Zero Tax on Reinvested Profit – the Example of Estonia

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Corporate taxation in Estonia

The system of taxation of corporate profits, introduced in 2000 in Estonia, is unique. Under this system ***the reinvested profit is not taxed***, only the distributed profit is taxed. Thus, the taxation is shifted from the moment when profits are earned to the moment when profits are distributed to the owners of the capital. This is the reason why the Estonian system of corporate taxation became well known as "zero corporate profit on reinvested profit".

Corporate tax is applied to all distributed profit irrespective of the way it is distributed, including:

- dividends and other profit distributions
- gifts, donations and representation expenses
- expenses and payments not related to business
- fringe benefits

In 2004 the Parliament of Estonia decided to cut the tax rate from 26% in 2004 to 24% in 2005, 23% in 2006 and to reach a 20% tax rate in 2007. The tax base is the gross distributed profit (including the tax), i.e. the tax rate on the net distributed profit is 23/77 of the amount.

Before the introduction of the zero tax on the reinvested profit in Estonia, there existed depreciation allowances – up to 8% for buildings and 40% for equipment. Because there is no taxation of the profits since 2000, there is no need for depreciation allowances.

Revenues in the government budget

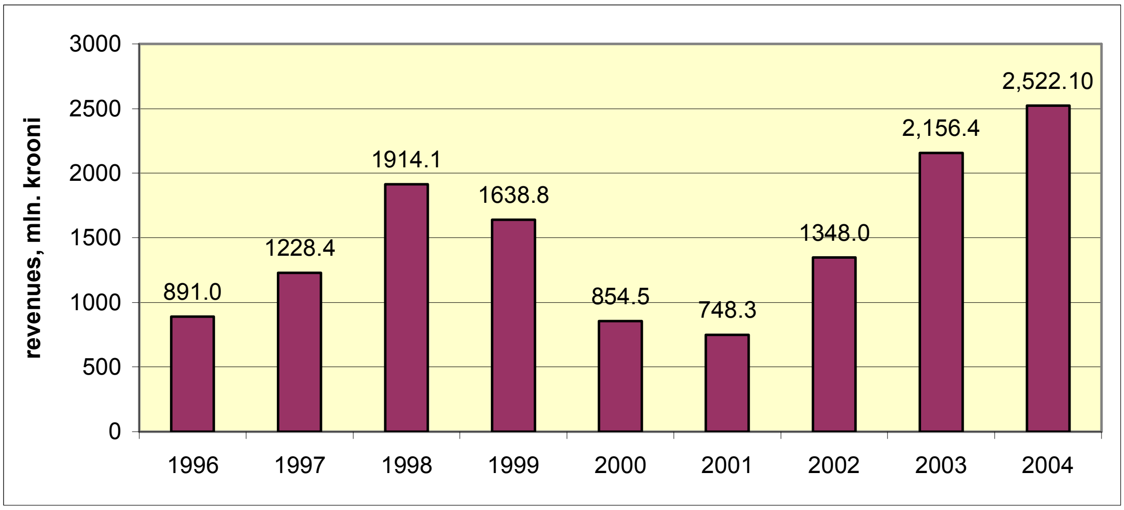
In the first years after the introduction of zero corporate tax on the reinvested profits the revenues from this tax in the consolidated budget decreased nearly twice. In 1999 the revenues were 1638.8 million krooni, in 2000 and 2001 the revenues are 854.5 and 748.3 million krooni /see graph 1/. Part of the explanation for this fall of the tax revenues is connected with a transitory rule, which allows to companies that pay dividends to use tax credit for the profit tax, paid before 2000.

However, the drop of tax revenues is short lasting – only three years later, in 2004, the tax revenues from he corporate tax increased nearly four fold and reached 2522 million krooni. Despite the zero corporate tax on the reinvested profit, the revenues from the corporate tax recovered within a few years.

The same tendency can be seen in the corporate tax revenues as percentage of the gross value-added (GDP) /see graph 2/. In the first two years after the introduction of zero corporate tax on the reinvested profit the corporate tax revenues dropped more than two times, but after that rapidly recovered. Moreover, the corporate tax revenues reached levels higher that the average level for the last nine years.

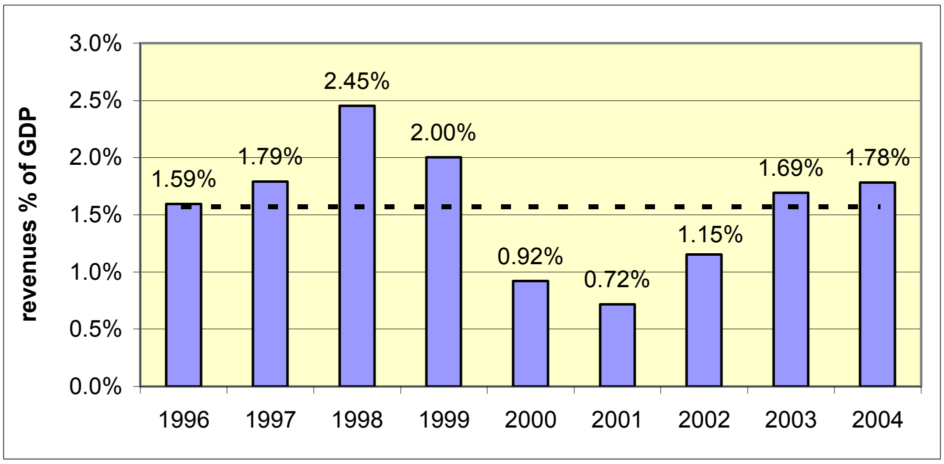
The introduction of zero corporate tax on the reinvested profit had only a temporary negative effect on the budget revenues, which after that rapidly recovered above the previous levels. The explanation for this phenomenon can be based on the so-called Laffer curve, which shows how the tax cut can lead to higher budget revenues because of dynamic effects – more investments, production and taxable income. This is exactly the conclusion of the Government of Estonia in the "National Report on Economic Reform 2004": "*Estonia's example is therefore good enough to say that **lower taxes contribute to economic growth while increasing budgetary revenues of the state**.*"

Graph 1: ***Revenues from corporate tax, mln. krooni***



Source: *Statistical Office of Estonia*

Graph 2: ***Revenues from corporate tax, share of GDP***



Source: *Statistical Office of Estonia, author's calculations*

Effect on economy

Academic research. In 2001 the Central bank of Finland published a research on the dynamic effects of the introduction of a zero tax rate on the reinvested profit in Estonia.[1] According the study "*The modeling and calibration results herein strongly support the view that Estonia's 2000 corporate tax reform should* ***encourage investment spending***". A subsequent study in 2005[2] confirms the positive effects from the introduction of zero corporate tax on reinvested profit – the 2000 tax law leads to higher investment, including foreign investment, in short, medium and long term.

Foreign investment. In 1999 the foreign direct investments in Estonia were 284 million euro. In the next year, when the zero corporate tax was introduced, they reached 424 million euro, and in 2004 – 838 million euro. Within five years the foreign investment increased three times.

The biggest increase was recorded by the reinvested profit. While in 1999 46 million euro were reinvested, in 2004 this amount reached 573 million euro. It increased 12 times within only 5 years.

The net direct investments, measured as the volume of the foreign investments in Estonia minus the volume of the Estonian investment abroad, also increased considerably. In 1999 they were 205 million, while in 2004 they reached 621 million. The increase is three times greater.

Overall, there is a ***significant growth of the foreign investment*** in Estonia in the years after the introduction of zero corporate tax on reinvested profit.

Table 1: ***Foreign direct investment, mln. euro***

	1999	2000	2001	2002	2003	2004
Direct investment in Estonia	**284.3**	**424.7**	**602.7**	**306.8**	**822.2**	**838.0**
Share capital	163.1	250.9	232.7	52.5	340.6	296.5
Reinvested profit	46.1	116.0	247.9	215.4	409.5	573.0
Other	75.0	50.9	123.1	67.0	94.2	-40.9
Direct investment abroad	-79.2	-66.7	-225.5	-139.9	-137.4	-216.5
Direct investment (net)	**205.0**	**358.0**	**377.2**	**166.9**	**685.0**	**621.5**

Source: *Central Bank of Estonia*

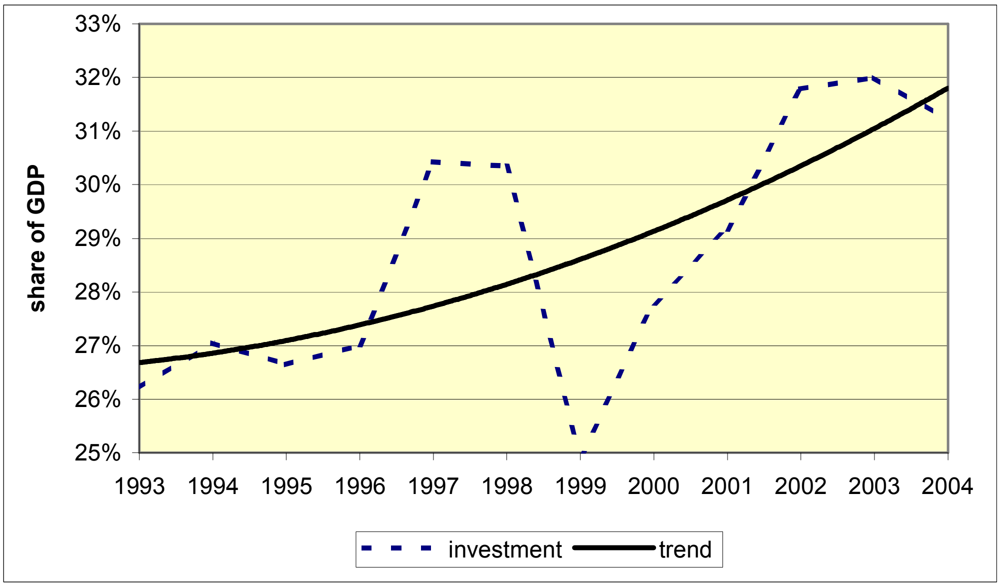
Total investment. Let's look at development of the total investment, measured by the national accounts methodology /see graph 3/. The investment expenditures are highly variable and depending on many factors, including the business cycle. In order to circumvent this complication, we can examine the trend of the investment expenditures – the trend will show the direction and magnitude of the change. We can see that, after the

[1] Michael Funke, 2001, "*Determining the taxation and investment impacts of Estonia's 2000 income tax reform*", Bank of Finland, Institute for Economies in Transition (BOFIT)

[2] Michael Funke, Holger Strulik, 2005, "*Taxation, Growth And Welfare: Dynamic Effects Of Estonia's 2000 Income Tax Act*", Hamburg University mimeo

introduction of the zero corporate tax on the reinvested profit, ***the trend of increase of the share of investment in GDP is accelerating***.

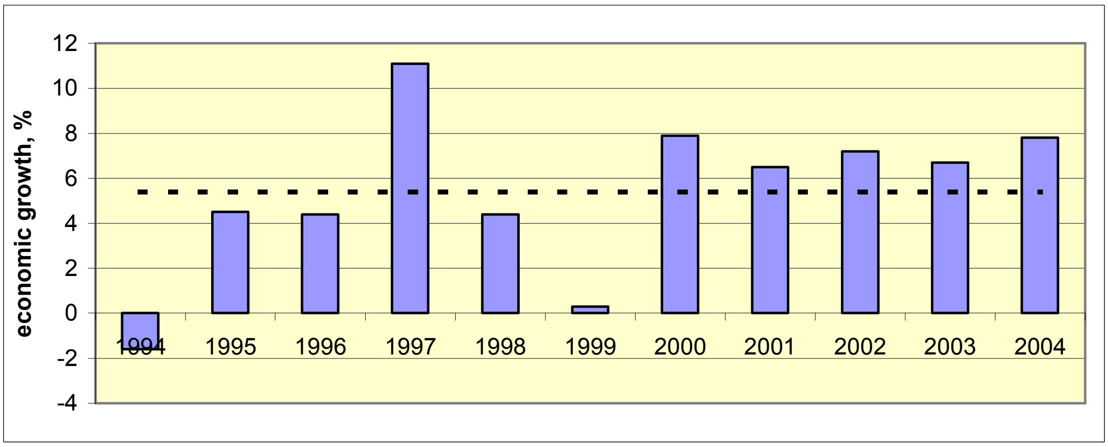
Graph 3: ***Total investment, 1993 - 2004***



Source: *Statistical Office of Estonia, author's calculations*

Economic development. The average economic growth between 1993 and 1999 was 3.85%. After the introduction of zero corporate tax on reinvested profit the economic growth nearly doubled and reached 7.22% for the period 2000 – 2004. Each and every year after 2000 the economic growth is above 6%, and most of the years it is higher than 7%. This shows a ***strong increase of the rate economic growth*** in the period after the introduction of zero corporate tax on reinvested profit.

Graph 4: ***Economic growth, 1994 - 2004***



Source: *Statistical Office of Estonia, author's calculations*

Conclusion

The introduction of zero corporate tax on reinvested profit in Estonia in 2000 is an undisputable success. After a short drop, the revenues in the government budget recovered rapidly. The foreign investment increased dramatically. The rate of growth of the total investment's share in GDP increased. The economic growth almost doubled.