

**Corporate Tax Cut as Incentive for Innovation: Evidence from Small and Large Businesses in  
Quebec**

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## 1. Introduction

This paper will look at the impact of a series of tax reforms from 2006-2008 leading to a four percent tax differential on large firms in the manufacturing and processing (M&P) sector in Quebec, relative to small M&P firms in Quebec. We then perform the same comparison with large and small M&P firms in both British Columbia and Ontario, who act as the control groups as they did not experience any relatively significant change during our sample period. We measure innovation through six dependent variables, using a triple difference in difference estimator: *i*) the number of patents filed by the firms, *ii*) the number of research and design (R&D) workers, *iii*) the firm's capital investment, *iv*) its total factor productivity, *v*) its EBITDA per worker, and *vi*) its return on machines.

In Canada, large firms were responsible for about 48 percent of the GDP in 2007 (Leung & Rispoli, 2012), showcasing their significant economic impact and hence importance of study.<sup>1</sup> Plus, understanding the effects of corporate tax changes on innovation is important to create precise policies, as the effects are conflicting in theory. While tax cuts may boost R&D investment by increasing after-tax profits (Akcigit et al., 2016), they can also lead to wealth redistribution through buybacks and dividends (Tørsløv and Wier, 2018). Hence, we believe to contribute by looking into long-term growth of a decade-old tax change targeted at Canadian-large businesses which have been pushed aside by researchers, who often favored small businesses.

Duan and Moon's paper titled "Corporate Tax Cuts and Worker Earnings: Evidence from Small Businesses" (2024) studies the effects of corporate tax reductions for small businesses on employee earnings due to a 2014 reform in Quebec, Canada. They then recreate this comparison with small firms in British Columbia and Ontario in a triple difference-in-difference. Their findings include that workers bear about 75 percent of the tax burden and are rewarded with higher earnings. Some limitations include that the reform impacts are greater for small M&P firms below 400,000 CAD in taxable income, so not applicable to all small firms in Quebec.

Crawford and Markarian's paper titled "The Effect of the Tax Cuts and Jobs Act of 2017 on Corporate Investment" (2020) analyzes the 2017 Tax Cuts and Jobs Act (TCJA) on U.S. corporate investment using a difference-in-difference model comparing U.S. and Canadian firms (2017–2019). Their findings include that U.S. companies experienced a greater increase in investment compared to their Canadian counterparts. Their limitations include the public debate of this law which could make firms, expecting a future tax reduction, withhold investments until then and lead to an overestimated coefficient on innovation in the future.

Atanassov and Liu's paper titled "Can Corporate Income Tax Cuts Stimulate Innovation?" (2020) analyzes the effect of all "large"<sup>2</sup> US corporate tax changes on innovation with a difference-in-difference research design. Their findings include that large tax cuts increase innovation, especially in firms with financial constraints. Some of their limitations include that the increase in innovation is partly due to firms acquiring other firms and patents through M&A,

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<sup>1</sup> In general, we contribute to the existing literature on the subject of how taxes affect firm investment and innovation (Cummins et al. (1996), Hassett and Hubbard (2002), Djankov et al. (2010), Heider and Ljungqvist (2015), and Giroud and Rauh (2019)).

<sup>2</sup> Greater or equal to one percent, enacted in one or two years, and not reverted for at least three years.

meaning that the general level of innovation is not truly increasing and the coefficient on innovation would be overestimated.

## **2. Institutional Background**

Firms in Canada are subject to two types of corporate income taxes: the first is federal, and the second is provincial. The general, M&P federal tax rate from 2004 to 2007 was 22 percent, decreasing to 19 percent in 2009 and 18 percent in 2010. This tax rate applies to large businesses, which are described as possessing a total taxable capital greater than 10 million CAD.<sup>3</sup> The small firm, M&P federal tax rate from 2004 to 2007 was 22 percent, decreasing to 19 percent in 2009 and 18 percent in 2010.

The M&P tax in Quebec, our treatment province and second largest in terms of number of firms, was 9.9 percent in 2007 (since 2006) and decreased to 11.9 percent from 2009 until 2016. By contrast, the M&P tax in Ontario, the largest by number of firms, was 12 percent in 2007 (since 2004) and remained as such until 2009. In British Columbia, the third largest, it was 12 percent in 2007 (since 2005), and decreased to 11 percent in 2008, then to 10 percent in 2011.

Small business tax was also reduced in Quebec in 2006 from 8.9 to 8 percent, as part of the province's plan to make Quebec more competitive and attract new investments. The province also implemented a capital tax reduction of over 50 percent by 2009, introduced a 5 percent capital tax credit for new investments in machinery and equipment, and lowered the taxation rate for SMEs. Additionally, to foster R&D, innovation, and exports, the Budget included various initiatives, such as raising the refundable tax credit for R&D salaries to 37.5 percent (Finances Québec, 2005). To our knowledge, there were no other policy changes in or around 2007 specific to small or large M&P firms in Quebec.

We choose to use Quebec, British Columbia, and Ontario as they contained about 73 percent of Canadian firms in 2007. Nunavut, Nova Scotia, Saskatchewan, and Newfoundland/Labrador's individual effects on innovation are quantitatively negligible since they only make up about eight percent of firms in 2007 (Government of Canada, 2010). All other provinces experience non-trivial tax changes either three years before or after 2007, which we consider to be the minimum number of years to eliminate risks of external policies affecting our estimate of changes in innovation – and they are hence dropped.

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<sup>3</sup> This definition of total taxable capital follows the Government of Canada's specifications as per the governmental website.

### 3. Data Sources and Variable Definitions

Two major datasets, all from the official websites of Canadian government departments, will be applied to this study. The first dataset is Trademarks researcher datasets: Applications and registrations, which can be accessed via the Canadian Intellectual Property Office. Within this dataset, we accessed the application histories of intellectual properties and the applicants' information. Therefore, using the table of TM\_Applicant\_Classifications, the specific industrial sector of the applicants (whether manufacturing or non-manufacturing), and the placements of applicants can be observed, which allows the researchers to calculate the overall number of patent applications in each group and draw the trend before and after the tax policy change.

Another dataset that will be used is the Canadian Employer-Employee Dynamics Database (CEEDD), which has 5228 records starting from 2001 until 2024. There are different sections in this dataset like the Financial Declaration File (T1FD, 2005 onward), Record of Employment (ROE), and National Accounts Longitudinal Microdata File (NALMF). From these sections, researchers can find data on the number of staff in the R&D department, capital investment, average profits of machines, total factor productivity, and EBITDA per worker. For instance, the data of the “Financial Declaration File” from 2005 and onward provides basic information about the firms like the location, size, and industries, which will help the researchers categorize the samples.

The dependent variable is the level of innovation as measured by i) the number of patents created, ii) the number of R&D employees, iii) the firm's capital investment, iv) the total factor productivity, v) the EBITDA per worker, and vi) the return on machines. The independent variable is the tax cut. The controls include industry via year-fixed effects.

#### 4. Empirical Design

To show the tax effect on firm outcomes, we estimate the following triple difference in difference model:

$$Y_{jt} = \sum_{\tau=2003}^{2011} \theta_{\tau} \cdot Small_j \cdot QC_j + \sum_{\tau=2003}^{2011} \beta_{\tau} \cdot Small_j + \sum_{\tau=2003}^{2011} \gamma_{\tau} \cdot QC_j + \alpha_j + \phi_t + u_{jt}$$

where  $Y_{jt}$  is the outcome variable for firm  $j$  in year  $t$ ,  $Small_j$  is an indicator for small firms in the M&P sector,  $QC_j$  is an indicator for firms located in Quebec,  $j$  are firm fixed effects, and  $t$  are year fixed effects. Each coefficient  $\theta_{\tau}$  measures the change in the outcome variable  $Y_{jt}$  for treated firms relative to control firms in the year  $\tau$ .  $\theta_{2006-2008}$  variable is normalized to zero, such that we have three years of pre-periods and four years of post-periods. The data is limited to M&P sectors, such that concerns regarding industry shocks are mitigated.  $\alpha_j$  are firm fixed effects,  $\phi_t$  are year fixed effects. We limit our data to Canadian-controlled private corporations (CCPCs).

The main average estimate would be:

$$Y_{jt} = \theta \cdot Post_t \cdot Small_j \cdot QC_j + \beta \cdot Post_t \cdot Small_j + \gamma \cdot Post_t \cdot QC_j + \alpha_j + \phi_t + u_{jt}$$

where  $Post_t$  is a dummy equal to one if year  $t$  is after the reform year 2006 – 2008.

We have multiple key identification assumptions for our research design.

i) We assume parallel trends for our control and treatment groups. This means that without the tax decrease, the innovation of small and large firms in the M&P sector in Quebec would have changed by the same amount (if at all) and the trend would have been parallel over time. We will check for parallel trends between the control and treatment groups pre-2006, and also conduct placebo tests in years without a tax change such as 2011 or 2019 and re-estimating the model, to check that there is indeed no effect.

ii) We assume that no exogenous shock occurred at the same time as our treatment (tax decrease) and that no exogenous shock affected our treatment and control groups differently, which could otherwise bias our treatment estimate. For example, a sudden increase in global demand for products mostly offered by large firms in Quebec could lead them to gain more profits and invest in innovation, hence underestimating our treatment effect.

## 5. Potential Issues or Limitations

Providing additional tax benefits to small firms could lead to bunching, as these could under-report their taxable capital and/or stay below the taxable capital threshold to keep such benefits. If it were true, our treatment estimate would be overestimated. To address this issue, we implement various different definitions of small manufacturing. The first definition will use the 2001 Quebec policy wherein SMEs were given a tax break if their taxable capital was below 20 million CAD (Gouvernement du Québec, 2007). The second definition is businesses with less than 500 employees and 50 million CAD in annual revenues (Government of Canada, 2012). Additionally, we expect no bunching behavior prior to the implementation of the 10 million CAD limit, so we limit our observations to these firms and drop those who were five percent above and below this threshold. Another channel of bunching could be through location and industry categorization, where firms change their location or industry to benefit from the tax cut. To address this issue, we drop firms that moved across provinces, are multi-provincial and/or switched industries.

We also consider the sample period's length of three years as a potential limitation. Indeed, the effect on our observations could be dampened due to tax-induced investment smoothing, and underestimate our coefficient. This is because over the three years, firms' increase in innovation investment will be slower rather than faster. On the other hand, tax-induced intertemporal substitution, where firms expect the tax benefit and limit their innovation investment until then, could overestimate or introduce noise to our results. To address this problem, we group the 2006-2008 period into one observation variable, rather than treat them as separate time variables.

Another limitation of the paper could be the controls. As seen in Table A, British Columbia had a two percent tax change that favored large M&P firms in 2005. This would potentially bias our results by overestimating the triple difference estimator. To address this, we will run two types of controls. One control would be Ontario only, as it only experiences changes of around one percent, which we consider insignificant compared to our four percent rate of interest. While this control also addresses the concern of British Columbia's two percent relative corporate tax change, the latter could potentially bias our result as it is sensitive to differential shocks related to Ontario's economy. To address these concerns, we implement the second control of British Columbia and Ontario together. A possible third control would be British Columbia, Ontario, and Alberta together.

A last limitation is that one of our key assumptions relies on Quebec sharing similar characteristics and economies with British Columbia and Ontario. This assumption is not fully true. For example, Quebec's 2007 SME manufacturing sector contained 55% and 40% of Canada's aerospace and pharmaceutical production, respectively (Riding & Orser, 2007b). This compares to Ontario's automotive manufacturing, reaching 60% of Canada's supply (Riding & Orser, 2007a). Aerospace and pharmaceutical being relatively more R&D intensive (Csversko, 2022), firms in Quebec might showcase a naturally stronger response to a tax cut designed to increase innovation, and overestimate our coefficient. To address this limitation, we assume that the provinces are similar enough to perform a valid comparison and implement various provincial controls as mentioned previously.

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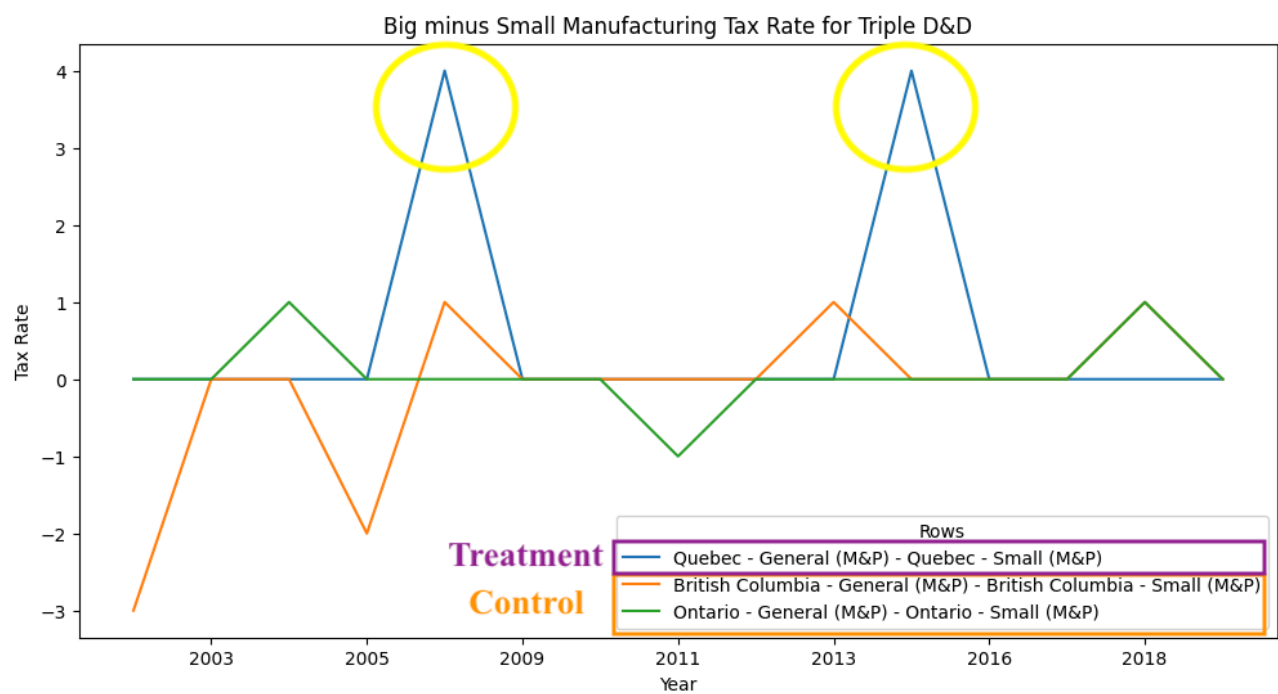
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Appendix



**Table A:** Graph demonstrating the treatment versus control groups' responses, large (M&P) firms - small (M&P) firms, 2001-2019.

Unnamed: 0		2001	2002	2003	2004	2005	2006_2008	2009	2010	2011	2012	2013	2014_2015	2016	2017	2018	2019
0	Quebec - General (M&P) - Quebec - Small (M&P)	NaN	0.0	0.0	-0.0	0.0	4.0	0.0	0.0	0.0	0.0	0.0	4.0	0.0	-0.0	-0.0	-0.0
2	British Columbia - General (M&P) - British Col...	NaN	-3.0	0.0	0.0	-2.0	1.0	0.0	-0.0	-0.0	0.0	1.0	0.0	0.0	0.0	1.0	0.0
4	Ontario - General (M&P) - Ontario - Small (M&P)	NaN	-0.0	0.0	1.0	0.0	0.0	0.0	0.0	-1.0	0.0	0.0	0.0	0.0	0.0	1.0	0.0
6	Alberta - General (M&P) - Alberta - Small (M&P)	NaN	-0.0	-0.0	-0.0	0.0	-2.0	0.0	0.0	0.0	0.0	0.0	1.0	1.0	1.0	0.0	-1.0

**Table B:** Table of Differences, Large (M&P) Firms - Small (M&P) Firms, Treatment and Control 2001-2019.

Province	Firm Type	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019
Federal	General (M&P)	22	21	21	21	21	21	21	18.5	19	18	16.5	15	15	15	15	15	15	15	15
	General (non-M&P)	28.12	25	23	21	21	21	21	16.5	19	18	16.5	15	15	15	15	15	15	15	15
	Small (M&P)	13.12	12	12	12	12	12	12	11	11	11	11	11	11	11	11	10.5	10.5	10	9
Federal	Small (non-M&P)	13.12	12	12	12	12	12	12	11	11	11	11	11	11	11	11	10.5	10.5	10	9
	General (M&P)	9.04	9	9	8.9	8.9	8.9	9.9	11.4	11.9	11.9	11.9	11.9	11.9	11.9	11.9	11.9	11.8	11.7	11.6
	General (non-M&P)	9.04	9	9	8.9	8.9	9.9	9.9	11.4	11.9	11.9	11.9	11.9	11.9	11.9	11.9	11.9	11.8	11.7	11.6
Quebec	Small (M&P)	9.04	9	9	8.9	8.9	8.9	8	8	8	8	8	8	8	6	4	4	4	4	4
	Small (non-M&P)	9.04	9	9	8.9	8.9	8.9	8	8	8	8	8	8	8	6	4	4	4	4	4
	General (M&P)	16.5	13.5	13.5	13.5	12	12	12	11	11	10.5	10	10	10.75	11	11	11	11	12	12
British Columbia	General (non-M&P)	16.5	13.5	13.5	13.5	12	12	12	11	11	10.5	10	10	11	11	11	11	11	12	12
	Small (M&P)	4.5	4.5	4.5	4.5	4.5	4.5	4.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2	2	2
	Small (non-M&P)	4.5	4.5	4.5	4.5	4.5	4.5	4.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2	2	2
British Columbia	General (M&P)	11.75	11	11	12	12	12	12	12	12	11	10	10	10	10	10	10	10	10	10
	General (non-M&P)	12.5	12.5	12.5	14	14	14	14	14	14	12	11.5	11.5	11.5	11.5	11.5	11.5	11.5	11.5	11.5
	Small (M&P)	6.5	6	5.5	5.5	5.5	5.5	5.5	5.5	5.5	4.5	4.5	4.5	4.5	4.5	4.5	4.5	4.5	3.5	3.5
Ontario	Small (non-M&P)	6.5	6	5.5	5.5	5.5	5.5	5.5	5.5	5.5	4.5	4.5	4.5	4.5	4.5	4.5	4.5	4.5	3.5	3.5
	General (M&P)	13.75	13	12.5	11.5	11.5	10	10	10	10	10	10	10	10	10	11	12	12	12	11
	General (non-M&P)	13.5	13	12.5	11.5	11.5	10	10	10	10	10	10	10	10	10	12	12	12	12	11
Alberta	Small (M&P)	5	4.5	4	3	3	3	3	3	3	3	3	3	3	3	3	3	3	2	2
	Small (non-M&P)	5	4.5	4	3	3	3	3	3	3	3	3	3	3	3	3	3	3	2	2
	General (M&P)	17	16.5	16	15.5	15	14.5	14	13	12.5	12	12	12	12	12	12	12	12	12	12
Manitoba	General (non-M&P)	17	16.5	16	15.5	15	14.5	14	13	12.5	12	12	12	12	12	12	12	12	12	12
	Small (M&P)	6	5	5	5	5	4.5	4	2	1	0	0	0	0	0	0	0	0	0	0
	Small (non-M&P)	6	5	5	5	5	4.5	3	2	1	0	0	0	0	0	0	0	0	0	0
Manitoba	General (M&P)	16	15.3	13	13	13	13	13	13	12.5	11.5	10.5	10	11.01	12	12	14	14	14	14
	General (non-M&P)	16	14.5	13	13	13	13	13	13	12	11	10	10	12	12	12	14	14	14	14
	Small (M&P)	4	3.5	3	2.5	2	1.5	5	5	5	5	5	4.5	4.5	4.5	4	4.5	3.5	2.5	2.5
New Brunswick	Small (non-M&P)	4	3.5	3	2.5	2	1.5	5	5	5	5	5	4.5	4.5	4.5	4	4.5	3.5	2.5	2.5
	General (M&P)	16	16	16	16	16	16	16	16	16	16	16	16	16	16	16	16	16	16	16
	General (non-M&P)	16	16	16	16	16	16	16	16	16	16	16	16	16	16	16	16	16	16	16
Nova Scotia	General (M&P)	5	5	5	5	5	5	5	5	5	5	4.5	4	3.5	3	3	3	3	3	3
	General (non-M&P)	5	5	5	5	5	5	5	5	5	5	4.5	4	3.5	3	3	3	3	3	3
	Small (M&P)	5	5	5	5	5	5	5	5	5	5	5	5	5	5	5	5	5	5	5
Nova Scotia	Small (non-M&P)	5	5	5	5	5	5	5	5	5	5	5	5	5	5	5	5	5	5	5
	General (M&P)	5	5	5	5	5	5	5	5	5	5	5	5	5	5	5	5	5	5	5
	General (non-M&P)	14	14	14	14	14	14	14	14	14	14	14	14	14	14	14	14	14	14	14
Newfoundland and Labrador	General (non-M&P)	14	14	14	14	14	14	14	14	14	14	14	14	14	14	14	14	14	14	14
	Small (M&P)	5	5	5	5	5	5	5	5	5	5	4	4	4	4	3	3	3	3	3
	Small (non-M&P)	5	5	5	5	5	5	5	5	5	4	4	4	4	4	3	3	3	3	3
Newfoundland and Labrador	General (M&P)	5	5	5	5	5	5	5	5	5	4	4	4	4	4	3	3	3	3	3
	General (non-M&P)	14	12	12	14	14	11.5	11.5	11.5	11.5	11.5	11.5	11.5	11.5	11.5	11.5	11.5	11.5	11.5	11.5
	Small (M&P)	14	12	12	14	14	11.5	11.5	11.5	11.5	11.5	11.5	11.5	11.5	11.5	11.5	11.5	11.5	11.5	11.5
Northwest Territories	General (non-M&P)	5	4	4	4	4	4	4	4	4	4	4	4	4	4	4	4	4	4	4
	Small (M&P)	5	4	4	4	4	4	4	4	4	4	4	4	4	4	4	4	4	4	4
	Small (non-M&P)	5	4	4	4	4	4	4	4	4	4	4	4	4	4	4	4	4	4	4
Northwest Territories	General (M&P)	5	4	4	4	4	4	4	4	4	4	4	4	4	4	4	4	4	4	4
	General (non-M&P)	14	12	12	12	12	12	12	12	12	12	12	12	12	12	12	12	12	12	12
	Small (M&P)	14	12	12	12	12	12	12	12	12	12	12	12	12	12	12	12	12	12	12
Nunavut	General (non-M&P)	5	4	4	4	4	4	4	4	4	4	4	4	4	4	4	4	4	4	4
	Small (M&P)	5	4	4	4	4	4	4	4	4	4	4	4	4	4	4	4	4	4	4
	Small (non-M&P)	5	4	4	4	4	4	4	4	4	4	4	4	4	4	4	4	4	4	4
Prince Edward Island	General (M&P)	7.5	7.5	7.5	7.5	16	16	16	16	16	16	16	16	16	16	16	16	16	16	16
	General (non-M&P)	16	16	16	16	16	16	16	16	16	16	16	16	16	16	16	16	16	16	16
	Small (M&P)	7.5	7.5	7.5	7.5	6.5	5.4	4.3	3.2	2.1	1	1	1	1	4.5	4.5	4.5	4.5	4	3.5
Prince Edward Island	Small (non-M&P)	7.5	7.5	7.5	7.5	6.5	5.4	4.3	3.2	2.1	1	1	1	1	4.5	4.5	4.5	4.5	4	3.5
	General (M&P)	10	10	10	10	10	10	10	10	10	10	10	10	10	10	10	10	10	10	10
	General (non-M&P)	17	17	17	17	17	14	13	12	12	12	12	12	12	12	12	12	12	12	12
Saskatchewan	Small (M&P)	6	6	6	5.5	5	5	4.5	4.5	4.5	4.5	2	2	2	2	2	2	2	2	2
	Small (non-M&P)	6	6	6	5.5	5	5	4.5	4.5	4.5	4.5	2	2	2	2	2	2	2	2	2
	General (M&P)	15	15	15	15	15	15	15	15	15	15	15	15	15	15	15	15	15	15	15
Yukon	General (non-M&P)	15	15	15	15	15	15	15	15	15	15	15	15	15	15	15	15	15	15	15
	Small (M&P)	6	6	6	6	4	4	4	2.5	4	4	4	4	4	3	3	3	3	2	2
	Small (non-M&P)	6	6	6	6	4	4	4	2.5	4	4	4	4	4	3	3	3	3	2	2

**Table C: Changes in corporate taxes, M&P and non-M&P, all Canadian provinces and territories, 2001-2019.**