Intelligence MEMOS

From: John Lester

To: The Hon. Chrystia Freeland, Minister of Finance

Date: August 24, 2022

Re: **R&D Tax Credit Review Needs to Focus on The Right Issues**

Canada is not keeping up in the global competition for innovation-led growth and prosperity.

Our research and development intensity is low relative to other countries and not enough of our inventions are commercialized at home. Can Ottawa's current review of the Scientific Research and Experimental Development (SR&ED) tax credit announced in its last budget make a difference?

In principle, yes, but early indications are that the review will focus on issues of dubious merit or those that would best be handled with new measures rather than by modifying SR&ED.

The federal review has two objectives. The first is to assess whether the SR&ED program is effective in encouraging R&D that benefits Canada. The second objective is to explore opportunities to modernize and simplify the SR&ED program.

Assessing if the SR&ED investment tax credit encourages R&D that benefits Canada appears to be shorthand for suggesting that the program be structured to encourage more commercialization of R&D in Canada. One way to achieve this would be to make SR&ED benefits conditional on retaining and commercializing the resulting intellectual property (IP) in Canada, as recommended by the Council of Canadian Innovators.

However, imposing these performance requirements would create an unpalatable trade-off: Less R&D would be performed in Canada, but a larger share would be commercialized here, with no guarantee that Canadians would be better off as a result. The performance requirement "stick" would lower the return to R&D, and hence the amount performed, because some firms could no longer choose to sell their IP to foreigners or to commercialize it abroad even when those are the most profitable options. This trade-off could be avoided by offering the "carrot" of a lower tax rate on income from IP. As I have argued **elsewhere**, an IP Box would be a cost-effective way to promote more R&D and its commercialization in Canada.

The budget announcement of the SR&ED review makes it clear that modernization will include revisions to the definition of work eligible for the SR&ED credit. One high-profile proposal is to make IP management costs eligible expenses. This approach has the disadvantage of tying assistance levels to the SR&ED tax credit rate. If subsidizing IP management costs is thought to be good public policy, a better approach would be to implement a separate measure with a distinct subsidy rate, such as multiple income tax deductions for these expenses. More generally, expanding the definition of R&D is risky. The current eligibility criteria are consistent with the internationally agreed definition of R&D, which may be subsidized without attracting countervailing duties.

The review will also explore opportunities to simplify the SR&ED tax credit. This is a worthy goal, but the government lacks an evidence base to make sound decisions. The only information available on overall compliance costs was gathered in 2011. That survey data should be updated and expanded to include details on how firms spend their time when applying for a SR&ED tax credit. The resulting information would help guide simplification efforts, in part by providing a perspective on how costs have evolved over time.

Overall, the review is not focused on the right issues to have a substantial impact on SR&ED's effectiveness. To improve Canada's performance in the global competition for innovation-led growth, two changes should be made.

First, support for large firms should be increased and support for smaller firms should be reduced. Governments subsidize R&D because its benefits are not confined to the firm performing the R&D. Some of the knowledge created while performing R&D inevitably leaks out or spills over to other firms, allowing these firms to benefit without performing the R&D themselves. These knowledge spillovers are greater for larger firms than for smaller firms, but R&D performed by smaller firms is subsidized at a much higher rate.

Rebalancing the tax credit rates would therefore raise the net social benefit of the SR&ED subsidy. Rebalancing would also raise the commercialization rate. Subsidies lower the hurdle rate for private investment, which allows R&D projects with less commercial potential to go ahead. Lower R&D subsidies for smaller firms would mean fewer unsuccessful projects would be undertaken, with a lesser or nil impact on the number of successful projects.

Second, credit rates should vary by the type of R&D performed. The social benefits from basic and applied R&D are higher than the social benefits from experimental development. The credit rates should reflect this difference.

Combined with an IP Box, these two changes would result in more R&D being performed, a higher success rate for R&D that is performed, and more commercialization activity undertaken in Canada. The review of tax support for R&D can make a difference if it is focused on the right issues.

John Lester is a C.D. Howe Institute author and an Executive Fellow at the School of Public Policy, University of Calgary.

*To send a comment or leave feedback, email us at **blog@cdhowe.org**.*

*An earlier version of this Memo first **appeared** in the Financial Post.*