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Abstract

This paper investigates the relationship between environmental regulations and innovation by focusing on the automobile industry in a cross-country setting. We provide empirical evidence that the presence of agency problems mitigates the negative effects of environmental regulations on overall R&D activity, which leads to full compensation when the degree of agency problems is sufficiently high. Guiding our empirical analysis, we provide a general model consistent with the structure of existing ownership data. Specifically, we model ownership structure as a combination of two extreme corporate governance types. On the one extreme there are profit maximizers, and on the other extreme there are managers who are only concerned with their private benefits. The model leads to a simple country level ownership indicator and shows that if an economy is dominated by firms with higher agency problems, then pollution tax might even increase overall R&D, while reducing pollution. According to our estimations, such an outcome is possible only for out-of-sample values of the ownership indicator, where the degree of agency problems is extremely high.

Keywords: Environmental regulations, Technological change, Porter Hypothesis, Corporate governance.

JEL: O440, Q550, G380

1. Introduction

The conventional view is that enhancing environmental quality via regulations hampers productivity growth by imposing extra costs on firms, such as reducing incentives to innovate. Mitigating this concern, there is a growing literature providing empirical and theoretical evidence that more stringent environmental regulations direct R&D towards environment-friendly technologies (see surveys by Jaffe et al., 2003; Ricci, 2007; Vollebergh, 2007; Popp et al., 2010). While ameliorating the negative effect on productivity, in an economy with profit maximizing firms, induced innovation may not totally offset the productivity loss, since it may crowd out some of the existing R&D activity (Popp and Newell, 2012). Indeed, if a given regulation is able to enhance overall productivity, profit maximizing firms are expected to adopt it even in the absence

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