

# INNOVATION, FIRM SIZE AND THE CANADA-US PRODUCTIVITY GAP

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## ABSTRACT

This paper evaluates the importance of innovation spending for understanding Canada-U.S. firm size and productivity differences. A standard model of heterogeneous producers, amended to include a channel for innovation, is calibrated to the U.S. to serve as a benchmark. Canadian specific features that affect innovation spending, namely tax/subsidy policy, regulatory burden and innovation costs are applied to this benchmark, together and in isolation, to quantify their importance. When applied together, the model replicates many aspects of the Canadian economy and predicts lower innovation spending, average firm size and productivity, closely in line with the evidence. Differences in innovation costs account for the majority of firm size and productivity differences, while fairly modest differences in regulatory burden translate to sizeable aggregate losses because they alter incentives to innovate. Subsidies to innovation have subdued effects due to higher innovation costs and regulatory burden, but imply larger productivity differences if absent. (C) 2017 Elsevier B.V. All rights reserved.

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