Tax Factors affecting International Competitiveness: Canada vs. United States Perspective

Odette M. Pinto, PhD., MBA, CPA-CGA
Department of Accounting and Finance
School of Business
MacEwan University
Edmonton, Alberta, Canada, T5J 4S2

Abstract

Globalization has created a competitive environment for corporations. In addition, trade agreements between countries emphasize the need for international competitiveness, as corporations can move business operations across borders, for example between Canada and the United States. Corporate income tax rates significantly impact international competitiveness. In addition, other taxes and fees increase the overall tax burden of a corporation. The tax and economic policy literatures have examined various factors affecting international competitiveness, including reference to some tax factors. This paper extends this literature by critically examining the key factors in Canada's tax system that affect its international competitiveness and analyzing these factors in assessing the international competitiveness of Canada and the United States. The paper focuses on an examination of five key tax factors, corporate income tax rates, other taxes and fees, capital allowances, complexity of the tax system and tax policy in foreign direct investment.

Keywords: globalization, international competitiveness, tax factors, corporate tax rates, tax burden.

1. Introduction

Globalization has created a competitive environment for corporations, including both large multinationals and small business corporations. In addition, trade agreements between countries emphasize competitiveness. Both globalization and trade agreements make it easier for corporations to move business operations across borders, for example, the location of production sites in Canada or in the United States. For such decisions, a comparison of corporate income tax rates in the two countries is an important factor, and a competitive tax rate is a major determinant of international competitiveness. However, is it solely corporate income tax rates or are there other elements in a country's tax system that affect international competitiveness? The tax policy literature has examined various factors affecting international competitiveness, with some reference to tax factors. This paper extends this literature with a critical examination of important factors in the Canadian and American tax systems that affect international competitiveness. In particular, this paper focuses on an examination of five important factors in a tax system, first corporate income tax rates, second, other corporate taxes and fees, third capital allowances for capital expenditures, fourth, the complexity of the tax system, and fifth, tax elements in a country's foreign direct investment policy.

Canada's general corporate income tax rate has been declining since 1987 and, particularly since 2001, the Federal government's overall plan has been to reduce corporate income tax rates and narrow the gap between the general corporate tax rate, applicable to large corporations, and the small business rate applicable to Canadian Controlled Private Corporations. This study will compare Canada's corporate tax rates to those in the United States, and assess the impact of tax rate differences on international competitiveness.

Although income tax is a major tax consideration, many corporations face a host of other taxes, for example business taxes, employment taxes and property taxes. In Canada and the United States, the types of other taxes vary across the provinces (states), with additional variability added because of municipal and school tax regimes. Price Waterhouse Coopers (PWC) has conducted extensive studies in several countries in the context of the "Total Tax Contribution" framework (Price Waterhouse Coopers, 2009; Price Waterhouse Coopers, 2012).

The PWC studies investigate the number of different taxes faced by corporations in a country, and emphasize how the number of "tax points" in a country can significantly affect the compliance obligations and administration costs for corporations. This study will assess the impact of other taxes and fees on the international competitiveness in Canada and the United States.

The Capital Cost Allowance (CCA) system in Canada outlines the rules applicable to the tax deduction for capital allowances i.e. the allocation (expensing) of capital expenditures (Pinto, 2010), while the MACRS system describes the rules applicable to the calculation of capital allowances in the United States. This study will focus on a comparison of the capital allowance systems in Canada and the United States, including an identification of differences in the classification of assets, as well as the capital allowance methods and rates in the two countries. As capital costs can be substantial, particularly in some industries, the differences in the capital allowance systems can affect international competitiveness; as such differences could affect corporate decisions in the selection of the location of production sites and corporate head offices, particularly for capital intensive industries.

The compliance and administration costs related to the payment of income taxes, as well as other taxes and fees, can be substantial. The complexity of a tax system and the general regulatory environment increases the compliance and administration burden faced by corporations. As both direct and indirect administration costs affect a corporation's cash flow, the impact of compliance costs on international competitiveness can be significant. PWC (2012) suggests that the number of tax categories in a country can significantly affect administration costs, which thus impacts international competitiveness.

A country's foreign direct investment policy covers many important issues, including the determination of a corporation's residence and liability for income taxes in a country. This study will provide an overview of tax factors in foreign direct investment policy that impact international competitiveness.

The organization of the paper is as follows. Section 2 of the paper will examine corporate income tax rates, Section 3 will examine other corporate taxes and fees, while Section 4 will investigate capital allowance systems, Section 5 the complexity of tax systems and compliance obligations, and Section 6 will examine tax factors that affect foreign direct investment. Section 7 will provide concluding remarks.

2. Corporate Income Tax Rates

Corporate income taxes can be a significant cost to businesses and can have a significant impact on a corporation's cash flow. Furthermore, tax planning by corporations, aimed to minimize income taxes, can result in additional accounting and legal costs. A country's corporate income taxes are a major factor in assessing its international competitiveness. Furthermore, as globalization and an increase in trade agreements between countries (e.g. the North American Free Trade Agreement (NAFTA)) makes it easier for corporations to shift business operations across borders differences in corporate income tax rates is increasingly important. Kemsley (1998) finds that a country's corporate income tax rates are a major factor in corporate decisions in regard to location, and can be a major incentive for corporations to move business operations across borders. The geographical proximity of Canada and the United States accentuates the ease and ability to shift business operations between the two countries.

Canada and the United States are neighboring countries with strong trade links. However, as Canada has a small, open economy compared to the much larger, open economy in the United States, it is especially important for Canada to ensure it maintains its international competitiveness with the United States. The corporate income tax rate is a key factor to consider in comparing the international competitiveness of corporations in the two countries. From Canada's perspective, the harmonization of corporate tax rates with the United States is of critical importance as Canada has a small open economy that is much smaller than the United States (Boidman and Glicklich, 2011).

The North American Free Trade Agreement (NAFTA) supports trade between Canada, the United States and Mexico, with a reduction in tariffs and, in general, allowing for more open trade borders between the three countries. NAFTA strengthens the ability of corporations to move business operations, including production, across the three countries. This emphasizes the importance of maintaining international competitiveness. For example, it is important that Canada's corporate income tax rates are comparable to those in the United States. Tanzi (1997) stresses the importance of corporate income tax rates in a country's overall international tax competitiveness.

In addition, it is important that there is no major disparity between corporate and individual tax rates as it is not overly difficult to shift income from the corporate to the non-corporate sector and vice versa (Shoven and Whalley, 1992).

The income tax system in the United States is a comprehensive tax system, therefore the general corporate tax rate applies to all sources of income, while the tax policy underling the income tax system in Canada's is based on the taxation of income that arises from ordinary business as opposed to the comprehensive taxation of all sources of income (Shoven and Whalley, 1992). This difference in policy results in important differences in the income tax system in the two countries, for example, Canada continues to give preferential tax treatment for capital gains while the United States does not. Another example is the concept of integration, which is a fundamental policy that underlies Canada's income tax system, with the overall intent being to avoid double taxation of income flowing between corporations and their shareholders. On the other hand, the United States does not incorporate integration in its tax system and the taxation of investment is similar to the taxation of business income, with no preferential treatment for investment income that is earned by a corporation but flows out to corporate shareholders when dividends are paid (Boidman, 2003).

Canada relies more on income tax as a source of government revenue. For example, in comparison to Canada, employment related taxes are a significant source of revenue in the United States (Shoven and Whalley, 1992). This has changed over time as Canada has moved to reduce corporate income tax rates and, instead, broaden the tax base, for example by increasing sales tax rates or the tax base subject to sales tax. Tanzi (1997) suggests that, since the tax reforms in the mid-1980s, many developed countries are moving toward decreasing corporate income tax rates and a broadening of a country's tax base through sales tax. Income taxes are a major source of revenue for the Canadian government while, in the United States, employment related taxes and business taxes are a substantial source of government revenue.

Prior to tax reform in the two countries, income tax rates in the United States were lower than Canada. In the 1980s, major tax reforms were introduced in both the United States (1986) and Canada (1987). The Tax Reform Act (TRA) (1986) in the United States examined the income tax system in a comprehensive way e.g. the taxation of business income and capital gains. The trend in the mid-1980s was toward a reduction in corporate tax rates (Tanzi, 1987). The TRA (1986) in the United States was similar to tax reform conducted in 14 other countries in the mid-1980s, and the underlying purpose of corporate tax rate reduction has been achieved (Tanzi, 1997). As Tanzi indicates, tax reform in the United States was aimed at a reduction in tax rates and a broadening of the tax base, primarily through value added sales tax. In Canada, the tax policy underlying tax reform was to reduce corporate income rates over a period of several years, continue to include only 50% of capital gains in the calculation of taxable income and generally to broaden the government's tax base by increasing other taxes, for example sales taxes. However, since the tax reform in the mid-1980s, the average corporate income tax rates in the United States (Federal and state level) have not decreased to the same extent at which corporate tax rates have decreased in Canada (Federal and provincial level) (Boidman and Guadiana, 2003). For example, in 1987, the corporate tax rate in the United States was 40% while it was 45% in Canada, in 1989, the corporate income tax rate in the United States was 34% compared to 43% in Canada, but currently, the average corporate income tax rate in the United States remains at 34% compared to 26.5% in Canada. This difference in corporate income tax rates has some policy makers questioning whether the tax system in the United States is progressive enough (Piketty and Saez, 2007).

In Canada, the reduction of the Federal corporate tax rates commenced earnestly in 2001, with significant rate reductions phased in between 2001 and 2004. This decrease in Canadian corporate income tax rates has resulted in a larger difference between the rates in the United States vs. the rates in Canada. Furthermore, Canada's overall tax policy is to lower corporate income tax rates and broaden the country's tax base through other taxes, for example to extend and/or increase sales tax. In addition, Canadian controlled private corporations continue to be eligible for the small business deduction that significantly reduces their overall corporate tax rates. However, it should be noted that Canada's long-term tax rate reduction plan is to reduce the tax rate differences between Canadian Controlled Private Corporations (CCPCs) and large corporations, to enhance the overall global competitiveness of all Canadian corporations. Canada's lower corporate income tax burden enhances its international competitiveness relative to the United States and should provide an incentive for corporations to locate their business operations in Canada, which should enhance inbound foreign direct investment.

However, as indicated in the following sections in this paper, other tax factors can affect this decision and, in addition, non-tax factors can also be a major factor in such decisions. A tax system can be used to penalize or incentivize taxpayers. For example, Canada's tax system continues to provide incentives for certain industries, for example the manufacturing industry, and small business. Historically, small business has been the backbone of the Canadian economy. The income tax system is also used during economic downturns, often through the use of temporary measures to stimulate certain industries or the economy in general. For example, after the 2007-2008 global financial crises, the Canadian government introduced accelerated capital cost allowance (ACCA) for manufacturing and processing equipment and an immediate write-off for computer equipment. Similarly, bonus depreciation was introduced in the United States in 2008. Thus, both countries use the income tax system for the purpose of economic incentives, primarily to stimulate the country's economy during recessions or to assist certain industries that are more severely affected during an economic recession.

Canada has succeeded in the reduction of corporate tax rates, with the country's Federal corporate income tax rate being the lowest among the G7 countries. The decrease in rates improves its international competitiveness. On the other hand, the corporate tax rate in the United States is one of the highest tax rates among developed countries. This difference in corporate tax rates is a concern for U.S. policy makers, as a continued, long-term spread in corporate tax rates could see a shift in corporate (capital) investment from the United States to Canada, especially because of the geographical proximity of the two countries. Generally, corporate income tax rates have decreased over the past decade in most developed countries, thus both Canada and the United States need to continue to monitor corporate income tax rates to maintain global international competitiveness. From a broader economic perspective, it should be mentioned that there are different schools of thought on the reduction of corporate tax rates, which is sometimes referred to as "trickle-down economics" i.e. does a reduction in corporate income tax rates, which lowers the corporate tax burden, result in an increase in a corporation's capital investment, higher wages to its employees and lower prices for consumers? Some policy researchers recommend a decrease in corporate income tax rates and a broadening of the tax base, for example through an increase in sales tax (Chen and Mintz, 2013) while other policy makers feel that corporations should pay their fair share of the tax burden as giving the corporate tax reductions does not necessarily "trickle-down" and translate into job creation, lower prices for consumers, etc., and thus the effects of the corporate tax reductions do not necessarily have positive effects for a country's overall economy.

There are also different schools of thought on the use of the tax system to incentivize or penalize, with some scholars suggesting that such incentives create distortions. Chen and Mintz (2014) suggest that tax incentives create distortions, for example, describing how the reduced tax rate for the manufacturing industry, creates a relative distortion for other Canadian industries. In addition, the Chen and Mintz suggest that the Small Business Deduction for CCPCs, which substantially reduces the corporate tax burden for qualifying corporations, creates a distortion between small and large corporations. It should be noted that Canada has phased in a general rate reduction, which applies to high-rate taxable income earned by large corporations that do not qualify for the small business deduction, and this has significantly reduced the difference in income tax rates between small and large corporations.

Overall, Canada continues to reduce corporate income tax rates. In addition, integration continues to be a cornerstone of the income tax system in Canada. On the other hand, there is a need for the United States to examine its corporate income tax rate and the full taxation of capital gains. In Canada, the income tax system continues to provide incentives for small business and certain industries, for example the manufacturing industry. On the other hand, although the United States uses incentives during economic downturns, for example recessions, the incentives are used primarily to stimulate the overall economy rather than targeting the incentives to specific industries.

3. Other Taxes and Fees

Although corporate income tax is perceived as a major tax cost that affects cash flow, other taxes and fees can result in substantial tax costs to corporations. Corporations face tax costs other than income tax, as well as various regulatory fees, at the school district, municipal, provincial (county or state), and federal levels of government. Thus, both corporate income taxes and other taxes/fees should be considered in assessing international competitiveness.

The issue of other taxes and fees has been raised in the tax policy literature as well as by accounting firms. For example, Price Waterhouse Coopers (PWC) (Price Waterhouse Coopers, Business Roundtable, 2014) has issued several policy statements and research papers related to a "total tax contribution", which suggests that the total tax burden faced by corporations goes beyond income taxes. The "total tax contribution" considers all taxes and fees at federal, state (province), municipal and school district levels, and research studies that examine a total tax contribution emphasize that income tax is a substantial tax cost but it is only one aspect of a corporation's tax burden. PWC has conducted studies related to total tax contribution in several countries, including Canada and the United States. The PWC studies (Price Waterhouse Coopers, 2009; Price Waterhouse Coopers, 2014) introduce the concept of "total tax contribution" that considers the total tax burden to a corporation, including taxes borne directly by a corporation and taxes collected by a corporation on behalf of the government and other parties. For example, taxes borne include income taxes, property taxes and business taxes, while taxes collected include employment taxes collected on behalf of the government and sales taxes imposed on a corporation's goods and services and then remitted to the government. Similarly, the KPMG (2016) report refers to the Total Tax Index (TTI) to measure the tax burden faced by corporations in different countries, including taxes and fees that extend beyond corporate income taxes.

Taxes borne are a direct tax cost paid by corporations that impact a corporation's cash flow. Income taxes are a direct tax cost paid by corporations, and similarly property taxes and business taxes are also a direct tax cost paid and incurred by corporations. On the other hand, taxes collected are not a direct tax cost to corporations, as this category of taxes reflects taxes collected by a corporation on behalf of the government, therefore the corporations receive and then subsequently remit these taxes to the government without bearing any actual tax cost. For example, employment taxes deducted from employees' salary or sales tax imposed on taxable supplies sold by corporations is subsequently submitted to the government. Taxes collected do not directly affect a corporation's cash flow. However, although corporations do not incur a direct tax cost with "taxes collected" they do incur substantial administration and compliance costs related to the collection of taxes on behalf of the government. For example, the collection of employment related taxes requires substantial administration, in Canada, in the determination of Canada Pension Plan (CPP), Employment Insurance (EI) and Income Tax (IT) to be withheld from employees' salaries. Furthermore, as the CPP, EI, and IT are indexed each year, there are administration costs related to the processing of these changes in the determination of the employment deductions. Similarly, the collection of sales tax requires substantial administration. These administration and compliance costs include labour (administrative staff) and other direct costs that do affect a corporation's cash flow. Both direct and indirect tax costs can affect a corporation's cash flow and thus are relevant factors to consider in assessing international competitiveness.

The PWC studies also refer to the "tax points" for a business, which indicate the number of taxes (categories of taxes) that a company faces. For example, Canada has been found a have a high number of taxes and taxing points (O'Brien and Wood, 2015). Canadian corporations can face up to 49 tax points, excluding municipal taxes, as compared to 56 in the United States and 22 in the United Kingdom. In the United States, it is estimated that, on average, corporations face 36 direct tax points and 20 indirect tax points, for a total of 56 tax points. Canada has a comparable number of tax points, with 49 direct and indirect tax points. On the other hand, in the United Kingdom there has been a concerted effort to reduce the number of tax points (to 22). The number of taxing points is also an important factor to consider in the assessment of international competitiveness, as the relative number of taxing points directly affects administration and compliance costs incurred by a corporation, with more taxing points resulting in higher administration and compliance costs.

Thus, the governments in both Canada and the United States need to streamline the administrative processes in tax compliance, as they have to strive toward being internationally competitive with other countries, for example the United Kingdom. The PWC study conducted in the United States also indicates that there are many categories of state and local taxes, which vary across the states, which further add to the complexity of the overall tax system and the related administration and compliance costs. Similarly, the KPMG (2016) report indicates that other corporate taxes vary widely between countries. In regard to compliance, the PWC studies compute the number of employees required to meet a corporation's overall tax compliance requirements in the United States and estimate that, on average, compliance costs results in 1.7% surtax over and above the actual tax burden faced by corporations in the United States.

Income tax is only one aspect of the tax burden faced by corporations. Canada has lowered corporate income tax rates but the government needs to examine the total tax burden, including other corporate taxes and fees, faced by Canadian corporations. In both Canada and the United States, the other corporate taxes and regulatory fees have grown, and continue to grow, particularly at the province (state) and municipal levels. In assessing international competitiveness, the total number and categories of taxes should be considered as an increase in the number of taxing points generally results in an increase in complexity, which translates into an increase in administration and compliance costs. Furthermore, complexity makes corporate decision making difficult, as corporations struggle to estimate the total tax burden, and undermines international competitiveness. For example, multinational corporations have to determine their Federal, state (province), municipal and, possibly, school district and other levels of taxation; this level of complexity is a deterrent to multinational corporations seeking to do business in Canada or the United States.

The total contribution tax can vary across states (provinces) but can also vary across industries. For example, in the United States, some states offer tax holidays or waive business taxes for the manufacturing industry. This can be a significant incentive to corporations seeking low-tax business production sites. Studies have shown that if a country or local authority (e.g. county, province, state, or municipality) gives corporations a tax holiday or waives taxes or fees this waiver can result in significant reductions in tax costs, which can be a major incentive for corporations. Furthermore, as corporations are able to move business operations more easily in a global environment, these incentives are important factors to consider in assessing international competitiveness.

4. Capital Allowances

In an income tax system, capital allowances are deductions pertaining to the tax write-off of capital asset expenditures, similar to the deduction for depreciation for accounting purposes. In Canada and the United States, as well as most other countries, capital allowances are computed based on specific rules. From a tax policy point of view, capital allowance systems should be based on the premise that capital allowances should reflect the economic depreciation of the underlying capital assets. In Canada, the Capital Cost Allowance (CCA) system outlines the methods, rates and other rules that apply to the computation of the CCA deduction, while in the United States the Modified Accrual Recovery System (MACRS) describes the rules that apply to the computation of the capital allowance deduction. In addition, it is important to note that current tax reform in the United States is looking to simplify the MACRS system.

In both countries, the current capital allowance rates do not generally reflect the economic depreciation of the underlying assets, with the tax write-offs, on average, being at a faster pace than economic depreciation. While the general concept in the CCA and MACRS systems are similar, there are also important differences. For example, the MACRS system in the United States allows the use of three acceptable methods, including the double declining method. On the other hand, in Canada, the CCA system primarily uses the declining balance method. Differences in the capital allowance method and rates generally allows for a faster write-off of capital expenditures in the early years in the United States, which provides for an incentive for capital intensive industries, for example the manufacturing industry. Another important difference is that assets are grouped together in CCA classes in Canada and the CCA deduction is computed on a class by class basis, while MACRS capital allowance is calculated for individual assets not for classes. In some industries, this difference provides a further advantage to the MACRS system in the United States.

Capital allowances are often a major expenditure for large corporations. As capital allowances can be substantial and can significantly reduce corporate income taxes, this can have a significant impact on cash flow and a corporation's cash flow decisions. Furthermore, capital expenditures require a long-term commitment by a corporation, and thus affect a corporation's long-term investment decisions (Pinto, 2014). Capital allowances are particularly high and a significant cost in some industries, for example the manufacturing industry, where investments in capital (fixed) assets are substantial (Pinto, 2014; Pinto, 2013). Differences in capital allowance systems and rates, in Canada and the United States, can thus be an important factor assessing international competitiveness. The disparity can be particularly important if countries are in close proximity, for example Canada and the United States, as corporations have the ability to move business operations to a neighboring country that has more favorable capital allowance deductions (Pinto, 2014). In addition, many countries often use the capital allowance system for economic policy purposes, for example to incentivize certain sectors of the economy during a recession.

For example, during the severe recession that followed the 2007-2008 global financial crisis, Canada introduced an accelerated CCA deduction (ACCA) that allowed for a much faster write-off of capital expenditures in manufacturing equipment and, in the United States, the economic stimulus package introduced bonus depreciation, which allowed for a faster write-off of most capital expenditures i.e. it was not limited to capital expenditures in manufacturing equipment (Pinto, 2014; Pinto, 2013). As previously indicated, such incentives can be very important in assessing international competitiveness, particularly if two countries are in close proximity, as Canada and the United States.

Capital allowances in some industries e.g. manufacturing corporations (Pinto, 2013; Pinto 2014) are substantial and are an important factor in assessing the international competitiveness of Canadian corporations and their counterparts in the United States, as capital allowances need to be comparable to ensure a level playing field. For example, after the 2008 financial crisis, the United States introduced an accelerated capital allowance for all assets, including manufacturing equipment. Canada had to introduce a comparable capital cost allowance (CCA) for manufacturing equipment, to ensure a level playing field was maintained for Canadian manufacturing corporations competing with U.S. manufacturing corporations. This is important, as there is a distinct competitive advantage to corporations in countries where capital expenditures can be written-off as expenses at a faster pace. Furthermore, this is not always a straight forward decision, as elements of capital allowance systems vary across countries. Examples of such differences are in the method of calculating capital allowances, for example the predominant use of the declining balance method in the Canadian CCA system as compared to the double-declining balance method or the straight-line method in the United States. Accelerated capital allowance rates and similar incentives can further exacerbate these differences. Thus, to maintain international competitiveness, countries should allow for some flexibility in a capital allowance system, for example, the flexibility to allow for expedient changes to the system in response to changes in economic conditions.

As capital expenditures are a major expenditure, require a long-term commitment and can significantly affect a corporation's cash flow, capital allowance systems can significantly affect international competitiveness. Furthermore, changes in the capital allowance systems for economic policy purposes, for example incentives during economic recessions, make the impact of capital allowance systems on international competitiveness even greater. Furthermore, the effects of capital allowance systems on long-term investment decisions emphasize its importance, as corporations seek long-term stability and capital expenditures represent long-term commitments by corporations. The proximity of Canada and the United States make capital allowance systems a major factor in assessing international competitiveness and ensuring that corporations are making good capital investment decisions.

5. Complexity of the Tax System

The tax policy literature has referred extensively to the complexity of the Canadian tax system (O'Brien and Wood, 2015; Pinto, 2013). For example, Pinto (2013) describes the unnecessary complexity of Canada's income tax system and the burden it creates for taxpayers. The income tax system has become increasingly complex and this complexity results in a significant increase in administration and compliance costs. Furthermore, Canadian corporations are faced with other taxes and fees that further increase administration and compliance costs. Overall, the regulatory environment for corporations can add substantial compliance costs. This increase in administrative and compliance costs increases the "total contribution tax" paid by Canadian corporations (Price Waterhouse Coopers, 2014). In the United States, it is estimated that "for an average corporation in the United States the cost of complying with tax payment obligations is equivalent to a 1.7% surtax on the taxes the companies bear" (Price Waterhouse Coopers, 2009). The call for simplification of the tax system has led to the creation of an Office for Tax Simplification in the United States.

In addition, the coordination of the administrative processes required for compliance for various taxes collected would reduce complexity and the administrative burden faced by corporations. Policy makers also call for a harmonization of some taxes, for example, the harmonization of federal and provincial sales taxes in Canada, which would not only reduce the tax burden but also reduce the related compliance and administration costs (Chen and Mintz, 2012).

The tax systems continue to increase in complexity in Canada and the United States, with changes introduced in annual budgets and the tinkering of legislation for tax incentives. Governments in both countries need to realize the administration and tax burden that complexity creates for all taxpayers, including corporations.

A simplification of the tax system would decrease costs significantly and thus enhance international competitiveness.

6. Foreign Direct Investment

A government's foreign direct investment (FDI) policies, both for inbound and outbound FDI, can affect international competitiveness; as such policies can have a significant effect on the environment in which corporations operate. Reports that have reviewed the history of foreign direct investment in Canada (Letiao, 2010) have examined the key factors that affect Canadian foreign direct investment, for example the impact of market size, trade policies in terms of trade openness, labour costs and economic stability. Foreign direct investment policies affect corporate decision making, for example access to global locations can allow corporations to take advantage of location advantages to reduce costs e.g. access to cheap labour reduces a corporation's labour costs (Nourbakhshian et al., 2012). In addition, the tax policies of a country can encourage or discourage foreign direct investment. For example, the corporate income tax rates of a country have been found to be an important factor in attracting inbound foreign direct investment.

There are different paradigms related to foreign direct investment, for example the NDP paradigm (Dunning and Fortanier, 2007) and the OLI paradigm (Kemsley, 1998), which suggest that a country's tax rates affect multinational enterprise decisions in the choice of production locations, for example, the attraction of low tax environments. Tax policies related to foreign direct investment can thus affect direct and indirect costs, which affect international competitiveness. Corporations with access to low labour costs or low cost production sites have a competitive advantage over corporations that don't have such access.

This paper has addressed how governments, at the Federal, state (province) or municipal level, can provide incentives to business, with the intent being to encourage corporations to commence or move business operations to their location. Incentives, including tax incentives, in foreign direct investment (FDI) policy can be important in international competitiveness as it affects corporate decision making in regard to the location of business operations and other capital investment decisions. Some tax policy researchers (Chen and Mintz, 2014) shy away from the use of tax incentives as it can distort the overall economic system. However, other studies indicate that a waiver of income taxes for an extended period of time, or other such tax incentives, can be an important factor in the selection of location sites for business operations and/or production sites (Pinto, 2013).

7. Conclusion

Tax factors are an important consideration in assessing international competitiveness, and a country's tax system is a major determinant of its international competitiveness. Tax reform, introduced in the mid-1980s in both the United States and Canada, resulted in lower corporate income tax rates and a broadening of the tax base for most taxpayers, including corporations. Corporate income tax rates have continued to decline around the world. Canada has actively pursued a reduction in corporate income tax rates, particularly since 2001, and has one of the lowest corporate income tax rates among the G7 countries. On the other hand, while the United States reduced corporate income tax rates in 1986, the tax rate has not decreased substantially since then, and the United States currently has one of the highest income tax rates among the G7 countries.

In addition, recent tax studies (KPMG, 2016: Price Waterhouse Coopers, 2014 and 2009) emphasize a need to consider the total tax burden faced by corporations rather than focusing solely on corporate income taxes. In assessing international competitiveness, other taxes and fees continue to be a major concern in Canada and the United States, especially as there are different levels of taxation beyond the Federal level, extending to the province (state), municipal, and school district levels of taxation. The levels and number of taxes increases the overall tax burden for corporations while also increasing the complexity and difficulties encountered by corporations in making capital investment decisions. In addition, corporations are held responsible for the collection of various other taxes, for example employment withholding taxes and sales taxes. The administration and compliance costs related to taxes collected (on behalf of the government) can be significant, particularly if there are annual updates, for example employment withholding taxes. The total tax burden for corporations, in both Canada and the United States, can be significantly higher when other taxes and fees are considered.

Capital allowances are another component of a country's tax system that affects international competitiveness, as capital expenditures are substantial, particularly in some industries. Capital allowances can significantly reduce corporate income taxes paid and thus affect a corporation's cash flow.

Furthermore, in Canada and the United States, the capital allowance system is used for tax policy incentives, for example, during economic recessions or to stimulate certain industries or business sectors. A prime example is the significant corporate rate reductions for the manufacturing industry and small business corporations in Canada. The underlying reasons for such incentives should be reexamined.

The tax systems in both Canada and the United States continue to be unnecessarily complex. Complexity is a major deterrent to international competitiveness, as complexity results in higher in compliance and administration costs, and creates roadblocks for corporate investment decisions e.g. in the selection of allocation for business operations or production sites. The tax policy literature continues to call for simplification of tax systems. In Canada and the United States, the simplification of the tax system will require coordination between the Federal, provincial (state) and municipal levels of government, to streamline the administrative processes underlying tax compliance across all levels of government.

This paper extends the literature on international competitiveness, while also providing useful information to tax policy makers in Canada and the United States. The paper has focused on an examination of tax factors affecting international competitiveness from the perspective of Canada and the United States. Future research could extend this line of research with an examination and comparison of tax factors that affect the international competitiveness of other countries. This paper has focused on five important tax factors that affect international competitiveness, including other corporate taxes and fees that extend beyond corporate income tax. Readers are cautioned that it is difficult to assess all corporate taxes and fees as this varies across countries and across different levels of government, for example, federal, state (province) and municipal levels of government in Canada and the United States.

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