Lithuania's Tax Reform Overshadowed by Estonia

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Elena Leontjeva highlights lessons from the abolition of the profit tax in Estonia

While Lithuania is contemplating the revocation of a zero-tax rate on reinvested profits, Estonians do not feel any nostalgia for corporate taxation, ended two years ago by a coalition government, composed of the Reform Party, Conservatives and Social Democrats. The removal of the corporate income tax was also in the official programme of the Lithuanian government, but it never materialised. What has Estonia won and Lithuania lost?

After the reform was implemented, companies registered in Estonia ceased to pay the profit tax. A 24-percent tax is levied only on dividends that are paid to individuals and foreign legal entities. No tax is charged on dividends that are paid to Estonian legal entities. Profits can thus freely circulate among companies.

At the same time tax rules were tightened up, exemptions were removed and all expenses made for other than business purposes were taxed. The aims were twofold: to ease the tax burden for economic activity and to prevent the concealment of profits that was possible by making outlays through companies. The new order created strong incentives to report real profits and to freely use them in furthering economic activity.

Changes were also made to reporting requirements. Companies are required to submit monthly reports to tax inspections on all outlays that are untypical of business activity and all transactions that were subject to withholding tax. All procedures and reports that had been used to calculate and pay the tax were abolished. It is these procedures that create the maze of bureaucracies and make companies err and transgress. The Estonian reform was an unprecedented step towards a new business ethics as it eliminated a factor that was eroding corporate governance.

The country's economy did not dither to show results. During the first year Estonian companies boosted investments by an average of eight percent. Investments of small companies rose by a total of 30 percent. Foreign investments increased one and a half times. Of this, reinvestments made up 29 percent. In 2000 Estonia's GDP grew by a striking 6.4 percent, as compared with Lithuania's mundane 3.3 percent. While state redistribution in Estonia is almost the same as in Lithuania (35 and 37 percent respectively), it is financed with a much lower, 26-percent personal income tax and without any profit tax.

It is understandable why neighbouring countries reacted with dismay to Estonia's bold move. Global competition explains the fears of global bureaucracy. Estonia may have to impose the same tax on all dividends in order to eschew discrimination of foreign entities for which it is being reproached. It would also be advisable to allow branches of international companies to use traditional tax rules tax so that in the meantime they can avoid the specifics of such pioneers as Estonia. While others babble away, Estonian reformers know better than to go back to the marshland of corporate taxation.