

Tax reforms in the Baltic states and international tax competition

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Abstract

The paper describes tax reforms in Estonia, Latvia and Lithuania. Some comparison of tax structure and dynamics is made between the Baltic countries and other transition economies. Several issues concerning tax reforms and the future evolution of the tax system are discussed in the context of international tax competition and possible future harmonization of taxes in the EU integration framework. As a special issue, Estonian corporate tax regime introduced since 2000 is discussed.

Introduction

All the Baltic states have pursued tax reforms as an important part of economic transformation from planned to market economy. Tax reforms had an important role in the realization of responsible fiscal policy in which the Baltic states more or less succeeded in the 1990s. Starting from the last years of the 1990s, the EU accession process through screening and harmonization procedures and perspectives of future EU membership have strongly influenced the development of the tax system in all the Baltic states. However, as this process is not finished yet, several critical issues of harmonization of taxes are still urgent. These problems are discussed also in the current paper. The paper also tries to analyze questions inquired in (Mitra and Stern 2002). The details for the analysis of the tax systems of the Baltic states were obtained from several other papers (Ginevicius and Tvaronaviciene 2001, Kaulina 2000, Kerem and Randveer 2001, Kerem 2000, Zvidrina 2000). The general procedures for the evaluation of different taxes are given in (OECD Tax Policy Studies, 2000)

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Main features of tax systems

Estonia

The tax reform introduced personal income tax with progressive bands with rates ranging from 16% to 33 %. Those rates were replaced in 1994 by a flat 26% income tax. The corporate income tax was reduced in 1994 from 35% to 26%. So, the initial idea of reform was to apply the same flat tax rate for personal and corporate income tax in simplifying in this way the system and signaling to taxpayers neutrality of authorities to corporate versus non-corporate form of economic activities. Starting from January 1, 2000, the new Income Tax Law introduced several new regulations regarding personal and corporate income tax. The most disputable topic was exemption of undistributed profits from corporate income tax. These particular problems are discussed separately in the last part of the current paper.

The payroll tax has been introduced at the rate of 33% to finance social insurance (20%) and health insurance (13%), the employers paying the tax. A new law has been adopted which stipulates basics of the so-called three-pillar pension system with the second pillar of the system partly financed from redistributed 20% social insurance part of the payroll tax, partly from additional voluntary contributions through the regular payroll tax increased by 2%.

The value added tax of 10% was raised to 18% in 1992. The tax base is relatively wide with few exemptions such as subscribed periodicals, textbooks and other teaching materials, electricity produced by equipment using water or wind power taxed with 0% rate, heat energy sold to physical persons, housing cooperatives, churches and institutions financed from state or local budgets. The Estonian Government has promised to harmonize most of the still existing differences in VAT regulations with adopting a 5% tax rate for subscribed periodicals and textbooks starting of the day when Estonian EU membership will come into force.

The taxation of electricity produced by equipment using water or wind power and taxed now at 0% rate has been brought up by the Estonian Government in negotiations with the EU. The position of the Government is to achieve a transition period in harmonization of VAT for those items until the end of 2006 citing earlier solutions of the EU Commission and arguing with environmental protection purposes

of stimulating the use of sources of primary energy. The EU position has been that the VAT system applied in the EU foresees application of the same tax rate for the same items. The Estonian side still expects to achieve a positive solution in the negotiation procedure product (<http://spunk.mfa.ee/euro/liitumine.htm>).

Other issues still negotiated are VAT for heat energy with a transition period asked by the Estonian side for social reasons and registration of entities for VAT purposes Estonia having higher minimal level of turnover (16025 EUR) compared to the requirement of EU Directive 77/338/EMU article 24(2) to (6) (5000 EUR) asks for a permanent difference for permitted minimum product (<http://spunk.mfa.ee/euro/liitumine.htm>). There is also a tax free trade issue on ships commuting between Estonia and Scandinavian states, first of all Finland. The tax free revenue has been an important source of income of shipping companies. The negotiations are not finished yet on those issues and the Taxation chapter is still open in accession negotiations.

Latvia

Personal income tax is fixed at a level of 25%. The standard VAT rate is 18%. The payroll tax to finance social insurance was divided between the employer with 37% and the employee with 1% in the middle of the 1990s. The employer's part was diminished by 1% in 2000 and by another 1% in 2001. Social insurance is financed starting from 2002 with 16.5% paid by the employer as payroll tax and 16.5% paid by the employee, according to (Kaulina 2000).

The Corporate Income Tax law adopted in 1995 introduced the flat 25% tax rate. The stimulating policy to support investment has been realized through tax concessions. The 40% reduction of corporate income tax is applied for projects supported by the Latvian Government and only after the implementation of the respective project.

Starting from January 1, 2001, Latvian companies producing high tech and hardware or software products for computers are granted a 30% tax reduction of the corporate income tax. This tax reduction is guaranteed only to producers of whose output 75% consists of those products and who have ISO 9000, ISO 9001 or ISO 9002 certificates (Ginevicius and Tvaronaviciene 2001, p.135).

Lithuania

The flat 33% personal income tax has been applied since 1994. Social security contributions account for 34%, with employers paying 31% and employees 3% since 2000. The VAT is charged at a basic rate of 18%.

The corporate income tax history starts in Lithuania with 35% tax rate established in 1990 and reduced to 29% in 1991. Since 1993, a 10% rate has been applied to profits invested into the company.

Between 1993 and 1997, Lithuania applied different stimulating tools for foreign investors. From July 1, 1993 until the end of 1993, the income tax has been reduced by 70% for 5 years and by 50% for 3 more years for foreign companies. Since January 1, 1994 until August 1995, the regulation applied 50% reduction for 6 years. No requirements on minimal amount of foreign capital were applied. Since August 1995 until April 1, 1997, the regulation giving 3 years exemption from corporate income tax from the moment profit is received and 50% reduction for another 3 years has been applied if invested foreign capital has been worth at least USD 2 million.

Since March 1, 1997, a new regulation has been in force which allows to tax profit invested into the company at 0% rate. The same regulation put an end to the special treatment of foreign capital. Since January 1, 2000, the corporate income tax rate has been reduced to 24%. The 0% rate for invested part of profit remained in force (Ginevicius and Tvaronaviciene 2001, p.131).

There is a withholding tax of 15% on payments of income made by corporate entities to non-residents for marketing, consulting and intermediary services; a withholding tax of 10% for the right to use trade marks, licenses and company names; a withholding tax at a rate of 29% on dividends paid to shareholders. A withholding tax at a rate of 29% is levied on all income paid to foreign companies registered in low tax areas and generated by Lithuanian legal persons as well as from agents without legal status, i.e. personal enterprises and partnerships.

The Lithuanian corporate tax regulation has undergone more changes compared to Estonia and Latvia. This seems to be related to more frequent change of Governments, at least in comparison with Estonia. Lithuania also maintained special tax exemptions for foreign capital longer than Estonia or Latvia.

The case: Estonian corporate income tax

Special corporate tax exemptions on foreign investments have been abolished in tax regulations in force since January 1, 1994. However, earlier preferential treatment was still in force until the end of the period foreseen by the former regulation and adopted in the case of a particular company. So, a new regulation has been adopted on foreign investments realized since 1994.

In October 1997, the Parliament adopted an amendment into the income tax law allowing the Government to determine investments into particular regions to be subjects of tax concessions. Companies could deduct expenses made to acquire or upgrade fixed assets from taxable income. That law was applied from January 1, 1998 up to end of 1999. The idea of the regulation was to create advantages for investments into different regions of Estonia. In practice, all other regions except the capital Tallinn and Harju county surrounding it were objects of preferential treatment. Nevertheless, more than half of the total investments have been made into Tallinn and Harju county having around 30% of the total population of Estonia.

From January 1, 2000, resident companies and permanent establishments of foreign entities (including branches) are subject to income tax in respect of actual and deemed distributions. The tax is payable on any profit distributions and on transactions which could be treated as hidden distributions of profits, e.g. fringe benefits for employees, gifts and donations and transfer pricing adjustments. The corporate income tax rate is 26% of the taxable payments and expenses.

Under the new Estonian corporate tax law, income is treated as the profit withdrawn from an enterprise where the beneficiary of the income is either a physical person or a legal person. In the case of a physical person, the shareholders will later pay correspondingly less personal income tax because dividends have been taxed while the company distributed some part of profit. Though, distributed profits are taxed once.

In the case of legal persons, dividends paid to Estonian companies are not subject to income tax. Dividends paid to Estonian resident companies are exempt from further tax. Dividends paid to non-resident shareholders are subject to withholding tax. Non-resident persons with business income from Estonia pay 26%

income tax on the gain from the disposal of shares of an Estonian company where at least 10% of the shares were sold and 75% of the assets of the company comprise real estate or buildings located in Estonia.

In negotiations with the EU, the taxation of non-residents different from taxation of residents has been considered as discriminatory and in conflict with the Code of Conduct for Business Taxation ([http: spunk.mfa.ee/euro/ liitumine.htm](http://spunk.mfa.ee/euro/liitumine.htm)). The source of the problem is the consideration that the payment of income tax is postponed until the earned income is "inside" the entrepreneurship through reinvestment into the particular company or distribution of profits of that company to other companies through dividend payment, except non-resident legal persons. As a perspective member of the EU, Estonia has to guarantee the same rights to all residents of the EU. The problem is under investigation while the Taxation Chapter is not closed in Estonian negotiations with the EU.

Comparisons with general trends

The general trends of tax reforms are described in (Mitra and Stern 2002). The paper also includes some recommendations for future developments of tax systems in the Commonwealth of Independent States (CIS) and the Central and Southeastern European and Baltic States (CSB). The developments in those countries have been compared with industrial countries.

In the Baltic States, the share of tax revenues in the GDP has had different trends. According to data presented here, Estonian total budget revenue increased from 37.2% in 1991-92 to 38.7% in 1999-2000, tax revenue increased respectively from 34.4% to 36.1%.

In Latvia the share of total revenue increased from 36.6% to 38.7%, but the share of tax revenue decreased from 33.7% to 32.7%. In the Latvian case, the initial period is 1994-95, though the figures are not exactly comparable with Estonia or Lithuania. One reason for higher non-tax revenues has been proceedings from privatization of infrastructure objects realized in Latvia later than in Estonia.

In Lithuania, the share of total revenue in the GDP decreased from 39.9% in 1990-91 to 31.2% in 1999-2000 and tax revenues decreased from 35.5% to 29.4%. One reason for Lithuania's lower tax burden has been smaller social security and

payroll taxes (Estonia had the share of payroll tax contributions to the GDP 12.2%, Latvia 11.8% but Lithuania only 7.0% in 1999-2000).

Several trends in the Baltic states have been quite similar to those described in (Mitra and Stern 2002). There was an increase in the share of personal income tax in the total tax revenue in all the Baltic states accompanied with a very sharp decrease in corporate income tax, with Lithuania and Estonia being the leaders in the race to bottom. The results are in accordance with tax policy measures of those countries described above.

The trend of domestic taxes on goods and services has been different in Estonia and Lithuania compared with the general picture described in (Mitra and Stern 2002). In all the Baltic states, the share of those taxes increased in the total tax revenue. In Estonia, the VAT revenue increased together with the revenue from excises. In Latvia and Lithuania, the proportion of the tax revenue from the VAT decreased, but that decrease was more than compensated with increased revenues from excise taxes. One reason for those developments is related to very clear determination of, first of all Estonia but also Lithuania and may be less Latvia, to distribute the general tax burden more on indirect taxes. That is one assumption for reform of corporate income tax. Another important issue has been improved administration capacities which, together with harmonization of the rates of excise taxes toward the EU minimal levels (that process is not finished yet), made it possible to increase significantly also tax revenues.

The Baltic states, first of all Estonia, are quite close to recommended levels of different taxes in (Mitra and Stern 2002). Maybe they are even they trying to go too far in increasing the role of indirect taxes which could be considered as regressive distribution of tax burden.

Conclusions

The tax reforms in the Baltic states have been quite successful for the reason that all the states managed to avoid very critical budget deficits. Lithuania has the largest deficit but due to the reformed tax system the situation seems to be sustainable. Estonia and Latvia had some critical years with budget deficits but the situation was under control as evidenced also by the small amount of state debt.

The tax reforms in the Baltic states have been very much targeted toward creation of a competitive market environment. This is evidenced by corporate income tax regimes and by tax rates generally friendly for business activities. However, as several studies have demonstrated, the tax burden is not the sole element of competitiveness and attractiveness for the FDI. Better administration of existing taxes and harmonization with the EU requirements are next important tasks in improving the tax systems in the Baltic states.

There is practically no special treatment of small companies in the tax systems, except minimal level of turnover needed to register for the VAT procedures. On the other hand, in the creation of the business environment, the enterprise sector as general has been targeted. One option for future development of the tax system is to consider some possibilities of supporting small companies. Some activities in that field have been already realized in other areas of business support (credits, consultancy, business incubators).

As a new corporate income tax arrangement has been in force for a short time there is very limited information about its exact impact. Funke estimated the total impact of the tax arrangement on 6% of the GDP over a long period (Funke 2001). An evidence could be also the largest ever amount of the FDI Estonia received in 2001.

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