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Experience of Flat Income Tax - the Estonian Case

1. Historic background

The first income tax law of the re-independent Estonia entered into force in 1991. Until 1994 Estonia applied a progressive tax rate for individuals (the rates were 16%, 24%, 33% and for a short period even 50%)[1]. Due to the very high inflation in that period, the progression scales had to be changed very often.

In 1994 Estonia introduced the flat tax rate. In general 1994 was the first year for Estonia to have its own tax policy and tax legislation the main principles of which have remained in force until today. Before 1994, the tax legislation was drafted on ad hoc basis without a clear tax policy and it was rather transitional system from Soviet tax rules to Estonia's own system. In 1994 several new tax laws entered into force, including the law for individual and corporate income taxes. Actually the Estonian legislation does not differentiate between corporate and personal income taxes; officially they have the same name- *tulumaks* (income tax).

The *Basic World Tax Code* prepared by Harvard University was used as an example to prepare the new law. There were several reasons for introducing the flat rate:

- It was suggested by the US tax advisers that an easy system with a **broad tax base and low tax rates** is **much easier to administer**. In 1994 the Estonian tax administration as well as entrepreneurs and other taxpayers were still relatively inexperienced in taxation matters, it was necessary to establish a system that would meet their administrative capabilities. It was decided to abolish the different exceptions and set up a relatively low tax rate.
- We should not underestimate the aspect of **the high inflation rate in the beginning of 1990s.** For example in 1992 (the year of replacing Soviet roubles with the Estonian own currency *Eesti kroon*) the consumer price index in Estonia had a growth of 1076%; in 1993 the increase was 89.8% and in 1994 47.7%. In case of a flat rate there is no need of frequent adjustment of tax brackets.
- The flat rate system is **easier to administer if the same tax rate applies both for individuals and legal persons**.
- The system with a broader tax base and one tax rate provides **more transparency.**

The Income Tax Act of 1994 remained in force until the end of 1999. In 2000, the current Income Tax Act entered into force. The reason for drafting a new law was the introduction of the modernised corporate income tax system. According to the new system, taxation of corporate profits is deferred from the time of earning of profit to the time of profit distribution. In other words, only distributed profits and non-deductible expenses are taxed.

In both cases, in 1994 (for personal income tax) and in 2000 (for corporate income tax), Estonia was the first country in Europe to introduce innovative (or unfamiliar as some people may say) tax regulations. Although during 1990s the Estonian flat rate system seemed to be rather weird in the European context, it has been followed by a number of countries by now.

2. Development and Basic Features of the System

Under the Estonian tax system all three types of income – earned income, business income and capital gains – are taxed at the same **flat tax rate of 23%**, irrespective of how much a person earns. Initially the tax rate was 26%, but in order to maintain the Estonia's attractiveness for investors and to create more jobs, the trend in current tax policy decisions is to reduce the taxes applicable

* Ministry of Finance, Estonia

[1] From 1992 until 1994 the corporate tax rate was 35%.

Chart 1: Tax Rate for Individuals and Legal Persons

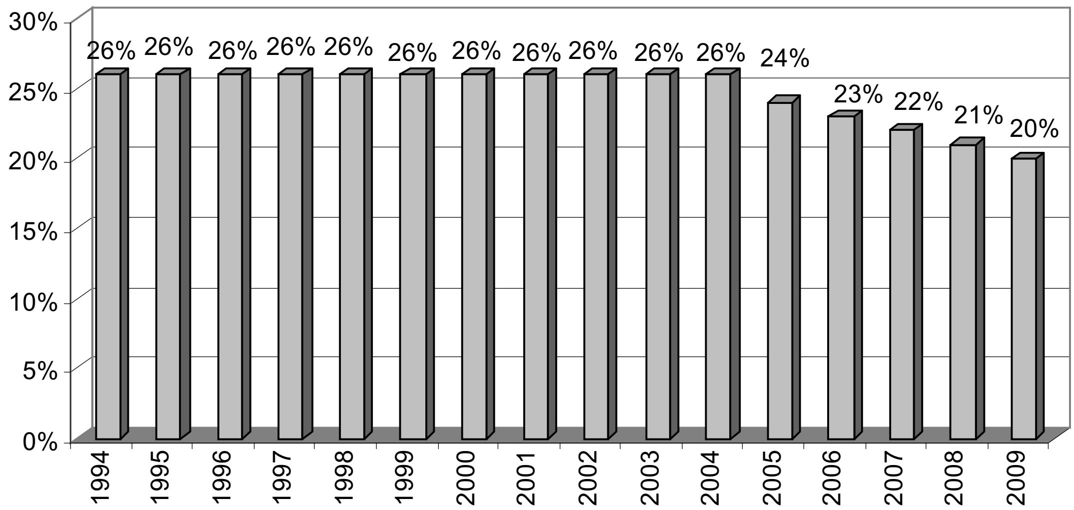
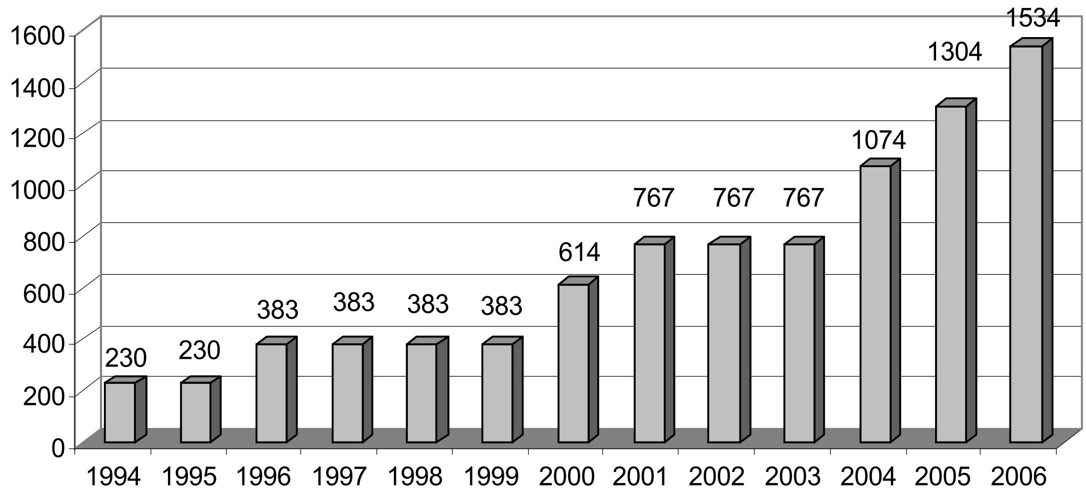


Chart 2: Basic Personal Allowance (EUR per Calendar Year)



Source: Ministry of Finance, Estonia.

on labour. Therefore the Estonian parliament has decided to reduce the income tax rate gradually to 20% by 2009 (see the chart 1).

The current amount of the annual basic tax-exempt income (**personal allowance**) is 24000 Estonian kroons[2] (approx. 1534 euros). Also, a further increase of the basic personal allowance is being discussed in order to provide better conditions for low-paid persons. Simultaneously, the excises on alcohol, tobacco and fuel have been gradually increased. Currently the preparation of a major ecological tax reform is in the pipeline, which will increase taxes on the usage of national resources. The following chart describes the changes of the personal allowance.

In addition to the basic personal allowance, the state pensions and pensions from compulsory pension schemes are subject to an additional personal allowance of 36 000 Estonian kroons per year (2298 euros)[3].

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[2] The fixed exchange rate is: 1 EUR=15,6466 EEK

[3] Before 2002 the state pensions were entirely tax exempt, but starting from 2002 there is a special allowance (non-taxable part) for the total amount of state pensions and benefits from compulsory pension schemes. It means that the tax base has been widened. Formerly the average amount of state pensions was very low and it was not acceptable for the society to tax them.

The main principle of the Estonian tax system is to keep the system simple; it is based on a combination of low tax rates and a broad tax base. It is, however, rather difficult to follow this principle in practice. Different interest groups and political parties tend to propose an unlimited number of different tax incentives. Tax incentives used in other countries are often used to explain such proposals. The risk of introducing new tax incentives is higher before parliamentary or local government elections.

Although the Ministry of Finance is committed to resist such kind of proposals, there still are some tax incentives for individuals. Most important of these are in form of **deductions** that can be made from taxable income. The list of deductions includes:

- mortgage interest paid to credit or leasing institutions (since 1996);
- educational expenses (all types and levels of education) (since 1996);
- contributions to voluntary pension schemes (since 1998);
- gifts and donations to charities and political parties (since 1999);
- trade union membership fees (since 2000);
- additional allowance per second and every following child[4] (since 2001).

The total amount of the abovementioned deductions[5] is limited to the lower of the following two conditions: 50000 Estonian kroons (3192 euros) per year or maximum of 50% of the taxable income. A taxpayer has to submit an annual income tax return for benefiting from these deductions. In most cases there is no need to submit the tax return and pay additional amounts of tax after the tax year because in case of most payments there is already a withholding tax in place (in calculating the withholding tax, the basic personal allowance is taken into account)[6].

Most of the **annual tax returns** are submitted voluntarily, for using different tax deductions available. In spite of different deductions, the system is simple and individuals spend in average 10-15 minutes to submit their returns. In principle, a taxpayer can access one's tax return over the Internet. The tax return is already pre-filled by the tax authority and the taxpayer simply has to confirm (or correct, if necessary) the data submitted in the return. In 2005, approximately 76% of taxpayers submitted their tax returns through the Internet. For income tax refunds the **electronically submitted tax returns** are processed first. The Estonian tax administration uses an electronic control system for processing income tax declarations. Tax returns are processed on the basis of risk assessment (so-called corridors with different colours (green, red, etc) as in case of customs). In 2005, the overpaid income tax was refunded during five working days to almost 90 per cent of those taxpayers who used electronic channels for submitting their income tax returns.

Estonia has an interesting scheme for the **tax allocation of income tax** paid by resident individuals. While income tax paid by non-residents and resident legal persons is collected to the state budget, the tax paid by resident individuals is allocated differently. In the latter case, the tax revenue is divided between the state and the local government of the taxpayer's residence. From 1994 to 2003 local governments received a certain percentage of income tax actually paid by resident individuals[7]. It meant that if the Estonian parliament decided to introduce any new tax incentive (deduction), to increase the basic personal allowance or to reduce the tax rate, there was a negative impact for local governments' budgets. But starting from 2004 the amount received by local governments is calculated as a percentage of a person's taxable **income**[8] (deductions are not taken into account). The excess amount goes to the state budget. In any case the income tax paid on pensions and capital gain goes to the state[9]. Such a system is not only a formula

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[4] The unused part of a child's annual personal allowance is transferred to one of the parents after the end of the taxation year. For 2001-2005 the additional allowance was available per *third* and every following child.

[5] The limit is not applicable to the contributions to certain voluntary pension schemes. Such contributions have separate limit -15% of the taxable income of the person (taking into account not employment income but all types of income).

[6] It is necessary to submit the annual income tax return if a person has received income from foreign sources, from self-employment, in form of capital gain or if the amount of income tax withheld is less than required by the law.

[7] Initially 52%, later 56% of the income tax actually received.

[8] For 2006 and onwards it is 11,8% of the income; the rate was 11,6% for 2005 and 11,4% for 2004.

[9] For small municipalities it is difficult to estimate capital gains derived by some wealthy habitants. It may lead to over- or underestimations of budget revenue. In case of pension income, most amounts of state pensions are still below the additional pension allowance and only minor part of retired people pay income tax on their pension. It would be distorting if the central government would transfer to municipalities substantial amounts of tax revenue that is actually not received.

of distributing income tax revenue, but also a rather stable basis for financing local governments.

In case of persons with low income, the tax administration transfers more money to the local government than the taxpayer actually paid.

Example:

Annual taxable income 30000 EEK
Basic personal allowance 24000 EEK

Taxable income 6000 EEK (tax rate 23%)
*Income tax payable **1380 EEK***

Income tax transferable to the local government of the taxpayer's residence:
*30000 EEK*11,8%=**3540 EEK***

In addition to the abovementioned changes, Estonia has made a number of amendments in its income tax law due **to the accession to the European Union**. The tax rules for non-resident individuals are becoming more and more similar to the rules applicable to residents. It is still an ongoing process to achieve the equal treatment of residents and non-residents in all aspects where it is necessary.

3. Economic Background and Results

People from countries with progressive income tax rates are sometimes afraid that a proportional tax rate might not reflect social values like solidarity between the rich and the poor people. In theory the **flat rate system meets both important requirements for an income tax system: vertical and horizontal equality.** In practice it is clear that equality principle is already reflected in the flat tax system as a person earning 100000 Estonian kroons is liable to a proportionately bigger amount of tax due than a person who earns only 10000 kroons (respectively 23000 kroons and 2300 kroons, not taking into account personal allowance that reduces the effective tax rate significantly more for the low-paid). Equality and fairness are among the guiding principles stipulated by the Estonian Constitution and are also reflected in the tax laws. Tax system is not the only vehicle for redistribution. If necessary, direct subsidies to poor people are also available.

Some progression has still remained in the flat rate system through the personal allowance. The Estonian system has sometimes been referred to as a system with a progressive tax scale of 2 rates: 0% and 23%. As described above, there are special deductions available for certain special groups of people (e.g. families with several children as well as retired persons).

Some counteractive role for social differentiation is also played by the social security contributions (social tax) that are based on solidarity principle. In case of employees, social security contributions (33%) have no upper ceiling and there-fore people with high income pay relatively more tax than they use services (e.g. health-care) financed through social security contributions.

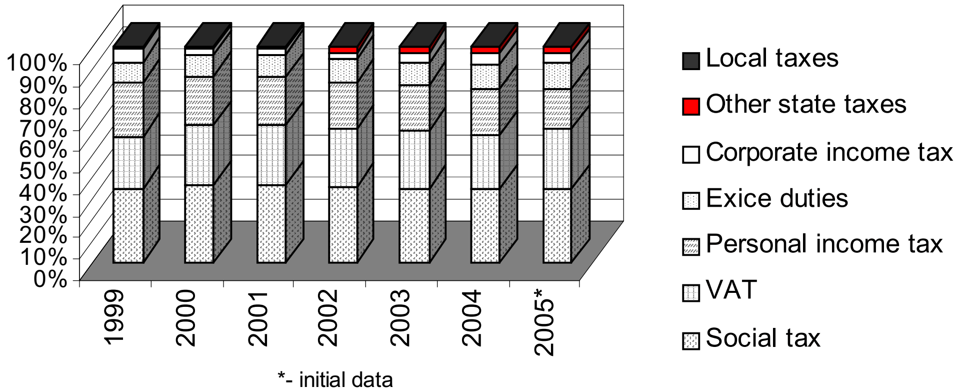
Switching from progressive tax rates to flat tax rate did not have a negative impact for the state budget. The same can be said for the reduction of tax rates during the recent years. One of the main reasons is that the general tax base remained the same. When tax rates were lowered, eliminating different incentives broadened simultaneously the tax base. The following table gives an overview of the collection of individual income tax to the state revenue before and after the tax reform of 1994.

In the Estonian tax structure, the personal income tax (PIT) raises about a quarter of total tax revenue. The importance of personal income tax is clearly decreasing. For instance, in 1999 it raised approximately 25% of tax revenues, but in 2005 only 18%.

	GDP real growth %	Taxes	Personal income tax	
		% of GDP	% of GDP	Million EEK
1990*	-6,5			
1991*	-13,6	31,7	6,6	120,0
1992*	-14,2	29,2	6,5	856,9
1993	-8,5	34,8	8,0	1 832,1
1994	-1,6	36,4	7,6	2 388,2
1995	4,5	35,4	8,3	3 593,1
1996	4,5	34,0	7,8	4 353,7
1997	10,5	34,9	7,6	5 240,0
1998	5,2	34,2	8,0	6 239,1
1999	-0,1	32,8	8,0	6 531,8
2000	7,8	31,6	7,1	6 594,4
2001	6,7	30,7	6,8	7 099,1
2002	7,2	31,9	6,7	7 806,4
2003	6,7	32,9	6,9	8 818,2
2004	7,8	32,5	6,7	9 416,9
2005 (forecast)	9,3**	33,5	6,1	9 727,0

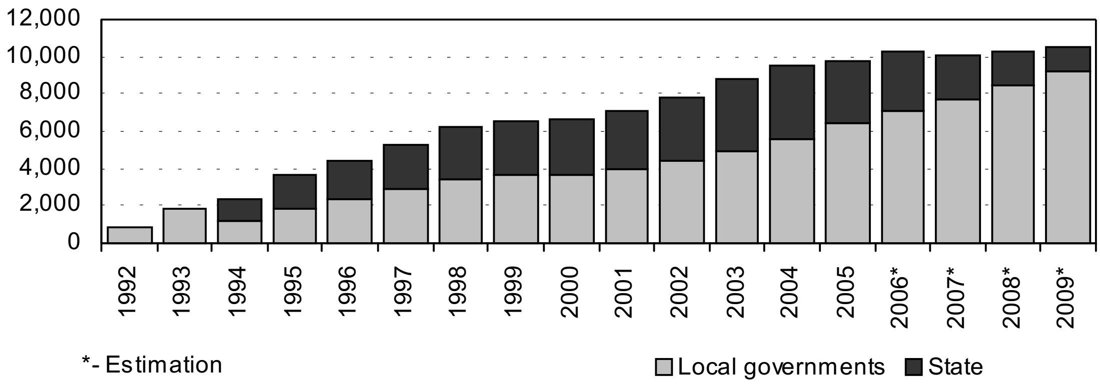
Source: Ministry of Finance, Estonia
Notes: * Actually Estonian national accounts start with the year 1993 and so the GDP growth numbers with the year 1994. The numbers for the former years are not so reliable.
**- annual growth based on 9 months of 2005.

Chart 3: Tax Structure



Source: Ministry of Finance, Estonia.

Chart 4: Personal Income Tax (Million EEK)



Source: Ministry of Finance, Estonia.

One of the reasons is the compulsory increase in tax rates of value added tax and excise duties. For keeping the former level of total tax burden, reduction of direct taxes is necessary. It also reduces the tax burden on labour and encourages the creation of new jobs.

In addition, the chart above indicates that the proportion of local taxes is almost zero. Local municipalities are financed mainly via state taxes (personal income tax and land tax[10]).

The following chart shows that since 1994 the proportion of the PIT received by local municipalities has increased. When Estonia will introduce 20% rate in 2009, local governments will receive the major part of the PIT.

4. Plans for the Future

Estonia has more than 12 years of experience of applying the flat rate. The experience has been only positive, there are no clear disadvantages. **Most of the Estonian people like the flat tax rate.** When analysing the political situation, it is clear that almost all political parties are in favour of the flat tax rate. The situation was different years ago when there were only few countries in Europe that applied the proportional tax rate. Recent decisions of other countries to apply a flat rate indicate that in 1994 Estonia made a step in right direction. The reintroduction of progressive rates in Estonia is very unlikely.

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[10] According to the law, land tax is a state tax but the local municipality where the land is situated receives all tax revenue. There are more than 200 municipalities and it is cheaper to administer the land tax centrally.

The main challenge for the future is to abolish some inefficient tax incentives or narrow their scope. It is clear that the tax laws are the most expensive tools for redistribution of wealth or achieving other goals of social policy. Tax incentives are often used by wealthy people, making their effective income tax rate rather regressive. It is easy to introduce new incentives but almost impossible to abolish them.

In broader terms, the **main goal for the future is shifting tax burden from income and employment to consumption and environmental taxes.** The objective is to leave more resources available to people to save and to invest and discourage spending their income on "bads" such as alcohol, tobacco and gambling. The project for preparing the ecological tax reform is still ongoing, according to which the inefficient and polluting usage of national resources would be taxed higher.