ZESZYTY NAUKOWE UNIWERSYTETU SZCZECIŃSKIEGO nr 802
Finanse, Rynki Finansowe, Ubezpieczenia nr 65 (2014)

s. 105–114

Taxation in the Baltic States – the case of Estonia

Alicja Kasperowicz-Stępień*

Abstract: Since its accession to the structures of the European Union, what should be noted is the dynamic development of the economies of the Baltic States. Particularly strong have been the economic developments in Estonia which introduced one of the most liberal and simple tax systems in the European Union.
The purpose of this article is explain the characteristics of the Estonian tax system.
In the study the following methods of research were used:
– analysis of the literature,
– analysis of normative acts,
– analysis of statistical data.

Keywords: Baltic states, economic situation, tax reform

Introduction

The Baltic states regained independence from the Soviet Union in 1991 and established their own market-based economies. In order to combat high inflation and to facilitate international trade, the countries of the Baltic States established fixed exchange rate systems at an early stage; Estonia and Lithuania opted for a currency board, while Latvia chose a conventional but tight peg. The countries privatized most enterprises and cut spending to reduce the size of the public sector. Among the Baltic States, Estonia is considered as one of the most successful examples of fiscal policy and of how to manage the development of a small economy. The Estonian economy was one of the fastest growing in the world until 2006 with growth rates even exceeding 10% annually.

During the world economic crisis, Estonia experienced the most moderate decline among the Baltic States; it recovered quickly and was able to join the European Monetary Union. It is one of the best according to the index of economic freedom and business environment assessments. Among the "new" EU member-states it is the third state (after Slovakia and Slovenia), which has introduced the euro – this took place in 2011.

The aim of the implemented tax reform in Estonia, was to build the simplest, most comprehensible and most convenient taxation system as possible. It is necessary to remark that Estonia was the first among the Baltic countries to adopt a flat rate income tax system.

* dr Alicja Kasperowicz-Stępień, Uniwersytet Ekonomiczny w Krakowie, Katedra Finansów, ul. Rakowicka 27, Kraków, kasperoa@uek.krakow.pl, Phone 606678047.

The purpose of this article is to explain the character the Estonian tax system, treated as the most liberal and simple system in the European Union.

In the study the following methods of research were used:

– analysis of the literature,
– analysis of normative acts,
– analysis of statistical data.

1. The macroeconomic situation in the Baltic States

The uniqueness of the Baltic States arises due to the fact these are the only former Soviet Republics that became members of the European community. For many years, their small economies were centrally planned and managed. Since the beginning of the transition process in the 1990s, the Baltic States have substantially reoriented their markets, including the structure of foreign trade as well as changes in exports and imports. During that decade, the Baltic states developed trade with the West, particularly with the Nordic countries, while simultaneously limiting the importance of countries in the East. This applies specifically to Russia and the other former Soviet republics because as early as 1998 Lithuania, Latvia and Estonia were experiencing the effects of the Russian economic downturn, when the ruble was devalued and there was a clear negative effect on Baltic exports. However, this was an important impulse to reorient their economies from the closed East-focused, centrally planned systems to open and diversified markets. For instance, at the beginning of the 1990s, less than 5% of Estonia's foreign trade was with Western countries, and of this, only 21% were exports. Then the privatization process remained crucial as early as 1995 in Latvia the share of the private sector of the country's GDP reached 60%, and in Lithuania it was even higher, about 65%, and 75% in Estonia. Moreover, relatively early after the transition, all of the Baltic States introduced their own currencies and had pegged exchange rates, which significantly reduced the possibility of using fiscal policy during the upcoming crisis (Dudzińska 2013: 2–6; European Commission 2012: 3–26; Deroose et al. 2010: 2–9).

Since 2003, and especially after the Baltic States joined the EU in 2004, all three economies witnessed an unprecedented and unexpected growth cycle, resulting in dynamic increases in GDP. Although Lithuania, Latvia and Estonia were very often described as the "Baltic Miracle" or "Baltic Tigers," an increasing number of imbalances in these countries became visible just before 2008. By then their economies were showing symptoms of overheating, meaning inflation had increased as a result of the prolonged high growth rate, especially in Latvia. In fact, the considerable-to-high domestic consumption, easy access to cheap credit and rapid inflow of foreign investment to the Baltic area decisively created the first symptoms of overheating as early as 2007 (Dudzińska 2013: 2–6; European Commission 2012: 3–26; Deroose et al. 2010: 2–9).

Table 1

Macroeconomic indicators in the Baltic States in the years 2003–2012

	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012
	GDP in mln Euro									
Estonia	8,718.9	9,685.3	11,181.7	13,390.8	16,069.4	16,235.1	13,969.7	14,371.1	16,216.4	17,415.1
Lithuania	16,576.1	18,244.8	20,969.1	24,104.2	28,738.8	32,414.3	26,654.4	27,709.7	30,958.5	32,256.9
Latvia	9,942.5	11,154.6	12,927.8	15,981.9	21,026.5	22,889.8	18,521.3	18,038.9	20,211.3	22,939.8
	HICP inflation rate in %									
Estonia	1.4	3.0	4.1	4.4	6.7	10.6	0.2	2.7	5.1	4.2
Lithuania	–1.1	1.2	2.7	3.8	5.8	11.1	4.2	1.2	4.1	3.2
Latvia	2.9	6.2	6.9	6.6	10.1	15.3	3.3	–1.2	4.2	2.3
Unemployment rate in %										
Estonia	10.0	9.7	7.9	5.9	4.7	5.5	13.8	16.9	12.5	10.2
Lithuania	12.4	11.4	8.3	5.6	4.3	5.8	13.7	17.8	15.4	10.6
Latvia	11.3	11.2	9.6	7.3	6.5	8.0	18.2	19.8	16.2	15.0
Budget balance as % of GDP										
Estonia	1.7	1.6	1.6	2.5	2.4	–2.9	–2.0	0.2	1.1	–0.2
Lithuania	–1.3	–1.5	–0.5	–0.4	–1.0	–3.3	–9.4	–7.2	–5.5	–3.2
Latvia	–1.6	–1.0	–0.4	–0.5	–0.4	–4.2	–9.8	–8.1	–3.6	–1.3
Public debt as % of GDP										
Estonia	5.6	5.0	4.6	4.4	3.7	4.5	7.1	6.7	6.1	9.8
Lithuania	21.0	19.3	18.3	17.9	16.8	15.5	29.3	37.8	38.3	40.5
Latvia	14.7	15.0	12.5	10.7	9.0	19.8	36.9	44.4	41.9	40.6
Foreign trade balance as % of GDP										
Estonia	–9.5	–7.8	–7.4	–11.3	–10.7	–3.2	4.9	8.1	4.4	1.0
Lithuania	–5.9	–11.3	–7.1	–8.9	–13.1	–12.4	0.9	–2.3	–1.7	1.4
Latvia	–14.1	–15.9	–13.2	–23.7	–20.7	–11.7	–1.7	–1.4	–6.2	–1.9

Source: Eurostat Database http://epp.eurostat.ec.europa.eu/portal/page/portal/eurostat/home (26.01.2014).

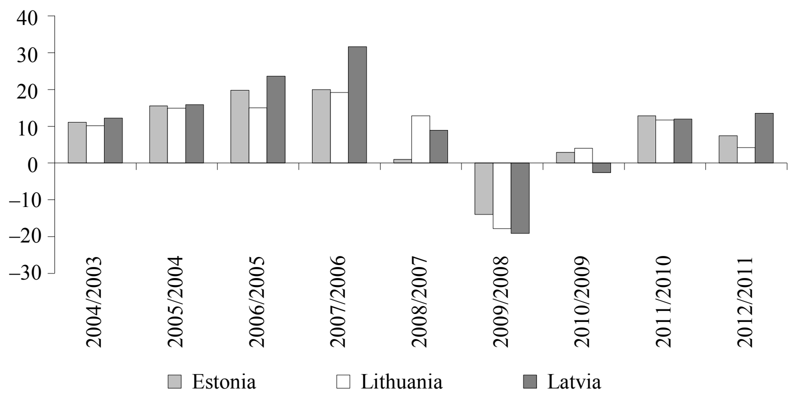

Figure 1. The growth rate of GDP in the Baltic States in the years 2003–2012

Source: Own study based on Eurostat Database http://epp.eurostat.ec.europa.eu/portal/page/portal/eurostat/home (26.01.2014).

The global economic crises at the end of the decade hit the open economies hard, with real GDP declining in 2009 and unemployment surging into double digits. However, the Baltic States are on a good road to recovery. In 2011, all three economies were growing rapidly again and particularly strong were the economic developments during 2010–2012 in Estonia. Export growth was strong, unemployment decreased to 10.2% in 2012. Estonia introduced the euro as of January 1, 2011. Although similarly to the neighboring countries inflation remained high in 2011 (Estonia 5.1%, Latvia 4.2%, and Lithuania 4.1%), in 2012 inflation declined to about the EU average. Estonia, with its lowest government debt level in the European Union and a small budget surplus continues to provide a stable and attractive business environment (Table 1, Figure 1).

2. Changes in the tax system in the Baltic countries – Estonia as an example

The Estonian tax system is one of the most liberal and simple systems in the world. In 2000, Estonia implemented a comprehensive tax reform with an aim to create the simplest, most comprehensible and most convenient taxation system possible. The main advantage of Estonia is the low-tax system that can be described as a simple system with no hidden surprises and that was basically established to promote business and increase profits (Ministry of Finance of Estonia 2013).

The taxation system of Estonia includes state taxes stipulated by the tax legislation and local taxes imposed by local governments or city councils in the respective territories according to laws and regulations. The state taxes are the following: excise duty; income taxes; gambling tax; value added tax; land tax; social tax; customs tariffs; heavy goods vehicle tax (Ministry of Finance of Estonia 2013).

It should be emphasized that Estonia is a European pioneer in income taxation having introduced flat income tax rates. The idea of a flat tax, a tax levied at a single rate, has become an increasingly discussed and implemented fiscal strategy across Europe and the rest of the world. Estonia, Latvia, and Lithuania adopted flat tax systems in 1994 and 1995, making them the first modern countries to adopt flat tax structures (Greenberg 2009: 7–12).

On January 1, 1994, Estonia introduced a flat-rate personal income tax of 26 %. Previously, Estonia followed a progressive tax system with the top personal income tax rate in 1993 held at 33 % (Table 2).

Table 2

The rates of the Personal Income Tax in Estonia in the years 2003–2012

	1993	1994	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012
PIT	16-33	26	26	26	24	23	22	21	21	21	21	21

Source: Ministry of Finance of Estonia (2013); European Commission (2012): 73–77.

Residents pay tax on their worldwide income. Taxable income includes, in particular, income from employment (salaries, wages, bonuses and other remuneration); business income; interest, royalties, rental income; capital gains; pensions and scholarships (except scholarships financed from state budgets or paid on the basis of law). Taxable income does not include dividends paid by Estonian or foreign companies when the underlying profits have already been taxed.

Unilateral relief for double taxation in respect of income derived from abroad is available in the form of ordinary tax credit with per country limitation. The credit is limited to Estonian tax computed on the item of income. Moreover, the double taxation of employment income is avoided by way of an exemption method if all the following conditions are fulfilled (Ministry of Finance of Estonia 2013):

- the person has stayed in the foreign state for the purpose of employment for at least 183 days over the course of a period of 12 consecutive calendar months,
- the specified income has been the taxable income of the person in the foreign state and if this is certified and the amount of income tax is indicated on the certificate (even if the amount is zero).

Non-residents pay income tax on their income from Estonian sources as listed in the Income Tax Act. Income taxable in Estonia includes income from employment or government services provided in Estonia; income from a business carried on in Estonia; part of the interest received from Estonian sources that is above market conditions; royalties arising in Estonia; certain types of capital gains; gains from the disposal of assets located in Estonia; directors' fees paid by Estonian enterprises; and the income of a sportsmen/women or an artiste from his/her activities in Estonia, pensions, and insurance payments (Ministry of Finance of Estonia 2013).

The basic exemption for resident individuals is 1,728 Euros per year (144 euros per month). There is also an increased basic exemption available for raising children (1,728 Euros starting with the second child), for pensions (2,304 Euros per year) and for compensation for an accident at work or an occupational disease (768 Euros per year). Taxpayers can also deduct their mortgage interest, training expenses and certain charitable gifts and donations (up to 1,920 Euros per year but not more than 50% of taxable income). Contributions to a supplementary funded pension system are deductible as well (up to 6,000 Euros or 15% of taxable income). Mandatory social security contributions are fully deductible. The same deductions are available for certain non-resident individuals deriving most of their taxable income in Estonia (Ministry of Finance of Estonia 2013).

Certain categories of income of resident and non-resident individuals are not subject to taxation, such as scholarships paid on the basis of law; fringe benefits (taxable at the level of employer); child allowances and other subsidies and benefits paid from the State, local, or Social Insurance budgets; per diem and accommodation reimbursements for business trips; compensation for the use of private vehicles; insurance proceeds and other payments received under insurance contracts; inheritances and gifts received; gains from the alienation of movables in personal use and from the alienation of taxpayer's main home; lottery winnings; expropriation payments and compensation received for expropriation. Income of the following persons is not subject to tax in Estonia: foreign diplomatic representatives, consular representatives, special or diplomatic missions, representatives of international or intergovernmental organizations and co-operation programs exercising their official functions in Estonia, plus persons employed with them who are not citizens or permanent inhabitants of Estonia. The above-mentioned persons, with the exception of the members of representations of co-operation programs, must be registered in the Ministry of Foreign Affairs (Ministry of Finance of Estonia 2013).

Taxable income derived by a self-employed person from the realization of self-produced, unprocessed agricultural products up to the amount of 2,877 Euros is not subject to income tax.

The withholding tax rate on royalties, payments to non-residents for services provided in Estonia, and on payments to non-resident artists and sportsmen/women is 10%. The withholding tax rate for certain pensions is also 10%. The period of taxation is a calendar year.

Employment income is subject to a withholding tax at the general rate of 21%. The withholding agent (enterprise or employer) has the obligation to remit the relevant amounts to the tax authority monthly. A taxpayer does not have to file a tax return when his/her annual income comprises only income on which the tax has been correctly withheld or when his/her annual income does not exceed the basic exemption. Otherwise, tax returns are due by March 31 of the year following the period of taxation (Ministry of Finance of Estonia 2013).

The amount of personal income tax received by local municipalities does not depend on tax deductions anymore. The introduction of new deductions, increasing basic exemption or reducing tax rate will have an impact only on the state budget tax revenue. The amount of income tax revenue for the municipality where a resident natural person lives is calculated as 11.4 per cent of the taxable income of the person (Ministry of Finance of Estonia 2013).

The Estonian corporate income tax system effective from 1 January 2000, has merited substantial interest from tax law scholars by virtue of its peculiarity and difference from traditional CIT systems.

Until 1 January 1994, personal income tax and corporate income tax were stipulated in two different acts. On 8 September 1993, the Estonian Parliament passed a new Income Tax Act, which regulated both personal and corporate income tax; this took effect on 1 January 1994. However, this act has been amended 34 times since then, and some of these changes undermined the taxable base, rendered the application of the Income Tax Act ineffective, and threatened to distort competition. It was, therefore, necessary to draft a new Income Tax Act (Lehis et al. 2008: 14–16).

On 1 January 2000, the new Income Tax Act came into force that stipulated the unique CIT system of Estonia. The main difference of the Estonian CIT system from traditional systems is that profits are not subject to tax at the moment when they are earned. Instead, taxation is deferred until the distribution of profits. Additionally, expenses not related to business and, therefore, not deductible in traditional CIT systems are subject to tax in the Estonian CIT system. Consequently, the difference from the traditional expression of the system is only technical (the timing of tax liability); however, the Estonian CIT system is easier to comply with both for taxpayers and for the tax administration (Lehis et al. 2008).

The aim of the CIT reform of 2000 was to facilitate the development of enterprises and attract investors. This objective was undoubtedly achieved, as the profits of the companies have grown significantly Furthermore, because of the CIT reform, the unequal treatment of different legal persons was eliminated, since all tax incentives were abolished. As a result of the reform, there are no special rules favoring certain economic sectors, giving an incentive for investments in certain regions, or special tax incentives for foreign investors (Lehis et al. 2008).

The main merit of the Estonian CIT system is that it is simple and easy to both understand and administer, by virtue of its minimum number of exceptions and deferral of taxation of profits from the moment when they are earned till their distribution. Such a difference in timing enables the preservation of all substantial elements of a traditional CIT system and at the same time to reduce considerably the number of technicalities from that required in a traditional CIT system.

Under a traditional system, in order to establish the taxable amount, the commercial profits are, first of all, calculated according to the accounting rules; then they are adjusted on the basis of the tax rules (e.g., certain expenses increase the taxable amount). In Estonia, distributed profits reflect the commercial profits and, additionally, non-deductible expenses are taxed on the cash basis. So, the only difference seems to be in timing; however, the Estonian CIT system has a considerable advantage – there is no need for amortization and depreciation rules. Moreover, since the Estonian Commercial Code stipulates that profits can be distributed with the proviso that there are no losses from previous years (§ 276 of the Commercial Code), there is no need for special rules regulating carrying forward losses. If the company has losses from previous years, the profits cannot be distributed and, therefore, are not subject to tax (Lehis et al. 2008).

Additionally, the distributed profits and payments taxable on the corporate level are not subject to personal income tax on the level of the recipient. Therefore, double taxation is fully avoided. Furthermore, as natural persons do not have a liability to declare such payments, the number of tax returns submitted, as well as that of possible mistakes and corrections of tax returns, is reduced. Consequently, the administrative burden and compliance costs are also reduced. Because of these advantages, most corporate taxpayers are satisfied with the Estonian CIT system and would not like it to be changed.

The tax rate is 21% of taxable income. The withholding tax rate on royalties, payments to non-residents for services provided in Estonia, and on payments to non-resident artist and sportsmen/women is 10%. Estonia has double taxation avoidance treaties with 48 countries.

Changes in tax rates for the years 2003–2012 are presented in Table 3.

Table 3

The rates of the Corporate Income Tax in Estonia in the years 2003–2012

	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012
CIT	31	31	31	28	22	21	21	21	21	21

Source: Ministry of Finance of Estonia (2013); European Commission (2012): 73–77.

Similarly as in other European Union countries the main source of incomes of the state budget is Value Added Tax (VAT). VAT is levied on transactions with goods and services in Estonia and on the import of goods. The standard tax rate is 20% of the taxable value; the reduced rate is 9% (books, newspapers, medicines, accommodations) and 0% in some cases (exports, intra-community supplies, vessels and aircrafts used on international routes). The VAT registration threshold is 16,000 EUR a year (Ministry of Finance of Estonia 2013; European Commission 2012: 73–77).

According to the VAT Act the export of goods means the dispatching of Community goods from the Community customs territory. The import of goods means the entry into the Community of the goods from third countries. The Intra-Community acquisition of goods means trading activities between Member States. The Intra-Community supply of goods is a taxable transaction, which must contain the transfer of goods to a taxable person from one Member State to another and the taxable person must be registered. The place of the supply of goods is a Member State where goods are dispatched and the VAT rate is 0%. Changes in tax rates of VAT in the period 2003–2012 are presented in Table 4 year (Ministry of Finance of Estonia 2013; European Commission 2012: 73–77).

The acquirer will pay VAT in the country of destination. The requirements of invoices are harmonized in the European Union. Accordance with the requirements of the European Union VAT Act defines, among other things such concepts as year (Ministry of Finance of Estonia 2013; European Commission 2012: 73–77): Taxable person, Taxable person with limited liability, Taxable person with limited liability, Taxable period.

Taxable person is a person engaged in business who is registered as a taxable person. A taxable person shall add to the amount of VAT to the taxable value of the goods transferred or services provided, calculate the amount of VAT due pursuant to pay, pay VAT, preserve documents and maintain records and issue invoices in accordance with the requirements. Taxable person with limited liability is a person, except a natural person not engaged in business or a registered taxable person, who is registered or required to register as a taxable person with limited liability. The threshold for obligatory registration as a taxable person is 16,000 Euros. The threshold for a taxable person with limited liability is 10,000 Euros in case of the acquisition of goods, there is no threshold in the case of the acquisition of services.

Taxable period is one calendar month and value added tax returns shall be submitted to the tax authority by the twentieth day of the month following the taxable period. The standard rate of VAT is 20%, the reduced rate is 9% and 0% in some cases.

Table 4

The rates of the VAT in Estonia in the years 2003–2012

	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012
VAT	18	18	18	18	18	18, 5, 0	20, 9, 0	20, 9, 0	20, 9, 0	20, 9, 0

Source: Ministry of Finance of Estonia (2013); European Commission (2012): 73–77.

Analyzing the tax rates in the period 2003–2012, it should be noted that in order to restore the budgetary balance the government of Estonia decided to increase the fiscal burden of VAT (Table 4). So the Estonian government decided to reform the tax system, the main goal for the future-shifting tax burden from income and employment to consumption and environmental taxes.

In addition to the above-mentioned taxes employers pay social tax on payments in cash and in kind made to natural persons. Sole proprietors pay tax on their business income. The social tax rate is 33% on a cross salary. Employers pay an unemployment contribution of 1.4% and employees 2.8% on a cross salary. In addition to the taxes a discussed tax system contains excise duties, gambling tax, land tax (0.1–2.5% of taxable value excluding buildings), customs tariffs, and heavy vehicle duty. Some insignificant local taxes like boat tax, advertisement tax, motor vehicle tax, animal tax also apply.

Conclusions

Since its accession to the structures of the European Union, it should be noted that the dynamic development of the economies of the Baltic countries took place. Particularly strong were economic developments in Estonia with its lowest government debt level in the European Union and a small budget surplus in 2010–2011 and a deficit of 0.2 percent of the GDP.

The Estonian tax system is one of the most liberal and simple systems in the European Union. Tax policy is guided by the following principles

- simple tax system,
- broad tax base,
- low rates.

Estonia is a European pioneer in income taxation having introduced in 1994 flat income tax rates and it has developed a unique corporate tax system since 2000. Thus, reform of the Estonian tax system should ensure a healthy and sustainable economy and competitive taxation system.

References

Deroose S., Flores E., Giudice G., Turrini A., (2010), The *Tale of the Baltics: Experiences, Challenges Ahead and Main Lessons*, European Commission, vol. 10.

Dudzińska K. (2013), *The Baltic States' Success Story in Combating the Economic Crisis: Consequences for Regional Cooperation within the EU and with Russia*, Policy Paper, PISM no. 6.

European Commission (2012), Taxation trends in the European Union. Focus on the crisis: The main impacts on EU tax systems, Eurostat.

Eurostat Database http://epp.eurostat.ec.europa.eu/portal/page/portal/eurostat/home (26.01.2014).

Greenberg D. (2009), *The Flat Tax: An Examination of the Baltic States*, CUREJ – College Undergraduate Research Electronic Journal, University of Pennsylvania.

Lehis L., Klauson I.H., Pahapill H., Uustalu E. (2008), *The Compatibility of the Estonian Corporate Income Tax System with Community Law*, JURIDICA INTERNATIONAL XV/2008.

Ministry of Finance of Estonia (2013), *Estonian taxation policies and reform plans*, www.fin.ee/?lang=e (26.01.2014).

OPODATKOWANIE W KRAJACH BAŁTYCKICH – PRZYPADEK ESTONII

Streszczenie: Od czasu przyjęcia w struktury Unii Europejskiej, należy zauważyć dynamiczny rozwój gospodarek Krajów Bałtyckich. Szczególnie silny rozwój odnotowano w Estonii, która wprowadziła jeden z najbardziej liberalnych i najprostszych systemów podatkowych w Unii Europejskiej. Celem tego artykułu jest wyjaśnienie charakterystyki estońskiego systemu podatkowego. W badaniu zostały wykorzystane następujące metody:
- analiza literatury,
- analiza aktów normatywnych,
- analiza danych statystycznych.

Słowa kluczowe: Kraje Bałtyckie, sytuacja ekonomiczna, reforma podatkowa

Citation

Kasperowicz-Stępień A. (2014), *Taxation in the Baltic States – the case of Estonia*, Zeszyty Naukowe Uniwersytetu Szczecińskiego nr 802, „Finanse, Rynki Finansowe, Ubezpieczenia” nr 65, Wydawnictwo Naukowe Uniwersytetu Szczecińskiego, Szczecin, s. 105–114; www.wneiz.pl/frfu.