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[Working Paper No. 828](#)

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R&D intensity for small firms is high and persistent over time. At the same time, small firms are often financially constrained. This paper proposes a theoretical model that explains the coexistence of these two stylized facts. It is shown that self-financed R&D investment can distort the effort allocated to different projects in a firm. In a dynamic environment, it is optimal for the firm to invest in R&D projects despite the borrowing constraints. In addition, this paper shows that beyond a certain threshold, effort substitution between R&D and production appears. When transfers from investor to entrepreneur are large enough, R&D intensity decreases with respect to financial resources. Conditional on survival, the more innovative and financially constrained firms are, faster they grow and exhibit higher volatility.

I thank seminar participants at Macro Workshop at TSE, Central Bank of Colombia, the 2014 North American Winter meeting of the Econometric Society and the Spring 2014 Midwest Macro Meeting. The views expressed in the paper are those of the author and do not represent those of the Banco de la República or its Board of Directors.