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Development trends in the tax systems of Estonia and other countries

Summary

The Future-proof Tax Structure research stream

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Summary

In this paper, we summarize the main developments of European countries' tax systems, looking at both longer term trends as well as more significant reforms in recent years. We look at labour taxes (including the personal income tax and social security contributions), corporate income tax, consumption taxes, and property taxes.

The distribution of tax revenue by type of tax base (labour, capital, and consumption) has remained remarkably stable in EU countries over the past two decades, despite significant technological, economic, institutional, and demographic changes. Likewise, the overall share of tax revenue in GDP has remained stable. Based on past data, it is therefore not easy to extrapolate any broad trends or shifts away from one tax base and toward another, or to predict an inevitable increase or decrease in tax burdens. Tax structures, broadly considered in terms of the relative importance of the different tax bases, appear to be sufficiently resilient enough to survive, with moderate adjustments, fairly substantial societal and economic changes. That of course doesn't mean that there haven't been significant reforms and developments in individual taxes in many countries, or that they wouldn't be necessary in the future.

Foreseeable demographic developments in Estonia are not favourable for labour tax revenue. Assuming that these are not compensated by substantial immigration, the coming decades are going to bring a decrease in the share of the working age population and an increase of the share of the elderly. Although the rising pension age and active labour market measures supporting employment will increase employment among the elderly, age-related health problems will still mean their employment won't reach the levels of prime aged people. Other trends that might reduce labour tax revenue in the future include automation and the development of artificial intelligence, which will make it possible in the future to replace human labour in more and more complex jobs. Technological developments have also supported the emergence of new forms of work (virtual and platform work), the treatment of which in terms of taxation needs to be resolved. The diminishing tax base leaves the choice of either increasing the tax burden on labour or shifting it to another source of tax or other revenue.

Corporate income tax is affected by several different trends. Internationally coordinated efforts to limit tax evasion and regulate the taxation of digital services may to a certain extent exert upward pressure on the tax burden. On the other hand, the tax base remains mobile and some competition among tax jurisdictions will remain.

The value added tax has probably the greatest potential for growth as a source of revenue in many countries. It has a broad base, is easier to administer compared to many other types of tax and can be supported by digitalization and real time solutions. In many countries, improved administration has the potential to increase tax revenue even without raising tax rates. However, Estonia is somewhat exceptional in this regard – the share of VAT in tax revenue is already significantly higher than in most European countries, as is the VAT revenue ratio (the ratio of actual tax revenue to the maximum possible tax revenue). Should a shift be considered toward even greater share of consumption taxes, one should also consider their regressivity (since low-income households consume a larger share of their income) and the already high share in tax revenue.

The share of environmental taxes is probably on the increase. However, since these taxes are typically oriented toward behavioural change (reduction of harmful consumption and making alternatives more attractive), their base will be reduced to the extent the taxes are successful in achieving their primary aim. This will limit the potential of their importance as a source of tax revenue in the future.

Property taxes make up a small share of revenue and past data do not point to notable trends in this regard. In the future, property taxes might increase in importance if the growth in real estate prices leads to growth in inequality, leading to more pressure to raise taxes on property. This, however, could be constrained by the unpopularity of this type of tax as well as difficulty of administration.

Estonia’s tax structure has several characteristics that make it stand out among other European countries. While several countries are looking to increase the share of VAT as a broad-based and easy to administer source of revenue, Estonia is already ahead of that trend – the share of VAT (and consumption taxes in general) is significantly higher in Estonia compared to other European countries.

While the share of labour taxes in tax revenue is similar in Estonia and the EU on average, the shares of corporate income tax and property taxes in tax revenue is smaller in Estonia. Corporate income tax may have some potential for increased share in tax revenue depending on whether Estonia is willing to continue with its system of taxing not all of corporate income but only distributed profits. International developments in developing common unified tax base definitions and combating tax evasion are relevant trends in the background that might influence that decision one way or the other.

Developments in property taxes in Estonia will depend on future domestic challenges, especially the declining share of the working age population and the increased pressure on the social security system. If current demographic trends continue, one can foresee the need to compensate the reduction of the base of labour taxes by either changing the tax parameters (in other words, raising taxes), or by increasing the importance of some other type of tax.

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