the real increase in R&D, we obtain a user cost elasticity closer to 1.3. Notice that the empirical literature focused on OECD countries (see Hall and Van Reenen, 2000; Becker, 2015) has typically found an elasticity ranging from 0.4 to 1.8 based on direct R&D tax credit programs. Thus, our estimates indicate that, once we correct for the re-labeling behavior of Chinese manufacturing

\(^{33}\)We can approximate the increase in R&D intensity with $\alpha(1 - a^*(a^-))\Delta D^* \approx 0.89\%$ for large firms in 2009.

\(^{34}\)We explore robustness of these estimates in Table A.5, where we show that the ITT estimates are robust to using an alternative, second-best parametrization of the counterfactual density of R&D intensity.

\(^{35}\)We compute the user cost of R&D by generating an equivalent-sized tax credit. This credit is the ratio of tax savings to R&D investment. We then use the standard Hall and Jorgenson (1967) formula as in Wilson (2009).
firms, their user cost elasticity is comparable to those in more developed economies.

As an alternative metric, we consider how much it costs the government to increase R&D investment in terms of foregone revenue. Panel A of Table 3 shows that the policy reduced corporate tax revenues by 12.8%. Thus, for every 1% increase in R&D, we find that there was a 0.88% decrease in tax revenue. This statistic is a useful ingredient for deciding whether the InnoCom policy is too expensive, or whether externalities from R&D investment merit further subsidies. However, this statistic does not line up perfectly with the government’s objective, since part of the response may be due to relabeling, and since this estimator relies on the average percentage increase, which may differ from the percentage increase in total R&D. The structural model in the next section bridges this gap by computing the fiscal cost of raising real R&D, and by showing how the fiscal cost depends on the design of the InnoCom program.

6 Structural Estimation and Simulation of Counterfactual Policies

The empirical estimates from the previous sections evaluate the average effects of the current program on reported R&D investment, suspected relabeling activities, and firm productivity. However, the previous analysis does not allow us to understand how relabeling and the selection of heterogeneous firms that vary by productivity and adjustment costs affect the fiscal cost of the InnoCom program. Similarly, these estimates cannot be used to evaluate how heterogeneous firms respond to alternative policies. This section proposes a method of simulated moments (MSM) framework to estimate the structural parameters of the model in Section 4.

6.1 Structural Estimation

We first discuss how we parametrize the model. We begin by calibrating $\theta$, which we set at $\theta = 5$ based on the survey by Head and Mayer (2014). We use the fact that the evolution of productivity in Equation 1 is an AR(1) process with persistence $\rho$ and a normally distributed shock with variance $\sigma^2$. Given a value of $\theta$, the persistence and volatility of log sales of non-R&D performing firms map directly into $\rho$ and $\sigma^2$, which yields the following calibrated values of $\rho = 0.725$ and $\sigma = 0.385$. This process implies a stationary normal distribution for the underlying productivity $\phi_1$.\footnote{This value implies a gross markup of $\frac{\theta}{\theta - 1} = 1.25$. We calibrate $\theta$ since, without data on physical quantity produced, we are not able to separately identifying this parameter from the productivity distribution.}

We now parametrize the distributions of $b$ and $c$, which we assume are distributed i.i.d. across firms. We assume $b$ is log-normally distributed, $b \sim LN(\mu_b, \sigma^2_b)$, and that $c$ has an exponential distribution.\footnote{Appendix J investigates the parametric assumption that total factor productivity exp($\phi_1$) follows a log normal distribution. We find that the distribution of measured empirical TFP closely matches that of a log normal distribution, which implies that this assumption is consistent with our data.}
distribution, \( c \sim \mathcal{E}(\mu_c) \). We adopt the following functional form for the costs of relabeling: 
\[
\frac{\exp(\eta \delta) - 1}{\eta}
\]
where \( \theta \) is the fraction due to relabeling. While it is necessary to specify a functional form, this specification is quite flexible as the function can be linear, convex, or concave depending on the value of \( \eta \) (e.g., Notowidigdo, 2019).

We use the method of simulated moments to estimate the parameters \( \Omega = \{ \varepsilon, \eta, \mu_b, \sigma_b, \mu_c \} \). To implement the MSM estimator, we form the criterion function:

\[
Q(\Omega) = \left[ \begin{array}{c} h_B(\Omega) \\ h_{ITT}(\Omega) \end{array} \right]^{'} W \left[ \begin{array}{c} h_B(\Omega) \\ h_{ITT}(\Omega) \end{array} \right],
\]

where \( W \) is a bootstrapped weighting matrix. \( h_B(\Omega) \) and \( h_{ITT}(\Omega) \) are moment conditions based on our bunching and ITT estimators, respectively. \( h_B(\Omega) \) includes (1) the fraction of firms below \( d^*- \); (2) the fraction of firms in the excluded region that do not bunch; (3) the fraction of firms above \( d^*+ \); (4) the minimum bunching point \( d^*- \); and (5) the percentage increase in R&D intensity over the excluded region \( \Delta d \). That is, we choose our model parameters so that our simulated data can rationalize the bunching patterns estimated in Section 5.1. In addition to this unconditional empirical density, we also require that the model match the joint distribution of TFP and R&D intensity. Specifically, we use the (observed) average TFP for firms below \( d^*- \), in the excluded region, and above \( d^*+ \). As we discuss below, these moments play an important role in identifying key model parameters. We first estimate the model parameters relying on the moments in \( h_B(\Omega) \) and excluding \( h_{ITT}(\Omega) \). This allows us to measure the fraction of R&D that is relabeled independently of the ITT estimates in the previous section.

We then estimate a second model that matches all moments in \( h_B(\Omega) \) and \( h_{ITT}(\Omega) \). The \( h_{ITT}(\Omega) \) moments include the treatment effects on the administrative expense ratio and on TFP growth that we estimated in Section 5.2. Let \( \omega = \{ \phi_1, b, c \} \) denote a firm with random draws of its fundamentals—i.e., productivity, adjustment cost, and fixed cost. We construct moments that match the empirical and simulated counterparts of the ITT estimates:

\[
h_{ITT}(\Omega) = \int_{d^{No Notch}(\omega) \in (d^-, d^+)} E[Y(\omega; \text{Notch}) - Y(\omega; \text{No Notch})]dF_\omega(\Omega) - \hat{ITT}Y,
\]

where \( \hat{ITT}Y \) is an estimate from Section 5.2.

**Identification**

While each of the simulated moments depends on multiple moments, we follow the discussion in Sections 4.4–4.5 to give a heuristic description of the data patterns that identify each parameter.

Consider first the model that only relies on bunching estimates. We start by discussing the identification of the distribution of fixed and adjustment costs. First, the parameters of the

\[38\] Note that the simulated ITT restricts the support of \( \omega = \{ \phi_1, b, c \} \) to firms in the excluded region.
distribution of adjustment costs, $\mu_b$ and $\sigma_b$, are identified by the counterfactual distribution of R&D intensity below $d^*$ and above $d^+$. Next, the fraction of firms that do not bunch informs the parameter of the distribution of fixed costs of certification: $\mu_c$.

Given estimates of fixed and adjustment costs, we would obtain higher values of the returns to R&D, $\varepsilon$, and lower costs of relabeling (lower $\eta$) if there is a larger increase in reported R&D, $\Delta d$, or if the marginal buncher has a lower value of $d^-$. This is intuitive since both the benefit and cost of R&D enter the optimal choices of innovating firms. To separately identify these parameters, we rely on the model’s insight that firms’ R&D decisions are not distorted below $d^*$ or above $d^+$. Thus, the ranking of firms’ measured productivity across these regions is determined by $\varepsilon$, and is not affected by the InnoCom program. For this reason, including the joint distribution of TFP and R&D intensity in $h^B(\Omega)$ helps to separately identify the returns from R&D, $\varepsilon$, from relabeling costs, $\eta$.

Consider now the role of the $h^{ITT}(\Omega)$ moments. The ITT estimate on measured TFP growth also helps to discipline $\varepsilon$. Note, however, that this estimate combines three mechanisms: the returns to R&D, selection into the treatment, and the potential for relabeling. In practice, we find that the relabeling margin plays an important role in influencing these ITT moments. For this reason, the ITT estimate on the administrative expense ratio is informative of both $\eta$ and $\varepsilon$.

The $h^{ITT}(\Omega)$ moments serve a dual role in practice. First, they are an out-of-sample robustness check when they are not used for estimation. This is useful since the benefit of the ITT estimates is that they do not depend on a particular structure. Second, they are helpful over-identifying moments that can help pin down the estimates of the full model. To the extent that the model is consistent with both sets of moments, including the $h^{ITT}(\Omega)$ moments in the estimation can increase the precision of the estimates.

### Estimates of Structural Parameters

We estimate the model using a Laplace-type estimator that is based on Markov Chain Monte Carlo (MCMC), following Chernozhukov and Hong (2003). This procedure provides a numerically attractive way of obtaining point estimates and conducting inference. We construct the weighting matrix $W$ based on the bootstrapped covariance matrix of our data moments.

Table 4 reports estimates of our structural parameters: $(\varepsilon, \eta, \mu_b, \sigma_b, \mu_c)$. Panel A reports the parameter estimates and the standard errors for our two models. All the estimates are statistically significant in both models. Overall, we estimate remarkably similar parameters when we rely on the bunching moments $h^B(\Omega)$ or when we also include the ITT moments $h^{ITT}(\Omega)$ in the estimation. Thus, while the ITT moments provide independent information, our model’s quantification of the forces that generate the R&D bunching patterns in Section 5.1 are consistent with the treatment effects estimated in Section 5.2.

Consider the estimate of the returns to R&D, $\varepsilon$. The estimate from the full model in Table 4

26
panel A implies that doubling R&D increases measured TFP by 9.8%. Hall et al. (2010) survey the extensive literature on R&D elasticity in similar production function setups. Our estimate lies within the broad range of previous result between 2% and 17%. Almost all of these previous studies use micro-data from developed countries, so it is interesting to see that the returns to R&D of Chinese firms are comparable in magnitude.

Consider now the relabeling cost parameter, $\eta$. The estimate from both models is close to 5.7, which indicates that, at the margin, the cost of relabeling is highly convex in terms of $\delta$. In other words, it is easy for firms to overstate their R&D by a small amount, but the cost rises quickly for firms that are farther away from the required threshold $\alpha$. To understand this result, note that the marginal benefit of relabeling includes reductions in investment costs and in adjustment costs, which include technological opportunity constraints. Thus, firms that face a higher shadow cost of R&D (i.e., a higher $b$) will be more willing to engage in relabeling. On average, we calculate that firms’ realized relabeling cost is 4.7% of the implicit R&D savings. Finally, the estimated certification cost is quite modest: for the firms who decide to bunch and certify as high-tech firms, the fixed certification cost is on average 2% of their realized profit.

Panel B of Table 4 compares the simulated moments with the data moments and shows that our models do a very good job of matching the data. The first model (excluding ITT moments) replicates the distribution of firm-level R&D intensity and the bunching pattern almost perfectly. It also captures the positive correlation between R&D intensity and measured productivity very well. We also report the predicted values of the (untargeted) ITT moments and we find that they match the data moments quite closely. The last column of panel B reports the simulated moments for the full model. As would be expected, this model trades-off a slightly better fit of the ITT moments for slight deviations from the bunching moments. However, these trade-offs are very minor: both models do a remarkable job of fitting the data.39 Because the model is consistent with both sets of moments, one of the benefits of adding $h^{ITT}(\Omega)$ in the full model is an increase in the precision of the estimated parameters. While the full model features smaller standard errors for all the parameters, the biggest difference is in the standard error of $\eta$, which drops from 1.17 to 0.12. This drop makes sense from the perspective that one source of uncertainty in the model is how to separate the roles of $\varepsilon$ and $\eta$ in determining the bunching response and the extent of relabeling. The addition of the ITT moments reduces this uncertainty along with the estimated standard error for $\eta$.

Finally, we evaluate the sensitivity of our point estimates to each individual moment. We calculate the local derivative of our estimated parameters in the full model with respect to each moment using the methods of Andrews et al. (2017). The recovered sensitivity matrix is reasonable

39 In Appendix J we discuss estimates from alternative models that allow for heterogeneous $\varepsilon$’s and a constant $b$. While these models result in similar average values of $\varepsilon$ and $b$, these models do not match the data as well as our benchmark model. Specifically, these models cannot match the joint distribution of TFP and R&D intensity.
and conforms to the heuristic discussion above. We find that the joint distribution of TFP and R&D intensity are important determinants of $\varepsilon$. For instance, with a small change in the average TFP of firms above $d^*$, $\varepsilon$ would increase by around 10 percent from its estimated value. In contrast, we find that $\varepsilon$ is not very sensitive to changes in the ITT of TFP. These methods also allow us to consider the potential that part of the reduction in administrative expenses is not due to relabeling.\footnote{For instance, administrative costs may reduce if the tax incentive causes firms to pay closer attention to their accounting of R&D expenses, or if firms substitute inputs in response to the policy.} If half of the decrease in administrative costs is not related to relabeling, our sensitivity analysis shows that $\varepsilon$ would decrease by 0.002, which is a very modest amount. We report the complete set of sensitivity results for $\varepsilon$ and $\eta$ in Figure A.9.

Overall, the structural model exploits the estimates from our reduced-from analysis for identification and is able to replicate these data patterns quite well. Our estimates leverage the relative benefits of estimating treatment effects and structural models. While the structural model combines information from multiple moments and leverages functional form assumptions to increase the precision of the estimates, the benefit of the treatment effects approach is that it places no restrictions on the parameters of the model. By estimating a model that is consistent with both approaches, we are assured that functional form assumptions are not constraining the estimated parameters in ways that would bias the treatment effects of the InnoCom program. At the same time, our model parameters are not sensitive to identification assumptions related to the estimated treatment effects. For these reasons, the model provides a robust micro-foundation for simulating the effects of counterfactual policies.

**Benchmark Model Implications**

Given our model estimates, we can simulate our benchmark model to gain a deeper understanding of how heterogeneous firms respond to the existing policy.

First, we find that firms that comply with the policy are positively selected on several margins. Complier firms are, on average, 9.64% more productive than firms in the excluded region that do not comply with the policy. They also have idiosyncratic adjustment costs that are 34.5% lower than non-compliers, which indicates much better technological opportunities from R&D investment. Finally, they also have substantially smaller certification costs.

Second, our model shows that 30.3% of the reported R&D investment is due to relabeling, on average. This fraction is dispersed across firms, with the 10th percentile firm relabeling 6.8%, and the 90th percentile relabeling 51.9%. This dispersion is driven mostly by dispersion in the adjustment costs, $b$. Conditional on firm productivity, firms with higher adjustment costs relabel a higher fraction of their R&D. Intuitively, firms with limited technological opportunities are willing to risk the punishment from relabeling in order to achieve the program threshold.

Lastly, we also find heterogeneous increases in real R&D for complying firms. Our model
suggests that the distribution of real R&D investment is such that the 10th percentile firm sees an increase of 10.2%, the 90th percentile firm increases by 25.0%, and the median firm increases by 15.1%. This dispersion in investment then results in a dispersed distribution of gains in TFP.

6.2 Simulation of Counterfactual Policies

We now use our model estimates to simulate the effects of alternative R&D tax incentives and we quantify their implications for reported R&D investment, real R&D investment, tax revenue, and productivity growth. We first simulate alternative versions of the InnoCom program that vary the tax advantage and the location of the notch. We then compare our results with a counterfactual policy that follows a more standard investment tax credit.

Alternative Notches and Tax Cuts

We analyze alternative versions of the InnoCom program that vary the tax advantage and the location of the notch for two reasons. First, even though standard policy recommendations avoid prescribing discontinuous incentives, notches are present in many settings (Slemrod, 2013) and may be justified in cases where governments may use them as a way to limit relabeling (Best et al., 2015). Second, given the explosive growth in R&D in China and that the government has chosen to use this policy, it is important to understanding the economic and fiscal consequences of this type of policy.

Figures 11-12 study the effects of changing the preferential tax rate for three values of the notch: 2%, 3%, and 6%. Each line shows the change in a given outcome from moving the preferential tax rate between 10% to 22% for a given notch, relative to the current benchmark where $\alpha = 0.03$ and $t_{HT} = 15\%$.

Panels A and B of Figure 11 analyze how changes in the policy parameters affect the characteristics of the compliers. We find that higher values of the notch lead to a selection of more productive firms, and of firms with lower adjustment costs, on average. This graph also shows that, as we increase the tax break for high tech firms (lower preferential tax rate), the program selects firms with lower productivity and higher adjustment costs. The selection effect is more pronounced along adjustment costs than on productivity. For instance, when we change the threshold from 3% to 2%, the average adjustment cost for the compliers almost doubles, while the productivity is only around 2% lower. These results show that there are decreasing returns from expanding the InnoCom program by increasing the tax advantage, and that a larger tax break might exacerbate misallocation of R&D by incentivizing R&D investment in firms with lower productivity and higher adjustment costs.

Panels C and D of Figure 11 show how real R&D investment and relabeling respond to changes in the InnoCom program. Panel C shows that there is more real investment when firms face a
lower preferential tax rate. However, the fraction of R&D due to relabeling also increases in the size of the tax cut. As panel D illustrates, when we set the notch threshold at 6%, moving the preferential tax rate from 22% to 10% increases the fraction of reported R&D due to relabeling by almost 15 percentage points.

Panel A of Figure 12 plots the average growth in productivity induced by the InnoCom program for firms in the excluded region. This effect is driven by two forces. First, as in panel C of Figure 11, complier firms invest more with a lower preferential tax rate. Second, the fraction of firms that participate in the program also increases with a lower preferential tax rate. When $\alpha = 3\%$ and the preferential tax is reduced to 10%, the average firm sees a TFP increase of 1.4%. This is a larger increase than in the benchmark case where firms see a 0.8% increase in TFP.

Finally, we use our simulations to answer the question: What is the lowest-cost policy for a government that wants to increase R&D by a given amount? To answer this question, we first estimate the elasticity of the tax revenue cost to the real increase in R&D investment for different values of $\alpha$ and $t^{HT}$. We then plot these ratios in panel B of Figure 12 according to the total increase in real R&D. This graph thus represents cost frontiers for a government that wants to increase real R&D by a given amount. The current policy of $\alpha = 3\%$ and $t^{HT} = 15\%$ corresponds to a cost-ratio of about 2.8. The black line shows that a policy defined by $\alpha = 6\%$ and $t^{HT} = 17\%$ would result in a similar increase in real R&D investment, but at a lower average cost. Alternatively, a policy defined by $\alpha = 6\%$ and a larger tax advantage $t^{HT} = 12\%$ would result in a twice-as-large increase in R&D investment for a similar tax-to-R&D ratio. This result is driven by the fact that policies with larger $\alpha$ will positively select more productive firms as well as firms with better technological opportunities. Nonetheless, as shown in panel D of Figure 11, this policy would also be accompanied by more relabeling.

These simulations show that the effectiveness of notch-based programs depends strongly on firm selection. As incentives for R&D increase, this may lead to misallocation of R&D to firms with worse technological opportunities. Moreover, incentives that encourage R&D investment at the lowest cost to taxpayers may lead firms to engage in relabeling activities that are likely socially undesirable.

**R&D Tax Credit**

A more common R&D subsidy policy is the R&D tax credit, which is prevalent in a large number of European and North American countries. We now use our estimated model to evaluate the effects of drastically changing the Chinese InnoCom program into an R&D tax credit system comparable to...
to that of the U.S. While the U.S. system has numerous accounting details, we define it by the two most fundamental features: the base amount $\bar{D}_i$ and the tax credit rate $\tau$. The U.S. government provides a credit of $\tau = 20\%$ on qualified R&D expenditures that exceed the base amount $\bar{D}_i$.\footnote{Since $\bar{D}_i$ typically depends on an average of R&D intensity in previous years, it is natural to assume that $\bar{D}_i = D_{i1}^*$, the interior optimum. We can thus set up the firm’s optimal R&D decision problem as}

If firms find it optimal to not misreport ($\delta^* = 0$), then the R&D tax credit effectively reduces the marginal cost of real R&D, $D^K$, by $(1 - t_1)\tau$. When there is no relabeling, an R&D tax credit is a relatively cheap way to induce incremental R&D investment. Indeed, the tax-to-R&D elasticity equals $(1 - t_1)\tau \approx 0.15$, which is significantly more effective than the 2.8 elasticity of the benchmark InnoCom program. If we impose the estimated cost of relabeling of $\eta = 5.7$, as in our benchmark case, firms find it very costly to misreport and set $\delta^* = 0$. In this case, the R&D tax credit system is a superior policy.

However, there are reasons to suspect that tax enforcement will be more difficult under an R&D tax credit system since the tax authority will need to audit all firms. This implies that individual firms will face lower costs of relabeling. With positive misreporting, the cost-effectiveness of the R&D credit quickly worsens. To see this, note that the R&D tax credit is calculated as

$$
(1 - t_1)\tau \left[ \frac{D^K - D_{i1}^*}{1 - \delta^*} - D_{i1}^* \right] \equiv (1 - t_1)\tau \left[ (D^K - D_{i1}^*) + \frac{\delta^*}{1 - \delta^*} D^K \right].
$$

If firms relabel $\delta^* > 0$ of reported R&D, then the effective tax cost of inducing the marginal dollar of real R&D becomes $(1 - t_1)\tau [1 + \frac{\delta^*}{1 - \delta^*} \frac{D^K - D_{i1}^*}{D^K - D_{i1}^*}]$. When the incremental real R&D, $D^K - D_{i1}^*$, is small, the misreported R&D dominates the tax to real R&D elasticity. When we set the relabeling cost to match our benchmark relabeling of $\delta^* = 0.3$, our simulated model implies a tax-to-R&D elasticity of 7.97. This high fiscal cost is largely driven by relabeling. Intuitively, firms were already at their interior optimum. The tax credit therefore induces mostly a relabeling responses, with a very small increase in real R&D. In this case, the large relabeling response yields the surprising result that an InnoCom-style program is more effective at stimulating real R&D than a linear tax credit.

This analysis reveals that the choice of subsidy critically depends on the costs of relabeling. Using our model’s estimates of firm-level R&D adjustment costs and returns to R&D, we searched for the relabeling cost parameter that equalizes the fiscal cost of an R&D tax credit regime with the InnoCom program. We find that when $\eta = 1.324$, which implies a lower fraction of relabeling of 9.9\% (in contrast to 30.3\% in our benchmark), the R&D tax credit policy achieves the same fiscal
elasticity of 2.8. Therefore, a tax credit would be a more cost-effective policy if the government can significantly increase the cost of relabeling. However, this may come at the cost of devoting additional government resources to detect relabeling.

7 Conclusions

Governments around the world devote considerable tax resources to incentivizing R&D investment. However, there is widespread concern that firms respond by relabeling other expenses as R&D expenditures. This paper takes advantage of a large fiscal incentive and detailed administrative tax data to analyze these margins in the important case of China. We provide striking graphical evidence consistent with both large reported responses and significant scope for relabeling. These results suggest misreporting of R&D may contaminate estimates of the effectiveness of R&D investment and may lead to misallocation of R&D toward firms with less innovative projects. Despite the relabeling responses, we find significant effects on firm-level productivity that are consistent with sizable returns to R&D.

Optimal subsidies for R&D depend on the fiscal cost for the government and whether R&D investment has external effects. This paper provides a useful metric that traces the government’s tradeoff between own-firm productivity growth and tax revenues. If R&D is believed to have positive externalities on other firms’ productivity, our estimates then provide a bound on the size of the externality that would justify government intervention.

Finally, while we find evidence consistent with relabeling, the unusual structure of the InnoCom program may limit the scope of relabeling and evasion through pre-registration and auditing. In contrast, R&D investment tax credits may be more susceptible to relabeling in developing, and even developed countries. As this paper demonstrates, accounting for relabeling has important implications for the design of R&D subsidies. Future research should explore the potential for relabeling in other contexts.
References


Figure 1: Cross-Country Comparison: R&D as Share of GDP

NOTES: This figure plots the aggregate R&D Intensity, i.e. R&D expenditure as share of GDP, in the private sector for China, Canada, India, and US. Chinese R&D intensity started at 0.5% in 1996, a similar level to India. It increased dramatically by more than three-fold to above 1.5% in 2011, on par with Canada. The R&D intensity of the U.S. remained stable at 2.5% during the same period. Chinese R&D intensity improved from 1/5 in 1996 to around 2/3 of the U.S level in 2011. The red line marks the year of the tax reform. Source: World Bank.
Figure 2: Bunching at Different Thresholds of R&D Intensity (2011)

A. Full Sample

B. Small Firms

C. Medium Firms

D. Large Firms

NOTES: This figure plots the empirical distribution of R&D intensity for all manufacturing firms with R&D intensity between 0.5% and 15% in the Administrative Tax Return Database. Panel A reports the pooled data distribution with all sizes of firms. Panels B, C, and D report the R&D intensity distribution of “Small”, “Medium”, and “Large” firms respectively. Note that large fractions of the firms “bunch” at the thresholds (6% for large, 4% for medium, and 3% for large) that qualify them to apply for the InnoCom certification. Source: Administrative Tax Return Database. See Section 3.1 for details.
Figure 3: Effects of the 2008 Tax Reform on the Bunching of Foreign-Owned, Large Companies

A. Bunching Before 2008 Tax Reform

B. Bunching After 2008 Tax Reform

NOTES: This figure compares the R&D intensity distribution for large foreign-owned firms before and after the 2008 tax reform. To make the two samples comparable, the figure only plots firms that we observe in both the SAT and ASM data. The tax reform eliminated the preferential corporate income tax for foreign-owned firms and increased their incentives to qualify for the InnoCom program. Compared with panel A, panel B shows that these firms increase their bunching behavior substantially after 2008. The R&D intensity is concentrated around the 3% threshold. Source: Administrative Tax Return Database and Annual Survey of Manufacturers. See Section 3.1 for details.
NOTES: This figure plots the non-R&D administrative expense to sales ratio at each level of R&D intensity. The green dots/line are for the large firms, the red dots/line are for the medium firms, and the blue dots/line are for the small firms. The threshold of R&D intensity for firms to qualify applying for InnoCom certification differs across firm size: 6% for small firms, 4% for medium firms, and 3% for large firms. For each size category, there is a pronounced drop of the administrative expense to sales ratio when the R&D intensity approaches the required threshold. Source: Administrative Tax Return Database. See Section 3.1 for details on data sources and Section 4 for details on the estimation.
Figure 5: Lack of Sales Manipulation

A. Lack of Sales Manipulation Around R&D Intensity Threshold

B. Lack of Firm Size Manipulation: Small and Medium Firms

C. Lack of Firm Size Manipulation: Medium and Large Firms

NOTES: This figure examines the potential manipulation of sales data. Panel A shows firms do not manipulate sales by under-reporting their sales in order to reach their respective notch. Panels B and C show firms do not attempt to over-report their sales in order to move into the next size category and thus reduce the threshold of R&D intensity needed to qualify for the InnoCom program. Overall, there is little evidence of sales manipulation. Source: Administrative Tax Return Database and Annual Survey of Manufacturers. See Section 3.1 for details.
Figure 6: Induced Notch in Profit Functions

A. Bunching is Sub-Optimal for this Firm  
B. Firm is Indifferent between Internal Solution and Bunching

C. Marginal Buncher and Relabeling

NOTES: This figure provides intuition for when a firm decides to bunch or not. In panel A, we characterize a firm whose value of performing the interior optimal level of R&D is larger than bunching at the threshold. In panel B, we characterize another firm whose value of performing the interior optimal level of R&D is exactly equal to bunching at the threshold. The fundamental determinant of this relationship is the unobserved firm heterogeneity, $\phi_1$, which is reflected by the interior optimal R&D. Panel C shows that when firms can relabel non-R&D expenses as R&D expenses, the marginal firm will have a lower interior optimal R&D level level $D^{**}$. See Section 4 for details.
Figure 7: Theoretical Bunching Predictions

A. Predicted Bunching in the Simple Model

Panel A plots the implied empirical R&D density distribution in our baseline model of R&D investment with productivity as the only source of heterogeneity at the firm-level. The model predicts that all the firms between the marginal firm and the notch will bunch, creating a dominated interval in the density.

B. Predicted Bunching with Heterogeneous Frictions

Panel B plots an enriched model where firms’ R&D decision is subject to heterogeneous adjustment costs and a fixed cost of certification. These heterogeneities create frictions such that not all the firms in the dominated interval bunch on the notch. See Section 4 for details.
Figure 8: Estimates of Excess Mass from Bunching at Notch (2009)

A. Small Firms

\[
\begin{align*}
\Delta d &= 0.056(0.093) \\
\Delta D &= 0.378^{***}(0.092) \\
P\text{-value \(M=B\)} &= 0.9763 \\
Frictions: a^* &= 0.739^{***}(0.283)
\end{align*}
\]

B. Medium Firms

\[
\begin{align*}
\Delta d &= 0.133^{**}(0.067) \\
\Delta D &= 0.782^{***}(0.299) \\
P\text{-value \(M=B\)} &= 0.9037 \\
Frictions: a^* &= 0.659^{***}(0.027)
\end{align*}
\]

C. Large Firms

\[
\begin{align*}
\Delta d &= 0.149^{***(0.019) } \\
\Delta D &= 0.694^{***}(0.058) \\
P\text{-value \(M=B\)} &= 0.7866 \\
Frictions: a^* &= 0.570^{***}(0.016)
\end{align*}
\]

NOTES: This figure reports the results of our bunching estimator for small, medium, and large firms in 2009. In each panel, we plot the empirical density of R&D intensity in red and the estimated counterfactual R&D intensity in blue. The lower bound \(d^-\) and upper bound \(d^+\) for the excluded region are indicated by vertical dashed lines. \(\Delta d\) is the percentage increase in R&D in the excluded region, \(\Delta D\) is the increase for the marginal firm, \(a^*\) is the fraction of firms that are constrained from participating in the program, and we report the p-value of the test that the missing mass equals the excess mass. See Section 5.1 for details. Source: Administrative Tax Return Database.
Figure 9: Estimates of Excess Mass from Bunching at Notch (2011)

A. Small Firms

\[ \Delta d = 0.114^{**}(0.061) \]
\[ \Delta D = 0.577^{***}(0.125) \]
\[ P\text{-value (M=B)} = 0.9805 \]
Frictions: \( a^* = 0.605^{**}(0.273) \)

B. Medium Firms

\[ \Delta d = 0.207^{***}(0.035) \]
\[ \Delta D = 0.655^{**}(0.390) \]
\[ P\text{-value (M=B)} = 0.8253 \]
Frictions: \( a^* = 0.369^{***}(0.072) \)

C. Large Firms

\[ \Delta d = 0.307^{***}(0.078) \]
\[ \Delta D = 0.921^{***}(0.165) \]
\[ P\text{-value (M=B)} = 0.7198 \]
Frictions: \( a^* = 0.334^{***}(0.032) \)

NOTES: This figure reports the results of our bunching estimator for small, medium, and large firms in 2011. In each panel, we plot the empirical density of R&D intensity in red and the estimated counterfactual R&D intensity in blue. The lower bound \( \mathbf{d}^* - \) and upper bound \( \mathbf{d}^+ \) for the excluded region are indicated by vertical dashed lines. \( \Delta d \) is the percentage increase in R&D in the excluded region, \( \Delta D \) is the increase for the marginal firm, \( a^* \) is the fraction of firms that are constrained from participating in the program, and we report the p-value of the test that the missing mass equals the excess mass. See Section 5.1 for details. Source: Administrative Tax Return Database.
Figure 10: Robustness of Bunching Estimates

A. Placebo Test: Large Foreign Firms Before 2008

\[ \Delta d = -0.011(0.028) \]
\[ \Delta D = 0.069(0.086) \]
\[ P\text{-value (M=B)} = 0.8877 \]

B. Large Firms in 2011 (No Extensive Margin)

\[ \Delta d = 0.318^{***(0.021)} \]
\[ \Delta D = 0.887^{***(0.049)} \]
\[ P\text{-value (M=B)} = 0.8686 \]

Frictions: \[ a^* = 0.284^{***(0.008)} \]

C. Large Firms in 2011 using Large Foreign Firms to Inform Counterfactual

\[ \Delta d = 0.264^{***(0.006)} \]
\[ \Delta D = 0.855^{***(0.018)} \]
\[ P\text{-value (M=B)} = 0.7198 \]

Frictions: \[ a^* = 0.382^{***(0.010)} \]

NOTES: This figure reports robustness checks of our bunching estimator in panel C of Figure 9. Panel A reports a placebo test where we use the data from large foreign firms before 2008. Panel B implements our bunching estimator for large firms which already performed R&D in previous years. Panel C uses large foreign firm’s R&D intensity before 2008 to inform the counterfactual distribution. See Section 5.1 for details.
NOTES: These figures report the effects of different policy parameters on the selection of firms into the InnoCom program and on aggregate outcomes of interest. Panels A and B show that lower preferential tax rates select firms with higher adjustment costs and lower productivity. Panels C and D show how real and relabeled R&D respond to changes in parameters of the policy. See Section 6.2 for details on the structural model and the simulation.
Figure 12: Simulated Counterfactual Policies: Productivity and Fiscal Cost of Stimulus

A. Average TFP Increase (Excluded Region)

B. Tax Revenue Cost of Stimulating Real R&D

NOTES: These figures report the effects of different policy parameters on aggregate outcomes of interest. Panel A shows how different reforms affects TFP. Panel B plots the elasticity of the tax cost to the government to the real R&D increase. This figure represents the fiscal cost curve of incentivizing R&D investment for the government, and shows that notches that target larger firms have lower fiscal costs. See Section 6.2 for details on the structural model and the simulation.
Table 2: Descriptive Statistics

A. State Administration of Tax Data 2008 - 2011

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<th>Mean</th>
<th>Std</th>
<th>p25</th>
<th>p50</th>
<th>p75</th>
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<tr>
<td>Sales (mil RMB)</td>
<td>118.263</td>
<td>1394.828</td>
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<td>42.056</td>
<td>1202257</td>
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<td>Fixed Asset (mil RMB)</td>
<td>32.912</td>
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<td>1139038</td>
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<td># of Workers</td>
<td>175.402</td>
<td>852.494</td>
<td>17.000</td>
<td>48.000</td>
<td>136.000</td>
<td>1213497</td>
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<tr>
<td>R&amp;D or not (%)</td>
<td>0.081</td>
<td>0.273</td>
<td>0.000</td>
<td>0.000</td>
<td>0.000</td>
<td>1219630</td>
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<tr>
<td>R&amp;D/Sales (% if &gt;0)</td>
<td>3.560</td>
<td>7.019</td>
<td>0.337</td>
<td>1.544</td>
<td>4.296</td>
<td>98258</td>
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<td>Administrative Expense/Sales (%)</td>
<td>9.417</td>
<td>11.886</td>
<td>2.809</td>
<td>5.814</td>
<td>11.103</td>
<td>1171365</td>
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<td>TFP</td>
<td>2.058</td>
<td>0.522</td>
<td>1.638</td>
<td>2.007</td>
<td>2.434</td>
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B. Annual Survey of Manufacturing 2006 - 2007

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<th>Mean</th>
<th>Std</th>
<th>p25</th>
<th>p50</th>
<th>p75</th>
<th>Observations</th>
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<tr>
<td>Sales (mil RMB)</td>
<td>110.801</td>
<td>1066.080</td>
<td>10.760</td>
<td>23.750</td>
<td>59.513</td>
<td>638668</td>
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<tr>
<td>Fixed Asset (mil RMB)</td>
<td>42.517</td>
<td>701.282</td>
<td>1.630</td>
<td>4.492</td>
<td>13.370</td>
<td>638668</td>
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<tr>
<td># of Workers</td>
<td>238.379</td>
<td>1170.327</td>
<td>50.000</td>
<td>95.000</td>
<td>200.000</td>
<td>638668</td>
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<tr>
<td>R&amp;D or not (%)</td>
<td>0.102</td>
<td>0.303</td>
<td>0.000</td>
<td>0.000</td>
<td>0.000</td>
<td>638668</td>
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<tr>
<td>R&amp;D/Sales (% if &gt;0)</td>
<td>1.631</td>
<td>3.184</td>
<td>0.118</td>
<td>0.461</td>
<td>1.736</td>
<td>65267</td>
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NOTES: Various sources, see Section 3.1 for details.
Table 3: Estimates of Treatment Effects

A. Estimates of Intent-to-Treat (ITT) Effects

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<td><strong>2009</strong></td>
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<tr>
<td>Admin Costs</td>
<td>-0.096</td>
<td>0.025</td>
<td>-3.822</td>
<td>-0.136</td>
<td>-0.054</td>
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<td>Admin Costs (level)</td>
<td>-0.003</td>
<td>0.001</td>
<td>-3.686</td>
<td>-0.005</td>
<td>-0.002</td>
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<td>R&amp;D</td>
<td>0.146</td>
<td>0.065</td>
<td>2.245</td>
<td>0.037</td>
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<td>R&amp;D (real)</td>
<td>0.090</td>
<td>0.044</td>
<td>2.074</td>
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<td>User Cost</td>
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<td>0.037</td>
<td>-1.929</td>
<td>-0.130</td>
<td>-0.009</td>
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<tr>
<td><strong>2011</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
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<tr>
<td>Tax</td>
<td>-0.128</td>
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<td>-7.293</td>
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<td>TFP</td>
<td>0.012</td>
<td>0.006</td>
<td>1.953</td>
<td>0.001</td>
<td>0.022</td>
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B. Estimates of User-Cost-of-Capital Elasticities

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<th>Estimate</th>
<th>Bootstrap 5th Perc.</th>
<th>Bootstrap 95th Perc.</th>
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<tbody>
<tr>
<td>Reported R&amp;D to User Cost (2009)</td>
<td>-2.052</td>
<td>-7.919</td>
<td>-0.016</td>
</tr>
<tr>
<td>Real R&amp;D to User Cost (2009)</td>
<td>-1.272</td>
<td>-4.900</td>
<td>-0.010</td>
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<tr>
<td>Tax to Reported R&amp;D (2011)</td>
<td>-0.879</td>
<td>-2.730</td>
<td>-0.458</td>
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NOTES: This table reports estimates of ITT effects of the notch on various outcomes. Panel B reports ratios of estimates in panel A. Standard errors computed via bootstrap. See Section 3.1 for details on data sources and Section 5 for details on the estimation. Source: Administrative Tax Return Database.

\[
ITT = \frac{1}{N_{Excluded}} \sum_{i \in (D^-, D^+)} Y_i - \int_{D^-}^{D^+} \hat{h}_0(r) E[Y|rd, \text{No Notch}] dr
\]
Table 4: Structural Estimates

A. Point Estimates

<table>
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<tr>
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<th>TFP Elasticity of R&amp;D</th>
<th>Relabeling Cost</th>
<th>Distribution of Adjustment Costs</th>
<th>Distribution of Fixed Costs</th>
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<td></td>
<td>ε</td>
<td>η</td>
<td>µ_b</td>
<td>σ_b</td>
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<tr>
<td><strong>Model 1: Excluding ITT Moments</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Estimate</td>
<td>0.093</td>
<td>5.657</td>
<td>8.311</td>
<td>1.465</td>
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<tr>
<td>Standard Error</td>
<td>(0.011)</td>
<td>(1.171)</td>
<td>(0.674)</td>
<td>(0.416)</td>
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<td><strong>Model 2: All Moments</strong></td>
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<tr>
<td>Estimate</td>
<td>0.098</td>
<td>5.663</td>
<td>8.581</td>
<td>1.648</td>
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<tr>
<td>Standard Error</td>
<td>(0.008)</td>
<td>(0.121)</td>
<td>(0.363)</td>
<td>(0.216)</td>
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NOTES: This table reports estimates of structural parameters of the model in Section 4. Estimates based on calibrated values of θ = 5, ρ = 0.725, and σ = 0.385. Model 1 estimates the structural parameters using all moments except the ITT estimates on administrative costs and TFP. Model 2 uses all the available moments to estimate the structural parameters. See Section 6 for estimation details.

B. Simulated vs. Data Moments

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<th>Simulated</th>
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<td>Excluding ITT</td>
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</tr>
<tr>
<td>Bunching Moments: (h^B(Ω))</td>
<td>Probability Mass for (d &lt; d^{-})</td>
<td>0.280</td>
</tr>
<tr>
<td></td>
<td>Fraction not Bunching</td>
<td>0.675</td>
</tr>
<tr>
<td></td>
<td>Probability Mass for (d &gt; d^{++})</td>
<td>0.189</td>
</tr>
<tr>
<td></td>
<td>Bunching Point (d^{-})</td>
<td>0.88%</td>
</tr>
<tr>
<td></td>
<td>Increase in Reported R&amp;D: (Δd)</td>
<td>0.146</td>
</tr>
<tr>
<td></td>
<td>Average TFP for (d &lt; d^{-})</td>
<td>-0.032</td>
</tr>
<tr>
<td></td>
<td>Average TFP for (d \in (d^{-}, d^{++}))</td>
<td>0.000</td>
</tr>
<tr>
<td></td>
<td>Average TFP for (d &gt; d^{++})</td>
<td>0.056</td>
</tr>
<tr>
<td>ITT Moments: (h^{ITT}(Ω))</td>
<td>ITT TFP</td>
<td>0.012</td>
</tr>
<tr>
<td></td>
<td>ITT administrative cost ratio</td>
<td>-0.33%</td>
</tr>
</tbody>
</table>

NOTES: This table compares the moments generated by our simulations with those from the data. The simulation is based on 30,000 firms. The table shows our model does a remarkable job of matching 10 moments from the data using a relatively parsimonious model based on 5 parameters. Model 1 estimates the structural parameters using all moments except the ITT estimates on administrative costs and TFP, which are shown in italics and in parentheses. Model 2 uses all the available moments to estimate the structural parameters. See Section 6 for estimation details and discussion of how these moments inform the structural parameters in our model.
Online Appendix: Not For Publication

This appendix contains multiple additional analyses. Appendix A includes additional details of the Chinese corporate income tax system. Appendix B describes in more detail the data we use in our analysis. Appendix C discusses the estimation of our measure of log-TFP. Appendix D shows that firms do not respond to the InnoCom program by manipulating sales expenses. Appendix E provides a detailed derivation of the model. Appendix F shows that the missing mass in the bunching analysis can be used to approximate the effects of the notch on R&D investment. Appendix G discusses details of the implementation of the bunching estimator. Appendix H discusses additional robustness checks of our bunching estimates. Appendix I describes details of the implementation of the ITT estimator. Finally, Appendix J explores the robustness of our structural estimation by showing that the actual distribution of TFP is very close to being log-normal and by discussing estimates of an alternative structural model with heterogeneous $\varepsilon$.

A Additional Details of the Chinese Corporate Income Tax System

China had a relatively stable Enterprise Income Tax (EIT) system in the early part of our sample from 2000 - 2007. During that period, the EIT ran on a dual-track tax scheme with the base tax rate for all domestic-owned enterprises (DOE) at 33% and foreign-owned enterprises (FOE) ranging from 15% to 24%. The preferential treatment of FOEs has a long history dating to the early 1990s, when the Chinese government started to attract foreign direct investment in the manufacturing sector. The government offered all new FOEs located in the Special Economic Zone (SEZ) and Economic and Technology Development Zone (ETDZ) a reduced EIT of 15%. It also offered a reduced EIT of 24% for all FOEs located in urban centers of cities in the SEZs and ETDZs. The definition of foreign owned is quite broad: it includes enterprises owned by Hong Kong, Macau, and Taiwan investors. It also includes all joint-venture firms with a foreign share of equity larger than 25%. The effective tax rates of FOEs are even lower since most had tax holidays that typically left them untaxed for the first 2 years, and then halved their EIT rate for the subsequent 3 years.

In addition to the special tax treatments of FOEs, the Chinese government started the first round of the West Development program in 2001. Both DOEs and FOEs that are located in west China and are part of state-encouraged industries enjoy a preferential tax rate of 15%. West China is defined as the provinces of Chongqing, Sichuan, Guizhou, Yunnan, Tibet, Shaanxi, Gansu, Ningxia, Qinghai, Xinjiang, Inner Mongolia and Guangxi. Finally, there is also a small and medium enterprise tax break, which is common in other countries. However, the revenue threshold is as low as $50,000, and is effectively irrelevant for our sample.
The Chinese government implemented a major corporate tax reform in 2008 in order to eliminate the dual-track system based on domestic/foreign ownership and established a common rate of 25%. Some of the existing tax breaks for FOEs were gradually phased-out. For instance, FOEs that previously paid an EIT of 15% paid a tax rate of 18% in 2008, 20% in 2009, 22% in 2010, and 24% in 2011. In contrast, the West Development program will remain in effect until 2020.

B Data Sources

We connect three large firm-level databases of Chinese manufacturing firms. The first is the relatively well-studied Chinese Annual Survey of Manufacturing (ASM), an extensive yearly survey of Chinese manufacturing firms. The ASM is weighted towards medium and large firms, and includes all Chinese manufacturing firms with total annual sales of more than 5 million RMB (approximately $800,000), as well additional state-owned firms with lower sales. This survey provides detailed information on ownership, location, production, and the balance sheet of manufacturing firms. This dataset allows us to measure total firm production, sales, inputs, and, for a few years, detailed skill composition of the labor force. We supplement this data with a separate survey by the Chinese National Bureau of Statistics that includes firms’ reported R&D. We use these data for years 2006–2007.

The second dataset we use is the administrative enterprise income tax records from Chinese State Administration of Tax (SAT). The SAT is the counterpart to the IRS in China and is in charge of tax collection and auditing. In addition, the SAT supervises various tax assistance programs such as the InnoCom program. The SAT keeps its own firm-level records of tax payments as well other financial statement information used in tax-related calculations. We have acquired these administrative enterprise income tax records from 2008–2011, which allows us to construct detailed tax rate information for individual manufacturing firms. We also use these data to construct residualized measures of firm productivity.\textsuperscript{43} The scope of the SAT data is slightly different from the ASM, but there is a substantial amount of overlap for the firms which conduct R&D. For instance, the share of total R&D that can be matched with ASM records is close to 85% in 2008.

The third dataset we use is the list of firms that are enrolled in the InnoCom program from 2008–2014. For each of these manufacturing firms, we have the exact Chinese name, and the year it was certified with high-tech status. This list is available from the Ministry of Science and Technology website, and we have digitized it in order to link it to the SAT and ASM data. We use these data to cross-validate the high-tech status recorded in the SAT data.

\textsuperscript{43}We discuss the details of this procedure in Appendix C.
C  Estimation of Residual Productivity

This appendix describes how we construct an empirical measure of firm-level productivity $\hat{\phi}_{it}$. First, we use the structure in our model of constant elasticity demand to write firm revenue (value-added) as:

$$\ln r_{it} = \left(\frac{\theta - 1}{\theta}\right) [\kappa \ln k_{it} + (1 - \kappa) \ln l_{it} + \hat{\phi}_{it}],$$

where $l_{it}$ is the labor input which we assume may be chosen each period. Second, we obtain the following relation from the first order condition of cost minimization for the variable input $l_{it}$:

$$\ln s_{it} \equiv \ln \left(\frac{w l_{it}}{r_{it}}\right) = \ln \left[ (1 - \kappa) \left(\frac{\theta - 1}{\theta}\right) \right] + v_{it},$$

where $v_{it} \sim iid$, and $E[v_{it}] = 0$ is measurement error or a transitive shock in factor prices. Third, we obtain a consistent estimate of $(1 - \kappa)(\frac{\theta - 1}{\theta})$ for each 3-digit manufacturing sector. Finally, given our benchmark value of $\theta = 5$, we construct a residual measure of log TFP as follows:

$$\hat{\phi}_{it} = \frac{\theta}{\theta - 1} \ln r_{it} - \hat{\kappa} \ln k_{it} - (1 - \hat{\kappa}) \ln l_{it}.$$

D  Lack of Manipulation of Other Expenses

In Figure 4, we show a significant downward break in the administrative expense-to-sales ratio at the notches for each firm size category. Given the fact that administrative expenses and R&D are categorized together under the Chinese Accounting standard, we think that is the natural place to find suggestive evidence of the relabeling behavior. In this section, we address the question of whether other types of expenses might also illustrate similar empirical patterns. We plot a similar graph to Figure 4 in Figure A.3 for the sales expense-to-sales ratio for all three size categories. We find that there are no detectable discontinuities at the notches for all firms. Note that, while there is a drop for small firms at the 6% notch, Table A.4 shows that this drop is not statistically significant. This analysis suggests that the drops we observe in administrative costs are likely not due to substitution of inputs, and are likely due to relabeling.

E  Detailed Model Derivation

E.1  Model Setup

Consider a firm $i$ with a constant returns to scale production function given by:

$$q_{it} = \exp\{\phi_{it}\} F(K_{it}, \ldots, V_{it}),$$
where $K_{it}, \ldots, V_{it}$ are static inputs with prices $w_{it}$, and where $\phi_{it}$ is log-TFP which follows the law of motion given by:

$$\phi_{i,t} = \rho \phi_{i,t-1} + \varepsilon \ln(D_{i,t-1}) + u_{it}$$

where $D_{i,t-1}$ is R&D investment, and $u_{i,t} \sim \text{i.i.d. } N(0, \sigma^2)$. We assume $D_{i,t-1} > 0$, which matches our empirical analysis on firms with non-trivial R&D. This setup is consistent with the R&D literature where knowledge capital depreciates over time (captured by $\rho$) and is influenced by R&D expenditure (captured by $\varepsilon$). In a stationary environment, it implies that the elasticity of TFP with respect to a permanent increase in R&D is $\varepsilon / (1 - \rho)$.

The cost function for this familiar problem is given by:

$$C(q; \phi_{it}, w_{it}) = q c(\phi_{it}, w_{it}) = q \frac{c(w_{it})}{\exp\{\phi_{it}\}},$$

where $c(\phi_{it}, w_{it}) = \frac{c(w_{it})}{\exp\{\phi_{it}\}}$ is the unit cost function.

The firm faces a constant elasticity demand function given by:

$$p_{it} = q_{it}^{\theta - 1} / \theta$$

where $\theta > 1$. Revenue for the firm is given by $q_{it}^{\theta - 1}$.

The profit-maximizing $q_{it}$ is given by:

$$q_{it}^* = \left( \frac{\theta - 1}{\theta - 1} \frac{1}{c(\phi_{it}, w_{it})} \right)^{\theta}.$$

Revenue is then given by:

$$\text{Revenue}_{it} = \left( \frac{\theta}{\theta - 1} \frac{1}{c(\phi_{it}, w_{it})} \right)^{\theta - 1} = \frac{\theta}{\theta - 1} q_{it}^* c(\phi_{it}, w_{it})$$

That is, revenues equal production costs multiplied by a gross-markup $\frac{\theta}{\theta - 1}$. Head and Mayer (2014) survey estimates of $\theta$ from the trade literature. While there is a broad range of estimates, the central estimate is close to a value of 5, which implies a gross-markup around 1.2. Per-period profits are then given by:

$$\pi_{it} = \frac{1}{\theta - 1} q_{it}^* c(\phi_{it}, w_{it}) = \frac{(\theta - 1)^{\theta - 1}}{\theta^\theta} c(\phi_{it}, w_{it})^{1 - \theta}.$$

Uncertainty and R&D investment enter per-period profits through the realization of log-TFP $\phi_{it}$. We can write expected profits as follows:

$$\mathbb{E}[\pi_{it}] = \frac{(\theta - 1)^{\theta - 1}}{\theta^\theta} c(\rho \phi_{i,t-1} + (\theta - 1)\sigma^2/2, w_{it})^{1 - \theta} D_{i,t-1}^{(\theta - 1)\varepsilon}$$

$$= \tilde{\pi}_{it} D_{i,t-1}^{(\theta - 1)\varepsilon},$$
where $\tilde{\pi}_{it}$ denotes the expected profit without any R&D investment.

We follow the investment literature and model the adjustment cost of R&D Investment with a quadratic form that is proportional to revenue $\theta \pi_{it}$ and depends on the parameter $b$:

$$g(D_{it}, \theta \pi_{it}) = \frac{b \theta \pi_{it}}{2} \left( \frac{D_{it}}{\theta \pi_{it}} \right)^2.$$  

### E.2 R&D Choice Under Linear Tax

Before considering how the InnoCom program affects a firm’s R&D investment choice, we first consider a simpler setup without such a program. In a two-period context with a linear tax, the firm’s inter-temporal problem is given by:

$$\max_{D_{i1}} (1 - t_1)(\pi_{i1} - D_{i1} - g(D_{i1}, \theta \pi_{i1})) + \beta(1 - t_2)\tilde{\pi}_{i2} D_{i1}^{(\theta - 1)\varepsilon},$$

where the firm faces and adjustment cost of R&D investment given by $g(D_{i1}, \theta \pi_{i1})$. This problem has the following first order condition:

\[
\text{FOC} : -(1 - t_1) \left( 1 + b \left( \frac{D_{i1}}{\theta \pi_{i1}} \right) \right) + \beta(1 - t_2)\varepsilon(\theta - 1)D_{i1}^{(\theta - 1)\varepsilon - 1}\tilde{\pi}_{i2} = 0. \tag{E.1}
\]

Notice first that if the tax rate is constant across periods, the corporate income tax does not affect the choice of R&D investment.\(^{44}\) In the special case of no adjustment costs (i.e., $b = 0$), the optimal choice of $D_{i1}$ is given by:

$$D_{i1}^{*} = \left[ \frac{\beta(1 - t_2)(\theta - 1)\varepsilon}{1 - t_1} \right]^{1/(\theta - 1)\varepsilon} \tilde{\pi}_{i2}. \tag{E.2}$$

Even in the general case (unrestricted $b$), we also observe that the choice of R&D depends on potentially-unobserved, firm-specific factor $\phi_{i1}$ that influences $\tilde{\pi}_{i2}$. A useful insight for the proceeding analysis is that we can recover these factors from $D_{i1}$ as follows:

$$\tilde{\pi}_{i2} = \frac{(1 - t_1)(D_{i1}^{*})^{1-(\theta - 1)\varepsilon}}{\beta(1 - t_2)\varepsilon(\theta - 1)} \left( 1 + b \left( \frac{D_{i1}^{*}}{\theta \pi_{i1}} \right) \right).$$

Substituting $\tilde{\pi}_{i2}$ into the objective function, we can write the value of the firm as

$$\Pi(D_{i1}^{*}|t_2) = (1 - t_1) \left[ \pi_{i1} + D_{i1}^{*} \left( \frac{1}{(\theta - 1)\varepsilon} - 1 \right) + \left( \frac{b}{(\theta - 1)\varepsilon} - \frac{b}{2} \right) \left( D_{i1}^{*}\right)^2 \right].$$

Rewriting this equation in terms of firm’s optimal R&D intensity $d_{i1}^{*} = \frac{D_{i1}^{*}}{\theta \pi_{i1}}$, the value-to-sales ratio is

$$\frac{\Pi(d_{i1}^{*}|t_2)}{\theta \pi_{i1}} = (1 - t_1) \left[ \frac{1}{\theta} + d_{i1}^{*} \left( \frac{1}{(\theta - 1)\varepsilon} - 1 \right) + (d_{i1}^{*})^2 \left( \frac{b}{(\theta - 1)\varepsilon} - \frac{b}{2} \right) \right]. \tag{E.3}$$

\(^{44}\)This simple model eschews issues related to source of funds, as in Auerbach (1984).
Second Order Condition

This problem may feature multiple solutions. To ensure our model results in sensible solutions, we confirm the second order condition holds at the estimated values. The SOC is given by:

\[ SOC : -(1 - t_1) \left(b \left[ \frac{1}{\theta \pi_{i1}} \right] \right) + \beta (1 - t_2) \varepsilon (\theta - 1) ((\theta - 1) \varepsilon - 1) (D^*_i)^{(\theta - 1) \varepsilon - 2} \tilde{\pi}_{i2} < 0. \]

It is sufficient to have \((\theta - 1) \varepsilon < 1\) in order for the second order condition to hold. We can also use the implicit function theorem to show that R&D decision \(D^*_i\) is increasing in \(\phi_{i1}\) if \((\theta - 1) \varepsilon < 1\), which is consistent with numerous empirical studies.

E.3 A Notch in the Corporate Income Tax

Assume now that the tax in the second period has the following structure that mirrors the incentives in the InnoCom program:

\[ t_2 = \begin{cases} 
  t_{2LT} & \text{if } d_{i1} < \alpha \\
  t_{2HT} & \text{if } d_{i1} \geq \alpha 
\end{cases}, \]

\(t_{2LT} > t_{2HT}\) and where \(\alpha\) is the R&D intensity required to obtain the high-tech certification and \(LT/HT\) stands for low-tech/high-tech. In addition, we introduced a fixed costs of certification \(c\) such that firms need to pay \(c \times \alpha \theta \pi_{i1}\) to obtain the tax benefit when they pass the R&D intensity threshold. Intuitively, this tax structure induces a notch in the profit function at \(d_1 = \alpha\). Figure 6 presents two possible scenarios following this incentive. Panel A shows the situation where the firm finds it optimal to choose a level of R&D intensity below the threshold. At this choice, the first order condition of the linear tax case holds and the optimal level of R&D is given by Equation E.1. From this panel, we can observe that a range of R&D intensity levels below the threshold are dominated by choosing an R&D intensity that matches the threshold level \(\alpha\). Panel B shows a situation where the firm that is indifferent between the internal solution of panel A and the “bunching” solution of panel B. The optimal choice of R&D for this firm is characterized both by Equation E.1 and by equating \(d^*_1 = \alpha\).

Which of the two scenarios holds depends on determinants of the R&D investment decision that may vary at the firm level and are summarized by \(\tilde{\pi}_{i2}\), adjustment and fixed costs \(b, c\), as well as on the degree to which R&D investment is valued by firms in terms of future profits (i.e. \(\varepsilon(\theta - 1)\)). However, as long as \(\tilde{\pi}_{i2}\) and \((b, c)\) are smoothly distributed around the threshold \(\alpha\), this incentive will lead a mass of firms to find \(d_1 = \alpha\) optimal and thus “bunch” at this level.

We first calculate the optimal profit of the firm conditioning on bunching at the notch, \(\Pi(\alpha \theta \pi_1 | t_{2HT}^*)\), by substituting for the unobserved components of the firm-decision, i.e. \(\tilde{\pi}_{i2}\), us-
ing Equation E.1 to obtain:

\[
\Pi(\alpha \theta \pi_1 | t_2^{HT}) = (1 - t_1) \left( \pi_{i1} - \alpha \theta \pi_1 (1 + c) - \frac{b \theta \pi_{i1}}{2} \left[ \frac{\alpha \theta \pi_{i1}}{\theta \pi_{i1}} \right]^2 \right) + \beta (1 - t_2^{HT}) (\alpha \theta \pi_{i1})^{2} \tilde{\pi}_{2}
\]

\[
= (1 - t_1) \left[ \pi_{i1} - \alpha \theta \pi_1 (1 + c) - \frac{\alpha^2 b \theta \pi_{i1}}{2} \right] + \frac{(1 - t_2^{HT})}{\varepsilon(\theta - 1)(1 - t_2^{LT})} \left( \frac{\alpha \theta \pi_{i1}}{D_{i1}^*} \right)^{(\theta - 1)c} \left( 1 + b \left[ \frac{D_{i1}^*}{\alpha \theta \pi_{i1}} \right] \right) D_{i1}^* \right].
\]

Let \( \frac{\Pi(\alpha | t_2^{HT})}{\theta \pi_{i1}} \) be the value-to-sales ratio of the firm conditional on bunching at the notch. We can write it again in terms of the optimal interior R&D intensity \( d_{i1}^* \) as

\[
\frac{\Pi(\alpha | t_2^{HT})}{\theta \pi_{i1}} = (1 - t_1) \left[ \frac{1}{\theta} + \alpha \left( \frac{d_{i1}^*}{\alpha} \right)^{1-(\theta-1)c} (1 + b d_{i1}^*) \left( \frac{1 - t_2^{HT}}{1 - t_2^{LT}} \right) \frac{1}{\varepsilon(\theta - 1)} - (1 + c) - \frac{\alpha b}{2} \right] \quad (E.4)
\]

A firm will bunch at the notch if \( \frac{\Pi(\alpha | t_2^{HT})}{\theta \pi_{i1}} \geq \frac{\Pi(d_{i1}^* | t_2)}{\theta \pi_{i1}} \), which occurs when

\[
\left( \frac{d_{i1}^*}{\alpha} \right)^{1-(\theta-1)c} \left( 1 + \alpha b \frac{d_{i1}^*}{\alpha} \right) \left( \frac{1 - t_2^{HT}}{1 - t_2^{LT}} \varepsilon(\theta - 1) \right) - (1 + c) - \frac{\alpha b}{2} \geq \frac{d_{i1}^*}{\alpha} \left( \frac{1}{\varepsilon(\theta - 1)} - 1 \right) + \alpha \left( \frac{d_{i1}^*}{\alpha} \right)^2 \left( \frac{b}{\varepsilon(\theta - 1)} - \frac{b}{2} \right) \quad (E.5)
\]

For each specific realization of adjustment and fixed costs \((b, c)\), we define the marginal firm with interior optimal R&D intensity \( d_{i1}^{b,c} \) such that Equation E.5 holds with equality.

### E.4 R&D Choice Under Tax Notch with Relabeling

Assume now that firms may misreport their costs and shift non-R&D costs to the R&D category. Following conversations with CFOs of large Chinese companies, we model relabeling as a choice to misreport expenses across R&D and non-R&D categories. Misreporting expenses or revenues overall is likely not feasible as firms are subject to third party reporting (see, e.g., Kleven et al. (2011)).

Denote a firm’s reported level of R&D spending by \( \tilde{D}_{i1} \). The expected cost of misreporting to the firm is given by \( h(D_{i1}, \tilde{D}_{i1}) \). We assume that the cost of mis-reporting is proportional to the reported R&D, \( \tilde{D}_{i1} \), and depends on the percentage of mis-reported R&D, \( \delta_{i1} = \frac{D_{i1} - \tilde{D}_{i1}}{D_{i1}} \), so that:

\[
h(D_{i1}, \tilde{D}_{i1}) = \tilde{D}_{i1} \tilde{h}(\delta_{i1}).
\]

We also assume that \( \tilde{h} \) satisfies \( \tilde{h}(0) = 0 \) and \( \tilde{h}'(\cdot) \geq 0 \).

The effects of the InnoCom program are now as follows:

\[
t_2 = \begin{cases} 
  t_2^{LT} & \text{if } \tilde{D}_{1} < \alpha \theta \pi_{1} \\
  t_2^{HT} & \text{if } \tilde{D}_{1} \geq \alpha \theta \pi_{1}
\end{cases}
\]
Notice first that if a firm decides not to bunch at the level \( \alpha \theta \pi_1 \), there is no incentive to misreport R&D spending as it does not affect total profits and does not affect the tax rate. However, a firm might find it optimal to report \( \tilde{D}_1 = \alpha \theta \pi_1 \) even if the actual level of R&D is lower. We start by characterizing the firm’s optimal relabeling strategy \( \delta_{i1}^* \) conditional on bunching and its resulting payoff function \( \Pi(\alpha \theta \pi_1, D_{i1}^{*K}|t_2^{HT}) \). We again substitute for the unobserved components of the firm-decision, i.e. \( \bar{\pi}_{i2} \) with the interior optimal R&D \( D_{i1}^{*} \) using Equation E.1:

\[
\max_{D_{i1}^{*K}} (1 - t_1) \left( \pi_{i1} - D_{i1}^{K} - \alpha \theta \pi_{i1} c - \frac{b \theta \pi_{i1}}{2} \left[ \frac{D_{i1}^{K}}{\theta \pi_{i1}} \right]^2 \right) - \alpha \theta \pi_1 \bar{h} \left( \frac{\alpha \theta \pi_1 - D_{i1}^{K}}{\alpha \theta \pi_1} \right) + \frac{(1 - t_1)(1 - t_2^{HT})}{\varepsilon (\theta - 1)} \left( \frac{D_{i1}^{K}}{D_{i1}^{*}} \right)^{(\theta - 1)\varepsilon} \left( 1 + b \left[ \frac{D_{i1}^{*}}{\theta \pi_{i1}} \right] \right) D_{i1}^{*}
\]

The first order condition is:

\[
(1 + b \left[ \frac{D_{i1}^{K}}{\alpha \theta \pi_{i1}} \right]) = \left( 1 - t_2^{HT} \right) \left( \frac{D_{i1}^{K}}{D_{i1}^{*}} \right)^{(\theta - 1)\varepsilon - 1} \left( 1 + b \left[ \frac{D_{i1}^{*}}{\theta \pi_{i1}} \right] \right) + \bar{h} \left( \frac{\alpha \theta \pi_1 - D_{i1}^{K}}{\alpha \theta \pi_1} \right) \frac{1}{1 - t_1}
\]

This equation defines the optimal relabeling strategy \( \delta_{i1}^* \) as an implicit function of the interior optimal R&D intensity \( d_{i1}^{*} \) as the following:

\[
\left( \frac{d_{i1}^{*}}{\alpha (1 - \delta_{i1}^*)} \right)^{1 - (\theta - 1)\varepsilon} \times \left( \frac{1 - t_2^{HT}}{1 - t_2^{LT}} \right) \left( 1 + b \left( \frac{d_{i1}^{*}}{\alpha} \right) \right) = \frac{1}{\alpha} \left[ 1 + b \left( \frac{d_{i1}^{*}}{\alpha} \right) - \frac{\bar{h}'(\delta_{i1}^*)}{(\alpha \theta \pi_1)} \right] \tag{E.6}
\]

The firm decides to bunch if the profits from the optimal relabeling strategy \( \Pi(\alpha \theta \pi_{i1}, D_{i1}^{K}|t_2^{HT}) \) are greater than when the firms is at the optimal interior solution (and truthful reporting) \( \Pi(D_{i1}^{*}, D_{i1}^{*}|t_2^{LT}) \). We write this in terms of value-to-revenue ratio comparison and obtain:

\[
\left( \frac{d_{i1}^{*}}{\alpha (1 - \delta_{i1}^*)} \right)^{1 - (\theta - 1)\varepsilon} \left( 1 + b d_{i1}^{*} \right) \times \left( \frac{1 - \delta_{i1}^*}{\theta - 1} \right)^{\varepsilon} \times \left( \frac{1 - t_2^{HT}}{1 - t_2^{LT}} \right) - c - (1 - \delta_{i1}^*) - \frac{\alpha b}{2} (1 - \delta_{i1}^*)^2
\]

\[
- \frac{\bar{h}'(\delta_{i1}^*)}{\alpha (1 - t_1)} \geq \frac{d_{i1}^{*}}{\alpha} \left( \frac{1}{(\theta - 1)\varepsilon} - 1 \right) + \alpha \left( \frac{d_{i1}^{*}}{\alpha} \right)^2 \left( \frac{b}{(\theta - 1)\varepsilon} - \frac{b}{2} \right) \tag{E.7}
\]

The marginal firm \( d_{i1,c}^{*} \) in this case is determined by Equation E.6 and Equation E.7 when it holds with strict equality.

F Bunching Approximations

This section provides detailed derivations of expressions that approximate changes in the R&D investment with the estimated density.
F.1 Percentage Increase in R&D Intensity of Marginal Firm

As in Kleven and Waseem (2013), we can approximate the behavior of the marginal firm with the quantities $B$ and $h_0(\alpha)$. We first consider the special case without frictions, and note that

$$B = \int_{d^*-}^{\alpha} h_0(u) du \approx h_0(\alpha)(\alpha - d^*) = h_0(\alpha)\frac{\alpha - d^*}{\Delta D^*}.$$  \hspace{1cm} \text{(F.1)}

The first part of Equation F.1 makes the point that the excess mass $B$ will equal the fraction of the population of firms that would have located in the dominated region. This quantity is defined by the integral of the counterfactual distribution $h_0(\cdot)$ over the dominated interval, which is given by $(d^*, \alpha)$. The second part of Equation F.1 approximates this integral by multiplying the length on this interval by the value of the density at $\alpha$. Simplifying this expression and solving for $\Delta D^*$ we obtain:

$$\Delta D^* \approx \frac{B}{h_0(\alpha)\alpha}.$$  

Thus, in order to estimate $\Delta D^*$, it suffices to have an estimate of the counterfactual density $h_0(\cdot)$, and to use this to recover the quantities $B$ and $h_0(\alpha)$. Note that while $\Delta D^*$ is the percentage increase relative to the notch, the percentage increase relative to the initial point of the marginal firm is given by: $\Delta D^* = \frac{\alpha - d^*}{\alpha - d^*}$. Similarly, the increase in R&D intensity for the marginal firm is given by $\alpha\Delta D^* = \alpha - d^*$.  

In the case of heterogeneous frictions, we may obtain a similar approximation if we assume that the probability of being constrained from responding to the program does not depend on $d$. While this may be a strong assumption, it provides a useful approximation for $B$. To see this, note that

$$B = \int_{d^*}^{\alpha} \int_{b,c} \mathbb{I}[d \geq d_{b,c}]h_0(d, b, c)d(b, c)dd$$

$$= \int_{d^*}^{\alpha} \int_{b,c} \mathbb{I}[d \geq d_{b,c}]h_0(b, c|d)d(b, c)h_0(d)dd$$

$$= \int_{d^*}^{\alpha} (1 - Pr(Constrained|d))h_0(d)dd,$$

where the second line uses the definition of conditional probability, and the third line integrates over $(b, c)$. Using the assumption that $Pr(Constrained|d)$ does not depend on $d$ and using the
same approximation as in Equation F.1, we obtain:

\[ B = (1 - \Pr(\text{Constrained})) \int_{d^*}^{\alpha} h_0(d) dd \]
\[ \approx (1 - \Pr(\text{Constrained})) h_0(\alpha) \alpha \frac{\alpha - d^*}{\Delta D^*}. \]

The formula for \( \Delta D^* \) now becomes:

\[ \Delta D^* \approx \frac{B}{h_0(\alpha) (1 - \Pr(\text{Constrained}))}. \]

### F.2 Average Percentage Increase in R&D Intensity

We now derive an approximation for the average percentage increase in R&D due to the notch. We begin by writing the average R&D intensities in both situations as:

\[ \mathbb{E}[d| \text{No Notch}, d \in (d^*, d^{*+})] = \int_{d^*}^{d^{*+}} dh_0(d) dd \approx \frac{\alpha + d^*}{2} \int_{d^*}^{\alpha} h_0(d) dd + \frac{d^{*+} + \alpha}{2} \int_{d^*}^{d^{*+}} h_0(d) dd \]

\[ \mathbb{E}[d| \text{Notch}, d \in (d^*, d^{*+})] = \int_{d^*}^{d^{*+}} dh_1(d) dd \approx \frac{\alpha + d^*}{2} \int_{d^*}^{\alpha} h_1(d) dd + \frac{d^{*+} + \alpha}{2} \int_{d^*}^{d^{*+}} h_1(d) dd \]

We can then write the change in R&D intensity as:

\[ \mathbb{E}[d| \text{Notch}, d \in (d^*, d^{*+})] - \mathbb{E}[d| \text{No Notch}, d \in (d^*, d^{*+})] \approx \bar{d} \int_{d^*}^{d^{*+}} (h_1(d) - h_0(d)) dd \\
\quad + \bar{d} \int_{d^*}^{\alpha} (h_1(d) - h_0(d)) dd \\
\quad = B(\bar{d} - \bar{d}), \quad (F.2) \]

where we use the fact that the excess mass above the notch is equal to the missing mass below the notch.

Taking the following approximation of \( \mathbb{E}[d| \text{No Notch}, d \in (d^*, d^{*+})] \):

\[ \mathbb{E}[d| \text{No Notch}, d \in (d^*, d^{*+})] = \int_{d^*}^{d^{*+}} dh_0(d) dd \approx \int_{d^*}^{d^{*+}} \alpha h_0(\alpha) dd \\
\quad = \alpha h_0(\alpha) (d^{*+} - d^*) = 2\alpha h_0(\alpha)(\bar{d} - d), \]

we obtain:

\[ \frac{\mathbb{E}[d| \text{Notch}, d \in (d^*, d^{*+})] - \mathbb{E}[d| \text{No Notch}, d \in (d^*, d^{*+})]}{\mathbb{E}[d| \text{No Notch}, d \in (d^*, d^{*+})]} = \frac{B}{2\alpha h_0(\alpha)}. \quad (F.3) \]
Note that, while these derivations do not explicitly include the role of heterogeneous frictions, these expressions are not affected by the presence of heterogeneous frictions.

**F.3 Identification of Intent-to-Treat Effect**

The ITT estimates are identified by firms that “comply” with the tax incentive. To see this, note:

\[
\mathbb{E}[Y|\text{No Notch}, d \in (d^-, d^+)] = \int d^- \alpha Y h_0(d) \times \mathbb{P}(\text{Constrained}|d) \, dd + \int d^+ \alpha Y h_0(d) \times (1 - \mathbb{P}(\text{Constrained}|d)) \, dd + \int \alpha Y h_0(d) \, dd
\]

Similarly, we can write

\[
\mathbb{E}[Y|\text{Notch}, d \in (d^+, d^+)] = \int d^- \alpha Y h_1(d) \, dd + \int d^+ \alpha Y h_1(d) \times (1 - \mathbb{P}(\text{Constrained}|d)) \times I[d_0 \in (d^-, \alpha)] \, dd + \int \alpha Y h_1(d) I[d_0 \in (\alpha, d^+)] \, dd,
\]

where we assume that there are no defier firms that would be above the notch without the InnoCom program, but would be below the notch with the InnoCom program. Noting that \( h_0(d) \times \mathbb{P}(\text{Constrained}|d) = h_1(d) \), and that \( h_1(d) \times I[d_0 \in (\alpha, d^+)] = h_0(d) \), we can write the ITT as:

\[
\text{ITT}^Y = \int d^+ \alpha Y h_1(d)(1 - \mathbb{P}(\text{Constrained}|d))I[d_0 \in (d^-, \alpha)] \, dd - \int d^- \alpha Y h_0(d)(1 - \mathbb{P}(\text{Constrained}|d)) \, dd,
\]

which is just the change in the average of firms in the excluded region that is driven by the compliers.
Approximation of Intent-to-Treat Effect

Finally, we can obtain more intuition behind the ITT estimates by noting that:

\[ B = \int_{d^*}^{d^*+} h_1(d)(1 - \mathbb{P}(\text{Constrained} | d)) \mathbb{I}[d_0 \in (d^*-, \alpha)] dd = \int_{d^*}^{\alpha} h_0(d)(1 - \mathbb{P}(\text{Constrained} | d)) dd. \]

Using this fact, the following expression is an approximation of Equation F.4:

\[ ITT_Y \approx B(\bar{Y} - \bar{Y}) \quad \text{(F.5)} \]

where \( \bar{Y} \) is the counterfactual average value of \( Y \) for compliers with \( d_0 \in (d^*-, \alpha) \) and \( \bar{Y} \) is the average value of \( Y \) for compliers with \( d_1 \in (\alpha, d^*+) \). This equation gives a discrete treatment effect interpretation to the ITT by showing that the ITT is driven by the amount of switching of compliers between the “below notch” and “above notch” regions, given by \( B \), and the change in the outcome associated from being in the “above notch” region. Note that this approximation implies a constant treatment effect. While we do not rely on this assumption in our analysis, we find it useful in order to build intuition for the interpretation of the ITT estimates.

G Cross-Validation of \( p \) and \((d^*-, d^*+)\) in Bunching Analysis

We follow Diamond and Persson (2016) in using a data-based approach to selecting the excluded region (i.e., \((d^*-, d^*+)\)), and the degree of the polynomial, \( p \). In particular, we use K-fold cross-validation to evaluate the fit of a range of values for these three parameters.

Our cross-validation procedure searches over values of \( p < 7 \), and all possible discrete values of \( d^* < \alpha \) and \( d^*+ > \alpha \) that determine the excluded region. Given the monotonically decreasing shape of the R&D intensity distribution, we restrict the estimated \( \beta_k \)'s to result in a decreasing density.

For each triple \((p, d^*-, d^*+)\), the procedure estimates the model in \( K = 5 \) training subsamples of the data and computes two measures of model fit on corresponding testing subsamples of the data. First, we test the hypothesis that the excess mass (above the notch) equals the missing mass (below the notch). Second, we compute the sum of squared errors across the test subsamples. We select the combination of parameters that minimizes the sum of squared errors, among the set of parameters that do not reject the test of equality between the missing and excess mass at the 10% level.

Note that a common practical problem in the literature is the higher frequency in the reporting of “round numbers.” As Figures 2 and A.1 in Section 3 demonstrate, our data does not display “round-number” problems that are often present in other applications.

Finally, we obtain standard errors by bootstrapping the residuals from the series regression, generating 5000 replicates of the data, and re-estimating the parameters.
Robustness of Bunching Estimates

This section discusses additional robustness checks of our results in Section 5.1. Figure A.5 estimates the counterfactual density of R&D intensity when we exclude certain groups of firms from the data. Panel A analyzes data on large firms from 2011 and shows that excluding state-owned enterprises from our data does not have a meaningful effect on our estimate of $\Delta d$. Similarly, panels B and C show that excluding firms with low profitability and firms that are not in designated high-tech industries, respectively, results in very similar estimates of the effects of the notch on R&D investment.

Figure A.6 shows that our estimates of counterfactual densities are robust to the choice of $(p, d^*-\leq, d^{*+})$. This figure shows that restricting $(p, d^*-\leq, d^{*+})$ to the second-best estimate either with $p = 3$ (panel A) or $p = 4$ (panel B) results in very similar estimates. Panel C of this graph further restricts the estimation to only rely on data such that $d > d^+$ to recover the counterfactual density. This panel shows that even relying only on data beyond the bunching region results in very similar estimates.

Estimation of $E[Y|d]$ for ITT Analysis

Section 5.2 discusses the estimation of the ITT effects of the notch on our outcomes of interest. The ITT estimates depend on estimates of the counterfactual distribution, $h_0(d)$, as well as the predicted value of the outcome over the excluded region, $E[Y|d, \text{No Notch}]$. In this section we discuss estimates of these functions. We focus on large firms since, as shown in Figure A.4, they account for the vast majority of R&D in the economy. In addition, all analyses report the effects of the notch in 2009 on outcomes in 2009 and 2011. The counterfactual density of interest is presented in panel C of Figure 8.

We estimate $E[Y|d, \text{No Notch}]$ using the following regression:

$$Y_{it} = \sum_{k=0}^{p} \beta_k \cdot (d_{it1})^k + \gamma \cdot 1 \left[ d^{-*} \leq d_{it1} \leq d^{*+} \right] + \delta Y_{it1} + \phi_s + \nu_{it},$$

where we use the same exclusion region as in panel C of Figure 8 (see Appendix G for details), and we use a quadratic polynomial for each outcome. Figure A.7 shows the average value of our outcomes as a function of R&D intensity in 2009 (blue circles) along with the fitted values from these regressions (red lines). The size of the circles indicate the weights based on the number of observations in each bin.

Panel A considers the case of log R&D intensity. Since this is a mechanical function of R&D intensity, we know what $E[Y|d, \text{No Notch}]$ should look like. This figure shows that, even though
the polynomials are driven by data outside of the exclusion region, we are able to fit non-linear functions very well. Other panels show the red lines provide a good fit for data outside of the exclusion region. As firms self-select into the InnoCom program, we cannot evaluate the fit inside the exclusion region, since these patterns may be due to selection. Finally, note that we allow for the user-cost to have a discontinuous jump in panel C, since, in contrast to other outcomes, we would expect participation in the program to have a mechanical effect on the user cost of R&D. 45

J Robustness of Structural Model Assumptions

In this section, we conduct a few additional robustness checks of the parametric and modeling assumptions we have made in our structural estimation analysis.

Parametric Distribution of Firm Productivity

In our benchmark model, we micro-found the cross-sectional TFP distribution from a Normal AR(1) process. We use the persistence and volatility of the sales for non-R&D firms to calibrate the persistence parameter $\rho = 0.725$ and variance parameter $\sigma = 0.385$. The assumption of this process restricts the cross-sectional distribution of firm TFP $\exp(\phi_1)$ to be Lognormal. Since we have constructed firm-level TFP in our data, it allows us to check this parametric assumption directly with the TFP data.

We use ideas proposed by Kratz and Resnick (1996) and Head et al. (2014) in this robustness check. The basic idea is to construct the empirical CDF of our sample firms’ measured TFP as $\hat{F}_i, i = 1, 2, ..., N$, with $i$ ranked based on firm TFP and the $N$th firm of the highest measured TFP. With the Log-normal parametric assumption, we know the theoretical CDF is $F_{LN}(lnTFP) = \Phi(\frac{lnTFP - \mu_{tfp}}{\sigma_{tfp}})$, with $\Phi$ as the standard Normal CDF. Thus, we can write the $lnTFP$ of each quantile $i$ as:

$$lnTFP_i = \mu_{tfp} + \Phi^{-1}(F_i)\sigma_{tfp}.$$  

With our frequency estimate $\hat{F}_i$, we can then predict the “theoretical” $ln\hat{TFP}_i$ using the formula above. Notice that we have used the parametric Normal assumption in this calculation. This procedure allows us to evaluate how reasonable the Lognormal parametric assumption is by comparing the empirical fit of $ln\hat{TFP}$ and $lnTFP$.

In Figure A.8, we show that the predicted TFP from imposing the Lognormal CDF tracks the 45 degree linear line, i.e., the data quite well. It thus provides strong evidence that Lognormal is a reasonable parametric assumption for the TFP distribution.

45Diamond and Persson (2016) allow for discontinuities in their estimates of $E[Y|d, No Notch]$ since, in their application, being manipulated above the notch may have a direct effect on outcomes. In our case, we would not expect a direct effect of the program on firm-level outcomes apart from the effects related to tax incentives, which would mechanically affect the user cost of R&D.
Heterogeneity in the TFP Elasticity: $\varepsilon$

Our benchmark model assumes firms have heterogeneous technological opportunities of R&D investment that is driven by heterogeneity in adjustment costs, $b$. An alternative way of modeling the heterogeneity in firms’ technological opportunities is to allow for heterogeneity in $\varepsilon$. As we show in this appendix, our average estimates of $\varepsilon$ and $b$ do not depend on which can be heterogeneous. However, models where $\varepsilon$ was allowed to be heterogeneous produced worse fits of the data. Specifically, these models predict that R&D intensity is not increasing in TFP, which is contrary to what we observe in the real world. For this reason, we believe our benchmark model is superior to models with heterogeneous values of $\varepsilon$.

To investigate how this alternative setup affects our results, we estimated models where $\varepsilon$ follows a Beta distribution $B(\alpha_\varepsilon, \beta_\varepsilon)$ between 0 and an upper bound of $\bar{\varepsilon}$. We chose the Beta distribution since its probability density function is highly flexible in the interval $[0, \bar{\varepsilon}]$. We estimated two versions of the heterogeneous-$\varepsilon$ model. In Model A, we restrict the Beta distribution to be symmetric, i.e. $\alpha_\varepsilon = \beta_\varepsilon$, and jointly estimate $\alpha_\varepsilon$ and $\bar{\varepsilon}$. In Model B, we impose $\bar{\varepsilon} = 1/(\theta - 1) = 0.25$, a value that guarantees the second order condition of firm’s R&D choice problem. We then estimate $\alpha_\varepsilon$ and $\beta_\varepsilon$. The results are reported in Table A.6.

Several findings are worth highlighting. First, the implied mean $\varepsilon$ are 0.113 and 0.114 in Model A and B, respectively. These values are comparable to our benchmark value of 0.098. Second, the average adjustment cost parameter is 8.659 and 8.677 for the two cases, again very similar to our benchmark estimate. However, the set of moments summarizing firm TFP at different R&D intensity regions had noticeably worse fit than the our benchmark. When $\varepsilon$ is heterogeneous, our model predicts a non-monotonic relationship between TFP and R&D intensity, which is inconsistent with the positive correlation we observe in the data. This is because despite the fact that firm R&D itself is increasing in TFP, its R&D Intensity becomes decreasing in TFP when the value of $\varepsilon$ is small. Combined, these findings indicate that despite obtaining similar estimates of key model parameters, our benchmark model of heterogeneous adjustment cost is a a preferable model for our data.

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Note that our data variation cannot separately identify heterogeneity in both $\varepsilon$ and $b$. 

65
Figure A.1: Bunching at 5% R&D Intensity (2005-2007)

NOTE: This figure plots the R&D intensity distribution of manufacturing firms conducting R&D during the period of 2005 to 2007. We include the firms that had the R&D intensity between 1% and 15%. There is a significant bunching of firms at the 5% threshold. Source: Annual Survey of Manufacturers. See Section 3.1 for details.
Figure A.2: Alternative Empirical Evidence of Relabeling

NOTE: This figure summarizes the ratio of R&D to administrative expense for small, medium, and large firms in our sample. This figure shows that this ratio jumps discontinuously across the thresholds of R&D intensity prescribed by the InnoCom program. This suggests firms manipulate their reported R&D intensity by relabeling non-R&D administrative expenses as R&D. See Table A.3 for estimates of the structural break.

Figure A.3: Lack of Manipulation of Sales Expenses

NOTE: This figure shows the binned plot of sales expense-to-sales ratio for each size categories of firms. Table A.4 shows that we do not find a detectable drop in this ratio at the notches.
NOTE: This figure summarizes the share of total R&D accounted for by the small, medium, and large firms in our sample. As it illustrates, the large firms account for more 90% of the total R&D and thus is the most important group for aggregate implications of the policy.
Figure A.5: Robustness of Bunching Estimates to Dropping Groups of Firms

A. Dropping SOEs

\[ \Delta d = 0.310^{***(0.052)} \]
\[ \Delta D = 0.880^{***(0.102)} \]
\[ P\text{-value (M=B)} = 0.8688 \]
\[ \text{Frictions: } a^* = 0.295^{***(0.022)} \]

B. Dropping Low Profitability Firms

\[ \Delta d = 0.284^{***(0.053)} \]
\[ \Delta D = 0.857^{***(0.107)} \]
\[ P\text{-value (M=B)} = 0.8265 \]
\[ \text{Frictions: } a^* = 0.337^{***(0.025)} \]

C. Dropping Low Tech Firms

\[ \Delta d = 0.313^{***(0.062)} \]
\[ \Delta D = 0.915^{***(0.134)} \]
\[ P\text{-value (M=B)} = 0.7437 \]
\[ \text{Frictions: } a^* = 0.316^{***(0.024)} \]

NOTE: This figure conducts robustness checks of the benchmark bunching analysis for large firms in 2011. In panel A, we drop the State-owned enterprises. In panel B, we drop the lowest 20% profitability firms. In panel C, we dropped all the firms that are not classified in the “High Tech” industries defined by the Chinese government. These graphs shows our benchmark results are robust across these subsamples.
Figure A.6: Robustness of Bunching Estimates to Specification of Counterfactual Density

A. Second-Best Choice of Specification (p=3)

\[
\Delta d = 0.308^{***}(0.056) \\
\Delta D = 0.915^{***}(0.122) \\
P\text{-value (M=B)} = 0.8551 \\
Frictions: a = 0.327^{***}(0.023)
\]

B. Second-Best Choice of Specification (p=4)

\[
\Delta d = 0.289^{***}(0.084) \\
\Delta D = 0.912^{***}(0.180) \\
P\text{-value (M=B)} = 0.6751 \\
Frictions: a = 0.367^{***}(0.036)
\]

C. Estimate Using Observations Above \(d^+\)

\[
\Delta d = 0.351^{***}(0.064) \\
\Delta D = 1.006^{***}(0.107) \\
P\text{-value (M=B)} = 0.7425 \\
Frictions: a = 0.302^{***}(0.037)
\]

NOTE: This figure conducts robustness checks of the benchmark bunching analysis for large firms in 2011. As discussed in Appendix G, we select \((p, d^-_*, d^+*)\) via cross-validation. In panel A, we use the second-best choice for the specification of \((p, d^-, d^+*)\). As in our benchmark case, \(p = 3\). In panel B, we further restrict \(p = 4\) and we select \((d^-, d^+*)\) via cross-validation. In panel C, we use the same value of \(d^+\) as in our benchmark case and we only use data above this value when estimating the counterfactual density. These graphs shows our benchmark results are robust to how we specify \((p, d^-, d^+*)\).
NOTE: This figure reports the polynomial regression of binned outcome variables on R&D intensity. The size of each circle indicates the weights based on the number of observations accounted for by each bin. We leave out all the observations in the manipulated region. Overall, these graphs show a good fit on the data outside of the exclusion region. The fit in the exclusion region cannot be evaluated since the data patterns may be due to selection. See Appendix I for more details.
NOTE: This figure reports the predicted TFP from imposing Lognormal CDF and the 45 degree linear line. It shows that the predicted TFP tracks the data TFP quite well. It thus provides strong evidence that Lognormal is a reasonable parametric assumption for the TFP distribution.
Figure A.9: Sensitivity Analysis

A. Sensitivity Analysis for \( \varepsilon \)

NOTE: This figure reports results of sensitivity analysis based on Andrews et al. (2017). We report the sensitivity matrix \( \Lambda \), which captures how a local change in each moment affects the parameter estimates. To make it comparable across parameters, we scale the \( \Lambda \) to present the magnitude in terms of percent of each parameter.
### Table A.1: Manipulation of the Administrative Expense to Sales Ratio

<table>
<thead>
<tr>
<th></th>
<th>(1)</th>
<th>(2)</th>
<th>(3)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Small</td>
<td>-0.014**</td>
<td>-0.013***</td>
<td>-0.008***</td>
</tr>
<tr>
<td>(0.007)</td>
<td>(0.004)</td>
<td>(0.003)</td>
<td></td>
</tr>
<tr>
<td>Observations</td>
<td>5,016</td>
<td>8,336</td>
<td>8,794</td>
</tr>
</tbody>
</table>

NOTES: This table reports estimates of the structural break at the notches in Figure 4. The table shows that the ratio of administrative expenses to sales drops across the notches of the InnoCom program, which suggests firms qualify for the InnoCom program by relabeling non-R&D expenses as R&D. See Section 3.1 for details on data sources and Section 3.3 for details on the estimation. Standard errors in parentheses. Source: Administrative Tax Return Database.

* p < .1, ** p < .05, *** p < .01

### Table A.2: Lack of Sales Manipulation at R&D Intensity Thresholds

<table>
<thead>
<tr>
<th></th>
<th>(1)</th>
<th>(2)</th>
<th>(3)</th>
</tr>
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<tbody>
<tr>
<td>Small</td>
<td>0.108</td>
<td>-0.021</td>
<td>0.055</td>
</tr>
<tr>
<td>(0.103)</td>
<td>(0.067)</td>
<td>(0.114)</td>
<td></td>
</tr>
<tr>
<td>Observations</td>
<td>1,096</td>
<td>1,952</td>
<td>1,665</td>
</tr>
</tbody>
</table>

NOTES: This table reports estimates of the structural break at the notches of panel A in Figure 5. The table shows that firms do not manipulate their sales to comply with the InnoCom program. See Section 3.1 for details on data sources and Section 3.3 for details on the estimation. Standard errors in parentheses. Source: Administrative Tax Return Database.

* p < .1, ** p < .05, *** p < .01
Table A.3: Alternative Estimates of Manipulation of Administrative Expenses

<table>
<thead>
<tr>
<th></th>
<th>(1)</th>
<th>(2)</th>
<th>(3)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Small</td>
<td>0.053**</td>
<td>0.056***</td>
<td>0.054**</td>
</tr>
<tr>
<td>Medium</td>
<td>(0.026)</td>
<td>(0.020)</td>
<td>(0.022)</td>
</tr>
<tr>
<td>Large</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Observations</td>
<td>3,544</td>
<td>5,710</td>
<td>5,597</td>
</tr>
</tbody>
</table>

NOTES: This table reports estimates of the structural break at the notches in Figure A.2. The table shows that the ratio of administrative expenses to R&D jump across the notches of the InnoCom program, which suggests firms qualify for the InnoCom program by relabeling non-R&D expenses as R&D. See Section 3.1 for details on data sources and Section 3.3 for details on the estimation. Standard errors in parentheses. Source: Administrative Tax Return Database.

* p < 0.10, ** p < 0.05, *** p < 0.01

Table A.4: Lack of Manipulation of Sales Expenses at R&D Intensity Thresholds

<table>
<thead>
<tr>
<th></th>
<th>(1)</th>
<th>(2)</th>
<th>(3)</th>
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</thead>
<tbody>
<tr>
<td>Small</td>
<td>-0.002</td>
<td>-0.000</td>
<td>-0.001</td>
</tr>
<tr>
<td>Medium</td>
<td>(0.006)</td>
<td>(0.004)</td>
<td>(0.004)</td>
</tr>
<tr>
<td>Large</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Observations</td>
<td>4,774</td>
<td>8,064</td>
<td>8,600</td>
</tr>
</tbody>
</table>

NOTES: This table reports estimates of the structural break at the notches in Figure A.3. The table shows that firms do not manipulate sales expenses to comply with the InnoCom program. See Section 3.1 for details on data sources and Section D for details on the estimation. Standard errors in parentheses. Source: Administrative Tax Return Database.

* p < .1, ** p < .05, *** p < .01
Table A.5: Robustness of Estimates of Treatment Effects

### A. Estimates of Intent-to-Treat (ITT) Effects

<table>
<thead>
<tr>
<th>Year</th>
<th>Outcome</th>
<th>ITT</th>
<th>SE</th>
<th>T-Stat</th>
<th>5th Perc.</th>
<th>95th Perc.</th>
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</thead>
<tbody>
<tr>
<td>2009</td>
<td>Admin Costs</td>
<td>-0.095</td>
<td>0.025</td>
<td>-3.809</td>
<td>-0.137</td>
<td>-0.054</td>
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<tr>
<td></td>
<td>Admin Costs (levels)</td>
<td>-0.004</td>
<td>0.001</td>
<td>-3.700</td>
<td>-0.005</td>
<td>-0.002</td>
</tr>
<tr>
<td></td>
<td>R&amp;D</td>
<td>0.146</td>
<td>0.065</td>
<td>2.255</td>
<td>0.037</td>
<td>0.250</td>
</tr>
<tr>
<td></td>
<td>R&amp;D (real)</td>
<td>0.087</td>
<td>0.042</td>
<td>2.051</td>
<td>0.021</td>
<td>0.158</td>
</tr>
<tr>
<td></td>
<td>User Cost of Capital</td>
<td>-0.071</td>
<td>0.037</td>
<td>-1.919</td>
<td>-0.131</td>
<td>-0.009</td>
</tr>
<tr>
<td>2011</td>
<td>Tax</td>
<td>-0.130</td>
<td>0.018</td>
<td>-7.345</td>
<td>-0.158</td>
<td>-0.101</td>
</tr>
<tr>
<td></td>
<td>TFP</td>
<td>0.012</td>
<td>0.006</td>
<td>1.930</td>
<td>0.002</td>
<td>0.022</td>
</tr>
</tbody>
</table>

### B. Estimates of User-Cost-of-Capital Elasticities

<table>
<thead>
<tr>
<th>Ratio</th>
<th>Estimate</th>
<th>Bootstrap</th>
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<tbody>
<tr>
<td></td>
<td>Estimate</td>
<td>5th Perc.</td>
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<tr>
<td>Reported R&amp;D to UCC (2009)</td>
<td>-1.914</td>
<td>-7.845</td>
</tr>
<tr>
<td>Real R&amp;D to UCC (2009)</td>
<td>-1.030</td>
<td>-4.823</td>
</tr>
<tr>
<td>Tax to Reported R&amp;D (2011)</td>
<td>-1.153</td>
<td>-2.751</td>
</tr>
</tbody>
</table>

NOTES: This table reports robustness of estimates of ITT effects of the notch on various outcomes. Relative to Table 3, this table uses an alternative, second-best estimate of the density of counterfactual R&D distribution. Panel B reports ratios of estimates in panel A. Standard errors computed via bootstrap. See Section 3.1 for details on data sources and Section 5 for details on the estimation. Source: Administrative Tax Return Database.

\[
ITT = \frac{1}{N_{Excluded}} \sum_{i \in (D^{--}, D^{++})} Y_i - \int_{D^{--}}^{D^{++}} \hat{h}_q(r) E[Y|rd, \text{No Notch}]dr
\]
### Table A.6: Structural Estimates with Heterogeneous $\varepsilon$

#### A. Point Estimates

<table>
<thead>
<tr>
<th></th>
<th>Model A ($\alpha_\varepsilon = \beta_\varepsilon$)</th>
<th>Model B ($\varepsilon = 1/(\theta - 1)$)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Distribution of TFP Elasticity of R&amp;D Cost</td>
<td>Relabeling Adjustment Cost</td>
</tr>
<tr>
<td>$\alpha_\varepsilon$</td>
<td>Estimate</td>
<td>1.287</td>
</tr>
<tr>
<td></td>
<td>SE</td>
<td>0.192</td>
</tr>
<tr>
<td>$\beta_\varepsilon$</td>
<td>Estimate</td>
<td>3.256</td>
</tr>
<tr>
<td></td>
<td>SE</td>
<td>0.091</td>
</tr>
</tbody>
</table>

**NOTES:** This table reports estimates of structural parameters of the model in Section J. Estimates based on calibrated values of $\theta = 5$, $\rho = 0.725$, and $\sigma = 0.385$.

#### B. Simulated vs. Data Moments

<table>
<thead>
<tr>
<th></th>
<th>Model A</th>
<th>Model B</th>
<th>Data</th>
</tr>
</thead>
<tbody>
<tr>
<td>Probability Mass for $d &lt; d^{-*}$</td>
<td>0.324</td>
<td>0.296</td>
<td>0.280</td>
</tr>
<tr>
<td>Fraction not Bunching</td>
<td>0.676</td>
<td>0.665</td>
<td>0.675</td>
</tr>
<tr>
<td>Probability Mass for $d &gt; d^{+*}$</td>
<td>0.259</td>
<td>0.217</td>
<td>0.189</td>
</tr>
<tr>
<td>Bunching Point $d^{-*}$</td>
<td>0.78%</td>
<td>0.90%</td>
<td>0.88%</td>
</tr>
<tr>
<td>Increase in Reported R&amp;D: $\Delta d$</td>
<td>0.145</td>
<td>0.141</td>
<td>0.146</td>
</tr>
<tr>
<td>ITT TFP</td>
<td>0.008</td>
<td>0.009</td>
<td>0.012</td>
</tr>
<tr>
<td>ITT administrative cost ratio</td>
<td>-0.25%</td>
<td>-0.24%</td>
<td>-0.33%</td>
</tr>
<tr>
<td>Average TFP for $d &lt; d^{-*}$</td>
<td>-0.029</td>
<td>-0.029</td>
<td>-0.032</td>
</tr>
<tr>
<td>Average TFP for $d$ between $d^{-<em>}$ and $d^{+</em>}$</td>
<td>-0.050</td>
<td>-0.039</td>
<td>0.000</td>
</tr>
<tr>
<td>Average TFP for $d &gt; d^{+*}$</td>
<td>0.075</td>
<td>0.135</td>
<td>0.056</td>
</tr>
</tbody>
</table>

**NOTES:** This table compares the moments generated by our simulations with those from the data. The simulation is based on 30,000 firms.