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Evidence of the effect of domicile on corporate average effective tax rates in the European Union

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Abstract

We estimate (worldwide) corporate average effective tax rates (ETRs) from financial statements for companies domiciled in European Union (EU) member states during 7 years from 1990 to 1996. Our objective is to compare the tax rate effectively experienced by each company with the corporate statutory tax rate (STR) in the EU country in which each company is domiciled. The difference between the corporate statutory tax rate and the financial statement-based corporate average effective tax rate provides information on the magnitude of tax incentives provided by governments within the EU. These tax incentives come on top of the directly observable differences in statutory tax rates between EU member states. We find (1) that the use of tax incentives, over and above differences in STRs, differs substantially between EU member states (corporate domiciles) and (2) that the provision of tax incentives does *not* have the effect of equalizing corporate ETRs between EU member states (corporate domiciles).

Keywords: Domicile; Effective tax rates; Financial statements; Tax incentives

1. Introduction

We use consolidated financial statements to determine actual or effective tax rates (ETRs) for companies domiciled in European Union (EU) member states. There already exist differences in statutory corporate tax rates (STRs) between EU countries. These differences are relatively

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easy to observe (see below). But EU countries also provide tax incentives[1] to companies. To the extent that this happens, STRs do not provide a complete picture of (1) actual corporate tax burdens in EU countries and (2) of differences in actual corporate tax burdens between companies domiciled in different EU countries. In this paper we attempt to determine ETRs experienced by companies in EU countries using consolidated financial statement data for the recent 1990–1996 period. These ETRs provide a picture of both differences in STR *and* the provision of tax incentives between EU member states, i.e., of actual corporate tax burdens.

Such a picture is important because actual corporate tax burdens, which ETRs attempt to measure, are generally thought to be an important element in the "competitive" position of a country, e.g., in terms of location decisions of companies[2] or of founding rates of new companies. Also, actual corporate tax burdens are a constant item in discussions about tax competition between countries in general and between EU countries in particular. Knowledge about actual tax burdens is important for these discussions.

This paper is the first to measure ETRs using financial statement information for (listed) companies in all 15 current EU member states. There are alternative approaches to measuring ETRs. We use financial statement-based ETRs to measure firm-level worldwide corporate tax burdens. Another approach is to measure assumption-based ETRs.

ETRs determined using financial statements are firm-specific and require no simulation and underlying assumptions. They also can be used conveniently to make a distinction between permanent tax incentives and timing tax incentives provided by the EU member state governments to companies domiciled in their jurisdiction.

Our findings are as follows. First, comparing EU member states on the basis of the difference between the STR and the ETR that takes into account permanent tax incentives, reveals considerable variation. That is, the use of (permanent) tax incentives differed quite substantially between EU member states (corporate domiciles) in the recent 1990–1996 period. Second, we also find that the range of the ETR across EU member states is *less* centered than the statutory tax rate range. This means that the provision of permanent tax incentives does *not* have the effect of "equalizing" the existing differences in STRs between EU member states (corporate domiciles).

Additional analyses based on (1) using two alternative ETR measures (one less sensitive to financial accounting differences between EU member states and one taking into account timing tax incentives as well), (2) restricting our attention to those countries that already were a EU member state in 1990, and (3) restricting our attention to those EU member states that had already adapted national law to the seventh EU company law Directive, requiring consolidated financial statements from EU companies, by 1990, do not change these findings.

2. Motivation, ETR measurement, financial accounting issues and previous research

2.1. Motivation and ETR measurement

STRs and tax bases differ between EU member states. The last few years these intra-EU differences have given rise to an increasingly active political discussion. The discussion is