The Proposed tax hikes on Value-Added Tax and Income Tax Rates in Estonia

August 2023

The parliament in Estonia, known for its pro-business environment and simple tax system, has voted on significant tax changes to bolster its economy and address budgetary challenges. The proposed tax hikes, aimed at increasing Value-Added Tax (VAT) and income tax rates, have sparked intense debates among policymakers, economists, and citizens. This article will explore the key elements of the proposed tax reforms and their potential impacts on Estonia's economic landscape.

Value-Added Tax (VAT) Increase

Estonia's VAT system has long been regarded as one of the most efficient in the European Union, with a flat rate of 20%. However, starting from the 1st of January 2024 the government has proposed an increase in the standard VAT rate by 2 percentage points to 22%. The VAT rate was last changed in 2009, during the economic crisis turmoil, when it was raised from 18% to the 20%, we have right now.

It is also important to mention that the lower VAT rate for accommodation service providers will be raised on the 1st of January 2025. It means that the VAT rate in accommodations that tourists stay in will rise from 9% to 13%. Initially the Estonian government wanted to raise the VAT rate for accommodation to 22%, the same rate as the regular VAT would be starting from 2024. The Estonian Chamber of Commerce and Industry expressed their issues with the proposed change saying that they are clearly against raising the VAT rate for accommodation services as it was planned during that time. They argued that as the first step, a comprehensive impact analysis would have to be carried out to understand what effect the increase in the VAT rate would have, for example, on the growth of the economy or rural tourism businesses.

Since the deadline for the tax increase regarding accommodation businesses is planned for 01.01.2025, there was no need to adopt the changes urgently. The main problem for the Estonian Chamber of Commerce and Industry was that raising taxes does not always bring more money to the budget, and could lead to negative consequences. Previous analyses have also shown that increase in VAT would reduce the number of visitors to accommodation companies. In 2014, the analysis carried out by the Estonian Economic Institute pointed out that increasing the VAT rate for accommodation services to 20% would reduce the number of visitors by 6%, therefore a raise to 22% could be even more detrimental.

Proponents argue that this VAT hike will generate additional revenue for the government, allowing it to invest in crucial public services and infrastructure projects. The increased revenue could also help reduce budget deficits and support economic development initiatives. Critics, on the other hand, express concerns that the VAT hike might lead to higher consumer prices, reducing household purchasing power and potentially dampening domestic consumption. Small and medium-sized enterprises (SMEs) could also feel the burden, as they may struggle to absorb the higher VAT costs, impacting their competitiveness. This has been especially concerning for businesses that provide accommodation to tourists.

Income Tax Rate Adjustment

Estonia has maintained a unique and attractive approach to income taxation. Under this system, corporate profits are taxed only when distributed as dividends, and individuals pay a flat income tax rate on personal income, irrespective of their earnings. Starting from the 1st of January 2025 the Estonian income tax will be raised from 20% to 22% and the 14% preferential rate on companies' regularly distributed profits stops.

Supporters argue that this change promotes a fairer distribution of the tax burden and allows the government to generate more revenue from high-income individuals. It may also discourage tax evasion and improve income equality in the country.

Critics, however, raise concerns that altering the current tax system could deter foreign investments and hamper Estonia's attractiveness as a business-friendly destination,

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since the 14% preferential rate on companies' regularly distributed profit is still very attractive for foreign investors as of right now. They argue that the existing system has been a catalyst for entrepreneurship and growth, and any drastic changes could undermine the country's competitive edge.

Striking the Right Balance

Finding the right balance in implementing tax reforms is essential for the economic stability and growth prospects of any country. On the one hand, increasing taxes can provide additional resources for social welfare and public investment. On the other hand, overly burdensome taxes could stifle entrepreneurship, investment, and economic expansion.

It is crucial for policymakers to carefully assess the potential impacts of these tax hikes on various stakeholders, including consumers, businesses, and investors. Striking a balance between generating additional revenue and maintaining a country's attractiveness as an investment hub will be critical.

In conclusion Estonia's tax hikes on VAT and income tax rates present both opportunities and challenges for the nation's economy. While increased revenue can fund social programs and infrastructure development, policymakers must be cautious not to deter entrepreneurship and foreign investment. It is crucial that the proposed changes to the tax system will ensure sustainable economic growth and prosperity for the country and its citizens.