

# 1 Introduction

*Creative destruction*, the process through which the invention of new products, methods or processes lead to the obsolescence of old ones, was seen by Joseph Schumpeter as the “essential fact of capitalism” (Caballero, 2010, p.24), and incorporated in economic theory as a determinant of long-run economic growth (Aghion & Howitt, 1992; Artz et al., 2010; Jones, 1995). For a society to engage in *creative destruction* it must invest in its innovative capacity, and researchers have recognized that investing in innovative ideas resembles a public good, which will result in free-riding and a suboptimal level of private innovation (Bloom et al., 2019). An extensive literature has emerged to study fiscal incentives for innovation, notably on research and expenditure (R&D) tax credits, yet alternative policies to promote innovation, and their effects on intellectual property, are understudied. In this paper, I investigate a fiscal policy aimed to increase investment in innovative firms in Canada, the Alberta Investment Tax Credit (AITC), and its effect on patent applications.

The extensive literature on the effects of R&D tax credits has mostly found that these programs positively impact R&D expenditure (see Becker (2015), Hall et al. (2010) and Hall and Van Reenen (2000) for a review), and it has been observed that countries with higher R&D to GDP ratios grow faster Jones (2016). R&D tax credits typically involve subsidizing R&D by lowering the firm’s tax bill, hence increasing incentives for such expenses. However, observed stagnation in productivity growth in developed economies despite the growth in R&D expenditure has questioned the validity of the R&D and innovation relationship. Notably, despite Canada being one of the most generous tax jurisdictions for R&D, the country has not seen a significant R&D intensity ratio (McKenzie, 2006). This apparent paradox underscores the importance of understanding how alternative fiscal incentives, such as tax credits to investments in inventive firms, can affect innovation outcomes.

In January 2017, the Government of Alberta passed the *Investing in a Diversified Alberta Economy Act*, which introduced the Alberta Investor Tax Credit (AITC), a tax credit for investors who financed Albertan firms undertaking research, development and commercialization activities. As an investment tax credit, the AITC is fundamentally different to the R&D tax credit in that it doesn’t aim to subsidize R&D expenditure, but rather to provide easier

access to financing for innovative firms. I estimate the impact of the AITC on patent applications using a two-way fixed effects difference-in-differences design, validating causal identification through event study specifications. I map patent applications to provinces using a novel administrative dataset from the Canadian Intellectual Property Office (CIPO), using the reported locations of parties from patent applications to assign them to provinces. My results show that the AITC had an overall null effect on patent applications from Alberta. Separating by International Patent Classification (IPC) sections, I find that the intervention increased human necessity and textile invention patents, yet the effect was offset by a decrease in fixed construction patents. These results are validated replicating the analyses using parties in applications as the innovation outcome and higher frequency data, ensuring that results are not driven by the mapping of applications to provinces or the aggregation of data to the quarterly frequency. The relatively small size of the standard errors in both DD and event study regressions also show that it is unlikely that the null effect is due to imprecision in the estimates.

Focusing on patent applications is a useful way to measure innovation when R&D is not observed by the researcher. Patent statistics have been extensively used to measure innovation, as they proxy the outputs of the inventive process (Artz et al., 2010; Nordhaus, 1969; Pavitt, 1985; Trajtenberg, 1990). Patents have been used to estimate the knowledge spillover generated by the innovation process, specifically using patent citations in patent applications (Jaffe et al., 1993; Trajtenberg, 1990). While using patent data has been shown to have limitations (Lanjouw et al., 1998), others have been shown that patents move together with other innovation products (Lanjouw & Schankerman, 2004).

My findings make three main contributions to the literature. First, I provide the first evidence on how investment tax credits affect innovation outcomes. The AITC is a unique policy in that it provides easier access to financing for innovative firms, rather than subsidizing R&D expenditure. The literature in investment taxes has typically focused on macroeconomic impacts and firm outcomes, mostly finding positive effects (Lyon, 1989; Pereira, 1994; Slattery & Zidar, 2020). This owes to the fact that invest tax credits are typically used to stimulate investment in capital goods, which has a fundamentally different purpose to the traditional R&D tax credits. However, modern programs such as the AITC have received significant attention

from the public (Alberta Chamber of Commerce, 2023; Zabjeck, 2016) and governments may increasingly use multipurpose tax credits to promote their goals. The literature should incorporate non-traditional fiscal incentives to understand how they affect innovation outcomes, given their importance for economic growth.

Second, to my knowledge, no work has been done in evaluating any type of fiscal incentive on intellectual property outcomes. The literature has mostly focused on how R&D tax credits affect R&D expenditure. Focusing on R&D expenditure as the main measure for innovation has been criticized for not capturing innovation outside the R&D process (Xie et al., 2019). Using patent applications as the innovation outcome allows me to capture innovation which is not necessarily produced through a research and development process. Further, recent evidence has shown that tax credits targeting innovation may induce the relabelling of non-innovative business expenditure as R&D by firms to leverage tax savings (Chen et al., 2021). The incompatibility between the slowdown in productivity growth and the positive effects of R&D tax credits on R&D expenditure may be explained by this phenomenon. Exploiting variation in patent applications allows me to avoid this issue altogether.

Third, I extend the literature on Canadian fiscal policy, which has mostly focused on the Scientific Research and Experimental Development (SR&ED) programs. The SR&ED programs have motivated a large literature (Agrawal et al., 2020; Bernstein, 1986; Bérubé & Mohnen, 2009; Czarnitzki et al., 2011; Mansfield & Switzer, 1985), most of which has found positive effects of the programs on R&D expenditure. This literature has relied on firm-level outcomes and quasi-experimental designs, exploiting changes in program eligibility or provincial policy changes to estimate average treatment effects. However, these findings are also unable to reconcile the stagnation in R&D intensity in Canada with the positive effects of the SR&ED programs. Providing new evidence on how fiscal incentives affect innovation outcomes in Canada is crucial to understanding the Canadian innovation landscape.

The rest of the paper proceeds as follows. Section ?? provides an overview of the AITC and the institutional context of the research design. Section ?? describes the empirical strategy. Section ?? presents the results of the analysis. Section ?? concludes.