

Options to Strengthen the Tax System in Estonia

Irina Bunda and Tibor Hanappi

SIP/2025/102

IMF Selected Issues Papers are prepared by IMF staff as background documentation for periodic consultations with member countries. It is based on the information available at the time it was completed on June 23, 2025. This paper is also published separately as IMF Country Report No 25/182.

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Prepared by Irina Bunda and Tibor Hanappi

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ABSTRACT: Estonia's tax mix has been traditionally reliant on consumption taxes—especially VAT—whereas income taxes are a relatively small share of revenue. Recent and expected changes will further shift the tax burden in this direction. Consumption taxes are less distortive than income taxes, but higher spending needs may require a broader revenue base, reaching untapped potential. This Selected Issues Paper discusses alternative broad-based, growth-friendly options on how to strengthen income, VAT, as well as property taxes. Options to strengthen revenues include (i) addressing the personal income tax revenue (PIT) shortfall from the introduction of a uniform allowance by considering revenue neutral options, i.e., calibrate the basic allowance, the tax rates, and/or the tax brackets subject to the intended degree of progressivity; (ii) improving the capacity of the tax administration to analyze income statements and exploring alternative corporate income tax (CIT) regimes that would preserve the competitiveness of the current system while reaching a broader tax base; (iii) streamlining remaining VAT exemptions to broaden the tax base; and (iv) limiting exemptions on residential land and taking steps to introduce a modern tax on immovable property by developing a fiscal cadaster to ensure fair taxation based on value and use of property.

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SELECTED ISSUES PAPERS

Options to Strengthen the Tax System in Estonia

Republic of Estonia

Prepared by Irina Bunda and Tibor Hanappi



REPUBLIC OF ESTONIA

SELECTED ISSUES

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Prepared By Irina Bunda and Tibor Hanappi

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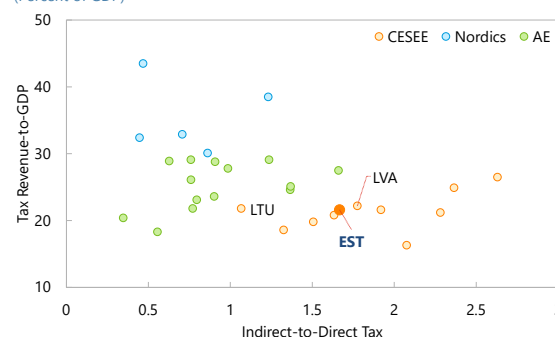
OPTIONS TO STRENGTHEN THE TAX SYSTEM IN ESTONIA¹

Estonia's tax mix has been traditionally reliant on consumption taxes—especially VAT—whereas income taxes are a relatively small share of revenue. Recent and expected changes will further shift the tax burden in this direction. Consumption taxes are less distortive than income taxes, but higher spending needs may require a broader revenue base, reaching untapped potential. This Selected Issues Paper discusses alternative broad-based, growth-friendly options on how to strengthen income, VAT, as well as property taxes. Options to strengthen revenues include (i) addressing the personal income tax revenue (PIT) shortfall from the introduction of a uniform allowance by considering revenue neutral options, i.e., calibrate the basic allowance, the tax rates, and/or the tax brackets subject to the intended degree of progressivity; (ii) improving the capacity of the tax administration to analyze income statements and exploring alternative corporate income tax (CIT) regimes that would preserve the competitiveness of the current system while reaching a broader tax base; (iii) streamlining remaining VAT exemptions to broaden the tax base; and (iv) limiting exemptions on residential land and taking steps to introduce a modern tax on immovable property by developing a fiscal cadaster to ensure fair taxation based on value and use of property.

A. Introduction

1. The tax system in Estonia was revamped in the early 90s on the principles of simplicity, compliance, and competitiveness. The Baltics' tax systems were regarded as highly innovative and came into being at a time when many countries worldwide were moving away from high marginal rates toward lower, more uniform, and simpler tax structures. As one of the most digital governments in the world, Estonia has been successful at quickly adopting the modern VAT and a tax mix that emphasizes the neutrality of taxation. Estonia's tax system prioritizes competitiveness, having maintained the top position in the OECD for over a decade (Tax Foundation [ICTI](#)). Key features include a single-rate corporate income tax (CIT) on distributed profits, a flat personal income tax (PIT) which excludes personal dividends, limited wealth taxation with a property tax based solely on land value, and a territorial tax system exempting foreign profits. The Estonian tax system has remained simple, but over time it has started to show its limits in terms of revenue mobilization, given its reliance on a relatively narrow base. The indirect consumption-based tax share has increased, supported by fully automated filing that

Indirect-to-Direct Tax and Tax Revenue-to-GDP Ratios, 2023
(Percent of GDP)



Source: Eurostat.

¹ Prepared by Irina Bunda (EUR) and Tibor Hanappi (FAD), with assistance from Sadhna Naik (EUR).

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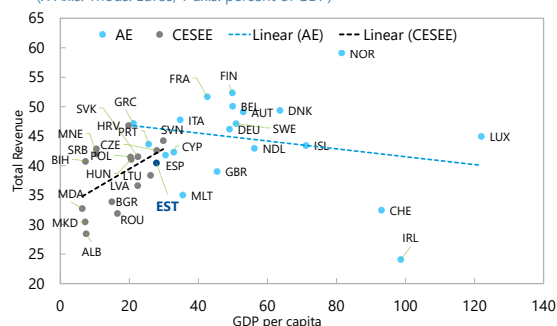
facilitates compliance. As a result, Estonia now has one of the highest indirect tax shares among advanced economies and the question is how much indirect taxes can achieve going forward.

2. Estonia is facing elevated near-term defense spending needs and, as other European countries, long-term pressures related to population aging and climate mitigation. Escalating defense spending needs in recent years have exacerbated imbalances and raised pressures to adjust. At 3.5 percent, Estonia features already one of the highest defense spending-to-GDP ratios in the EU, but the authorities recently announced a revised 5.4 percent target. Moreover, social outlays have gone up as a share of GDP relative to pre-pandemic, while pressure from an aging population are set to intensify over time. In a risk scenario (2024 [Ageing Report](#)), healthcare and long-term care could be 6 ppts higher in the long run than projected at current policies, among the highest increases in the EU. Tensions between retaining a competitive tax environment achieved at the expense of lower tax revenues than peers and moving towards broader provision of public services and a stronger social safety net have already resulted in policy uncertainty and a deterioration of Estonia's fiscal position. Recent and upcoming tax hikes try to address these imbalances, but excessive reliance on higher tax rates may ultimately narrow the tax base and undermine the objective of mobilizing higher revenue (Box 1).

3. Along with spending rationalization, Estonia should explore options to mobilize revenue. For the same level of development (as measured by GDP per capita), Estonia is about 6 ppts of GDP below European AEs and 1.7 percent below CESEE in terms of revenue, mainly reflecting different policy choices. A simplified but unbalanced tax system poses challenges. Faced with unexpected spending shocks, hiking rates can be a blunt instrument and pressures to loosen the sudden burden can build up. Financing additional spending needs with higher revenues would be better accepted (equitable) and less distortionary (less inefficient) if they come from an increased capacity of the tax system to redistribute. A comprehensive review of the tax system aimed at making the system more stable, diversified, and robust could be considered. The following sections offer options to durably strengthen tax revenues and build buffers to deal with current and future spending pressures.

Total Revenue, 2023

(X Axis: Thous. Euros; Y axis: percent of GDP)



Source: Eurostat and IMF staff calculations.

Box 1. Main Changes to Tax System Introduced in 2024-26

Income tax

- The income tax rate has increased from 20% to 22% in January 2025. For corporations, this is payable on distributed profits. The lower 14% rate on regular profit distribution was abolished.
- A quarterly advance CIT rate on overall profits payable by credit institutions and Estonian branches of foreign credit institutions has increased from 14% to 18%.
- The plan to replace the current phased-out income tax allowance with a flat €8,400 annual income tax allowance was postponed until 2026.
- Entrepreneur account: Tax rate cut from 40% to 20%.

Social contributions: Minimum obligation has increased from €239.25 to €270.60

Box 1. Main Changes to Tax System Introduced in 2024-26 (Concluded)

Value-added tax

- The VAT standard rate was increased from 20% to 22% in January 2024.
- Accommodation services are subject to a reduced 13% VAT, up from 9% for hotels, Airbnbs, and similar services previously.
- The lowest 5% rate was abolished. Hence, the VAT system has only three rates: 22%, 13%, and 9%.
- Special scheme for small businesses: €40,000/calendar year VAT registration threshold to include supply of real estate transactions and financial/insurance services.
- The definition of new buildings in the VAT Act was changed from the first day of use to “less than two-year-old.” If a building is sold by then, VAT must be added to the price (sales of buildings older than two years remain VAT- and income-tax exempt).

Motor vehicle tax

- New tax applied to all motor vehicles registered in January 2025; first payment deadline in June.
- The tax consists of (i) a registration fee and (ii) an annual motor vehicle tax determined by the base amount (min. €50), a CO₂ component, and the total weight of the vehicle. Average tax amount /passenger vehicle: €157.

Excise taxes

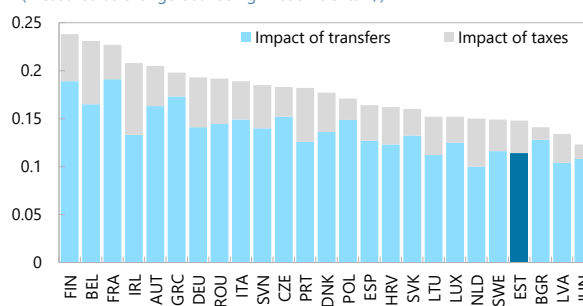
- Alcohol, tobacco: increase by 5% (Jan 2025), 5% (July 2025), and 10% (Jan 2026); Gasoline: increase by 5% (July 2025), and 5%/year (May 2026-28); Diesel: increase up to €493/kl May 2025-27.

National security tax

- The standard VAT rate will be further increased from 22% to 24%, starting from July 1, 2025.
- An additional 2% tax will be levied on personal incomes (including for the entrepreneur account) from January 1, 2026.
- An additional 2% tax will be levied on distributed profits from January 1, 2026.

4. A lean and efficiency-driven tax system has also come at the expense of lower revenue. Typically, as an economy advances, direct taxes (taxes on income and wealth) start to play a more significant role than indirect taxes (taxes on production and imports), as equity considerations progressively prevail over other guiding principles of tax policy such as efficiency and simplicity. More equitable tax reforms are more easily politically acceptable and reduce the need for compensation on the spending side through transfers. In advanced economies, the tax-benefit systems significantly reduce income inequality, as indicated by the Gini coefficient difference between market and disposable incomes—i.e., incomes before and after taxes. In Estonia, post-tax and transfers income inequality is reduced by almost one third, less than the euro area average of 38 percent. This is mainly achieved via transfers or social spending, as its tax system mainly relies on flat rates and offers only limited redistributive capacity. To note that in AEs income taxation can redistribute income more efficiently than untargeted measures on the spending side, while balancing equity and efficiency considerations.

EU: Redistributive Impact of Taxes and Transfers, 2022
(Measured as change between gini coefficients 1/)

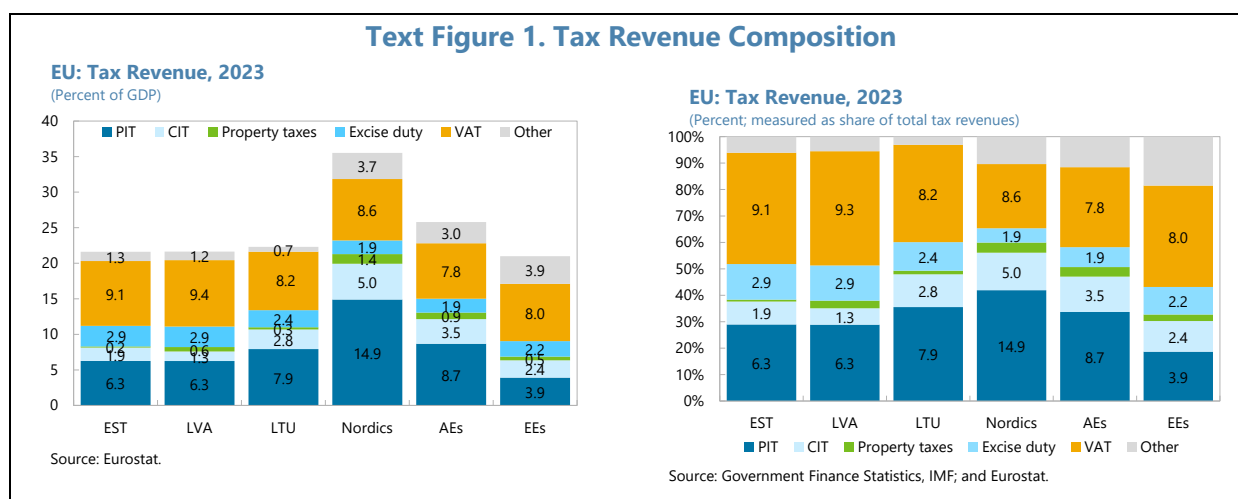


Sources: OECD Income Distribution Database; and IMF staff calculations.
Note: Data for Denmark and Germany is for 2019 and 2020 respectively.
1/ Total impact = gini (market income) - gini (disposable income); impact of transfers = gini (market income) - gini (gross income)

B. Tax Mix, Effort and Potential in Estonia

5. The overall tax mix is perhaps the most fundamental issue in the design of tax systems. In the last two decades, globalization has led to a general shift towards less mobile tax bases as trade and capital account liberalization has heightened tax competition between countries. Thus, statutory and average effective CIT rates were lowered in many countries, often offset by higher taxes on labor and consumption. Moreover, a trend toward reaping efficiency gains from the reform of tax systems has led to relatively lighter income taxation and a move towards more indirect forms of taxation. Tax progressivity—the degree to which the average tax rate rises with income—has been on a declining path (IMF, 2017) causing a shift of the tax burden toward the middle of the income distribution (Keen, Kim, and Varsano, 2008). In some CESEE countries (the Western Balkans), limited income tax progressivity and low rates have created twin equity and efficiency challenges and a high degree of informality. In others, shifts from social security contributions to VAT ('fiscal devaluation') were pursued to improve competitiveness; however, over time, higher VAT rates also had some adverse consequences (Jousten et al., 2022).

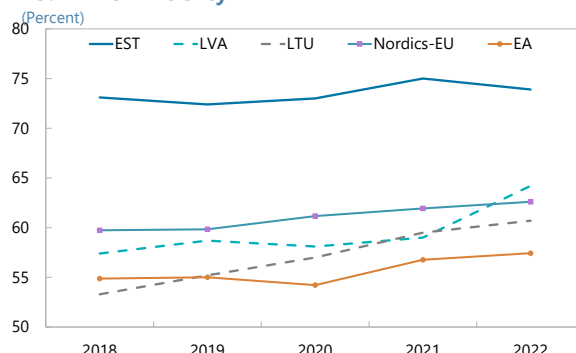
6. Estonia's tax structures and revenue levels resemble more those of European emerging market economies (EMEs) than European AEs and the Nordics (Text Figure 1). Relative to European AEs and Nordic countries, Estonia collects less tax revenue, 22 percent of GDP as of 2023; and only slightly more than European EMEs average. Indirect taxes, mainly VAT, are 42 percent of tax revenue. Direct taxes, mostly from PIT, account for 29 percent of tax revenues. In contrast, European AEs and Nordic countries collect higher tax revenue overall, reflecting different tax structures and social preferences. In the two groups, direct taxes, driven by income taxes, account for half of tax revenue for the European AEs and 60 percent for the Nordic countries, respectively. Revenue from other taxes (on wealth, but also, taxes not classified elsewhere) are three times lower in Estonia than in comparator countries, reflecting low diversified of revenue.



7. While consumption tax revenue—VAT and excises—is relatively high in Estonia/Baltic countries compared to European AEs, income taxes raise relatively less, suggesting narrow bases and untapped revenue potential. Estonia collects less CIT revenue (1.9 percent of GDP) than

all other country groups—5 percent of GDP for the Nordics, and 3.5 and 2.4 percent of GDP for European AEs and EMEs as of 2023, respectively. Estonia and Latvia are the only OECD/EU countries operating Distributed Profit Taxes (DPTs), which have narrower tax bases compared to a standard CIT (-reinvested profits being basically tax exempt), thus collecting less, notwithstanding the relatively high 22 percent statutory tax rate. Estonia outperforms European EMEs in PIT revenue collection but lags the Nordic and AE countries. Turning to VAT, Estonia's efficiency per unit of final consumption (74 percent in 2022) is the highest in EU/OECD, implying that only 26 percent of theoretical revenue is lost via policy decision and/or noncompliance. At almost 3 percent of GDP, revenue from excises in Estonia is higher than comparator countries. Finally, property tax revenue in Estonia is less than 0.2 percent of GDP, as only land is taxed. This contrasts with an average 1.0-1.4 percent for the Nordic and European AEs, reflecting widespread land tax exemptions and the absence of a modern recurrent tax on immovable property in Estonia.

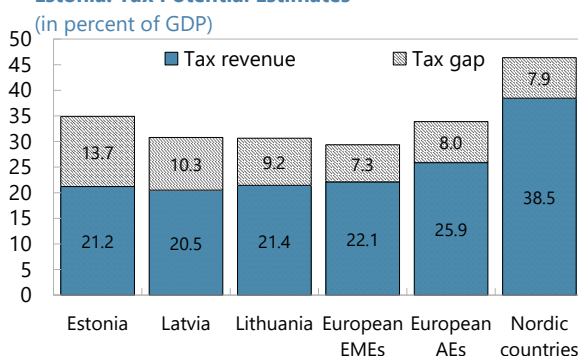
EU: VAT C-Efficiency*



*VAT C-efficiency is defined as the ratio of actual VAT revenue to theoretical VAT revenue, i.e., the product of VAT statutory rate to final consumption, another way to express the VAT gap. Source: European Commission.

8. Estonia's tax potential is estimated at around 35 percent of GDP using stochastic frontier analysis (Benitez et al., 2023). The approach estimates the maximum possible tax revenue that countries could collect (or tax potential), given their economic structure and other prevailing conditions and interprets the shortfall in actual revenue (or tax gap) as an inefficiency. The gap evolves over time and can be related to policies (i.e., reduced rates and exemptions) and/or compliance. It should be noted that the estimated tax potential does not necessarily represent the ideal level of tax revenue. Rather, it represents the maximum revenue achievable under the current structure. Societies have different preferences regarding the role and size of government, which affect the level of resources allocated to public services. These preferences, in turn, affect policymaking decisions. The optimal level of tax collection may thus be lower or higher than the theoretical tax potential.

Estonia: Tax Potential Estimates

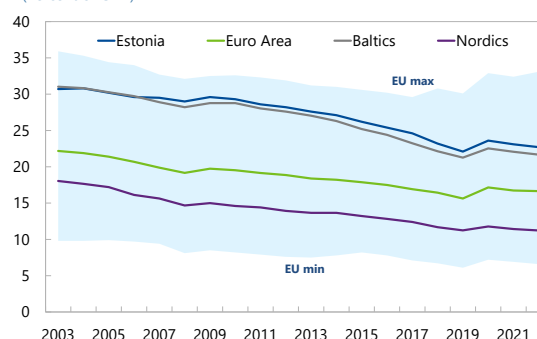


Sources: World (2024) and IMF staff calculations. See Benitez et al., 2023.
Note: Nordic countries include Denmark, Finland, Norway, and Sweden. The values for Denmark and Sweden refer to 2021. The latest year for the other countries is 2022.

9. Estonia exhibits a higher tax potential than European AEs as well as a wider tax gap, reflecting a lower tax effort (i.e., ratio of actual tax collection to potential tax revenue). The tax gap is estimated at about 14 percent of GDP, that is, actual revenues could be up to 14 percent of GDP higher, at the current level of development and structural characteristics. The tax gap is significantly larger than in peer countries: about 8 percent of GDP in European AEs and Nordic countries, and 7.3 percent in European EMEs. This divergence is driven not only by lower tax-to-GDP levels, but also by

structural factors related to untaxed sectors and activities. Estonia and the Baltics not only have a relatively higher share of informality than European AEs (especially affecting the collection of income taxes²), but also, some activities/sectors are untaxed (e.g., real estate, construction, corporate retained profits, wealth, social services, gambling) sometimes by design (e.g., with generous minimum thresholds) and could be brought into the tax net. Structural reforms in Estonia could therefore focus on strengthening the core of the tax system to mobilize higher revenues, including by enhancing the ability of the revenue administration to deal with the complexities arising from the various transactions generating income, as well as from broadening the tax base.

EU: Size of Shadow Economy, 2003-2022
(Percent of GDP)



Sources: European Parliament; and IMF staff calculations.

C. Benchmarking the Estonian Tax System against Best Practices

10. The role of the tax system is to generate the necessary revenues as efficiently, equitably, and manageably as possible, within the government's inter-temporal budget constraint. Taxation should minimize disincentives to work, invest, and save; equity considerations should be contemplated; and tax laws and regulations should be simple and easy to enforce. Beyond these first principles, there are many trade-offs to be considered in practice. Societal preferences and tax administration capacity are also decisive in the design of the tax system.

11. Estonia has the highest ratios of indirect to direct taxes among AEs. The ratio will increase further as VAT rate hikes are phased in and the PIT uniform allowance is launched. Empirical evidence has found that income taxes are generally more harmful for growth than consumption and property taxes (Johansson et al., 2008, Gemmell et al., 2014, IMF, 2017). VAT, unlike income taxes, does not distort consumer choice, as savings remain untaxed (thus encouraging saving and re-investing revenue) making it a more economically efficient tax than income taxes, although it is often considered a regressive tax. However, potential distortions depend on the tax design. For OECD countries, for instance, broadening the VAT base through fewer reduced rates and exemptions was found to be more conducive to higher long-run growth than higher rates. Raising rates coupled with a proliferation of reduced rates and exemptions create inefficiencies that are harmful to growth (Acosta-Ormaechea and Morozum, 2019). Exemptions of intermediate goods are especially inefficient because they disrupt VAT input tax crediting by businesses, causing taxes to be embedded in the final price. Opposite results are found in terms of inequality, i.e. income taxes tend

² Challenges for the Estonia revenue administration includes the construction and hospitality sectors, partially unofficial salaries (for PIT), hidden profit allocations: tax avoidance through structuring transactions, transfer pricing, taxation of profits attributed to a permanent establishment (PEs) (for CIT). Estonia's DPT system complicates the treatment of corporate restructuring, mergers and divisions, tax exemptions rights as well as the tax compliance assessments, with potential tax revenue and tax gap difficult to estimate.

to reduce inequality more than consumption taxes (IMF, 2017), as progressive income tax systems are predominant, especially in advanced economies.

Box 2. Income Taxation: Efficiency-Equity Trade-Off

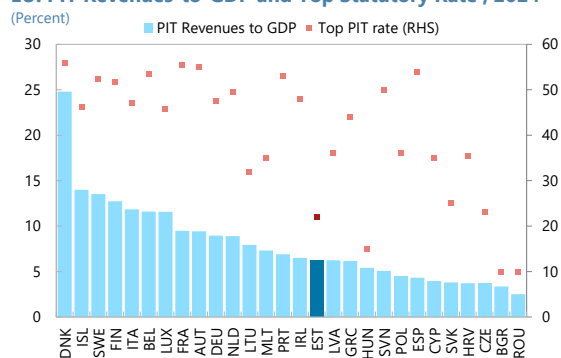
Tax **efficiency** refers to the impact of taxation on wellbeing, assuming economies are populated by identical representative agents. By transferring resources from the private to the public sector, taxes impose a loss on society that is generally higher than the generated revenue. The labor-tax wedge reflects the gap between the cost to an employer of hiring someone and the benefit that the employee receives from that employment. The deadweight loss is an indicator of this tax distortion. An efficient tax design aims to minimize the total deadweight loss of taxes, hence it is efficient (i) to impose taxes at a higher rate if demand or supply is inelastic; and (ii) to keep tax bases broad and rates low (since the loss increases more than proportionately with the tax rate)—justifying policy recommendations such as base broadening and rate reductions (Abdel-Kader and de Mooij, 2020).

Tax **equity**, or the fair distribution of the tax burden, requires a theory that departs from the representative agent assumption to allow for heterogeneity. The impact of a tax system on income distribution depends on the progressivity of the tax-benefit system, i.e., how rapidly the share of income paid as tax increases with the level of income. Redistribution is desirable because the declining marginal utility of income implies that transferring one euro from a rich to a poor person increases the joint utilities, and because of social aversion to inequality. A progressive system is warranted in the presence of imperfections in labor, capital, and insurance markets, thereby changing behaviors (e.g., reduce trade unions' wage demands, encourage investment in knowledge, etc.), hence improving efficiency from a societal perspective. Together with addressing externalities, redistribution is one of the rationales of government policy gaining prominence for policymaking in the recent decades.

Optimal tax theory (Mirrlees, 1971, Diamond, 1998, Saez, 2001) emphasizes the **equity-efficiency trade-off in income taxation**. Ideally, progressive tax-benefit system should reflect the exogenous innate ability of people. By setting a tax based on income, however, the system discourages effort, thus creating a distortion (welfare loss). The tax-benefit system can strike an optimal balance between equity and efficiency, with the marginal income tax rate optimally featuring a U-shaped form. The high marginal tax rate at the bottom accounts for the transfers being given to the lowest income (on the spending side) that are phased out for middle incomes to minimize costs. The low marginal tax rate for the large middle-income group avoids aggregate distortions in labor effort. A progressive tax rate structure from the middle to the top of the distribution increases progressivity and has revenue raising potential (Diamond and Saez, 2011). Most systems of means-tested benefits and PIT schedules nowadays follow these principles.

Text Figure 2. Personal Income Tax (PIT) Main Features

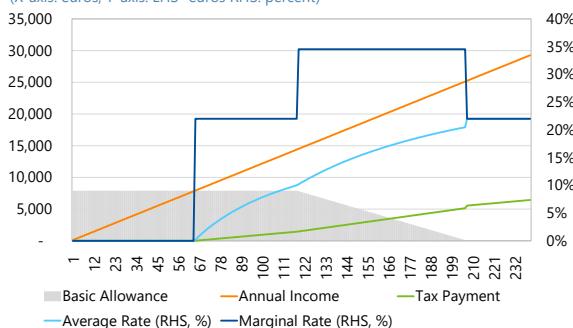
EU: PIT Revenues-to-GDP and Top Statutory Rate, 2024



Sources: Tax Foundation, GFSR, Eurostat.

Personal Income Tax Rate Schedule, 2024

(X-axis: euros, Y-axis: LHS- euros RHS: percent)



Sources: Statistics Estonia; Ministry of Finance; and IMF staff calculations.

12. The design of income taxes in Estonia tries to strike a balance between efficiency, simplicity, and equity (Text Figure 2). However, the combination of a generous threshold for the basic allowance (to stimulate labor force participation and provide income support to low-income groups), an overall lower statutory rate than peer countries, and a shift of the tax burden toward the middle of the income distribution leads to lower revenues. A steep phasing out of benefits as income increases implies high marginal tax rates and creates adverse labor supply effects, thus affecting efficiency. At the same time, marginal rates for top income earners are significantly lower, thus reducing the redistributive capacity of the PIT system.

13. Estonia's consumption tax is efficiently collected and aligned with best practices. Estonia's high-quality e-services coupled with simple and transparent tax regulations speed up VAT registration and refund processing. Companies can register online through the Estonian Tax and Customs Board and use electronic filing and payment options. As of 2023, 99 percent of declarations were submitted digitally, reducing physical contact in traditional offices. Automated analytics facilitate compliance risk management. The system is relatively broad-based with only few reduced rates. Estonia has abolished the super-reduced rate of 5 percent, now having only two reduced rates, in line with other EU countries. It still features a higher than EU average registration threshold to minimize compliance costs for small traders (with turnover in calendar year less than €40,000, i.e., for 60 percent of total Estonian businesses) by lowering the tax burden (and final prices) in rural areas where they would typically operate. Exemptions are more widespread, raising inefficiencies (by distorting firms' decisions and competition) and hindering a more equitable outcome.

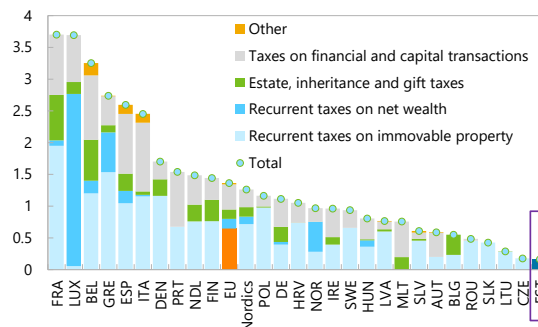
14. Although direct taxes on income and indirect taxes on consumption may seem theoretically equivalent, income taxes are preferable from an administrative perspective. In a theoretical setting, and based on certain standard assumptions, a uniform tax on consumption is broadly equivalent to a uniform tax on labor income and economic rents. This result holds if both taxes are designed to have the same impact on lifetime budget constraints while also keeping the relative price of consumption and saving unchanged, which is generally the case for consumption taxes that do not tax normal returns to capital. However, a comprehensive income tax would affect the relative price of consumption and saving because capital income, including normal returns, is part of the tax base. Therefore, the equivalence only holds if the income tax base captures only labor income and economic rents. However, individual incomes are easier to observe, compared to individual consumption, which makes income taxes preferable from an administrative perspective. In addition, consumption taxes have little benefit when it comes to redistribution (e.g., via multiple rates and exemptions), since these measures create inefficiencies and will always be less effective in terms of redistribution compared to a non-linear progressive income tax (Atkinson and Stiglitz, 1976, Abdel-Kader and de Mooij, 2020).

15. Capital income is relatively less taxed in Estonia. Estonia has a higher Gini coefficient for wealth than income, suggesting that wealth is more unevenly distributed than income. Various equity and efficiency-based arguments can be invoked to justify specific taxes aimed at reducing wealth inequality. However, three conceptually different approaches need to be distinguished: (i) taxing returns with capital gains taxes, (ii) taxing wealth stocks and (iii) taxing wealth transfers with

inheritance and estate taxes. Amongst these three options, capital income taxes as well as inheritance and estate taxes are generally less distortive and more equitable than wealth taxes (Hebous et al., 2024). In Estonia, capital gains from the sale or exchange of assets are generally taxed on a net basis as part of ordinary income, with capital losses being deductible only against capital gains. Certain qualifying capital gains are exempt from income tax, such as the gain from the sale of a personal residence. Also, capital gains derived by non-residents on the sale of shares in resident companies are generally not taxable. Finally, the DPT system leads to systematically higher capitalization and a high level of non-distributed profits.

Taxes on Wealth, 2022

(Percent of GDP)



Source: OECD

16. Real property taxes are lacking in Estonia. Given that they are paid mainly by residents, and property values likely reflect the value of local public services, property taxes resemble a benefit tax which can support the accountability of local authorities. However, Estonia lacks a property tax based on capital improved value. Steps towards taxing real property more significantly were taken in 2022 with the update of land values based on an automated mass appraisal.

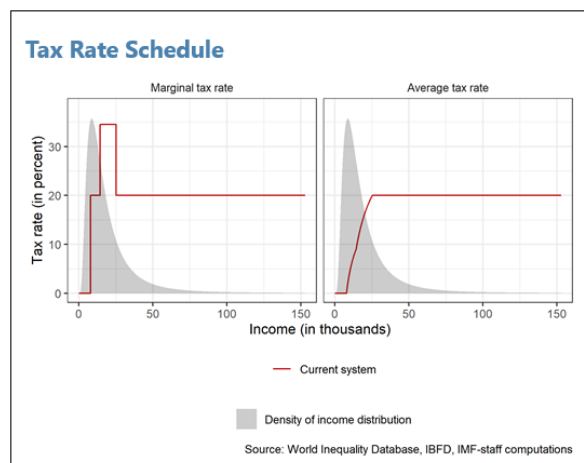
D. Labor Income Taxation

17. Estonia has adopted a relatively simple PIT structure combining one statutory rate with a basic allowance phased out at higher income levels. Estonia applies a single statutory tax rate of 22 percent on income above the basic allowance (or 'basic tax exemption') valued annually at €7,848 in 2024. The allowance is phased out linearly over the annual income range from €14,400 to €25,200. However, the marginal rate structure is more complex due to the phase out of the basic allowance and interactions with the statutory rate. The current phasing-out rule for the basic allowance implies that individuals face higher marginal rates in the middle-income segment (i.e., a 'hump'). Increasing labor supply, i.e., working more hours per year, implies not only higher (pre-tax) income but also a loss of a share of the basic allowance. The table below indicates the annual income range and the phase-out rate, i.e., how quickly the basic allowance is withdrawn. A phase-out rate of around 73 percent means that for an additional euro earned, 73 cents of the previously available allowance will be withdrawn. Hence the marginal rate increases in this income range by $72\% \times 22\% = 15.8\%$. Under the 'Status Quo' the tax structure therefore involves four tax brackets (Text Table 1).

Estonia	
Basic Allowance	7,848
Phase-out Range #1	14,400 to 25,200
Phase-out Rate #1	72.67%

18. The current PIT system, featuring an inverted U-shape of the marginal rate, has several drawbacks, leading to relatively lower revenues than in peer countries and creating disincentives to work for a relatively large share of the population. Using the PITA tool (IMF,

2024)³, we show that marginal tax rates reach relatively high levels at average annual income levels, about 35 percent, before declining to 22 percent for higher income levels. Fulltime workers earning a median wage are more likely than others to face higher marginal tax rates and thus are adversely impacted. The flat and lower marginal rate for top income earners hinders overall revenue mobilization. Redistributive and progressive capacity⁴ are also reduced. At 6.9 percent of GDP, PIT revenue is considerably lower than the European AEs average and less than half of Nordic countries. The Gini coefficient improves only by 3.2 ppts relative to pre-tax income. This is mainly due to a generous basic allowance (covering one third of incomes) and a shift in the tax burden for middle incomes. The combined effect of these two features results in disincentives to work and low marginal rates at the top –by EU standards, but also relative to middle incomes—which weigh adversely on revenue mobilization.



Text Table 1. Estonia: Summary of Personal Income Tax Reform Scenarios

(Euros, percent)

	Status Quo		Reform		Revenue Neutral (Lower Allowance)		Revenue Neutral (Higher Rate)		Revenue Neutral (Two Rates)		Two-Rates		More Progressive	
	TA (€)	MR (%)	TA (€)	MR (%)	TA (€)	MR (%)	TA (€)	MR (%)	TA (€)	MR (%)	TA (€)	MR (%)	TA (€)	MR (%)
Bracket #1	0	0	0	0	0	0	0	0	0	0	0	0	0	0
Bracket #2	7,848	22	8,400	24	6,750	24	8,400	26	7,848	15	7,848	22	6,000	10
Bracket #3	14,400	34.5	-	-	-	-	-	-	14,400	29	14,400	30	7,848	15
Bracket #4	25,200	22	-	-	-	-	-	-	-	-	-	-	14,400	25
Bracket #5	-	-	-	-	-	-	-	-	-	-	-	-	25,200	40

Source: IMF staff calculations.

Note: TA refers to taxable amount and MR refers to marginal rate.

19. The newly announced system will remove the hump in the marginal rate but may result in even lower tax revenue in the absence of significant design changes. The announced reform for 2026 tackles the ‘hump’ and improves progressivity to some extent but may further lower revenue. It introduces a universal basic exemption of €700/month or €8,400/year, while the flat rate increases to 24 percent (‘Reform’ in Text Table 1). A lower allowance was considered but was finally rejected for political reasons. Despite 2 ppts increase in the statutory rate, the new system is estimated to collect 0.5 percent of GDP less, while the share of people paying the tax is reduced due to the higher basic allowance. Several scenarios are presented below. We compute the parameters

³ PITA combines information on countries’ income distributions from World Inequality Database (WID) with current PIT rate structures to facilitate the analysis of revenue and distributional impacts of PIT reforms.

⁴ The progressive capacity is measured as the difference in the Gini coefficients after- and pre-tax income; the overall average tax rate is measured as total PIT collections to total tax base (Kakwani, 1977; Beer and Velutini, 2024).

that would keep the new system aligned with the status quo in terms of revenues by either (i) increasing the single statutory rate from 22 to 26 percent, or (ii) lowering the universal allowance from €8,400 to €6,750 to increase the tax base. The redistributive capacity is higher in (i) and lower in (ii) relative to the status quo. This suggests that higher rates for above median incomes would not only raise revenues but also improve upon PIT progressivity and efficiency. Alternatively, a two-rate scenario—with rates set at 22 and 30 percent—would yield 0.9 ppts of GDP additional revenue relative to the status quo and 1.4 percent relative to the announced reform by slightly shifting the burden of taxation to the right of the wage income distribution, from the middle (6–8th deciles) to the top 2 deciles. The redistributive capacity would improve, while the average rate increases by 2 ppts relative to the status quo, and by 3.5 ppts relative to the announced reform. Such type of design would improve efficiency and equity while also mobilizing additional tax revenue. If combined with a lower standard CIT rate on overall profits (e.g., 15 percent), a two-rate scenario (15 percent in bracket #2, and 29 percent in bracket #3) should be considered for the PIT to achieve revenue neutrality while preventing arbitrage. Such changes would imply lower rates for the bottom 90 percent of the taxpayers. The last scenario presents a more progressive PIT structure with four rates (10–15–25–40) and a lower universal allowance of €6,000. It would bring in 1.4 percent of GDP in extra revenues relative to the status quo and almost 2 ppts relative to the announced reform while reaching 85 percent of wage earners, with an average rate of 21.6 percent (Text Table 2).

Text Table 2. Estonia: Comparison of Personal Income Tax Simulations, 2025							
(Percent)							
Scenario	PIT/GDP	ΔPIT/GDP	Gini coeff.	Average Rate	Redistributive Capacity	Progressive Capacity	Share Paying Tax
Before tax	0	0	50.8	0	0	0	0
Status Quo	6.9	0.0	47.6	17.9	3.2	14.8	79.2
Reform	6.4	-0.5	47.4	16.6	3.4	17.1	77.2
Revenue Neutral (Lower Allowance)	6.9	0.0	47.9	17.9	2.9	13.5	82.8
Revenue Neutral (Higher Rate)	6.9	0.0	47.1	18.0	3.7	17.1	77.2
Revenue Neutral (Two Rates)	6.9	0.0	46.2	18.0	4.6	20.9	79.2
Two-Rates	7.8	0.9	45.4	20.2	5.4	21.4	79.2
More Progressive	8.3	1.4	44.5	21.6	6.3	22.9	85.0

Source: IMF staff calculations.

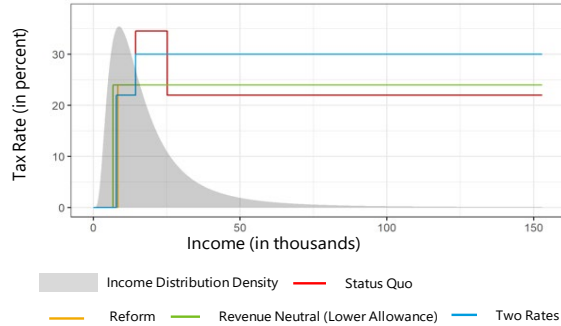
20. Considering a slightly more progressive tax structure (e.g., two rates) would bring significant advantages in terms of work incentives and revenue mobilization (Text Figure 3). Adjusting the marginal rate could improve efficiency and equity while also mobilizing additional revenue. Efficiency gains might be achieved as a reduction of marginal tax rates for median wage workers could incentivize positive labor supply responses. While tax reductions are generally expected to have such effects, tax elasticities of labor supply vary across workers and households, and other benefits such as availability of childcare have also been found to be important drivers of labor supply decisions. Decomposing redistributive capacities shows that the two scenarios ('Two Rates' and 'More Progressive') achieve higher redistributive capacity with higher average tax rates.

Figure 1. Discussion of Personal Income Tax Reform Scenarios

Various PIT design scenarios could correct the marginal tax rate spike and low redistribution of the status quo...

Marginal Tax Rate Schedule

(X-axis: thousand euros; Y-axis: percent)

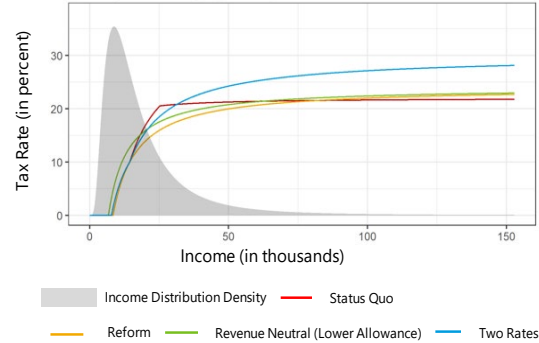


Source: World Inequality Database; IBFD; and IMF staff calculations.

...at slightly higher average tax rates and thus, also generating higher revenue mobilization.

Average Tax Rate Schedule

(X-axis: thousand euros; Y-axis: percent)

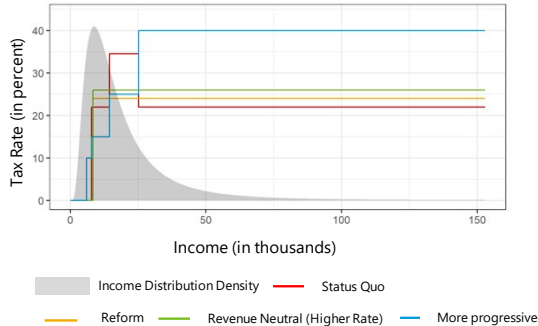


Source: World Inequality Database; IBFD; and IMF staff calculations.

Several revenue neutral options would involve either a lower allowance or a higher rate...

Marginal Tax Rate Schedule

(X-axis: thousand euros; Y-axis: percent)

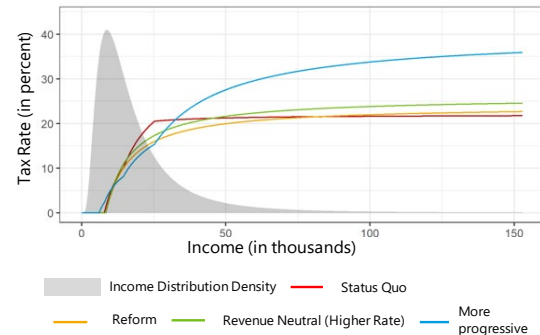


Source: World Inequality Database; IBFD; and IMF staff calculations.

...while slightly more progressive systems would improve work incentives and revenue mobilization even more.

Average Tax Rate Schedule

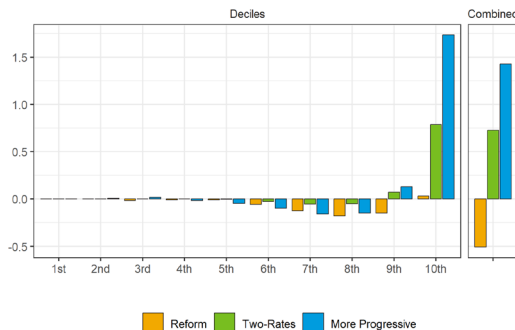
(X-axis: thousand euros; Y-axis: percent)



Source: World Inequality Database; IBFD; and IMF staff calculations.

The revenue neutral options would involve either a lower allowance or a higher rate...

**Revenue change (in percent of GDP)
by income group**



Source: World Inequality Database; IBFD; IMF-staff computations

...while slightly more progressive systems would improve work incentives and revenue mobilization even more.

Decomposition of redistributive capacity

higher values toward the upper right corner



Source: World Inequality Database; IBFD; IMF-staff computations

E. Business Income Taxation

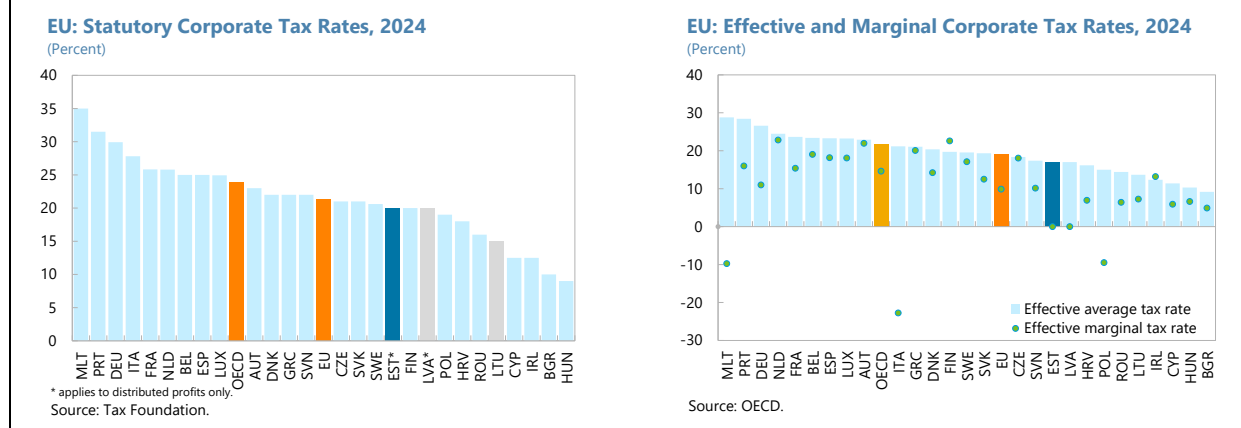
21. Most countries tax corporate income for pragmatic reasons. Income generally arises from labor effort—wages or entrepreneurial activity—and capital returns—interest, dividends, or capital gains. Corporate income is a subset of capital income. Although there are no fundamental reasons why capital income should be taxed through corporations (and not only at the individual level), at least two important pragmatic reasons exist why such an approach is in countries' interest. First, corporations are convenient collection agents, making the CIT a way for the government to reduce tax administration costs. Second, levying a (source-based, i.e., where capital owners reside) CIT allows countries to tax foreign capital owners on capital income earned locally. However, to the extent that CIT falls on the normal return to capital, as opposed to pure economic rents⁵, it is expected to adversely impact FDIs⁶ as well as to create distortions in the pattern of savings and investment. Taxing rents and thus fully exempting investments is the economic rationale that justified the simplified CIT system adopted by Estonia in early 2000s.

22. Corporate income taxes are part of a broader income tax system. Countries have adopted several alternative approaches to taxing income. One theoretically appealing approach would be to tax the sum of labor and capital income at a progressive rate structure. This is typically called a 'global income tax' or 'comprehensive progressive income tax'. However, an important concern with this approach is that it could lead to significant distortions of intertemporal savings decisions, thus being clearly suboptimal in the long term compared to other taxes. This is because it would imply that capital income taxes on the normal return to capital would be non-zero (as it is also the case with standard CIT). Different approaches have been developed to address this (and other) concerns. For example, full deductibility of capital expenditures has been proposed to eliminate taxes on the normal return to capital; 'flat taxes' have been conceived to simplify taxation by applying a single marginal tax rate to limit arbitrage opportunities between labor and capital income; and 'dual income taxes' stipulate that the progressive rate structure should only apply to labor income while capital income should be taxed at a (lower) flat rate. In practice, most tax systems apply a hybrid approach combining different elements of these stylized approaches. In the EU, for instance, most countries adopt dual income taxes with a more progressive PIT and a lower, single rate on overall profits. The average CIT rate in the EU is lower than the OECD average with some countries applying reduced CIT rates and other tax incentives, e.g., R&D tax relief provisions (Text Figure 4).

⁵ The normal return on capital is generally defined as the minimum return required to make investors equally well off (with an adjustment for risk) compared to some benchmark investment, such as a government bond. The remaining profit, over and above the normal return, is called 'rents.' While the normal return is clearly capital income, rents might in fact be subject to bargaining between workers and capital owners— and thus can be reflected either as capital income or as labor income (in the form of higher wages).

⁶ A CIT falling solely on pure economic rents would not be expected to have adverse investment impacts. However, if the CIT falls on quasi-rents, arising in the case of specific investments with fixed costs, adverse impacts on FDI could still materialize, perhaps to a lesser extent, e.g., if an alternative (and mutually exclusive) investment exist that is expected to earn higher quasi-rents.

Text Figure 3. Estonia: Corporate Income Tax (CIT)



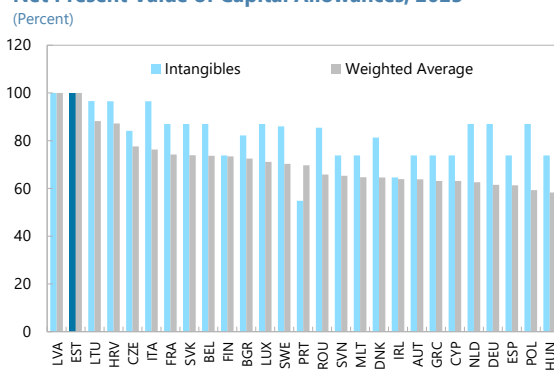
23. The total tax burden on capital income is determined by taxation at the corporate level (through the CIT) and at the individual level (through the PIT). In classical income tax systems, corporations are considered separate entities from their shareholders, and the CIT is thus levied separately as a withholding tax on equity returns.⁷ Since in such systems equity returns may also be subject to PIT—e.g., on dividends and capital gains—levied at the shareholder level, capital income is double taxed in the sense of being subjected to two separate layers of capital income taxes.

24. CIT systems can be classified based on the definition of the corporate tax base.

Typically, three general approaches are distinguished (King, 1987, Auerbach et al., 2010, IMF, 2021).

- Full return to equity.** This approach corresponds to standard CIT systems levying tax on corporate profit as defined by accounting rules, with some adjustments. Capital expenditure is not a deductible expense. Instead, depreciation of capital assets is deductible based on a pre-defined depreciation schedule (Figure). Interest is a cost and, therefore, deductible while profit is taxed irrespective of whether it is retained or distributed—thus giving rise to a different treatment of debt- and equity-financed investment at the level of the corporation⁸ (i.e., a 'debt bias'). As a result, standard CIT systems tax the normal return to capital income⁹ if investment is equity-financed (but not if it is debt-financed), implying that taxation might discourage marginal investments not earning any economic rents due to the resulting increase in the cost of capital.

Net Present Value of Capital Allowances, 2023



⁷ Wages and interest are generally deductible in classical corporate income tax systems.

⁸ If interest income is taxed higher than dividends at the individual level (through the PIT) it is possible that the debt bias is mitigated when taking both levels into account.

⁹ The full return includes the normal return as well as any economic rent.

When combined with other tax advantages, such as e.g. accelerated depreciation, interest deductibility is equivalent to a net subsidy to the borrower, which can have significant effects on financial markets by encouraging excessive leverage.

- **Full return to capital.** Several alternative approaches have been proposed to avoid the debt bias at the corporate level. One such approach, the comprehensive business income tax (CBIT) aims to achieve this by disallowing interest deductibility, thus effectively bringing the entire return on capital income into the corporate tax base (of the source country), irrespective of the source of finance. To avoid double taxation, interest income received by corporations would be excluded from the tax base. Due to the larger tax base, compared to a standard CIT, the rate could be set at a lower level without revenue loss; in addition, the PIT treatment of interest income should be aligned with the treatment of dividends and capital gains. The CBIT was developed by the [US Treasury Department](#) in 1992 (Hasen, 2013). In 2014 the Swedish Committee on Corporate Taxation proposed that [Sweden](#) adopts a CBIT system of taxation, although this proposal was finally not implemented (Lodin, 2014).
 - **Economic rents/cash flow corporate taxes.** Alternatively, the debt bias could also be removed by defining the CIT base such that only economic rents, but not the normal return, are subject to tax. Such taxes are typically referred to as ‘rent taxes’ and generally seen as more efficient from an economic perspective due to a lower propensity for distortions. Because economic rents are excess profits over the required (normal) return, the corporate tax would not create any efficiency losses. At the corporate level, these ‘cash-flow taxes’ are based on the Sources & Uses of Funds, rather than the Profit & Loss statement. They are also preferred on equity grounds, because they do not distort the pattern of savings and investment over time. Evidence suggests that cash-flow taxes have several preferable qualities compared to a standard CIT. Using IMF’s multi-region [GIMF](#) model, Carton et al., 2019 analyze the implications of replacing a standard CIT by cash flow taxes. They show that this type of reform boosts output in the country undertaking the reform and results in positive long-run spillovers to the rest of the world. Estonia’s CIT comes close to a type of cash flow tax (share- or ‘S-base’) on pure economic rents, with some caveats, given that it is not based on net profit distributions. Some EU countries have considered moving from standard CIT to cash flow corporate taxes to ensure tax neutrality with respect to both financial and investment decisions and encourage investment. However, such a structural reform of the CIT base carries significant revenue risks, especially in a transition phase, as the statutory rate would need to go up to keep revenue levels constant (with a narrower base).
- 25. Three main approaches for cash flow corporate taxes design exist.** First, a rent tax on real cash flows (‘R-base’ cash flow tax) can be achieved by making two adjustments to a standard CIT base: (i) allowing capital expenditures to be fully deductible from the corporate tax base; and (ii) disallowing interest and dividends deductions. The idea is that the tax is a levy on the sum of firm’s net cash flows resulting from its real economic activities. Investment expensing implies rent

taxation.¹⁰ Second, a rent tax on real and financial cash flows (**‘R+F-base’** cash flow tax) can be obtained by introducing full expensing of capital expenditures while retaining interest deductibility and adding net debt (hence ‘F’) to the tax base. Third (a less prominent case), a cash flow tax on share transactions (**‘S-base’** cash flow tax). Under this approach only the **net** distributions of corporations are taxed, i.e., in broad terms the tax base is defined as dividends plus share buybacks **minus** capital increases.

26. Another possible approach to ensure tax neutrality would be the introduction of an Allowance for Corporate Equity (ACE). Under a standard CIT system, this option would maintain interest deductibility and add an (mostly) equivalent notional interest deduction for equity capital such that the debt bias is at least reduced. The ACE was elaborated by the IFS Capital Taxes Group in the UK ([Institute for Fiscal Studies](#), 1991). Belgium and Italy have recently implemented variants of the ACE tax in their tax systems.

27. Estonia and Latvia tax distributed profits. Estonia and Latvia operate distributed tax profits (DPTs) since 2000 and 2018, respectively. Upon declaration of a dividend, the DPT is levied at a rate of 22/78 of the net amount of the profit distribution, corresponding to 28 percent on the gross amount distributed.¹¹ In both countries, undistributed corporate profits are tax exempt. This exemption covers active and passive income—i.e., received dividends, interest, royalties—as well as capital gains arising from the sale of shares or securities; in Latvia, but not in Estonia, immovable property owned by non-residents are excluded from this exemption. In both countries, resident companies and PEs of non-resident companies can benefit from this exemption.

28. The tax base is the directly distributed dividends, making revenues hard to predict. In Estonia, the tax is charged on selected transactions rather than on financial results for the period. There are neither carry forward nor depreciation rules for tax purposes. Corporate taxpayers would still compute economic depreciation according to an acceptable accounting rule. Standardized accounting rules must still be followed to determine net earnings from which the dividends are declared. The tax administration monitors the correctness of the net earnings calculations. However, over time, DPT revenues have been volatile and, various amendments were introduced to raise revenues, making them more predictable, while keeping the current system in place. To raise more revenue from CIT, the reduced 14 percent CIT rate on regular profit distributions (also taxed at 7 percent with a withholding tax) has been abolished from 2025. The advance CIT for credit

¹⁰ In the standard CIT system, the tax (t) directly increases the cost of capital. To be undertaken, an investment needs to yield a higher return, i.e., the cost of capital increases from r to $r/(1-t)$. Under the R-base cash flow approach, rent-earning investments would be taxed $R(1-t)$, but tax would never turn a profitable investment into a loss-making one. Similarly, an S-base cash flow tax levied on net distributions would achieve the same result since new equity injections would reduce tax liabilities in present value terms. To achieve neutrality in practice under the standard CIT, tax authorities need to refund (or carry forward with interest) negative tax liabilities when investment is undertaken.

¹¹ In Estonia, CIT is computed based on the grossed-up amount. Since January 2025, the tax rate on the net profit distribution is 22/78, i.e., about 28.2%. The amount of tax is equal to $(\text{Net Dividend} \times 22)/78$. From January 2026 the nominal rate goes up to 24%. The fractional rate will be 24/76, bringing the gross-up rate up to 31.6%. This is because at least in theory, Estonia is still taxing the profit not the dividend (‘profits upon distribution’).

institutions ('bank levy') has been increased from 14 percent to 18 percent. Compliance under DPT is hard to assess but the observed spikes in revenues before the recent tax hike announcements point to significant untapped revenue.

29. The DPT is likely less distortive than a standard CIT, because it falls mostly on rents.

Over time, the DPT has served Estonia well, by providing impulse to much-needed corporate investment. The system addresses the neutrality between debt and equity, thus reducing the need for debt financing. It is simple: there is no need to track revenues and deductible expenses, although this is not an exclusive feature of DPT. Other approaches can be used to achieve similar degrees of simplicity. It also works well in a digitalized environment, where it is easy to set up a company and file taxes online, compliance and enforcement are high, and institutions are strong. All these factors have led to limited costs relative to the size of tax administration. DPT's main drawbacks include the potential for sizeable loss in tax revenues, especially if statutory rates are not increased commensurately to make up for the narrower base. Several potential arbitrages can erode DPT's narrow tax base: e.g., high wealth individuals or service sector employees can incorporate and collect dividends rather than a remuneration subject to PIT; transactions tend to take place between corporates; and shareholders may defer profit distribution.

30. The Baltic DPTs levy taxes on gross distributions—distributed dividends and share buybacks without accounting for capital increases—thus failing to fully align with the canonical definition of a cash flow tax on share transactions ('S-base'). Being defined as gross distributions, the DPT captures more than just economic rents. Hence, the efficiency gains associated with rent taxes may not fully materialize. However, taxing gross distributions prevents the types of concerns, discussed above about debt being the preferred instrument to finance a company.

31. In the present context, the question arises whether the DPT system is still the main factor in attracting investment to Estonia. Attracting FDIs depends on features like the institutional framework, skilled workforce, infrastructure quality, and connectivity. Like for any other tax policy, there is a cost-benefit analysis to be made. The costs of such tax policies arise through forgone revenues, or the opportunity cost of public expenditures not being made due to these lost revenues. Another issue to consider is that over time companies may retain large profits that are taxed only upon realization as capital gains. Reforming CIT can thus be a way to ensure that capital income earned by corporations is taxed as it accrues. Against this background, various tax policy options could be pursued to strengthen revenue mobilization.

- **Improving current design of the DPT, including a higher statutory rate.** One option would be to continue improving the design of the current DPT and adapting it such that higher revenue yields can be mobilized. Estonia currently raises less CIT revenue than European AEs and the Nordics, notwithstanding relatively high statutory CIT rates. Increasing the rates may be attractive, especially if the tax base is aligned more closely with economic rents by moving from *gross* to *net* distributions. However, higher rates also imply stronger incentives for tax arbitrage across income types, sources of finance, organizational forms, and other margins; and it may

increase tax avoidance and evasion more generally. Since there is only limited experience with DPTs at higher statutory rates, this approach could be subject to considerable risks.

- **Moving towards a standard CIT.** A less risky option could be to transition the current DPT, through a well-sequenced incremental reform, towards a standard CIT. The standard system already applies to banks in Estonia. Although not without flaws, the standard CIT could be a credible option to achieve significant increases in the tax to GDP ratio. To mitigate the adverse investment effects stemming from the taxation of the normal return, additional provisions could be implemented, including an Allowance for Corporate Equity (ACE) or immediate expensing for specific asset types (as in the US and in the UK). Both approaches can help keeping the taxation of the normal return relatively close to zero, and thus the competitiveness of the CIT. ACE, for instance, would not only be more efficient than the current DPT system by not interfering with companies' internal decisions, but would also enable generating the same revenue at a lower rate. The standard CIT system is more complex as companies need to have accounts and calculate taxable income, and the capacity of the tax administration would need to be enhanced. However, ACE would provide the benefits of rent taxation while making the system more robust and less prone to tax avoidance.
- **Exploring other rent taxes, on efficiency grounds.** Rent taxes can be achieved through several different CIT designs, including cash flow taxes (on R- or R+F-base). Although, the current CIT design, relatively low CIT revenue levels and the existing experience with the DPT in Estonia (and Latvia) may provide a more amendable starting point for such a reform than is usually the case in other countries. That said, a switch towards another rent tax would also come with considerable risks, including the fact that such options have rarely been implemented on a broad basis despite their theoretical appeal.

F. Value-Added Tax

32. VAT C-efficiency has been high in Estonia since 2005. This reflects strong revenue performance achieved via a broad coverage, with fewer reduced rates compared to EU/EA averages (e.g., pharmaceuticals, hotel accommodation, periodicals, books), high reliance on automated, transparent, and efficient tax administration processes enabling very quick VAT returns, and a low compliance gap, despite some variability over time. Challenges for the tax administration may include turnover concealment, fraudulent tax returns and input VAT, and real estate-related tax frauds.

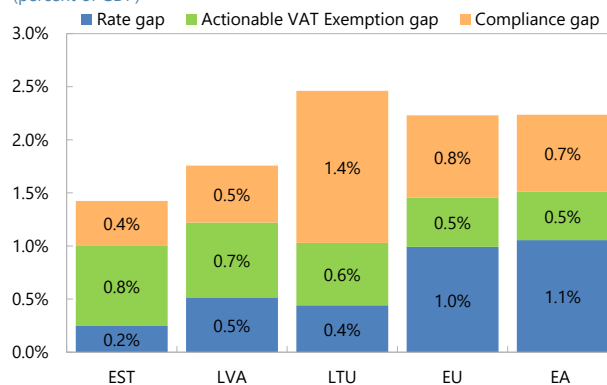
33. Higher revenue could be mobilized by further reducing the policy gap, while maintaining high levels of tax compliance. According to the 2024 European Commission's [VAT Gap](#) Report, the VAT policy gap is about one third of the theoretically collectable VAT revenue for Estonia. However, part of it is not actionable, since it is related to public services and healthcare. The actionable areas are related to exemptions that are largely not justified on social grounds (public goods) or can be identified (actionable exemption gap) as multiple, reduced and super reduced rates (rate gap). It is estimated that closing the actionable exemption gap would yield 1.1 percent of

GDP, while closing the rate gap would yield slightly less, 0.3 percent of GDP (based on 2022 data). Strengthening tax compliance could generate up to 0.4 percent of GDP.

34. More can be done to reduce the exemption gap and further strengthen compliance in the face of heightened uncertainty and statutory rates hikes (Figure). The main exemptions are related to the small enterprises scheme (registration threshold) to reduce tax complexity and facilitate market entry, real estate exemptions (e.g., rental real estate income, sale of immovable property), non-profit activities (e.g., use of sports facilities or sports equipment), online education, online gambling, and some medical procedures not covered under the EU's [VAT Directive](#) (2006). Higher statutory rates are typically associated with greater incentives for noncompliance—in the EU, on average noncompliance is estimated to worsen by about 0.5 ppts of theoretical revenues for each 1 ppts VAT rate increase (EC, 2024)—and in presence of higher uncertainty. Requiring that all invoices be declared in the VAT return annex (currently only transactions above \$1,000 are included) and expanding e-invoice for all VAT payers (from the current 7 percent coverage) would also improve collection, while reducing discrepancies and administrative burden (MoE, 2024).

EU: Actionable VAT Gaps

(percent of GDP)

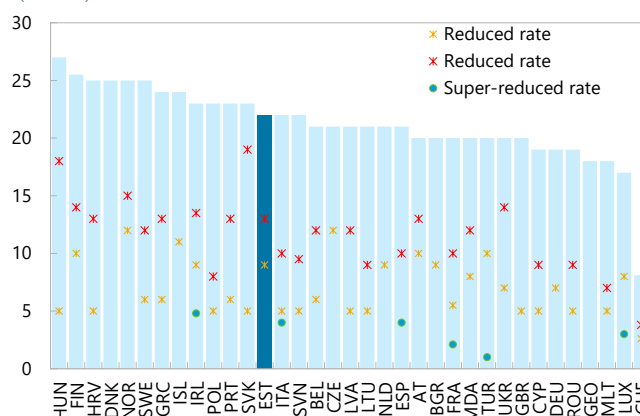


Sources: European Commission and IMF staff calculations

35. A proliferation of reduced rates and exemptions as statutory rates go up should be resisted. There have been proposals to tax food at a lower 5 percent VAT rate (for an estimated cost of around €400 million) or even introduce exemptions to improve distributional effects. This would be a costly way to pursue equity. While low-income households spend a larger proportion of their income on necessities, high-income households spend a larger absolute amount and thus would also benefit most from a low rate. Instruments better suited to pursuing fairness objectives can be designed, including income-based targeted transfers or other forms of cash support to the neediest. There is broad consensus that a uniform, broad-based consumption tax, with very few, well-specified exemptions and limited rate differentiation is a preferable benchmark. Increasing VAT revenue through a broader base and fewer reduced rates and exemptions, would be a more growth friendly option relative to standard rate increases. Exemptions create cascading effects through denied input tax credits,

2025 VAT Rates in Europe

(Percent)

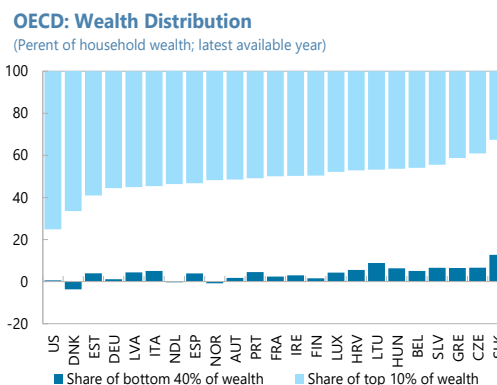


Source: Tax Foundation.

distortions in production decisions on inputs and outputs, as well as increased administrative burden and lowered compliance. A non-linear progressive income tax is typically seen as a more efficient way to achieve redistribution.

G. Property Taxes

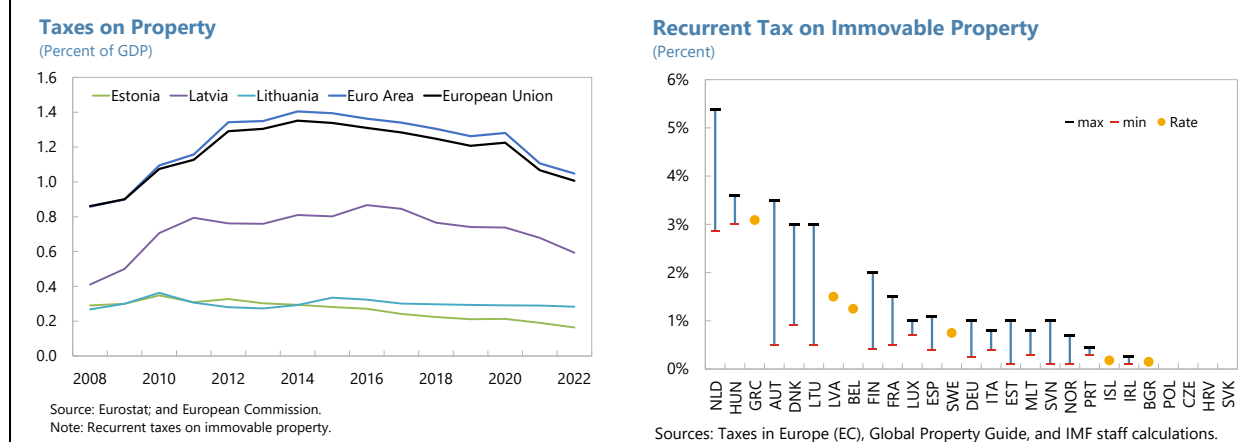
36. In Estonia, wealth is more unevenly distributed than income. In the OECD, the average share of wealth held by the top 10 percent of households is 50 percent, largely exceeding the average share of income (24 percent) held by the top 10 percent. Estonia has one of the largest differences, with the top 10 percent of households holding about 1/3 and the bottom 40 percent holding less than 5 percent of total wealth.



37. Taxes on property comprise a broad category of taxes that are payable on the use, ownership, or transfer of wealth, in return for benefits the taxpayer receives. They may be levied at regular intervals, one time only, or on a change of ownership (IMF, 2014, Grote and Wen, 2024). The most common type of property taxes is the recurrent tax on immoveable property (paid annually on an assessed value of buildings and land, that is, real estate) and the real property transfer tax (levied as a tax or a stamp duty when there is a change in real estate ownership). Real property taxes are imposed on gross values. They are among the least distortive for economic growth as their base is immobile. Property taxes are also progressive because land and capital are owned predominantly by higher-income individuals.

38. Property taxes raise on average around 1 percent of GDP in advanced economies. Their yield goes up to 3 percent of GDP in the UK and Canada, while EMDEs generally raise less than ½ percent of GDP. In Estonia, where only land is taxed, there could be scope to move toward a modern property tax. Where market-based valuation is hard, simplified approaches based on property areas can produce reasonable outcomes at lower administrative costs. A shift toward a recurrent property taxation could also mitigate distortions in housing markets.

39. Estonia collects limited property tax revenue in the form of a land tax, while residential land is exempt up to a generous threshold. Despite the relative importance of real estate activities in Estonia (about 5.5 percent of value-added and 3.5 of total employment, higher than EU average), taxes on property, that is, solely from the taxation of land, collects less than 0.2 percent of GDP and its share has been on a downward trend in the last decade. There is no assessment of buildings' value for taxation purposes and there is no real property transfer tax (Text Figure 5 and Box 3). The Land Tax Act provides for several preferential tax treatments. For example, a land tax exemption exists, whereby landowners are exempt from the obligation to pay land tax on residential land of up to 1,500 m² in cities and other densely populated areas and up to 2 hectares elsewhere. Local authorities may additionally exempt pensioners and other categories.

Text Figure 4. Real Property Taxation**Box 3. Property Taxation in Estonia***Acquisition:*

Transaction tax. Purchases of new properties are taxed at the standard VAT rate. From 2025, the definition of new buildings will encompass buildings of up to 2 years of age. There is no real estate transaction tax.

Holding:

Rental Income Tax: There is a flat income tax rate of 20 percent. Deductions of up to 20 percent are allowed based on proof of real expenses related to the property.

Profit Distribution Tax: An exemption from withholding tax on outbound dividends benefits real estate holding companies with international ties.

Property Holding Tax: Land in Estonia is subject to an annual tax, levied on the market value of the land. The rate is established by the municipal council and varies between 0.1 percent and 1.0 percent. Local government units have discretion in setting tax exemptions (up to €1,000 for residential land) and reduced rates to attract specific types of investments.

Disposal:

Capital Gains Tax: Capital gains are included in the computation of taxable income and taxed at the standard 20 percent rate. Income of nonresidents from sales of properties is subject to income tax by way of assessment and may be tax exempt. Taxable capital gain is generally computed as gross selling price less acquisition costs. Gains from the sale of a summer cottage or garden house are exempt if owned for more than 2 years.

40. Despite a very effective land survey and valuation systems, using a land tax to raise revenues has proven challenging and exemptions are widespread. Estonia has an effective central property tax administration, modern land valuation performed by the National Land Board and private valuers, and an efficient Cadaster Administration with only 1 percent of all land parcels not yet completely adjudicated in terms of registered property rights. However, no property tax revaluation was conducted in Estonia for over 20 years.¹² Prior to the 2022 comprehensive land revaluation, the maximum land tax rate was 2.5 percent of the taxable value of the land. With the 2022 revaluation implemented from 2024, property values have increased 8 times, requiring a lowering of the maximum tax rate. The upper bounds of the new tax rate for 2025 range from 0.1 to

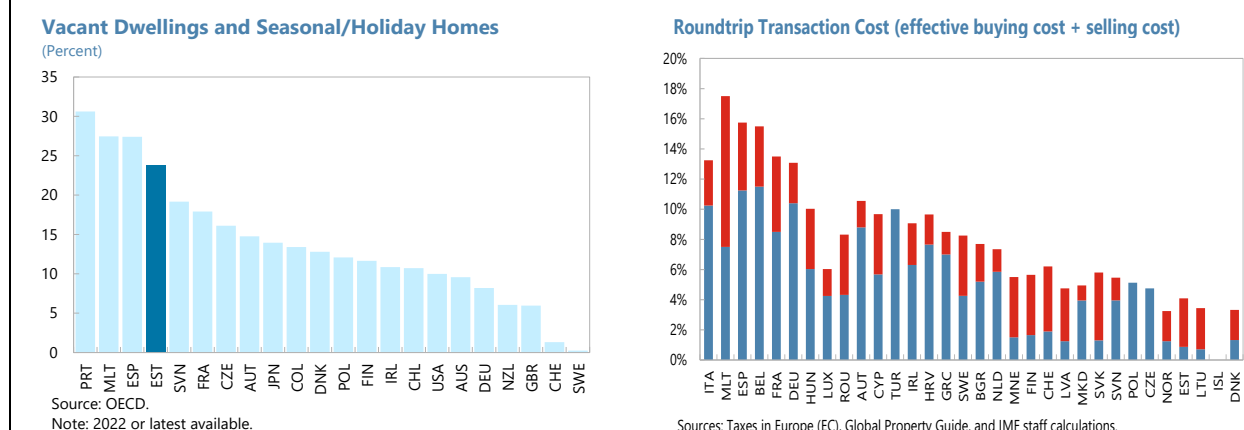
¹² The amendments to the Land Tax Act provide now for periodic revaluations every four years starting in 2022.

1 percent of market value for residential and agricultural land, from 0.1 to 0.5 percent for profit-yielding land, and from 0.1 to 2 percent for land with other intended use. To promote local fiscal autonomy, local governments are allowed to fix rates and exemptions by October 1st, annually.¹³ The 2022 values are applied progressively by municipalities, even though, in 2025, the cap on the value increase was increased significantly to 50 percent/€20 from 10 percent/€5 previously. From 2026, the homeowner's exemption will be decided by local governments and capped at €1,000. Homeowners will remain exempt from land tax for up to 1,500 m² of domestic land. The homeowner's tax exemption is also applicable to homeowners living on land with joint intended use. For instance, in 2025, the City of Tallinn exempted 172,500 homeowners from paying taxes on domestic land, accounting for about 80 percent of total taxpayers. Despite the recent changes, the estimated revenue collected in 2025 is still less than 0.2 percent of GDP.

41. There is no fully-fledged fiscal cadaster, and the various underlying registries are not synchronized. For the imposition of a property tax a fiscal cadaster to ensure fair taxation based on value and use of property is needed. Such cadaster would handle records of property values, tax information, and land use. The primary purpose of a fiscal cadaster would be to support the administration of property taxes and to ensure that landowners are taxed fairly based on the value and use of their property. The cadaster would state the coordinates and physical addresses of taxable properties, and the owners/occupiers. Synchronization of various registries would need to be improved, with due consideration to processing of personal data. Currently, legal ownership, including areas, are recorded in a land registry; buildings, including permits are entered into a building register; transaction data are forwarded to the Land Board, while the population registry is kept at the Ministry of Interior.

42. The share of vacant dwellings and seasonal homes is significant in Estonia, pointing to untapped tax revenue potential. Estonia has among the highest number of dwellings per inhabitant in the EU and real estate roundtrip transaction costs are low (Text Figure 6). Based on the 2021 census, the number of residential buildings in Estonia is 266,475. Of these, about ¾ are one-family dwellings, 18 percent are blocks of flats, and the rest are semi-detached houses and non-residential buildings, with at least one living space. About ¾ of all these dwellings are occupied, i.e. have at least one permanent resident, while ¼ are without permanent residents, and their share has been rising. There are nearly 39 million square meters of residential space, an average of 30.1 m² per person. Assuming a tax based on property value and allowing for some differentiation between primary and secondary residence (e.g., 0.05 percent and 0.1 percent, respectively), up to 5 times higher depending on the municipality, and assuming an exemption threshold of 10 percent, a new tax could generate as much as 1.7 percent of GDP.

¹³ For instance, Tallinn, the capital city and at the same time the largest municipality, adopted a tax rate of 0.5% for both residential and profit-yielding land, and a rate of 1% for land with other intended use.

Text Figure 5. Real Estate Market

43. A modern value-based property tax would help rebalance the existing tax structure. In the near term, municipalities should be encouraged to limit residential primary owner exemption. The mandatory residence registration system at the local level should be tightened and the information in the population registry with the land registry, real estate transactions, and income statements synchronized. The tax should be as broad as possible, with means-tested compensation mechanisms in place to offset the impact on low-income households. At the same time, preparation could start for a property registry of house valuations that could be used for taxation purposes ('fiscal cadaster'). A fiscal cadaster can be improved by using for example drones and satellite imagery to create property maps. Advances in digital mapping technologies offer possible solutions for identifying property parcels and buildings, registering their ownership, and mapping their geographic location in a central fiscal cadaster (IMF, 2018).

44. Measures to shield low-income households from the adverse impact of the reform can also be prepared. Tax deferment schemes for "asset-rich but cash-poor" taxpayers could lessen the cash impact on certain households, especially the elderly. Under a deferment scheme, it should be ensured that property tax arrears become due in full when the property is alienated through a sale or inheritance. Currently, the compensation mechanism during the application of the new land values is rather broad, with the increase in land tax in 2025 compared to land tax paid in 2024 compensated in the form of a grant transferred to the applicant's bank account, with no aid ceiling (for resident natural persons).

45. Local governments must be incentivized for maximum property tax effort. For instance, this could be done by reducing allocations of shared taxes over time or designing inter-governmental grants to reward greater municipal tax collection. To promote local fiscal autonomy, local governments should have some flexibility to select a property tax rate within a centrally determined narrow range.

46. Over the medium term, a full-fledged value-based property tax should be considered. This would follow completion of the necessary technical and legal preparations, including the fiscal cadaster. Best international practices show that a flat rate should be applied to a base with a

minimum of exemptions and a uniform treatment of business and residential property. Tax provisions could be considered in cases where individuals or companies own multiple properties, possibly located in different municipalities.

H. Conclusion

47. Given Estonia's low tax effort relative to peers along with imminent and longer-term spending pressures, options to support revenue mobilization could be considered. Estonia's tax mix is reliant on consumption taxes—especially VAT. Consumption taxes are less distortive than income taxes, but immediate spending pressures require reaching untapped potential. Staff recommends a review of Estonia's tax system to make it more robust and growth friendly, while strengthening revenue. Options highlighted in this SIP include (i) addressing the PIT revenue shortfall by considering revenue neutral options, i.e., calibrate the basic allowance, the tax rates, and/or the tax brackets subject to the intended degree of progressivity; (ii) improving the capacity of the tax administration to analyze income statements and exploring alternative CIT regimes that would preserve Estonia's tax competitiveness while reaching a broader tax base; (iii) streamlining remaining VAT exemptions to broaden the tax base; and (iv) limiting exemptions on residential land and taking steps to introduce a modern tax on immovable property by developing a fiscal cadaster.

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