OVERALL TAX BURDEN STABLE DESPITE THE INCOME TAX REFORM

Throughout the period of regained independence in 1991, the Estonian Government has been trying to keep the overall tax burden as low as possible. While in 1995 the tax burden stood at 37%, by now it has decreased to 31% of GDP. At the same time, a clear trend of attempting to tax consumption rather than income can be perceived. Namely, decreasing the overall tax burden has derived from the reduction of personal and corporate income taxes (see Figure a).

As of 1994, an equal income tax rate of 26% was applied to both private persons as well as corporations. Later on, the income tax system has been vigorously reformed twice. In 2000, the procedure of imposing taxes only on dividends paid on corporate profit entered into force.[1] In 2005, the Government started to curb the personal and corporate income tax statutory rate, aiming to reduce it to 20% within three years.

In order to ensure budget balance, the new government coalition that came to office in 2005 prolonged the period of reducing the income tax rate until 2009, but the goal remained unchanged and by 2006, for instance, the statutory income tax rate had shrunk to 23%. The general tax rate virtually experienced no decrease because the Government has increased taxes on consumption.

On the one hand, this stems from the need to bring excise duties on fuel and tobacco products to the EU minimum level by 2010, as foreseen in the state budget strategy for 2007–2010. Pursuant to this goal, the excise duty rates on tobacco products were raised in 2005. In addition, the same year excise duties on alcohol were increased as well. The increase in revenue from consumption taxes in 2005–2006 has also been supported by strong domestic demand. Therefore, the overall tax burden has actually remained at the level prior to tax reductions, i.e. at the level of 2004 (see Figure a).

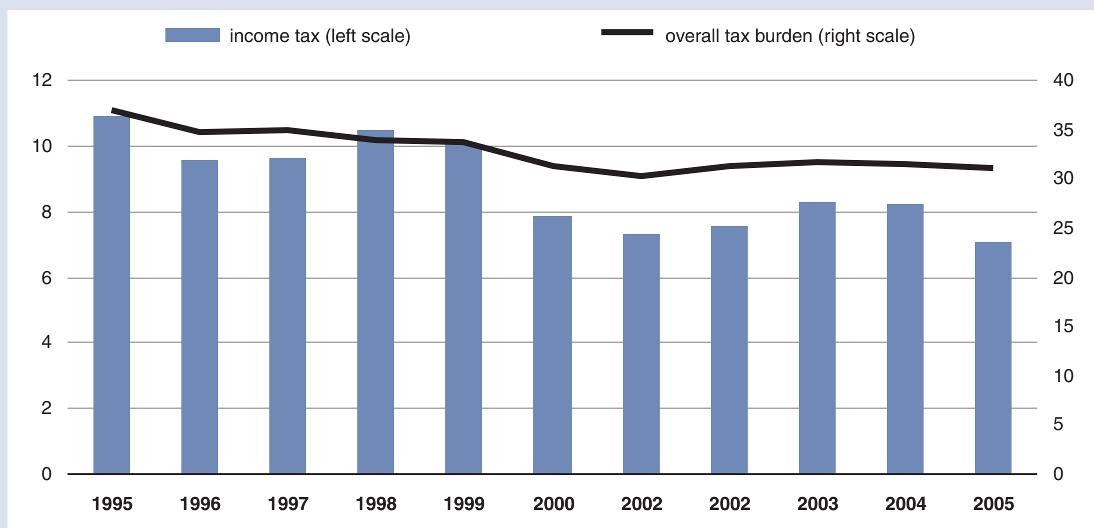

Figure a. Overall tax burden and collection of personal and corporate income tax during 1995–2005 (% of GDP)

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[1] The fact that retained earnings are not subject to taxes has sometimes been associated with a complete absence of corporate income taxes. In reality, this is but a postponement of taxation.

Although this has not been an end in itself, Estonia is one of the three or four countries with the lowest tax burden in Europe. Reducing taxes has always been associated with the Government's ability to control the increase in expenses. The general government budget balance has not deteriorated due to the decrease in the income tax rate either; on the contrary, the surplus even exceeds the level prior to reducing income taxes (see Figure b).

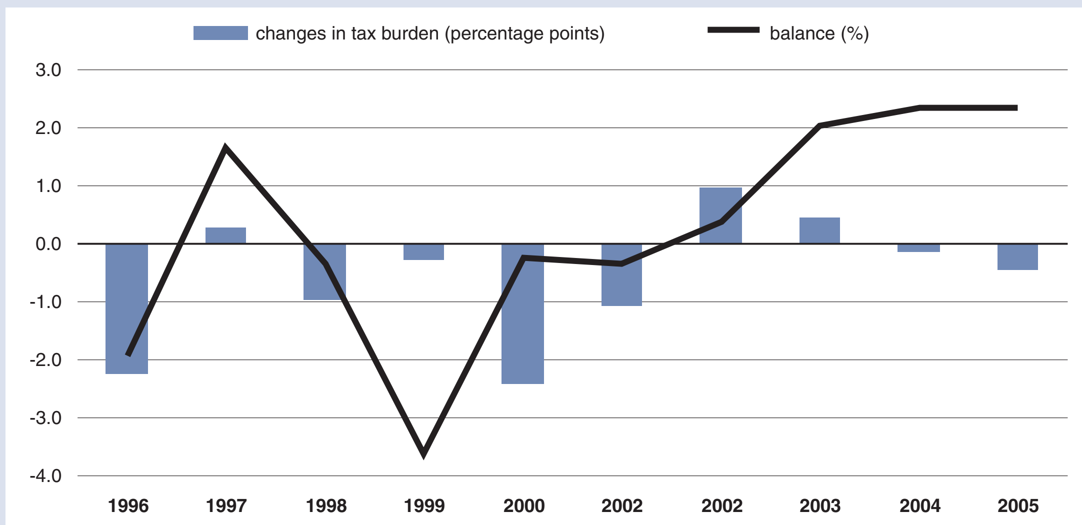

Figure b. Consolidated budget balance and changes in the overall tax burden during 1996–2005 (% of GDP)