



November 5, 2025

From: John Lester
To: Canadians Concerned About Federal Spending
Re: CURING CANADA'S INNOVATION ILLS

Canada faces a persistent productivity challenge that directly affects our national prosperity. At its core lies weak investment in machinery and equipment, and lacklustre innovation.

I propose a set of targeted reforms aimed at fixing Canada's innovation ills. Strengthening intellectual property (IP) ownership and commercialization, refocusing public R&D support, and removing tax barriers to growth would help Canada capture more of the economic value created by its innovators.

Compared to other advanced economies, Canada's R&D investment is lagging. We rank sixth among G7 nations and fall below the median for all OECD countries in both overall and business R&D spending as a share of GDP. And the problem goes deeper: Patents generated from Canadian R&D are fewer than expected, and those that are filed have a lower-than-expected impact on domestic productivity.

A recent World Intellectual Property Organization study highlights this patenting gap. Canada produces just over half the patents predicted by the quality and quantity of its academic research. This shortfall stems from two main factors: Academic institutions often prioritize research over commercialization, and some research is conducted for foreign entities that own the resulting IP. To address this, the federal government should require academic institutions to retain ownership of IP generated from publicly funded research and to develop clear commercialization plans, or transfer the IP to the funding agency if commercialization is not pursued.

The weak connection between patents and productivity growth in Canada is not due to low patent quality, but rather to the fact that many inventions developed here are not brought to market domestically. More than 40 percent of Canadian inventions are owned by foreign firms, with little commercialization activity occurring within Canada. For instance, employees at Google in Kitchener or Ubisoft in Montreal conduct R&D that generates IP for their multinational employers, which is then used globally. While supporting these firms can create valuable knowledge spillovers, the benefits are far greater when R&D leads to commercialization within Canada.

Another challenge is that many small, innovative Canadian firms sell their IP to foreign companies instead of commercializing it themselves. This is often due to patent "thickets" that are particularly difficult for small firms to penetrate. Modern technologies are complex, with many patentable components that may overlap with related technologies, forcing startups to conduct costly patent reviews and negotiate multiple licences. And incumbent firms frequently use patents defensively to block new competitors. Faced with these barriers and the threat of legal disputes, many small firms opt to sell their IP rather than develop it further.

The federal government has taken sound steps, such as launching the Innovation Asset Collective, IP Clinics, and IP Elevate, to help small firms overcome patent thickets, but the financial commitment is small and should be increased.

The government should also reform its SR&ED incentive to offer a two-tier SR&ED subsidy based not on size but on ownership of the resulting IP. Small firms would receive the higher subsidy but would be required to repay the excess if they sell their IP to a foreign entity. This approach, which would likely require transforming SR&ED to a spending program, would limit the use of public money to support the development of patent thickets that hinder innovation.

Several other policy changes would encourage startups to commercialize their inventions in Canada. Enhanced government support for risk capital would reduce reliance on foreign investors, making sales to these suppliers less likely.

Shifting some R&D support to commercialization would also help. For example, the \$400-million Industrial Research Assistance Program (IRAP) should be given a new mandate to support commercialization instead of R&D. This would boost commercialization activity and improve the quality of R&D by reducing excessive subsidies. Federal and provincial tax credits lower the cost of R&D by nearly 40 percent, and about 3,000 of the 17,000 small firms claiming tax credits also receive IRAP support – raising their average subsidy rate to a staggering 65 percent. Such high subsidies make low-return projects viable, but these are less likely to be commercialized.

Finally, the government should eliminate capital gains taxes on qualifying SME shares sold to Canadian buyers to increase the incentive and capacity for firms to grow. This would match the US treatment of capital gains. It would be good public policy because taxing capital gains on share sales amounts to double taxation. Innovations increase expected profits and raise the market value of an enterprise, which gives rise to a capital gain on the sale of shares. But these profits are taxed again when distributed as dividends.

This change should be funded by reducing the preferential income tax rate for small firms, signaling a shift from supporting small-scale production to fostering innovation.

By implementing these targeted reforms, Canada will benefit more from its R&D investment, boosting productivity and prosperity.

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