

THE EFFICIENCY OF ESTONIAN TAXATION SYSTEM

UČINKOVITOST ESTONSKOG POREZNOG SUSTAVA

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Abstract: Estonian taxation system was developed in 1993. The influence of the tax system on the development of Estonian society, especially on its economic environment, was weak in 1993-1999. Since 1 January 2000 the corporate profit is no more taxable in Estonia. Only the outgoing cash– dividends, benefits, and other payments are taxable. The purpose of this kind of taxation experiment was to encourage companies to reinvest more into their assets and to attract foreign investments. The results do not conform to the optimism of the authors of the idea.

Key words: taxation, budget, efficiency, corporate income tax

Sažetak: Estonski porezni sustav razvijen je 1993.godine. U razdoblju od 1993. Do 1999. utjecaj poreznog sustava na razvoj estonskog društva osobito na gospodarsko okruženje bio je neznatan. Od siječnja 2000. godine profit poduzeća nije podložan oporezivanju. Porez se naplaćuje na izlaznu gotovinu-dividende, naknade i druge isplate. Svrha ovog eksperimenta u oporezivanju bila je potaknuti kompanije na veće reinvestiranje u vlastitu imovinu kako bi se privukla strana ulaganja. Rezultati nisu u skladu s optimizmom autora ove ideje.

Ključne riječi: oporezivanje, proračun, učinkovitost, porez na dobit poduzeća



1. Introduction

Any kind of entrepreneurship needs a specific environment for its development. As entrepreneurship has a purpose to generate profit, thus it is very important to regard the profit margin as a guiding force of entrepreneurship.

Taxation is directly connected with the margin of profit. The main indicator characterizing the profitability is not the net dealing income but the indicators based on the taxation of profit. But the question: “How important is the influence of taxes?” remains.

The Estonian experiment of the virtual lifting of corporate income tax, prior to the country’s accession to the European Union, can now become an object of great interest. The author has not set a purpose to construct a model for the analysis of this experiment due to inadequate statistical databases the accuracy is insufficient. The purpose was to observe the influence of taxes in Estonia by using classical measurements of economics in 1993-2004 and changes that had taken place in economy prior to the accession to the EU on May 1, 2004.

2. Main characteristics of Estonian taxation system during 1993-1999

It was not until 1994 that Estonian economy first began to stabilize after leaving the rouble zone. Since that year the burden of taxation has been stable: 1994 – 36.3%, 1995 – 36.7%, 1996 – 36.5%, 1997 – 36.5%, 1998 – 36.4%, 1999 – 34.9%. The stability was possible as there were no principal changes in the tax system in 1994-1999.

Nor did the structure of the taxes undergo any remarkable changes. The greatest sources of tax revenue were the value added tax, personal income tax, and excises that in 1994 and 1999 accounted for 48.4% and 38.8%; 20.6% and 16.4%; and 9.4% and 17.4%, respectively. There are no property taxes in Estonia; the land tax is of lower importance. The social tax revenue flew into the social fund, whereas the health insurance fund remained outside the budget until 2000. General principles of taxation in the EU formed the basis for the VAT and excises in Estonia.

Doubling of their proportion in the tax revenues during 1993–1999 resulted from the population’s extremely low ability to pay subsequently to the monetary reform. Hence, the excises took effect at low rates, thereafter rising continuously throughout the entire period.

Yet, the personal income tax system in Estonia did not heed of the EU. Unlike the progressive personal income tax used by 15 “old” and 9 “new” member states, Estonia imposed only one tax rate - 26% (since January 1, 2008 – 21%).

It is very difficult to estimate the taxation system that existed in Estonia during 1994-1999. Nor did the author’s attempts to find some correlations between the main characteristics of the taxation system and DNP, the level of the real wages (its dynamics), the unemployment, the inflation, the amount of investments, and other economic indicators give any results. Some other factors, which could be stronger by an order of magnitude, influenced Estonian economy in that period.

3. Estonian taxation system during 2000 – May 1, 2004

The structure of Estonian budget was changed in the year 2000. First, the social tax (from which the charges for the pension and health insurance are covered) was included into the budget. Though it did not incur any principal change in the tax system, it still complicated the comparison of data regarding the budget and taxation before and after 2000. Social tax (35.3%) was the biggest generator of the tax revenues in 2000. Thus, the structure of Estonian budget in 2000 essentially differed from the structure of Estonian budget before 2000. Likewise, the system's structure differs from that of the previous period, due to principal changes that took place in the Estonian tax system in 2000.

On 1 January, 2000 a principal change was introduced in the tax system: the corporate income tax was lifted in Estonia. The idea of using low taxes to attract foreign investments is not a new one. Nor is it a new idea, that profits ploughed into real assets will increase these assets' value, thus enabling the assets to reproduce themselves.

Lifting the corporate income tax in Estonia can be regarded as an "experiment" whose objective may have been to turn the notion of object of taxation upside down. It has become a common concept that entire profit is the subject of taxation, with some benefits such as tax incentives written down in the text of laws. The Estonian income tax system is built up on an entirely different basis. It doesn't include the notion of profit; instead, certain ways of using the profit (e.g. payment of dividends, special benefits, etc.) have been made objects of taxation.

By the general practise in many countries of the world the corporate income tax liability arises instantaneously as the profit amount has been confirmed. Possible delays at it can be caused only by verification of accounting statements or by settling of accounts. Under Estonian laws, the profit earned can remain intact on the companies' bank accounts for years, as it is not subject to taxation unless being used for out-payments. Only when it is used, it becomes the object of taxation, that is, the question arises, whether a certain way of using the profit is subject to taxation or not.

4. The Influence of the Lifting of the Corporate Income Tax

As a consequence of lifting the corporate income tax the revenue from taxation dropped and thereafter the possibilities for financing the public sector dwindled. According to the state budget of the Estonian Republic for 2000, the expected corporate income tax revenue was estimated at 628.8 million kroons that is significantly less than compared to 1914.1 million kroons, received for the budget in 1998.

A budget shortfall of more than reducing the incentives of the value covered a milliard added tax, increasing the government fee and increasing the fines. The remainder was compensated by retrenchment of charges of the state budget. This restructuring of the tax burden is socially painful and it will be justified only in case its benefits can be obtained in another field. The expected outcome from the

liquidation of the corporate income tax should have been growth of investments capacity.

Savings are a natural source of investments. In the transition period of states with small value of the GD, the savings make up a small percentage of the GDP. Thus the small total amount of savings cannot meet the actual needs of economy. Investments are one of the most important inputs for production, and their scarcity in a certain period is an extremely influential factor impeding the development of economy of transition states.

It is very difficult to find a connection between the lifting of corporate income tax and the foreign direct investments (FDI) in Estonia. FDI depend on the expansion rate of GDP, hence on the economic cycle. It is difficult to point out the presence and the influence of the abolition of corporate income tax. Obviously, the influence of other factors, such as business expectations and the international companies' niche on the Estonian market, has been a greater than the impact from lifting the corporate income tax.

Estonia isn't much more attractive with its policies of investments' taxation. Many states such as Croatia, Lithuania and Slovakia, where special benefits are not taxed, aren't less attractive for the investors in terms of profit taxation.

All the mentioned facts confirm the conclusion from recent researches that FDI does not react to tax differentials or its response can be quite modest. The influence of the lifting of corporate income tax on FDI and other economic indicators can't be found out (it can't be differentiated from the influence of stronger factors). Cheap labour force and Estonian high image among the other East European states had a more powerful influence on the overall development.

5. EU and Estonian taxation system

The accession to the European Union has caused changes in Estonian taxation system. Most important among them in 2004 was the rise of excises on fuel (roughly 1 kroon per litre). An increase of the excises of about the same amount took place on 1 January, 2008.

The changes of the income tax have an important influence in Estonia. Firstly, it is obvious that EU can't permit offshore inside a unified economic space including Estonia. An appendix of the Merger Treaty Estonia has got an exception – the right to preserve the present system of corporate income tax until 31 December, 2008. Thus the date when Estonia has to change its income tax law has indirectly been appointed. That's why its re-establishment wouldn't have any significant setback if wisely done. The legislative changes were passed by Estonian Government in April 2008.

But the main essence of it has remained the same as profit isn't taxable till it isn't used. As there aren't any substantial changes, so any reckonable effect on the economical environment shouldn't be expected. Moreover, as it has been mentioned earlier, the lifting of corporate income tax in Estonia hasn't had any significant influence.

Major problem with regard to taxes and economic environment in Estonia will emanate from the issue of the burden of taxation. In 2004 the total burden of taxation

in EU-15 was 41% of GDP and in Estonia the respective figure was 33% of GDP. The average statutory corporate tax rate of the new member states is 21.5%, significantly lower than the average – 31.4% -- of the EU-15 member states. According to the Ministry of Finance the corporate tax burden of Estonia is 14.6 % of DNP

6. Conclusion

Estonian taxation system was developed in 1993. The influence of the tax system on the development of Estonian society, especially on its economic environment, was weak in 1993-1999.

The Estonian tax system was changed in 2000. Since 1 January 2000 the corporate profit is no more taxable. Only the outgoing cash– dividends, benefits, and other payments are taxable. The purpose of this kind of taxation experiment was to encourage companies to reinvest more into their assets and to attract foreign investments.

The results do not conform to the optimism of the authors of the idea. The growth rate of the investments hasn't increased. In 2000-2003 the figures of elasticity between FDI and the income tax rate, which are approximately - 0.2, were ranging from - 1.9 up to 3.8 in Estonia.

The accession to the European Union will obviously bring some rise in the burden of taxation in Estonia. Both the total burden of taxation (33.0%) and the corporate burden of taxation (14.6%) are significantly lower than the average of the EU (41% and 31.4 %, respectively). Preservation of the difference is principally impossible.

It can be suggested that the possible negative changes in the entrepreneurship environment aren't connected with the restoration of the corporate income tax. Moreover, the "experiment" of lifting it wasn't successful. Still, some increase of the tax burden can worsen the entrepreneurship environment.

7. References

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