Corporate Income Taxation in Estonia. Is It Time to Abandon Dividend Taxation?

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Abstract: Estonia introduced a new corporate income tax system in 2000, under which corporate profit is taxed only when it is paid out as dividends to shareholders. The switch to distributed profit or dividend taxation was billed as a means to attract investment, support enterprises and increase employment. This Research Brief summarises the experiences and compares with developments in Latvia and Lithuania. The reforms improved liquidity and reduced the debt financing in Estonian companies and may also have given rise to increased investment and productivity at the firm level. The results are, however, less encouraging at the macroeconomic level. The tax revenue as a percentage of GDP has been very low since the introduction of dividend taxation, even during the pre-crisis boom in 2004-2007, and there are no immediate effects on labour productivity and GDP growth. The conclusion is that the switch to distributed profit taxation has not improved the overall macroeconomic performance in Estonia despite the easing of financing conditions and lower corporate income tax revenue.


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The issue

Estonia introduced a new corporate income tax system in January 2000, under which corporate income is only taxable when it is paid out as dividends to the owners of the company. This was a radical break with the previous system which followed the convention that corporate income is taxable in the year in which it is earned. The reform was passed in 1999 at a time when the Estonian economy was in recession due to the fallout from the Russian crisis. In the circumstances, the switch to distributed profit taxation was seen as a means of strengthening companies and attracting investment (Lehis et al. 2008).

The commercial code states that dividends can only be paid out if the company has been profitable. The statutory tax rate on dividends is the same as the flat rate on personal income. This rate was 26 percent until 2004, but was changed to 24 percent for 2005, to 23 percent for 2006, to 22 percent for 2007 and to 21 percent from 2008. The tax is generally withheld by the company distributing the dividends, meaning that domestic and foreign dividend recipients are treated equally. Estonia does not levy any other taxes on corporate dividends.

The dividend taxation system in some respects eases the administrative burden for companies of depreciation rules, investment tax credits and the forward-carrying of losses (Hazak 2008). This easing should not be overstated given that companies still have to comply with the commercial code, accounting rules, etc.

Estonia was the first country to adopt a corporate income tax system in which only dividends are taxed. Before Estonia joined the European Union in 2004 there was some doubt as to whether the system was fully in compliance with the rules of the internal market, in particular the Parent-Subsidiary Directive, which bars double taxation and requires equal tax treatment for domestic and non-domestic dividends (Lehis et al. 2009). However, Estonia was allowed to retain its unique corporate income tax system after minor legal changes were made from January 2009 in order to ensure full compatibility with the Parent-Subsidiary Directive.

This Research Brief records the experiences and lessons of the switch to distributed profit taxation in Estonia. The discussion focuses on the performance of Estonian companies and society at large. Given the similarities across the three Baltic States, developments in Estonia will occasionally be compared with developments in Latvia and Lithuania.

Effects on companies

Dividend taxation entails that profit is only taxed when it is distributed as dividends, while a traditional corporate income tax system entail that profit is taxable in the year in which it is earned. In this respect dividend taxation can be seen as the government effectively injecting risk-sharing capital into profitable companies, worth 21 percent of the profit since 2008 (Hazak 2008). The capital injection does not give the government any right of decision or any other form of influence over the operations of the company, so in effect the government acts as a risk-sharing partner without representation. If the company continues to be successful, the
owners will sooner or later wish to distribute the accumulated profits, and the government will then receive the tax revenue from the distributed profit.¹

The upshot is that the Estonian corporate tax system, unlike a traditional corporate tax system, makes state financing available to companies on very flexible terms. Such an injection of state financing is likely to be particularly beneficial for companies when capital markets are underdeveloped or distorted so that it is difficult to access financing on commercial terms.

Although state-financing for private companies can be seen as a way to address imperfections in private capital markets, the criteria for support may be questioned. Capital is provided only to companies that have made a profit and not fully distributed it. If profitable companies have problems accessing financing at reasonable terms, the same is likely to be true for start-ups and for other companies making losses. Restricting state-support to profitable companies may, in isolation, be seen as a way of distorting competition in favour of established profitable companies.

Although the government is effectively an investor in a company that has made a profit and not distributed it, the government does not influence or supervise the operations of the company. If, alternatively, the company had to seek financing from banks, the stock market or the commercial paper market, it would typically face some conditions or some degree of governance from these forms of financing. The risk of moral hazard is contained by the fact that tax deference is conditional on the profit being retained in the company.

An important issue of any tax is the incidence or distribution of the tax burden. Staehr (2005) makes the point that the economic incidence of capital taxation depends on several factors, including the openness of the economy to foreign investment. If capital markets are fully integrated, post-tax returns to capital are likely to converge across different countries. The upshot is that changes in the taxation of capital may not affect the post-tax return much in a small economy, but will instead over time affect the returns to other factors of production. Precise estimates of the economic incidence of corporate income taxation require complex empirical studies and no such studies are available for Estonia.

A number of theoretical studies have sought to ascertain the impact on companies of the switch from traditional corporate income taxation to dividend taxation. Hazak (2007) models the corporate financing decision of companies under different corporate taxation systems with a particular focus on dividend policy. It is shown that the dividend decision does depend on whether traditional corporate income taxation or dividend taxation is applied, but there is no one-to-one relation as the rules of the tax system interact with other factors such as the underlying consumption preferences of the investors.

Funke (2002) focuses on the investment decision of companies using Tobin’s q theory, according to which investments depend on the ratio between the return to installed capital equipment and the costs of acquiring capital equipment. Numerical simulations suggest that a switch to dividend taxation leads to an increase in the capital stock of approximately 6 percent in the long term.

¹ Although widely reported as such, the corporate tax rate is not zero as profits are taxed when they are paid out as dividends. This is also consistent with the fact that Estonia, unlike some other EU countries, has not become a tax haven since switching to dividend taxation (Lehis et al. 2008).
Masso & Meriküll (2011) construct a neoclassical growth model extended with endogenous corporate finance. The model is calibrated using Estonian data and various scenarios are simulated. The switch to dividend taxation leads to increased equity financing and reduced reliance on debt financing in the steady state. Investment increases and the result is an increase in the steady-state capital stock of around 9 percent, of output by around 4 percent and of consumption by around 3 percent. The results are robust to changes in the model specification and calibration.

A few empirical studies have considered the effect on companies of the switch to dividend taxation. Hazak (2009) uses company-level data from 1995 and 2004 to study the capital structure and dividend decisions of Estonian companies before and after the switch, identifying the impact of the switch in time terms. The conclusion is that after the switch to dividend taxation in 2000, companies reduced their dividend payouts and reduced their reliance on external financing. The analysis also suggests that accumulated profits are held in large part as liquid assets and not invested in productive assets.

Masso et al. (2013) use company-level data and seek to identify the effect of dividend taxation using difference-in-difference and matching methods where the performance of companies in Estonia are evaluated against the performance of comparable companies in Latvia and Lithuania before and after the switch. The Estonian companies accumulate relatively more liquid assets and rely less on debt financing after the reforms. The Estonian companies also seem to invest more and exhibit higher total factor productivity growth, but these effects are estimated imprecisely and hence subject to some uncertainty. The positive effects of the reforms appear to be most pronounced for smaller companies.

**Effects on society**

Economic policy should ultimately address the welfare of individuals in society. Policies seeking to improve the economic environment for companies are of benefit to society only insofar as they eventually improve conditions for individuals. Whereas the previous section considered the performance of companies in Estonia, this section discusses broader societal developments.

The objective of corporate income taxation is in large part to generate tax revenue and thereby spread the tax burden across different tax bases. The statutory corporate income tax rate has been higher in Estonia than in Latvia and Lithuania since 1995. However, different macroeconomic developments and different rules on income definitions, deductions and the timing of taxation mean that there is no close connection between the statutory tax rates and the revenue from corporate income tax. Figure 1 shows corporate income tax revenue as a percentage of GDP in Estonia, Latvia and Lithuania for the period 1995-2011. A number of interesting observations follow.

The first observation is the collapse of corporate income tax revenue in Estonia following the switch to dividend taxation. Revenue hovered at around 2 percent of GDP in 1995-1999, but

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fell to around 1 percent of GDP in 2000-2002. This development is particularly striking given that 2000-2002 were years of rapid economic growth after a downturn in 1999 caused by the Russian crisis. The substantial decline in corporate income tax revenue in 2000-2002 reflects the fact that companies paid out only modest dividends in order to benefit from the new corporate income tax system.

Figure 1: Corporate income tax revenue in the Baltic countries, 1995-2011, percent of GDP

![Graph showing corporate income tax revenue in the Baltic countries from 1995 to 2011 as a percentage of GDP. The graph is labeled with Estonia, Latvia, and Lithuania.](source: Eurostat (2010, p. 308; 2013, p. 189)

The second observation is that while corporate income tax revenue in percent of GDP increased markedly in Latvia and Lithuania during the boom years 2004-2007, it remained largely constant and at a much lower level in Estonia. This divergence took place despite the broadly similar macroeconomic developments in the three countries. During the years following the outbreak of the global financial crisis in 2008, the revenue held up pretty well as a percentage of GDP in Estonia, while it fell dramatically in Latvia and Lithuania. Anecdotal evidence suggests that an important factor behind the stable corporate tax revenue in the crisis years is that company owners were in many cases experiencing economic problems and so they maintained their dividend payouts.

Figure 1 illustrates important differences between the traditional corporate income tax systems in Latvia and Lithuania and the dividend taxation system in Estonia. Since the switch to dividend taxation the revenue from corporate income taxation has on average been much lower in Estonia than in the other two Baltic States. This is the case even though the statutory tax rates have typically been higher in Estonia than in Latvia and Lithuania. The revenue has been a-cyclical in Estonia, i.e. broadly constant as a share of GDP, whereas it has been strongly counter-cyclical in the other two countries, i.e. increasing during booms and decreasing during downturns. The more stable corporate income tax revenue of the dividend tax system may facilitate forecasting and budgeting, but it also reduces the overall counter-cyclicality of the tax system.
While the drop in 2000-2002 can be seen as an adjustment to the new tax regime, it is arguably more surprising that the corporate tax payments did not catch up in the following decade. It is outside the scope of this Research Brief to provide a comprehensive discussion of the factors behind the modest revenue from corporate income tax in Estonia, so some comments are in place.

It is unlikely that the differences in tax revenue stem from differences in performance by companies in the three countries as the macroeconomic developments were quite similar across the countries. Moreover, data on the *implicit* or effective tax rate suggest that capital and business income has typically been taxed at a lower effective rate in Estonia than in Latvia and Lithuania, particularly during the pre-crisis boom in 2004-2007 (Eurostat 2013, pp. 72, 104, 108).

A possible explanation could be that Estonian companies invested more in productive capital than did Latvian and Lithuanian companies. Data on business investments by the corporate sector in percentage of GDP are available from 2000. The rate of business investment was very similar in Estonia and Latvia throughout the period 2000-2011, but somewhat larger than in Lithuania (Eurostat 2014, code: *nasa_ki*, Business investment to GDP ratio).³

It has been argued that the postponed taxation of profits makes it easier for profitable corporations to avoid taxation through legal and illegal means, simply because more time is available for companies to take measures to avoid or evade taxation. No academic studies have examined this issue. Meriküll *et al.* (2013) analyse data from a Baltic-wide survey in which business managers are asked to estimate the extent of underreporting among companies in their own industry. The perceived underreporting is substantial in all three countries, but not higher for Estonia than for Latvia or Lithuania. Kukk & Staehr (2014) provide estimates of income underreporting by households with business income in Estonia and find very substantial underreporting among such households.

The most innocuous explanation of the modest tax revenue is that companies in Estonia continue to accumulate liquid assets on the balance sheet as documented in Hazak (2009) and Masso *et al.* (2013). Such an accumulation of assets would be expected to make companies more resistant to negative shocks such as reduced demand or disruption to financing. Experiences after the outbreak of the global financial crisis do not suggest, however, that Estonian economy weathered the crisis any better than the economies in Latvia and Lithuania (see below).

The loss of tax revenue after the switch to dividend taxation in Estonia may or may not entail substantial welfare effects depending on distributional objectives and the excess burden of other sources of tax revenue. No studies have examined these issues for Estonia, arguably because the required computations are exceedingly complex. It is clear, however, that overall macroeconomic developments since 2000 have not differed markedly across the three Baltic States.

³ Data on the economy-wide investment rate are available from 1995. Investment rates for Estonia and Latvia move together, but are somewhat higher than for Lithuania (Eurostat 2014, code: *nama_gdp_c*). This pattern, however, precedes the switch to dividend taxation in Estonia. It is also noticeable that the high aggregate investment rates in Estonia have not on average resulted in higher rates of economic growth than in the other two countries (see below).
Figure 2 shows an index of real GDP for Estonia, Latvia and Lithuania. The performance of the countries has not differed much since 2000, or even since 1995 for that matter. If anything Lithuania seems to have exhibited slightly higher rates of economic growth than the other two countries, but the differences are marginal. Figure 2 also shows that the GDP decline after the outbreak of the global financial crisis was of roughly the same magnitude in Estonia as in Latvia and Lithuania.

Other macroeconomic data confirm that Estonia has generally not outperformed the other two Baltic States after the switch to dividend taxation. GDP per capita in purchasing power parity adjusted terms or labour productivity growth exhibit the same dynamics in the three countries. Estonia does however have somewhat lower unemployment and lower rates of emigration, but these developments cannot straightforwardly be linked to the switch to dividend taxation, given that the main effect of the switch is improved access to capital. The overall conclusion is that the macroeconomic effects of the switch to dividend taxation are either modest or will only appear after a very long gestation period.

Conclusion

This Research Brief has discussed the unique Estonian corporate income tax system, under which corporate income is taxed only when it is paid out as dividends. The system has been in place since 2000, and after more than 13 years it should be possible to reach some conclusions about the effects and the desirability of the system.
The reform appears to have improved liquidity and reduced the reliance of companies on outside financing. At the macroeconomic level the reform appears to have led to a marked reduction in revenue from corporate income tax, including during the boom in 2004-2007. The corporate income tax intake is largely a-cyclical in Estonia and does not contribute to a stabilisation of the business cycle. It is also noticeable that whereas the reform has benefited companies in Estonia, it is harder to identify positive effects at the macroeconomic level. Labour productivity and GDP have not grown faster in Estonia than in Latvia and Lithuania. The apparent disconnect between developments at the company level and developments at the societal level constitutes an interesting area for future research.

Since re-independence in 1991, Estonia has spearheaded a number of radical economic policies such as the currency board, flat income taxation and pension reform, and many of these policies have subsequently been implemented by other countries, chiefly in Central and Eastern Europe. The dividend taxation system has, however, not been adopted widely by other countries. A version was adopted by Moldova from 2008, although the withholding rules are very different (Lehis et al. 2008).

The overall conclusion of this Research Brief is that the benefits of the switch to dividend taxation in Estonia are rather diffuse, especially at the societal level, whereas the costs in the form of lower and a-cyclical tax revenue are noticeable. The Estonian dividend taxation system was put into place at a time when it was difficult for companies to access external financing as capital markets in Estonia were under-developed and crippled by the Russian crisis. State-financing of profitable companies through deferral of corporate income taxation may be a means of alleviating the effects of shallow financial markets. Both financial intermediation and the corporate sector have changed markedly since the reform of the corporate income taxation system in 2000, and these developments raise the question of whether the Estonian dividend taxation system will be the most appropriate corporate income tax system in the times ahead.
References


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