

Intelligence MEMOS



From: John Lester
To: Canadians Concerned About Innovation
Date: July 9, 2024
Re: **RETHINKING HOW WE SUPPORT R&D**

After two rounds of consultations, Finance Canada is considering reforms to its scientific research and experimental development (SR&ED) program. The review takes place against the backdrop of distressingly poor productivity performance, worries about the amount and effectiveness of R&D performed in Canada, and the incentives for innovative startups to commercialize and scale-up their operations.

These concerns exist even though the federal government spent almost \$11 billion last year to support innovation. Innovative firms get support to hire skilled workers, perform R&D, commercialize inventions and scale-up their operations.

The program review should recognize where SR&ED fits into the government's innovation support system. Its purpose is to encourage R&D, which benefits society through knowledge spillovers. SR&ED reforms should therefore focus on maximizing the net benefit from these knowledge spillovers.

Re-balancing support in favour of larger firms would be a good first step. The subsidy rate for small firms is now 35 percent, compared with just 15 percent for larger firms. This large gap would be justified if knowledge spillovers per dollar of R&D performed were greater for smaller firms than larger firms, but the limited available evidence points in the opposite direction.

The higher rate for small firms is often justified as compensation for the trouble many have accessing risk capital. Addressing this market failure with a subsidy for *all* small firms performing R&D is clearly wasteful. Further, young firms that are often “pre-revenue” already receive support from the Business Development Bank. If the Bank's \$4-billion allotment for risk capital financing is too low after SR&ED re-balancing, it should be increased.

Even with rebalanced SR&ED subsidy rates, however, support for R&D performed by small firms would be excessive. Of the 17,000 such firms that benefit from federal and provincial tax incentives, about 3,000 also receive support from the Industrial Research Assistance Program (IRAP). The average subsidy rate on R&D projects undertaken by these firms is now a staggering 65 percent. If there were a single SR&ED rate of 21 percent, that subsidy rate would fall – but to a still-high 58 percent. A subsidy rate that high substantially reduces the “hurdle rate” for private investors, leading to too many lower-quality investments that don't get commercialized.

Instead of helping over-subsidize R&D performed by small firms, IRAP should support the commercialization of inventions and scale-up of operations. Since the spillover benefits from commercialization/scale-up are smaller than from R&D, successful firms should have to repay the support they receive. Support should also be repaid if the intellectual property (IP) is transferred out of Canada before being commercialized.

This new mandate for IRAP should be complemented by a preferential tax regime for IP income – an IP Box. Properly [designed](#), an IP Box would encourage commercialization both by small firms anticipating higher returns from scaling-up in Canada and by large firms likely to reap an immediate benefit. It would also encourage additional R&D by reducing its after-tax cost. The OECD's global minimum tax framework has been adopted by enough countries that Canada can count on substantial repatriation of IP income from other jurisdictions, which would make an IP Box a very cost-effective policy tool.

SR&ED would likely be much more effective if the regular credit were refundable and support delivered independently of the tax system. Refundability would make the value of the large-firm credit more predictable, thus encouraging a stronger response to the incentive. Predictability would improve primarily because the value of the subsidy would not be affected by the firm's tax status in Canada. In addition, US-controlled firms operating in Canada would not be subject to a clawback of the benefit under the US Global Intangible Low-taxed Income regime because refundable credits are considered grants rather than a credit against taxes payable.

Because firms do not always have enough tax payable to claim the credit as it is earned, refundability would increase the fiscal cost of the program. Large-firm refundability should therefore be phased in.

The SR&ED subsidy could be delivered independently of the tax system either as a multi-year grant, as with the Strategic Innovation Fund, or as a statutory program, similar to the Small Business Financing Program. This change would substantially reduce the time lag between performing R&D and receiving the subsidy, thus increasing the subsidy's value to firms and strengthening their response to it.

A key objective of SR&ED reform is to “enable the next generation of innovative small- and medium-sized Canadian businesses to scale-up, create jobs, and grow the economy.” That's too much to ask of a single program. SR&ED reform is a good first step towards a more innovative Canada, but it needs to be accompanied with a revamped IRAP and an IP Box.

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A version of this Memo first [appeared](#) in the Financial Post.