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COMPARISON OF THE METHODOLOGIES FOR ASSESSING EFFECTIVE TAX BURDEN OF CORPORATE INCOME USED IN EUROPEAN UNION

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ABSTRACT

In relationship with the changes of tax regulations in surrounding countries and last but not least in connection with the reform of public finances again the question of the further development of the Czech tax system is getting forward. The primary reason for the existence of taxes is fiscal, i.e. to ensure sufficient sources of public budgets for financing public property, however the tax policy must be provided in parallel with measures on the expenditure side of public budgets, that means it is necessary to perceive the tax policy in the context of the whole financial and economic policy of the state.

In the sphere of direct taxes the most important external factor is the tax competition between single countries and that is also in the frame of the expanded European Union. The comparison of the income tax of legal entities shows in the last three years unambiguously the decreasing tax burden of firms. However, beside that economic behaviour of companies in connection with positioning their capital abroad reacts on comparability of tax conditions in single countries.

Statutory corporate income tax rates are not the right indicator for the comparison of the real economic tax burden of various companies both in the frame of the one state and between the states. That is why for these purposes are used so-called effective corporate income tax rates discussed in this paper, which describes three methodologies for assessing these rates used in the European Union. These methodologies are using either real data from accounting on the national macro level or on the individual company micro level concerning realized entrepreneurial intentions by now or the hypothetical data concerning investments of these companies planed in the future. In conclusion of this paper are presented main differences between these three approaches.

KEYWORDS

Statutory corporate tax rate, effective corporate tax rate, implicit tax rate, macro and micro backward-looking methods, micro forward-looking methods, tax wedge, cost of capital, effective marginal tax rate, effective average tax rate.

INTRODUCTION

Comparing tax systems is important for economics agents since taxes affect their decisions. When locating or doing business, companies assess tax consequences of their actions. Most surveys approach the question by comparing statutory income corporate tax rates. Nevertheless, given the complexity and diversity of elements composing the tax base, this approach has been deemed to be unsatisfactory. Statutory tax rates do not perfectly reflect the tax burden of companies and economists had to come up with measures of *effective corporate taxation*.

Effective corporate tax rates (ECTR) are tax rates which take into account not only the statutory corporate income tax rates but also other aspects of the tax systems which determine the amount of tax effective paid. In other words, they take into account the tax base and the manner (if any) in which corporate and personal tax systems are integrated.

ECTR are important for different reasons. First, comparing statutory and effective tax rates gives an idea of tax incentives given by authorities. Second, the comparison of effective tax rates across countries gives indications whether there are substantially different tax treatments of companies with the same characteristics but located in different countries. These figures can indicate whether or not a large dispersion in statutory tax rates may hide little differences in effective taxation. Indeed, countries with high statutory tax rates can lower the base and/or decrease tax enforcement. The analysis of effective corporate taxation should shed light on how corporate tax competition functions.

This paper describes and compares three different methodologies for determining these effective tax rates and present arguments for or against their use. These methodologies are named: *the macro backward-looking methods, the micro backward-looking methods and the micro forward-looking methods*. The distinction between macro and micro approaches depends on the data used. Macro approaches compute effective tax rates from aggregated macroeconomic data such as national accounts. Micro approaches compute these rates using elements of financial statements of individual companies, either with a theoretical perspective or with empirical data. The distinction between backward-looking and forward-looking approaches is based on the type of information used. Backward-looking approaches use ex-post real-life data to estimate the tax burden that companies bear. Forward-looking approaches use statutory features of the tax system to assess the tax aspects of specific future decisions.

MACRO BACKWARD-LOOKING METHODOLOGY

Macro approach derives effective corporate tax rate from aggregate data contained in national accounts, published by national or international organizations such as the European Commission, the OECD, or national statistic institutes. National accounts, which satisfy the criteria of reliability, coherence and up-to-date information are increasingly used in European Union (EU) policy making (own resources for the EU budget, allocation of Cohesion and Structural Funds, Stability and Growth Pact). They provide the time series for observing changes in the overall effective tax burden and a coherent framework for matching tax revenues with income flow data and economic aggregates.

The effective tax rates are measured as ratios of aggregated taxes on the income or profits including holding gains paid by corporations on a measure of the tax base which can be:

- a) *the aggregate corporate gross operating profit, or the aggregate corporate profit,*
- b) *the GDP, or the Total Tax revenue,*
- c) *the corresponding potentially taxable base including: net operating profit of non-financial and financial corporations, difference of received and paid interest, rents on land, dividends and insurance property income attributed to policy holders by non-financial and financial corporations and dividends received by households, self-employed and non-profit institutions, by general government and by rest of the world.*

The effective corporate tax rates calculated according to option c) are termed as *implicit tax rates on corporate income (ICTR)*. The potentially taxable bases used by computing ICTR do not measure the actual tax bases as defined in the national tax legislatures. ICTR represents party look on the effective tax burden of the capital as one of the three basic economic functions (the other two are consumption and labour).

The introduction of implicit tax rates on three basic economical functions was influenced by fact, that the level of GDP as the denominator of the effective tax rate computed according to method b) does not specifically relate to these economic functions, and considering only taxes in % of GDP is limited since it does not give any information on whether for instance, a high share of capital taxes comes from high tax rates or a large tax base in economy.

The implicit tax rates measure the actual or effective average tax burden directly or indirectly levied on different types of economic income or activities that could potentially be taxed by EU member states. *The implicit tax rate on consumption* is defined as all consumption taxes divided by the final consumption expenditure of private households on the economic territory. *The implicit tax rate on employed labour* is defined as all direct and indirect taxes and employees and employers social contributions levied on employed labour income divided by the total compensation of employees working in the economic territory. *The narrower implicit tax rate on capital and business income* is defined as all taxes levied on income earned from the economic activities of private sector investment and saving divided by a measure of potentially taxable capital income in the economy within national accounts. *The broader implicit tax rate on capital* includes also taxes that are related to stocks of wealth streaming from investments and savings in previous periods as well as taxes on transactions of these stocks. For the whole private sector are also computed *two implicit tax rates on capital and business income, i.e. for corporations and households*.

The narrower overall ITR on capital and business income for corporations and households is influenced through various channels. Therefore, developments of this indicator are sometimes difficult to explain. The reading of separate ITRs for the corporations sector and household sector is easier. The numerator of the overall ITR can be split using the allocation of taxes to the category “income corporations”, “(capital) income households” and “income self-employed”. *In most countries, tax revenues raised on corporate income equal the aggregate “taxes on the income or profits of corporations including holding gains”, which is*

possible to determine from the tax classification in national accounts according to ESA 95. The others tax categories of the overall ITR numerator are allocated to the household sector.

In order to split recorded tax revenues into more detailed categories, additional data made available by EU member states have to be used, apart from the aggregate data in national accounts. This holds most notably for the recorded personal income tax, which is typically broad-based, and relates to multiple sources of income. In practice, EU member states are using a variety of methods to split the personal income tax revenues according to economic functions. The methods attribute personal income tax to four main taxable income sources: income from employed labour, from self-employed labour, from capital and income in the form of social transfers and pensions benefits received. The resulting estimates of the personal income tax revenue that could be attributed to these taxable income sources are used in the numerators for the implicit tax rate on labour and capital (using relevant aggregate economic incomes as denominators) and in the breakdown of taxes (as a percentage of GDP) across the economic functions.

National accounts provide a consistent framework to match income and tax revenue data and to compare the tax burden of the economic functions. This is in fact the only framework, which enables to assess the relative tax burden generated by various taxes in a country. Most of the other calculations on effective tax rates only provide information on a given tax but do not allow comparisons of the tax burden implied by different taxes. Developments of these data over time enable to identify shifts between the taxation of different economic functions *e.g.* from capital to labour.

One of the advantages of these indicators is the comparability due to the improved consistency and harmonized computation of national accounts data in accordance with European System of Accounts (ESA 95) which was introduced in 1995. This system is an important step forward in getting harmonised definitions and registration rules and more detailed national accounts for the EU and its member states.

The attractiveness of the macro backward-looking methodology lies in its facility. Aggregate data are easily available from most statistical institutes, and ratios can be computed in a convenient and quick way. Furthermore, it is easy to compute time series to track the evolution of this ratio. Finally, predictions based on forecasts of aggregate data can also be computed without too much difficulty. These elements explain why this approach is commonly used by Eurostat to work out the annual analysis of the tax systems structures and the tax burden in member states of European union.

Nevertheless, these rates suffer from shortcomings due to the aggregate items they use. Aggregate data do not generally offer separated entries for different taxpayers or different recipients. This leads to different mismatching problems regarding numerator and denominator of the ratio. For example, the corporation sector in national accounts also comprises partly unincorporated enterprises, the so-called quasi-corporations. In many countries, these quasi-corporations also have to pay corporate income tax. However, there are some important exceptions. In Germany, a big part (cca 85 %) of all companies consists of partnerships (mainly "Personengesellschaften") that are treated as quasi-corporations. Their profits are recorded in the corporations sector in national accounts. Because they do not have an independent legal status, their owners are taxed under the personal income tax scheme and the related tax payments are recorded within the household sector in national accounts. In the "structures classification", they are reported within "taxes on self-employed". Actually this means that tax revenues are booked in a different sector than the underlying business income. Ignoring this booking principle by calculating ITRs on capital income for corporations or households (including self-employed), using the sector information of national accounts without corrections would lead to biased ITRs. Similar problem like in Germany exist in Luxembourg, Austria, Finland and Portugal.

Another issue is that aggregate gross operating profit usually also includes revenues from agriculture and forestry, revenues from royalties or rentals, revenues from capital assets, and revenues from tax-exempt institutions, which blurs the results. Finally, another shortcoming of the methodology lies in the timing of tax collection. Since taxes levied in year t are based on revenues from year $t-1$, computing ratios for the same year can lead to mismatching between numerator and denominator.

Although formulas for computing effective corporate tax rates described above are mathematically correct, it is hazardous to make an international comparison of corporate tax rates on the basis of aggregated economic data. On the one hand, the methods and definition of the national accounting systems differ between countries and, on the other these data are not sufficiently developed to distinguish different sources of

taxation. Moreover, tax rates based on macroeconomic data sometimes tend to show significant fluctuations from one year to another due to business cycle effects.

MICRO BACKWARD-LOOKING METHODOLOGY

This methodology uses financial statements to derive effective corporate taxation, and there are three different possibilities to compute effective tax rate. *These rates are measured as ratios of taxes on the corporation incomes or profits on a measure of the tax base which can be:*

- a) *gross total profit (GTP) = profit on ordinary activities before taxes (EBT) + extraordinary income (EXINC) – extraordinary charges (EXCH)*
- b) *net operating income (NOI) = net turnover,*
- c) *gross operating profit (GOP) = total operating income (TOI) – operating costs (OC) - other operating charges and taxes – employment costs (EMPL)*

The meaning of these terms used above is explained in the supplement.

The option a) would have been the best option to compare effective tax rates with statutory rates. Unfortunately, because this item is the result of numerous additions and subtractions (from turnover to tax), and because of possible differences in accounting rules, the use of this ratio may be problematic for comparisons between countries because the determination of profit differs from country to country and we therefore lack a common denominator.

Ratio computed according to option b) lead to very small figures which makes it difficult to adequately compare countries. Furthermore, the use of the turnover in the denominator of this ratio can lead to misinterpretations because information on costs is lost. So a small ratio does not necessarily mean that the company's profits face low taxation because a large turnover might be necessary to cover large costs.

The use of gross operating surplus for computing the ratio according to option c) is interesting because it gives profit before depreciation. This is important to obtain a denominator whose definition does not differ too much from country to country. Indeed, depreciation rules differ not only on the linearity versus accelerated dimension but also on whether the historical value or the market value of the assets is taken into account. Therefore, taking gross operating profit allows us to reduce some of the problems due to differences in accounting methods. Gross operating profit is more comparable between countries than profit on ordinary activities. These effective corporate tax rates can be computed per country, size, industry and year. Countries averages for a period, and industry or a specific size are computed by summing similar items over the period. These data are then used to build aggregate statistics for a period, an industry or for a size. For example, the effective rate for period n to $n+m$ for industry I and size S is:

$$(ECTR)_{I,S}^{n \rightarrow n+m} = \frac{\sum_{t=n}^{n+m} (taxes)_{t,I,S}}{\sum_{t=n}^{n+m} (gross\ operating\ profit)_{t,I,S}}$$

This ratio is preferred to a weighted average of yearly effective tax rates. Indeed, using this latter can create problems due to losses for some specific years. The ratio which we will compute as total taxes paid over a long period on total gross operating profit over the same period can reduced this problem. The rates for the European Union can be than computed as averages of effective corporate tax rates weighted by gross value added in the economy of individual countries.

The data necessary for computing of average ECTR in the European Union according to this methodology we can find out in database **BACH (Bank for the Accounts of Companies Harmonised)** available at the European Commission. This database presents the financial structures of non-financial companies, aggregated at various sectoral and size levels. BACH database is a compilation of individual (as opposed to consolidated or group) financial statements of companies. Data are presented in a structured form using a single accounts layout based on the one set in the Fourth Community company-law Directive (76/660/EEC). This database offers a decomposition made of six main sector classes – Energy and Water, Manufacturing Industry, Building and Civil Engineering, Trade, Transport and Communication, and Other Services. A distinction by size is made between three categories – Small (turnover < 7 mil ECU), Medium (7 =< turnover < 40) and Large (turnover >= 40).

Items from a balance sheet are given as a percentage of total assets (which of course is equivalent to total liabilities plus equity), while items in the profit and loss account are given as a percentage of the turnover. The data base also provides absolute figures for total assets and turnover.

Although these measures have the advantage of showing the actual tax burden borne by companies, they could be misleading if they are used to assess and compare the effective domestic tax burden in international comparisons. This is because approaches based on *ex post* company-specific data do not taken into account the interaction between personal and corporate taxation which is relevant when the marginal investor is domestic. In addition, they fail to measure the incentive for additional investment or to consider correctly the foreign source income from individual or consolidated company accounts. Moreover, the data sometimes tend to show significant yearly fluctuations depending on business cycle effects. For these reasons, backward-looking profit base indicators are imprecise indicators of the investment incentives of taxation. However, they do permit an assessment of effective actual tax burdens by firm size, sector or industry.

MICRO FORWARD-LOOKING METHODOLOGY

Indicators of the effective corporate tax burden computed by this methodology are most commonly used for analyzing the impact of taxation on corporate investment behaviour. They permit international comparison and are especially tailored to isolate the effects of taxation thus providing an indication on the general pattern of incentives to investment that are attributable to different national tax laws.

In this field are best-known three methods for computing of the corporate effective tax burden using similar approaches: The method of King & Fullerton from 1984, method created within the framework of OECD in 1991 and the method of Devereux & Griffith from 1998, which goes out from the first method and revise and extend it. All this methods are based on the assumptions that all markets, especially production factor markets, are competitive and the production function has the usual properties, notably constant return to scale. In this situation, the decision to invest and locate somewhere is influenced only by capital taxation, not by taxes or contributions on other factors such as wages, energy, etc.

This approach computes directly the between the rate of return on investment of a series of hypothetical investments and given alternative rate of return on savings. In the absence of taxes, when the decision-taker invests money to finance a project, he earns a rate of return equal to that earned on the project itself. When a tax is introduced, the rate of return will be lower. The difference between these two rates is termed as “*tax wedge*”. The size of the tax wedge depends, among other things, upon the system of corporate taxation, the interaction of taxation and inflation, the tax treatment of depreciation and inventories, the treatment of different legal forms of income, and a number of other elements linked to the definition of the tax base. It is clear, therefore, that the effective tax rate on an investment project depends upon the industry, where it is located, the particular asset purchased, the way the investment is financed, and the identity of the investor who supplies the finance.

The method of Devereux & Griffith, which is the most complex method of that three mentioned above, computes two measures of the company effective tax burden:

- a) *Effective Marginal Tax Rate (EMTR)*,
- b) *Effective Average Tax Rate (EATR)*.

The EMTR ad a) is specific to an *incremental “marginal”* investment located in a specific country undertaken by a company resident either in the same country (domestic case) or in another country (transnational case). A *marginal investment* is one whose expected pre-tax rate of return p° is just sufficient to convince the investors that the project is worthwhile, *e.g.* when it minimally equals real rate of interest r (“real” here means opposite to “nominal”, *i.e.* after taking account of inflation). In this case *the pre-tax net present value of the investment R° (termed also as the pre-tax net present value of the economic rent generated by investment)*, defined as $R^\circ = (p^\circ - r)/(1 + r)$, equals zero. *The post-tax net present value of the economic rent R generated by this investment equals in this case also zero.*

The EMTR is than computed as the proportionate difference between this rate and the real post-tax rate of return of investment to investors (shareholders) s :

$$EMTR = \frac{p^\circ - s}{p^\circ}$$

When we take into account the taxation and assess a post-tax rate of return s required by the company's shareholder (for instance, on interest earned in some alternative use of the capital), it is possible to use the tax code to compute the pre-tax rate of return of the hypothetical investment p that would be required in order to obtain the minimum post-tax rate of return s . For a given required post-tax rate of return s , the more severe the tax system, the higher the required pre-tax rate of return p , termed also as "*cost of capital*", and hence the less likely that any specific investment project will be undertaken. In comparing such investments in alternative locations, the underlying economic model would predict that, by identical circumstances, locations with a higher cost of capital or EMTR would have less investments.

A company that is contemplating a new investment project has, on the one hand, to compute the overall cost of the asset, taking into account not just the initial outlay, but also any reduction of that outlay due to tax relief received as a result of the investment. On the other hand, the company must also calculate the after-tax returns that it expects the investment to generate in the future. The company would undertake the investment provided that the present value of the after-tax profits from the investment is greater than the initial cost of the asset minus the present value of any tax relief. Hence, the principal impact of taxation on investment is through the cost of capital.

In the case of the various forms of incremental investment which are more profitable than marginal investment explained above (*i.e.* when $p > r$ and the firm expects to earn a positive post-tax economic rent R), the method of Devereux & Griffith computes EATR and b) as the indicator of the corporate effective tax burden.

A natural measure of the effective average tax rate would be the proportionate reduction in the economic rent generated as a result of the tax: $EATR = (R^\circ - R) / R^\circ$. However, this measure suffers from the problem that the EATR would be undefined for projects which are marginal in the absence of tax ($R^\circ = 0$). Devereux & Griffith therefore propose a slightly different measure, scaling the difference between R° and R by the net present value of the income stream in the absence of tax, $p / (1 + r)$. They also take the investors (shareholder's) marginal personal effective capital gains tax rate z into account (defined by King & Fullerton), which reduce the value of R :

$$EATR = \frac{R^\circ - (1 - z)R}{p / (1 + r)}$$

The relation between the EATR and the EMTR is:

$$EATR = \frac{p^\circ}{p} \cdot EMTR + \frac{p - p^\circ}{p} \cdot \tau$$

where τ is the *statutory corporate tax rate*.

The rationale of doing so is that often a company that has taken the decision to undertake a specific profitable investment has to choose between two or more mutually exclusive locations or type of investment. Examples include the location decision of multinationals in choosing a site for one new factory, and the choice of investment projects in the presence of binding financial constraints. In this case, the firm's choice depends on the tax on infra-marginal investments, and hence on the EATR.

Devereux & Griffith show that, in the absence of personal taxes, this measure of the EATR moves from a value equal to the EMTR (for a marginal investment when $p = p^\circ$) to an "*adjusted statutory tax rate*" equaling $1 - \gamma(1 - \tau)$ for a highly profitable investment, where the parameter γ denotes the net income received by the investor (shareholder) as a result of a one unit increase in dividends and is defined as:

$$\gamma = \frac{(1 - m_d)(1 - c)}{(1 - z)(1 - s)}, \quad (1 - c) = (1 - \tau_D) / (1 - \tau)$$

where:

m_d - the investor's (shareholder's) marginal personal income tax rate on dividend income,

- c - the rate of (net) withholding tax imposed on cash dividends paid by the firm to the shareholder's,
- s - the rate of tax credit available to the investor (shareholder), expressed as a proportion of the cash dividend,
- τ - the corporation tax rate on retained earnings,
- τ_D - the corporation tax rate on distributed profit.

In the case that the retained earnings which were generated by this investment are taxed by the corporate income tax rate τ , the same as the corporate income tax rate τ_D for the profit distributed to the investors (shareholders) in the form of dividend, *e.g.* when $\tau = \tau_D$, then the parameter $c = 0$. Under a full imputation system when $s = \tau_D = \tau$, then $\gamma = (1 - m_d)/(1 - \tau)(1 - z)$.

In a sense, then, this measure is quite general, applying to incremental investment of any level of profitability, and incorporating the EMTR.

The choice of “average” as opposed to “marginal” may look unfortunate since “average” is not taken here in the sense of average taxation paid by an investor considering its profits and losses, but as the “average” taxation borne by an investment for different level of profitability. The term refers then to the investment and not to the investor.

A BRIEF COMPARISON OF DESCRIBED METHODOLOGIES

All methods have their advantages and disadvantages. So, for example, the backward-looking approaches are able to detect overall taxation at national level, and the micro forward-looking approach, for a change, is able to detect tax differences for specific investment and financing decisions.

The backward-looking methodologies use real-life data while forward-looking methodologies use theoretical features of tax systems. In that sense, forward-looking approaches do not really compute effective (*i.e.* observed, actual) tax rates but implicit ones.

Backward-looking methodologies can't isolate national tax systems from influences of other foreign tax systems. One important consequence is that methodologies using the forward approach may find larger dispersion of effective tax rates while backward-looking approaches may find a smaller one.

The difference between macro and micro backward-looking approaches is one of level of aggregation of data. Macro approaches can't in practice compute effective tax rates at a sectoral level because data on corporate taxes and operating profit are there not available.

Also exists difference between backward and forward-looking approaches as to level of interaction between the different characteristics of tax system. Backward-looking approaches cannot tell what taxation would be in the absence or a change of a particular feature. Forward-looking studies can isolate the impact of the combination of several items on effective taxation but, for practicability reason, they cannot take them all in consideration and have to left some out since they cannot be all introduced in a model used to compute effective corporate tax rates by this methodology.

A last differentiation is whether the methodology investigates taxation based on the nationality of the tax system or on the nationality of companies. Micro forward looking approaches look at national systems taken separately. They mainly investigate taxation of domestic companies in their domestic system. If they also look at tax treatment of operations undertaken abroad, they lack information on the importance of these operations in company turnover. Micro backward-looking approaches rest on the nationality of companies whatever the tax systems that actually apply to their operations. The case of macro approaches is more difficult and depends on how data are collected.

PROFIT AND LOSS ACCOUNT AVAILABLE IN BACH DATABASE

(all items in %-age of net turnover)

Name	Profit and loss account
NOI <i>(net operating income)</i>	Net turnover.
+ (1)	Change in stock finished goods and work in progress.
+ (2)	Capitalised production.
+ (3)	Other operating income.
= TOI	Total operating income.
- OC <i>(operating costs)</i>	Costs of materials and consumables. <i>(Raw materials and consumables + Other external charges).</i>
- (4)	Other operating charges and taxes.
- EMPL <i>(employment)</i>	Staff costs. <i>(Wages and salaries + Social security costs).</i>
= GOP	Gross operating profit.
- DEPR	Value adjustments on non financial assets + Depreciation on intangible and tangible fixed assets + Other value adjustments and provisions.
= EBIT <i>(earnings before interest and taxes)</i>	Net operating profit
+ FININC	Financial income.
+ (5)	Value adjustments on financial assets.
- FINCH	Financial charges (Interest and similar charges) <i>(Interest paid on financial debts + Other financial charges).</i>
= EBT <i>(earnings before taxes)</i>	Profit on ordinary activities before taxes.
+ EXINC	Extraordinary income.
- EXCH	Extraordinary charges.
= GTP <i>(gross total profit)</i>	Overall profit before taxes
- T	Taxes on profit.
= NTP <i>(net total profit)</i>	Profit or loss for the financial year.

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