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# TAX POLICY IN NEW EU MEMBERS: ESTONIA AND THE OTHER BALTIC STATES

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This paper is part of a wider research on Tax systems and Tax Policy in EU New Members, carried on at this Department, under the direction of L. Bernardi, M. Chandler and L. Gandullia, and the supervision of V. Tanzi.

JEL CLASSIFICATION: H20 – H24 – H25

KEYWORDS: Taxation, Tax Reforms, EU New members, Estonia, Latvia, Lithuania

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AND THE OTHER BALTIC STATES

by

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**Abstract**
This paper is a part of a wider research program on taxation in EU New members, directed by L Bernardi, M. Chandler and L. Gandullia under the supervision of V. Tanzi. It is devoted mainly to Estonia whose fiscal data are better available and more reliable than for the other Baltic States. However both Latvia and Lithuania will have some room inside the paper and share with Estonia many kinds of their economies and fiscal systems. Estonia and the other Baltic States wrote a success story of transition to market economy and to an European-type taxation. No slowdown of GDP neither of budget balance took place during the 1990s. At present, total fiscal pressure is somewhat lower and better balanced, with respect to other New members (par. 2). Main taxes are not far from the European standards. However, PIT is a linear tax which exempts almost all capital incomes, CIT taxes just the distributed profits, excises have to be still harmonized to EU level (par. 3). Tax burden hits particularly labor, less consumption, still less and less capital and business income (par. 4). Macroeconomic and budget outlook seems at present favourable, thus allowing to Estonia a quick entrance into EMU. However as to the long run this requires to strengthen fiscal discipline trough some painful adjustments of both social expenditures (pensions, because of the aging of population) and tax revenue (excise, expecially tobacco, because of the EU requirements, while a low taxation of firms should be maintained and that on labor possibly reduced). The prospects for both Latvia and Lithuania are not far different, but Latvia might meet with more difficulties to comply with Stability Pact rules (par. 5).

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## 1. Introduction and executive summary

This paper is mainly concerned with the fiscal system of Estonia. This is neither the widest nor the most populated among the Baltic New members (Estonia, Latvia and Lithuania). However, enough fiscal data are available just for it. Being further all the Baltic States quite similar, just a final short paragraph will be devoted to Latvia and Lithuania.

Estonia is a small country, of 45,227 Kmq and 1,358 mn inhabitants. It became an independent republic from 1918 up to the begin (1940) of Second World War, when it was incorporated into the U.S.S.R. Independence was gained again in 1991 and a new parliamentary Constitution was adopted in 1992. Estonia will enter de facto into EU in 2004. Local currency is the Estonian Kroon (EEK = 0,063911 €), GDP is about 5,150 mn €, near 3,760 € per capita, somewhat less than 20 per cent of the EU average[1]. After a 1999-2000 slowdown, economy is at present fast growing, at rates of more than five per cent yearly, but unemployment is still over 10 per cent. Inflation runs around two-to-three per cent, as the Government deficit does. Public debt is not more than five per cent of GDP.

Current total fiscal pressure reaches in Estonia about 37-38 per cent of GDP. This level has been criticized as too high, when compared with the need not to interfere with the development process, but it is somewhat lower with respect to other New members. Direct taxes stay still below indirect taxes which will be still increased (especially excises) as a consequence of the access to EU.

Labor income is heavily hit, preventing job intensive growth, while inducing the development of underground economy, albeit during last years the problem of envelope salaries is decreasing and also the problem of illegal goods and smuggling. This raises also an equity problem, due to the fact that inequality in income distribution is greatly increased from the end of Russian regime. As in any former communist country, the level of local governments' activities is comparatively low with respect to Western European standards. Financing is raised mainly by taxes, which are mostly given by shares of National (income) taxes.

The fiscal reform, adopted after the collapse of the U.S.S.R. and the independence, went fast during the first years of the new Republic: unlike in many other transition countries, no revenues' fall occurred. As a consequence, during the 1990s the quantitative structure of the system did not change radically. At the late 1990s and the early years of this century a general

[1] All UN 2002 data, not weighted in PPP terms.

revision of tax laws was performed. Furthermore, the efforts to implement a modern tax administration were fairly successful. The main shortage concerns still the enforcement of tax collection. However, corruption has not been perceived as very high, and firms' bribing behavior is comparatively lower than in other transition economies.

At present the broad features of Estonian main taxes are not very different from the corresponding EU models, albeit they are generally simpler and show some distinctive features. Income tax exempts almost all capital incomes and its structure is rather similar to a linear income tax at a marginal rate of 26 per cent. The same rate is charged on corporate profits but only distributed profits are taxed, while all retained earnings are not taxed at all. This mild fiscal treatment of corporations is a common feature in the Baltic States. VAT is the usual tax-to-tax European model: the standard rate is set at 18 per cent, some essential commodities are taxed at five per cent and welfare and other public services benefit from a zero rate scheme. A complex structure of excise duties and stamp duties are the remaining main State sources of revenue. The local taxes may be levied on the same bases than State taxes or on different ones' (in particular on land). Quite high rates must be paid for social contributions on labor income: 20 per cent for pensions and 13 per cent for health.

Concerning the distribution of fiscal burden, the main contributions to total revenues come from labor-employed income and, to a lower extent, from consumption. Notice that in a low income setting, where wages are by large the main component of total income and consumption of total expenditure, the two kinds of taxation may overlap. About the fiscal burden on specific factors, implicit rates show that labor employed income suffers from a burden (about 40 per cent) almost twice than the one charged on capital and business income.

Estonia's Government budget moved around the balance during the 1990s. This was due also to the lack of the monetary financing of Central Bank (prevented by law). In 1999 the deficit jumped to near five per cent, in the wake of Russian crisis, but during following years a buoyant economic growth and fiscal discipline contribute to gradually reach a budged surplus of 1.3 points of GDP in 2002. It is expected to turn to deficit in 2003 and 2004, but for no more than half point of GDP.

Recent tax reforms were intended in particular to harmonize the existing tax system with EU requirements, particularly in the field of VAT and excise duties. A relevant change, as mentioned before, was adopted for corporation tax: only distributed profits are now subject to tax, while the retained ones' are exempt. The new incentive seems particularly intended to attract foreign capital, in competition with other transition economies. Anyway, it will be right to continue to have a mild taxation on corporations and productive activity. Simplified tax regimes will have to be envisaged for small business and this could also alleviate Tax administration activity.

Last progress toward EU (and then EMU) requires further harmonization efforts and the keeping of a low taxation of enterprises. This in turn requires a strict monitoring of expenditure, since the budget must continue to be balanced, even if population is declining and aging.

The fiscal situations of Latvia and Lithuania are not very different, but present some peculiarities. About total taxation, Latvia and, in particularly, Lithuania are taxing less than Estonia. Social contributions are particularly low in Lithuania, while both income tax and VAT in each country are under the Estonian levels. From the early to the late 1990s, total fiscal pressure did not change too much in Latvia as well as the main kinds of taxes. At the contrary, fiscal pressure went down in Lithuania: the market-oriented cut of corporations' tax rates was not substituted by an adequate increase of other taxes.

The high degree of centralization of both revenues and expenditures in Lithuania is similar to Estonian figure, while Latvia shows some more decentralization in both revenues and expenditures. The main taxes (Income tax, Corporation tax, VAT, Social contributions) do not show strong structural differences from their Estonian counterparts. In particular, income tax replicates the linear flat tax model and corporation tax tries to be mild with earnings and with re-invested profits.

Economic growth is fast running both in Latvia and Lithuania from the end of the 1990s. Latvia adopted a policy mix which favored a higher growth (six-to-eight per cent) coupled by an inflation rate at about two-to-three per cent and a Government deficit on the upper bound of Stability Pact. Lithuania's preference was in favor of a fiscal discipline which allowed the rate of inflation to go down around one per cent and Government deficit not to overcome two per cent. Thus both the countries are substantially in line with EU and EMU financial requirements.

## 2. The structure of the system at the end of the 1990s and its development after the collapse of U.S.S.R.

### 2.1 A broad view at the current structure of taxes and social contributions

At the end of the 1990s, Estonia's total fiscal pressure (37.5 per cent) was not far from New members' average (38.9 per cent) but some points under the EU mean level. Estonian broad fiscal structure (see Table 1) can be split almost exactly in two third of taxes and the remaining third of social contributions.

Direct taxes are still lower than indirect ones, but far less than in the average of the New members. The yield of the personal income taxes is not low, albeit it is limited by the narrow base as well as by the flat rate of income tax (see below, par. 3). The total amount of indirect taxes looks comparatively higher. This is not due to the existence of a complex structure of excise duties, but rather, to the narrow coverage of the VAT's reduced rate and to the small number of operations which benefit from a zero-rate scheme.

Social contributions on employed work are slightly lower than in the average of both New members and EU and formally are completely due by the employers. However, do not forget that the theory of fiscal incidence firmly states that attributing by law the tax charge to employers or employees does not much matter as to its final incidence.

Finally notice that this structure is just partially close to the "optimal" case, as it has been proposed by Mitra and Stern (2003) for the whole set of transition countries of Eastern Europe and the former Soviet Union. [1] Total taxes (37.5 per cent of GDP) are higher than the upper bound suggested by Mitra and Stern (31 per cent). Income tax (8.5 per cent) stays near the proper level (9 per cent). VAT (8.8 per cent) is high (7 per cent) as do are (3.8 per cent) excise duties (3.0 per cent). Most of all, social contributions (12.1 per cent) are over the recommended level (10 per cent). The conclusion should be (on the same topic, Gupta *et al.* 2001) that Estonian economy could gain efficiency by a substantial cut of taxes, especially indirect taxes and social contributions. Notice, however, that Mitra's and Stern's suggested rates are "optimal" just in the sense that they have been extrapolated from the most common trends resulting from a cross-section of developing and high income countries.

## 2.2 The development of the system from the early to the late 1990s

Estonian new Constitution was adopted in 1992 and the fundamental laws of the fiscal reform were passed during the early 1990s Some small changes occurred just in the relative share of

*Table 1* Structure and development of fiscal revenue in Estonia, New members and EU average as % of GDP, 1992-1998

| | *1992* | | | *1994* | | | *1996* | | | *1998* | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | *Estonia* | *New members* | *EU* | *Estonia* | *New members* | *EU* | *Estonia* | *New members* | *EU* | *Estonia* | *New members* | *EU* |
| *Direct Taxes, of which* | 13.3 | 10.1 | 13.5 | 11.6 | 10.0 | 12.9 | 10.0 | 9.6 | 13.4 | 11.1 | 9.2 | 13.7 |
| Personal income | 8.5 | 6.4 | 9.6 | 8.1 | 7.0 | 9.3 | 8.3 | 7.1 | 9.3 | 8.5 | 6.7 | 9.3 |
| Corporation income | 4.8 | 3.6 | 2.3 | 3.5 | 2.9 | 2.4 | 1.7 | 2.5 | 2.7 | 2.6 | 2.5 | 3 |
| *Indirect taxes, of which* | 12.3 | 15.6 | 13.4 | 14.9 | 16.5 | 13.7 | 15.5 | 16.9 | 13.7 | 14.3 | 15.5 | 13.9 |
| VAT | 9.2 | 5.1 | 6.7 | 11.2 | 7.4 | 6.8 | 10.0 | 7.4 | 6.9 | 8.8 | 7.9 | 7.0 |
| Excise duties | 1.9 | 3.4 | 3.4 | 2.1 | 4.2 | 3.5 | 3.3 | 4.1 | 3.4 | 3.8 | 4.1 | 3.5 |
| Others | 1.2 | 9.3 | 3.3 | 1.7 | 5.0 | 3.4 | 2.1 | 4.9 | 3.4 | 1.8 | 3.6 | 3.5 |
| TOTAL TAX REVENUE | 25.5 | 25.7 | 26.9 | 26.5 | 26.4 | 26.6 | 25.5 | 26.5 | 27.1 | 25.4 | 24.7 | 27.6 |
| *Social contributions* | 12.1 | 16.1 | 14.5 | 13.1 | 15.7 | 14.9 | 12.2 | 14.3 | 15.3 | 12.1 | 14.2 | 15.0 |
| Employers | 11.9 | 10,0 | 8.1 | 12.9 | 9.0 | 7.9 | 12.0 | 8.0 | 8.3 | 11.9 | 7.9 | 8.2 |
| Employees | 0.0 | 5.3 | 4.8 | 0.0 | 5.1 | 5.2 | 0.0 | 4.8 | 5.1 | 0.0 | 4.8 | 5.0 |
| Self employed | 0.2 | 1.8 | 1.6 | 0.2 | 1.6 | 1.8 | 0.2 | 1.5 | 1.9 | 0.2 | 1.6 | 1.9 |
| TOTAL FISCAL REVENUE | 37.7 | 41.8 | 41.4 | 39.6 | 42.2 | 41.5 | 37.7 | 40.8 | 42.4 | 37.5 | 38.9 | 42.6 |
| *Administrative level* | | | | | | | | | | | | |
| Central government | 16.6 | 25.9 | 22.8 | 22.0 | 25.8 | 22.4 | 20.3 | 25.4 | 22.4 | 20.1 | 23.9 | 22.9 |
| Local government | 9.0 | 3.0 | 3,0 | 4.5 | 3.5 | 3.2 | 5.2 | 3.4 | 4.0 | 5.3 | 3.7 | 4.0 |
| Social Security | 12.1 | 12.9 | 14.5 | 13.1 | 12.9 | 14.9 | 12.2 | 11.5 | 15.2 | 12.1 | 11.4 | 14.9 |

*Sources*: EU Commission (2000) for Estonia and New members (unweighted average); Eurostat (2000) for EU-15 (1997 unweighted average).
*Notes:* Czech data start in 1993 and Social security is only health.

corporation tax and of excise duties. Then the transition from the previous (U.S.S.R.) regime moved quite fast and thereafter no dramatic changes occurred in the basic structure of the Corporation tax progressively decreased (from 4.8 of GDP in 1993 to 2.6 per cent in 1998) as it came assuming the features of a proper market oriented corporation tax. Excise duties doubled during the 1990s from 1.9 per cent in 1993 to 3.8 per cent in 1998.

One must have well in mind that the transition to a market-oriented tax system raised tremendous institutional, administrative and behavioral changes, besides quantitative developments (Tanzi and Tsibouris 2000; Ebrill and Havrylyshyn 1999). A completely new set of administrative bodies and law rules had to be created. Previous hidden levies became transparent to taxpayers. Estonia and the other Baltic States were comparatively well performing going on with this process (e.g. Aghion and Blanchard 1994; Coricelli 1997). The early introduction of new taxes[2] was not followed by any significant fall in total Government revenues. Previous discretional tax practices gave no rise to the perception of a widespread and deep corruption[3]. Consequently firms' bribing behavior was comparatively lower than in other transition economies.

## 2.3 The apportionment of revenues among Government layers

The share of total revenues accruing to Central government (20.1 per cent of GDP in 1998) is near twice what goes to Social security bodies (pensions and health: 12.1 per cent). The room for autonomous financing of Local government is relatively wide, at least when it is compared with both New members' and EU's average.[4] This sharing did not change much during the 1990s, except for a not common increase of the share of Central Government, balanced by a reduction in that of local governments.

However, according to the institutional setting inherited by the U.S.S.R. structure, expenditure functions and taxing powers are strongly centralized. Local governments' expenditure in 1999 reached not much more than seven per cent of GDP (OECD 2002 for this

[2] All Baltic States got the maximum score as to the progress in tax policy reform, among both Central and Eastern European as well as CIS countries (Ebrill and Havrylyshyn 1999).
[3] Data reported in Tanzi and Tsibouris (2000) show for 1997 a level of the index near three time that of Russia and twice that of China.

and the subsequent data). Having the local budgets to be balanced, local governments' total revenues equal total expenditures at about seven per cent of GDP, and are close to 22 per cent of total general government revenues. This figure in turn can be split in about 68 per cent of taxes, nine per cent of non-tax revenues, 22 per cent of grants from central government. Notice that, again, just a small part of taxes (about ten per cent, property taxes) are effectively own resources of local governments, the remaining 90 per cent (income taxes) being no more than not autonomous sharing to national taxes.

## 2.4 A comparative view with other main New members and the average of EU[5]

Total fiscal pressure (37.5 per cent) is just about 1.5 points under the average of the New members 38.9 per cent), but more than five points below the EU average (42.6 per cent). Notice, however, than the share of taxes on total fiscal revenues is somewhat higher with respect with both the New members' and the EU's cases. The root of this spread can be mainly found in the absence of social contributions directly charged on employees and in the low burden of those suffered by self-employed. The splitting of taxes into direct and indirect ones seems to characterize Estonian system as more advanced with respect to New members and less in comparison with EU 15. Estonian direct taxes are higher when they are compared with those of selected New members but lower with respect with EU countries. The opposite happens in the case of indirect taxes. Still refer to Table 1 above for all that.

Estonian level of local expenditure (7.1 per cent) is very close to the average (7.2 per cent) of European and Baltic New members, but is less than an half than the mean value of EU unitary countries (16.2 per cent). The share of local taxes on total revenues (69 per cent)) is comparatively high vs. both the other New members (56 per cent) and EU countries (43 per cent). The financing by means of Central government grants is consequently lower (22.5 per cent), particularly in comparison with EU members (46 per cent). Remind however that Estonian local tax revenue is made up mainly by shares of national taxes.

[4] Notice that ESA95 National Accounting System does not include the sharing to national taxes in this figure.
[5] A detailed discussion may be found in Mitra and Stern, 2003.

## 3. Some quantitative and institutional features of main taxes[6]

### 3.1 National tax on individual income *(Üksikisiku Tulumaks*)

Estonian personal income tax was introduced in 1993[7] and further amended in 1999. It is close to the PIT standard model, but its features are somewhat simpler and country-specific. The yield from resident persons accrues at 44 per cent into the State budget and at 56 per cent into those of Local governments. Some items of the potential base are exempt by law, the main ones' being as follows.

Capital incomes: Domestic dividends, interest received from credit institutions, inheritances and gifts. Dividends are subject to distribution tax (see below), while all other types of interest are included in the taxable income:

a) capital gains, from the sale of taxpayer's own domestic dwelling and coming from the restitution of expropriated property and privatization of the economy;

b) Premium and expenses paid to qualified pension schemes.

c) Almost all insurance proceeds but just the pensions from qualified schemes. The last are taxed at a lower rate of 10 per cent by way of a final withholding.

The taxing unity is the individual, including children with own income, but resident spouses may submit a joint tax-return. Tax structure is very close to the scheme of the linear income tax. There is just a flat rate at 26 per cent, but a basic allowance of about € 770 (12,000 EEK) is allowed per tax year. The same amount holds for any child until 17 years old, starting from the third child. Other main allowances concern interest paid to buy a house, educational expenses, alimony payments, various social merit donations and social contributions.

### 3.2 Corporate income tax *(Ettevõtte Tulumaks)*

Also this tax has been adopted in 1993 and further amended in 1999 and 2000. The tax is payable to the benefit of Central government non only by limited liability companies, but also

[6] This paragraph owes much to EU Commission (2000) and IBDF (2002).

[7] 1993 is a crucial year for tax reforms in Eastern and Central Europe transition countries. Not just Estonia, but also the (then) Czech-Slovak Republic, Hungary and Poland introduced entirely new tax codes, under the clear influence of bodies as IMF and OECD, after the first 1989 initial reforms (Easson 1998).

by resident partnerships, cooperatives, associations, foundations, public-law legal persons as well as by Estonian branches or permanent establishments of non resident similar entities insofar as they derive Estonian-source income.

The base is made up by worldwide net income, including financial items. From 2000, the tax is not yet levied on any retained earning but only on distributed profits, gifts and capital gains. The rate is set at 26/74 of the net amount of the distribution (26 per cent of the gross amount).

### 3.3 Value Added Tax *(Käibemaks)*

VAT was introduced in 1993; it was further amended in 1999 and benefits the Central government. Persons (individuals, legal entities and public bodies) liable to taxation are those making supplies in the course of their business or importing goods and services into Estonia.

The structure is given by the standard European tax-to tax VAT and exemptions follow the general rules: educations, health and public services, credit and financing institutions services, individual letting of housing and so forth.

The standard rate is set at 18 per cent, but it is scaled down to zero (input tax being deductible) in these main cases: exports, scholarly textbooks and Estonian subscribed periodicals A reduced rate of five per cent applies to certain books, medicines and medical equipments, treatment of hazardous waste, funeral requisites and services, theatrical performances and concerts, heat and solid fuels sold to natural persons..

### 3.4 Excise duties *(*aktsiis)*

Estonia maintains a wide system of excise duties, which however has been largely updated during the 1990s. Main items are:

a) *alcohol* – The beneficiary is the State, but peculiarly 3.5 per cent of the revenue is transferred to the Cultural Endowment of Estonia. Curiously enough, rates are increasing not just from beer to other fermented more alcoholic beverages, but also from these to sparkling wines;

b) *tobacco* - The beneficiaries are the same as in the case of alcohol's excise. The tax is paid through revenue stamps, which can be bought by the producers and the importers of manufactured tobacco. The stamps' value is around ½ of Euro per package of cigarettes. This value will be increased each year until 2010 (ca 1-2 EEK per year);

c) *fuel* - All the revenue accrues to Central government. The tax is imposed (albeit with some exemptions) on any kind of motor fuel both manufactured in Estonia and imported. Rates range from about € 0.02 per liter of fuel oil to about € 0.25 per liter of gasoline. These excises will also be harmonized to the EU, beginning by 2004 there will be an increase;

d) additionally, there is the excise duty on packaging, The tax is paid by the importer of packages, by the user of packages, i.e. who fills packages with goods or by the re-importer of the packaging.

### 3.5 Heavy goods vehicle tax *(Raskeveokimaks)*

Further there will be the heavy goods vehicle tax from the beginning of 2004. Heavy goods vehicle tax is paid for following classes of vehicles which are intended for the carriage of goods: (1) lorries with a maximum authorised weight or gross laden weight of not less than 12 tons; (2) road trains composed of trucks and trailers with a maximum authorised weight or gross laden weight of not less than 12 tons. Heavy goods vehicles of the fire and rescue service agencies of the Defence Forces, National Defence League, Border Guard, police authorities, also state and local government agencies of the fire and rescue services are exempt from the heavy goods vehicle tax.

### 3.6 Local taxes

The autonomous sources of financing of Local authorities (fully or with sharing by Central government) basically are the following ones':

a) *local taxes (Kohalikud Maksud)* - They may be imposed on bases already taxed or not by Central government. Particularly: sales tax (maximum rate at one per cent), boat tax on owners of boats, advertisement tax, tax for closing roads and streets (for demonstrations, processions and so on), local tax on motor vehicles, tax on keeping animals, entertainment tax on recreational activities and parking charge;

b) *land Tax (Maamaks)* – The tax is due by the owners or users of land to the benefit of Local authorities. The tax is assessed on the value of owned land and the rates go from 0.5 to two per cent.

### 3.7 Social security contributions *(Sotsiaalmaks)*

Social security contributions were adopted by law as late as in 1998 to the benefit of Social security and Health insurance fund, as a part of the move of welfare system toward a Bismarkian model (Oksanen 2001). The total rate for all workers is quite high, being set at 33 per cent, of which 20 per cent for social insurance and 13 per cent for health insurance. In addition, unemployment insurance contributions must be paid on the income of the employees. The employer's contribution is levied at a rate of 0.5 per cent and the employee's contribution at 1 per cent.

### 3.8 Other minor taxes

Stamp duties (*Riigilõiv*) accrue to State budget, being imposed on legal acts and the emission of administrative documents. A gambling tax is levied on income gained from operating games of skill and betting, to the benefit of both the State and Local governments. Finally, a first faint move toward environmental taxation has been done by introducing in 1999 a pollution fee (*Saastetasu*) payable to Central government by the owner of an immovable property who releases pollutants or wastes into the environment.

## 4. The fiscal burden

### 4.1 The distribution of tax charge: taxation by economic function and implicit tax rates

The value of taxation according to economic function is given by the ratio of the total tax revenue assigned to some factor, divided by a general measure of economic activity, i.e. in practice GDP. The resulting values come from combining tax rates with the wideness of any factor and thus enable us to evaluate how any factor contributes to reach the total value of revenues.

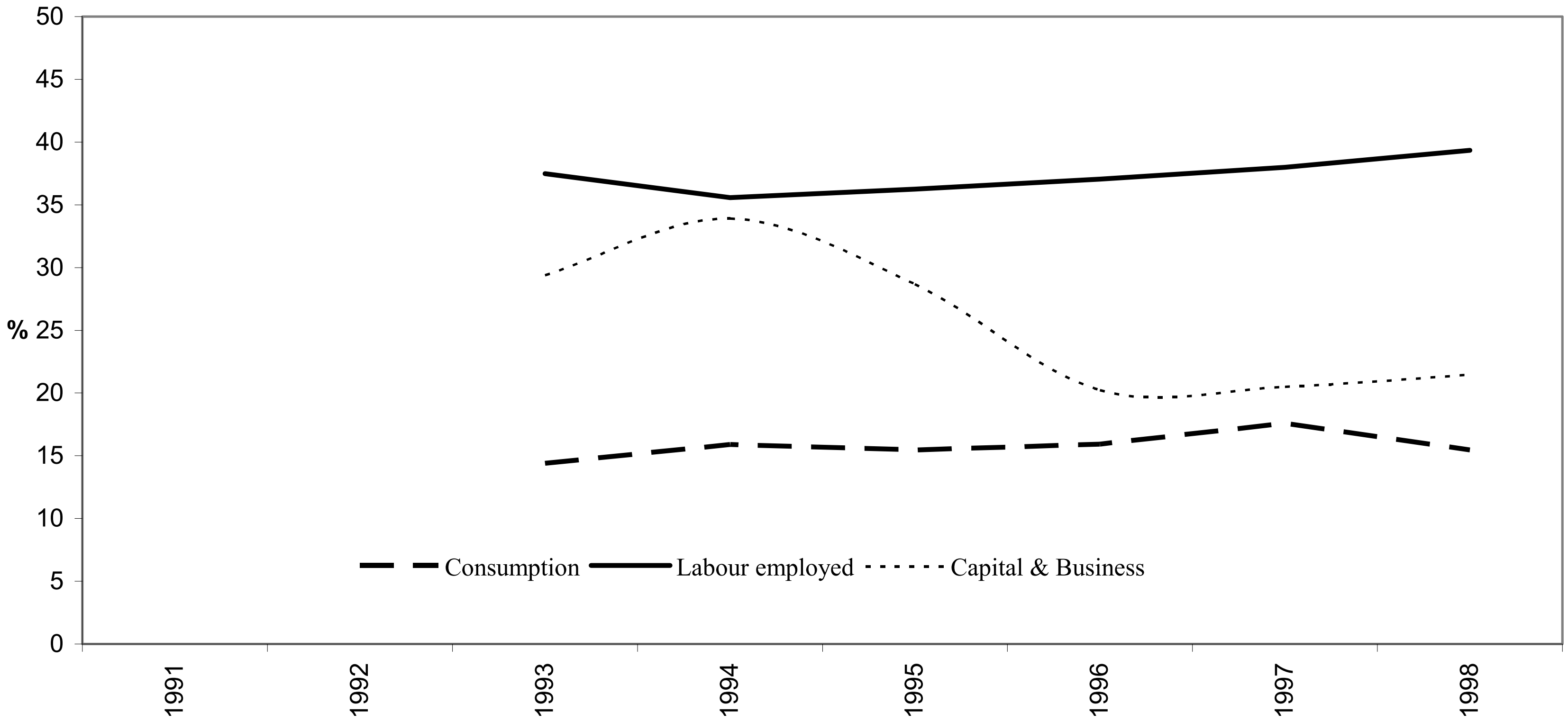
Keeping this in mind, we may see from Table 2 that the overall structure of Estonian taxation according to economic function broadly speaking is not unusual at all. Labor employed was the main source of tax revenues in Estonia in 1998 (19.8 per cent). A second high contribution came from consumption (12.7 per cent), whereas the shares

*Table 2* Structure and development of taxation by function and by implicit rates in Estonia, New members and EU 15, 1992-98

| | *1992* | | | *1994* | | | *1996* | | | *1998* | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | *Estonia* | *New members* | *EU* | *Estonia* | *New members* | *EU* | *Estonia* | *New members* | *EU* | *Estonia* | *New members* | *EU* |
| *Economic function* | | | | | | | | | | | | |
| Consumption | 11.4 | 13.6 | 10.9 | 13.5 | 14.5 | 11.2 | 13.5 | 14.7 | 11.3 | 12.7 | 13.5 | 11.4 |
| Labor Employed | 19.7 | 19.7 | 20.6 | 20.4 | 19.4 | 20.7 | 19.7 | 19.0 | 21.4 | 19.8 | 17.9 | 21.2 |
| Labor self-employed | 1.3 | 2.9 | 2.4 | 1.2 | 2.8 | 2.4 | 1.2 | 2.6 | 2.4 | 1.3 | 2.6 | 2.3 |
| Capital and business | 0.3 | 4.3 | 7.2 | 0.3 | 5.0 | 6.8 | 0.3 | 4.3 | 7.1 | 0.3 | 4.5 | 7.5 |
| *Implicit tax rates* | | | | | | | | | | | | |
| Consumption | 14.4 | 16.3 | 16.2 | 15.9 | 17.4 | 16.5 | 15.9 | 17.8 | 16.7 | 15.5 | 16.6 | 16.8 |
| Labor employed | 37.5 | 37.1 | 39.0 | 35.6 | 38.3 | 40.2 | 37.1 | 37.4 | 42.0 | 39.4 | 38.0 | 41.9 |
| Capital and business | 29.4 | - | 32.2 | 33.9 | - | 30.3 | 20.2 | - | 30.5 | 21.5 | - | 31.1 |

*Sources*: EU Commission (2000) for Estonia and New members (unweighted average); Eurostat (2000) for EU 15 (1997 unweighted average).
1992 implicit rates and all Czech rates refer to 1993. Implicit rates for capital and business are not available for all New members, except Estonia.

*Fig. 1* - Implicit Tax Rates



of self-employed labor as well as capital and business[8] were really very slight. Profits are the main components of the capital and business taxation. That from real estate and financial activities (shares and savings) is still quite low. Finally taxes on environment totaled 2.3 per cent in 1998, but 1.7 per cent of this was given by taxes on energy[9].

From the early to the late 1990s, the functional structure of Estonian taxation stayed almost unchanged. However, taxation of consumption increased by a little more than one point from 1992 to 1998, as a consequence of the increase of excise duties, as we have already seen. Taxation of employed labor went up by about two points, while that of self-employed labor remained constant at a very low level. That on capital and business practically did not go over the zero level.

Implicit rates are defined as the ratios of the total tax revenues assigned to an economic factor, divided by total National accounts income or cost of this factor[10]. Therefore, they show the weight of the fiscal burden suffered by any factor, for any dimension of the base. Consider again Table 2. In 1998 employed labor appears the factor more heavily taxed, at an implicit rate of near 40 per cent. This however means that average rates of income tax are low, given the total value of social contributions (33 per cent, as we saw in par. 2).

Furthermore, it is not surprising that the implicit rate on consumption (15.5 per cent) does not differ too much from the share by economic function of consumption's taxation. Obviously, when income per capita is as low as it is in Estonia (about 20 per cent of the EU average), consumption almost exploits the total amount of internal allocation of resources. Current implicit rate on capital and business looks no as gentle as one could expect just looking at taxation by function. This can easily be explained by considering the narrow share of these incomes on total ones'.

Looking back at the early 1990s, both the consumption and labor rates show an overall increasing trend, particularly during the first half of the decade, albeit with some recurrent ups and downs. The trend move was needed to compensate the slump down of capital and business rate which took place from 1994 to 1996. It was simply given by a wide cut in transfers due to the State by (public held) corporations during the U.S.S.R. regime.

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[8] Capital and business here are substantially given by National accounts operating surplus, less self-employed income. The main items are thus given by incomes and capital gains from the various kinds of wealth.

[9] Data not reported here. See EU Commission (2000).

[10] Notice that in this case self-employed labor income is included in operating surplus, i.e. capital and business.

## 4.2 The ability to attract foreign direct investments

During the 1990s more than 100 US $ 70 Billions of foreign direct investments flowed to the Central and Eastern European former communist countries and to the CIS new States. Indeed, they were highly correlated with cumulative privatization process but were also influenced by an investment friendly climate. Estonia performed quite well (Mitra and Stern 2003). Foreign direct investments reached 3.9 points of GDP in 1992-95, when the average values were 0.5 points for the Central an Eastern European and one point for the CIS countries. The Estonian score was still better in 1996-99, when FDI reached 5.2 per cent of GDP. During these years, however, also the performance of the European (3.3 per cent) and the CIS (2.5 per cent) countries improved. Contrary to a common trend, Estonian FDI were not very correlated with the diffusion of small enterprises, but were instead induced by a good interaction of tax and non-tax incentives. Tax-incentives (see also par. 5) firstly took the form of generous allowances and ad hoc tax-regimes. Subsequently it was realized that a more general mild tax environment would be preferable, according to the last suggestions of the literature (Holland and Owens 1997). It has been estimated that Tax Reform aAct of 2000 (which made exempt non distributed profit from taxation) may ave a substantial effect of attraction of FDI, thus contributing to improve Act's consequences on welfare (= consumption) (Funke and Strulik 2003).

## 4.3 A comparative view with other New members and EU 15 countries

We may compare Estonian tax system at 1998 with those of both New members and as well of EU 15 countries, by looking again at taxation both by function and by implicit rates. Estonian share of taxation on consumption is slightly lower than in New members and higher than in EU countries. However, this rank changes when considering the correspondent figures of implicit rates: the burden of Estonian taxes imposed on consumption is about one point under the level of both New members and EU countries. These three clusters do not much differ with respect to the share of taxation on labor employed and the corresponding implicit rates. Taxation spreads go up when comparing the burden on capital and business. Estonian figures are comparatively lower from both the two points of view (i.e. by economic function and by implicit rates). A tentative conclusion, at least for consumption and labor, is that the shares of burden are more determined by the relative wideness of the bases than by the specific statutory rates.

# 5. Tax reforms and further steps to get closer to the EU

## 5.1 Macroeconomic and budget outlook

During the 1990s Estonian General Government budget ran around the balance[11], also because the Central Bank is prevented by law from money financing. The economic slowdown of 1999 in the wake of Russian crisis increased however the deficit up to 4.7 per cent of GDP. VAT and excises went down, particularly on imports. Higher unemployment gave raise to a contraction of social contributions and income tax yields. During the following years and up to 2002 economic recovery was particularly buoyant (at about five per cent of yearly GDP increase) (EU Commission 2000b). A fast growth is forecasted to go on also in 2003 and 2004, notwithstanding the risks from external environment. Growth performance and fiscal discipline gradually changed the late 1990s Government deficit in a budget surplus which reached 1.3 points of GDP in 2002. Forecasted decreasing revenues coming from incentive-inducing tax cuts and additional expenditures due to EU and NATO membership will somewhat deteriorate budget balance, which is expected to turn negative but just to some half point of GDP in 2003-2004, a figure well inside the boundaries of Stability Pact. Inflation could go on to be the main Estonian departure from European financial requirements. But its rate, which reached 7.1 per cent in mid-2001, decreased to 3.5 per cent in 2002 and is forecasted stable at this level for both 2003 and 2004 (EU Commission 2003).

## 5.2 Last years' and planned tax reforms

Estonian tax system has been subject to some changes during last years and some other are planned for the near future (EU Commission 2000a, IBDF 2002b). A common aim is to make the system closer to the EU 15 standards. This target informed the reform (and increase) of excise duties (2001-2002) and a deeper change of VAT. Its regime was made consistent with EU "VI Directive" and a reduced rate (five per cent) was adopted for medicines, books and other minor items. International tax treaties were signed with some EU 15 countries.

[11] General government budget was in surplus by 2.2 per cent of GDP in 1997, in deficit by 0,3 per cent in 1998.

Importantly, only distributed (in any form) corporations' profits are now taxed, while those retained and invested have been made exempt. This is a relevant point (not exclusive of Estonia) which deserves a short digression.

The change has been justified as a general measure devoted to promote investments and growth. The true reason is somewhat subtler (Easson 1998). Recall that the main source of State financing was State owned enterprises transfers, under the U.S.S.R. regime. By transforming transfers into a corporation tax, very high rates emerged, around 60 per cent. This level would have discouraged any foreign location of investments in Estonia (and in any other former communist country). A preferential tax treatment was then accorded to foreign investors. As corporation tax rate fell, no reasons justified the survival of the specific regime.

Beginning from about 1996-98, tax competition to attract (Western) direct investments begun to increase among Eastern and Central Europe transition countries, and various kinds of tax incentives were introduced in corporation tax. Estonia has competed also by the allowance for retained profits. By means of a dynamic AGE model, this allowance has been estimated to be able to substantially increase investments and capital accumulation. However, some crowding out of consumption is likely to occur, as to leaving welfare not improved, at least in short-to-medium run (Funke and Strulik 2003).

### 5.3 The need for further steps

Summing up, Estonian tax system seems relatively close to EU 15 ones. Main rates are in line with EU 15 average. About the shares of broad aggregates of taxes, Estonian main deviation concerns a wider room for social contributions and indirect taxes. Directly or indirectly employed labor is thus heavily hint. Thus a double problem of both efficiency and equity arises. On the grounds of efficiency, a reduction of employed labor tax burden is recommended, to allow a more job-intensive growth, taking also in account that unemployment rate was still at 12 per cent in 2000 (European Commission 2002). The equity side of the problem comes (Tanzi and Tsibouris 2000) from the transition process having raised inequality in incomes per capita from a before-tax Gini of 0.23 in 1987 to a figure of 0.35 in 1995. Tax system should correct this fall of welfare, but it is difficult to envisage how it could do it. Since most incomes are highly concentrated around a low mean figure, the income tax redistributive effect is necessarily poor.

There will be further changes in tax rates in the field of indirect taxation. Estonia has got the transition periods for harmonizing excise duties of cigarettes and smoking tobacco until

2010 and VAT on heat and solid fuels sold to natural persons until 2007 (from 0% to 18%). Additionally, other he changes in tax rates will take place with joining the EU on 1 May 2004, for example excise duties on fuels will be increased, VAT will be levied at 5% on subscribed periodicals and scholarly textbooks etc. The transition period of tobacco products was applied for because it allows to increase excise duty step by step, otherwise, the sharp increase of tax rate would not effectively be administrated (the prices of cigarettes should be ca twice higher), cause the tax revenue loss (due to spread of illegal trade generated by price differences between Estonia and its neighbour countries) and will not correlate with the growth of the standard of living. Further recommended actions (EU Commission, 1998) suggest a stronger harmonization of tax policy with EU requirements, while preserving a simple and transparent tax policy of lower rates for enterprises. A strict control of expenditure is then needed, especially taking into account the trends of a declining and aging population. In fact we have already seen that in 1997 the Government reformed the pension system, by introducing a three-pillar scheme: this however had some additional costs for the public budget. To stimulate further growth, it would be helpful devising a simplified tax regime for small business which constitutes the most dynamic sector of the economy. For the same good aim, remaining tax exemptions and tax relieves should be eliminated. Along these lines the operating difficulties of the tax Administration could be alleviated (Mitra and Stern 2003).

## 5.4 Some information about Latvia and Lithuania

Both Latvia and Lithuania are similar to Estonia, with respect to location, wideness and, broadly speaking, the number of inhabitants and per capita income. The history of the three countries has been largely common, particularly during the last decades. Therefore it is usual to refer to these countries as the “Baltic States”, a community of about 6.5 millions of people, whose economy grew fast during last years. Unfortunately, for both Latvia and Lithuania we dispose of just few fiscal data in National account format, estimated by IMF-WB staff.

The story they tell shows few departures from the Estonian case. About current taxation, both Latvia and even more Lithuania are taxing less than Estonia. Social contributions are particularly low in Lithuania, while both income tax and VAT in each country are under the Estonian figure. This might be explained by the lower level of per-capita income of Latvia and Lithuania (around 3,500 $), compared with that of Estonia (about 4,300 $).

From the early to the late 1990s total fiscal pressure did not change much in Latvia, as did not change the main taxes’ basic features. At contrary fiscal pressure fell down in

Lithuania: the mark-oriented cut of corporation's tax rates was not adequately substituted. The high degree of centralization of both revenues and expenditures in Lithuania is quite similar to Estonian figure, while Latvia shows some more decentralization of both revenues (11 per cent of GDP) and expenditures (9.5 per cent) (OECD 2002 for about 1999). Both Latvian and Lithuanian Local governments do not have any own tax. They are financed almost exclusively (Lithuania) or largely (together with grants and non-tax revenues) by sharing to National taxes.

In Latvia (IBDF 2002a) individuals are subject to individual income tax. This is levied on all income received by the taxpayer, albeit with some standard exemptions, particularly with respect to capital incomes. As in Estonia, the rate is flat, at 25 per cent. A personal credit (about 450 €) is allowed for employment income; a credit (230 €) is allowed for each dependent. Corporations are subject to "enterprise income tax" which hits once for all corporate income in the hands of corporation, without any further levy on distributed dividends. Tax rate is decreasing from 2001 (25 per cent) and will reach 15 per cent by January 2004, but more than one favorable regime has been retained. Land and buildings are taxed by Local authorities at a rate of 1.5 per cent of cadastral value. VAT is due when the total yearly value of the supply or import of goods and services exceeds about 18,000 € for each taxable person. Standard rate is set at 18 per cent, but as by 2001 a reduced rate of nine per cent is applied to some essentialities. The National Insurance Fund provides benefits for almost all kinds of social disease. The rate of contributions given by employers is 26 per cent, that from employees is nine per cent, and that from self-employed is 32.3 per cent.

Lithuanian taxes are not very different (Ministry of Finance of Lithuania). The standard flat rate of personal income tax is set at 33 per cent. A reduced rate of 15 per cent is however applied to certain income sources as distributed profit, interest, pensions and insurances payments, royalties and properties' rents. Corporation tax has a standard rate on both retained and distributed profits of 15 per cent. The present structure of VAT is quite close to the EU's model. Standard rate is 18 per cent. In addition, the reduced rates of five per cent and of nine per cent are applied. The Law on VAT envisages cases when the supply is exempt and special VAT schemes for farmers, tourism services and so forth.

During the late 1990s growth went very fast in Latvia (at rates of five-to-eight per cent). This trend is projected (EU Commission 2003) to go on also in 2003-2004, driven by private consumption and fixed investments. Budget balance has benefited just slightly from economic expansion. This has been due to the already mentioned cuts of corporation tax, only partially compensated by VAT increases. Thus currently General government deficit runs at about two-to-three points of GDP on the upper bound of the Stability pact. Inflation rate is somewhat lower than in Estonia in the range of two-to-three per cent. The picture is not very different for Lithuania. Nearly as a paradox, GDP growth is somewhat lower, while both inflation rate (0.3 per cent in 2002) and Government budget (-1.9 per cent in 2002) seem to perform better. This is a result of a persistent strict fiscal discipline adopted from 1999, when Government deficit reached 5.6 per cent of GDP.

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**http://www.sdt.lt** - Lithuanian Department of Statistics

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