

Summary

Analysis of the competitiveness of the tax system, including analysis of taxes and fees impacting Estonian industrial companies' production costs and comparison with neighboring countries

The Contractor shall ensure compliance of the final report and brief summaries with Government of the Republic Regulation No. 146 of 12 September 2014 "Requirements and procedure for informing the public about the granting of structural assistance for the period 2014–2020, marking objects funded and referring to the participation of the European Union". The project is financed from measure 12.2 "Development of the quality of policy-making" of Priority Axis 12 "Administrative Capacity" of the Operational Program of the Cohesion Funds 2014-2020 financed from the European Union Social Fund.

AS Deloitte Advisory was commissioned by the State Chancellery to compile an overview of the competitiveness of the Estonian tax system. According to the instructions, an overview of the treatment of the competitiveness of the tax system in the scientific literature has first been prepared and the position of the Estonian tax system has been described on the basis of existing prestigious international studies. Subsequently, a study was conducted comparing taxes and charges affecting the input prices of Estonian industrial companies with the industrial companies in neighboring countries, in order to position the competitiveness of the Estonian tax system in terms of such taxes and charges.

According to the set objective, the impact assessment had to identify, whether and if so by which national taxes and environmental and energy charges the Estonian industrial sector is in a significantly different (worse) competitive situation in compared to the reference countries, and to make policy recommendations to improve the competition. Summary

I Part

The first part provides an overview of the competitiveness of the tax system in the scientific literature and explains which parameters are generally measured when assessing the tax system. No new studies were carried out for this purpose, instead we relied on the following prestigious studies carried out at international level:

1. "International Tax Competitiveness Index 2019" (referred to as the ITC index), which is based on data collected by the OECD Tax Foundation of the United States;
2. The "Paying Taxes" index of the World Bank's "Doing Business 2020" study (referred to as the Paying Taxes index)
3. The European Commission's 2019 report "Taxation Trends in the European Union", which is based on data collected by Eurostat, the statistical office of the European Union, on the Member States of the European Union including Iceland and Norway.

As a result of the analysis, it was found that the Tax Foundation's ITC index from 2019 and the World Bank's Paying Taxes index from 2018 place the Estonian tax system in the first place and in the twelfth place, respectively. The ITC index compares 34 OECD countries, whilst the 2018 Paying Taxes index compared 189 countries worldwide.

The ITC index ranked Estonia in the first place for the sixth year in a row, and in the Paying Taxes survey, Estonia has steadily increased over the last six years, from 32nd place in 2014 to 12th place in the most recent survey year. The ITC index covers, for each country, corporate income tax, personal income tax, VAT, property taxes and income earned abroad, and thus provides a fairly comprehensive assessment of a country's tax position. Estonia's first place is mainly based on four positive features:

- a corporate income tax rate of 20% or 14%, applicable only to the distribution of profits;
- 20% personal income tax rate (which, as a general rule, does not apply to dividend income);
- property tax is levied only on the value of the land and not on the value of the immovable property on it;
- dividends or profits received by companies from abroad are not normally subject to corporate income tax (with a few exceptions).

A clear advantage of the Estonian tax system is that companies have to spend less time complying with tax requirements than in any other OECD country. For example, across OECD countries, companies spend an average of 42 hours a year on compliance with corporate income tax requirements alone. In Estonia, it takes an average of 5 hours a year. Other taxes, such as VAT, also have a low tax compliance burden. The reason for this can probably be considered the relative simplicity of the Estonian tax system (few exceptions to the general rule) and the use of widespread digital solutions.

The Paying Taxes index is skewed in measuring the time taken to administer and pay taxes when assessing the tax system. Three of the four indicators (number of payments, time taken to administer taxes and time taken to check tax refunds) are all related to the administration and payment of taxes. Only one indicator, which accounts for 25% of the total score, analyzes the company's tax burden.

At the same time, the Estonian tax system is dominated by indirect taxes, especially VAT and excise duties, the competitiveness of which is very limited by the ITC and Paying Taxes methodologies.

In summary, it was pointed out that the Estonian tax system is undoubtedly competitive in the world, when taking into account these aforementioned prestigious international indices. At the same time, the indexes mainly measure the burden of direct taxes and the ease of administration. However, the Estonian tax system is dominated by indirect taxes, the competitiveness of which compared to other countries lacks studies and international comparisons.

II Part

The second part of the impact assessment focused on the analysis of taxes and charges that specifically affect the industrial sector. The taxes and fees were defined as such by the Client:

Analysed taxes and fees

Excise duties on fuels and gas

Waste/landfill taxes

Electricity taxes

Packaging excises

Network charges	Recycling organization's service charges
Renewable energy charges	Heavy Goods Vehicles taxes
Mineral extraction charges	Road tolls

Fees for the special use of water/water abstraction charges

Only the above taxes imposed at national level in the countries concerned are covered. Local taxes are not covered. The following reference countries were identified by the contracting authority: Latvia, Lithuania, Finland, Sweden, Germany, Poland.

Summary of compared taxes and fees

1. Excise duties on fuels and gas

Compared to the reference countries, Estonia stands out with less differences. All countries apply different exemptions in the taxation of fuel and gas excise duties, only some of the exemptions prescribed by the Directive have been established in Estonia. Several countries, such as Germany, Finland and Sweden, have introduced a number of fuel and gas excise tax incentives for industrial production.

In the case of natural gas, the excise duty rate in Estonia is differentiated depending on whether the intended use is as a propellant or heating fuel. In the case of the use of natural gas as a heating fuel, no distinction is made in Estonia as to whether it is used for business or non-business use. Finland and Sweden have followed the same path, but in other countries the use of natural gas as a heating fuel has been set at a more favorable rate in business use compared to non-business consumption.

The tax rate on natural gas used as a heating fuel in business is significantly higher in Estonia than in Latvia, Lithuania and Poland, but at the same time significantly lower than in Finland and in some cases also in Sweden. At the same time, Estonia has a reduced rate of 1.07 € / MWh for companies with intensive gas consumption, which brings Estonia to an average between the reference countries when looking at the rates of business purpose heating fuels, but even then the tax rate is approximately twice as high than in Latvia and Lithuania.

Thus, in comparing the excise duty rates on natural gas, Estonia's competitiveness is average.

In the case of diesel fuel, in comparison with reference countries, Estonia is the only country where the tax rate on diesel fuel does not depend on its use, content or environmental class.

The tax rate on diesel used as a heating fuel in business is therefore exceptionally high compared to other countries, 493.00€/1000 liters in Estonia (compared to 21.14€/1000 liters in Lithuania and 56.91€/1000 liters in Latvia). Estonia's position in this ranking is also not affected by the temporary relief for the period 01.05.2020-30.04.2022, which lowers the tax rate on diesel fuel used as a heating fuel in business to 372.00€/1000 liters. At the same time, it must be taken into account that the share of diesel fuel used as fuel, i.e. light heating oil, in the energy balance of the Estonian industrial sector is marginal, as biofuels are increasingly being used. Which in turn means that the competitiveness of the entire Estonian industrial sector is not significantly affected by the high excise duty rate on light heating oil.

The excise rate on diesel fuel used as a propellant in Estonia has been average compared to other countries, but after the tax relief that came into force on the 1st of May 2020, Estonia reached the same rate as Lithuania and only Poland has a lower rate than Estonia.

Therefore, in the comparison of excise duty rates on diesel fuel, the excise rate of diesel fuel used as a heating fuel in Estonia is in a significantly worse competitive situation compared to the reference countries in the region, considering the state-regulated prices of industrial production input. In the comparison of the excise rate on diesel fuel used as a propellant, the competitive situation in Estonia is average.

2. Electricity taxes: electricity excise duty, renewable energy charge and network charge

The electricity bill consists of the following components: electricity basic tariff, network charge, electricity excise duty and renewable energy charge. In summary, in the comparison of electricity taxes, Estonian industrial production inputs are in a slightly worse-than-average competitive situation considering the state-regulated prices. If a company qualifies as an electricity-intensive company, the competitive situation is average.

2.1. Electricity excise duty

Four of the six reference countries surveyed (Lithuania, Finland, Sweden and Germany) have different rates of excise duty on electricity for business and non-business usage.

The standard excise duty rate on electricity consumed in business is the third most expensive in Estonia, after Germany and Finland. From 1st of January 2019, a more favorable excise duty rate applies to electricity-intensive companies in Estonia, which is the lowest applicable excise duty rate in comparison between countries (standard rate 4.47€/MWh vs 0.5€/MWh for electricity-intensive companies). At the same time, the threshold for qualifying as an electricity-intensive company is high compared to the one proposed in the directive, and the legislator estimates that there are up to 240 companies to which this preferential rate applies in Estonia. The remaining companies are generally subject to the standard rate of excise duty.

The temporarily reduced electricity excise duty rate for the period 01.05.2020 - 30.04.2022, which is 1€/MWh, is competitive compared to the standard rates of other countries.

Out of all the countries in this study, Germany has introduced the most tax incentives for the industrial sector for electricity taxes. For example, in Germany, tax reliefs on electricity excise duty in the industrial production can be as high as 90% of the excise duty, depending on the amount of pension contributions paid by the company and the energy efficiency of the company. To receive the relief, the company must have a certified energy or environmental management system. However, certain energy-intensive production sectors (such as electrolysis, metallurgical processing, chemical processing, glass, ceramics, concrete, bricks, tiles and fertilizers) in Germany are fully exempt from electricity excise duty, meaning they are subject to full refunds.

According to Germany's experienced tax advisers, the current system of tax incentives and refunds is so complex that it overwhelms many advisers, as it requires knowledge of the legal field, financial indicators and, in some cases, engineering knowledge to assess the technology used for production. Many of the current incentives are planned to be abolished by 2023, as they are in breach of state aid rules.

Small and medium-sized enterprises in Germany benefit from simpler measures, but are required to demonstrate the energy efficiency of production.

2.2. Renewable energy charge

As in the case of network charges, the principles for collecting renewable energy charges are not as harmonized in the reference countries as other taxes and charges in question, so it is more difficult to draw generalizations. It is important to note that no similar charges are collected in Finland and Sweden. In the case of Sweden, this has a significant positive effect on the total price of electricity, as illustrated by the company's production case study addressed in this impact assessment. It turned out that Sweden had the lowest total electricity costs, where electricity costs accounted for 16.03% of total production costs, compared to Estonia, where total electricity costs accounted for 21.01% of total production costs.

In other countries (Latvia, Lithuania, Germany and Poland) a similar fee is collected, but on different bases. Only the German system is comparable, where the fee rate is significantly higher than in Estonia, but at the same time there are several tax exemptions and reliefs in Germany.

There are no tax exemptions or reliefs in Estonia, and in the case of large consumers the charge accounts for about 1/6 of the final price of electricity. In Lithuania and Poland, the renewable energy charge depends on the market price of electricity. In Latvia, in addition to the fixed fee, an additional component is applied, which depends on the amount of income earned.

2.3. Network charge

The network operator providing the electricity network service collects a separately stated fee for the provided service in all reference countries except for Finland and Latvia. Only in Estonia and Germany, the network charges are regulated at the national level. The calculation of the network fee in Estonia is cost-based and the amount of the fee has been approved by the Competition Authority. Consequently, network charges are not considered to be a national tax or a charge that can be directly influenced by the legislator. Therefore, it is not appropriate to draw conclusions from the comparison of network charges in the context of this impact assessment.

3. Environmental fees/charges

Environmental charges are not labelled as taxes in the Estonian tax system, but they burden companies in the same way as taxes do. Environmental charges are divided into (i) natural resource charges and (ii) pollution charges. The natural resource charge is paid for the extraction of mineral resources and for water abstraction. The pollution charge is imposed in the event of emission of pollutants into the ambient air, groundwater or soil, and upon waste disposal.

3.1. Mineral extraction charge

Fees for the right to extract mineral resources are calculated on very different bases throughout the reference countries. Also, the main types of mineral resources differ from country to country, and in some countries the corresponding fees are not collected at the national level, but at the municipal level.

Compared to Latvia, the fee rates for the right to extract Estonian mineral resources are significantly higher than the fee rates applicable to the corresponding mineral resources of our

southern neighbors. In comparison to Lithuania and Poland, tax rates for the extraction of some minerals are quite competitive.

3.2. Fee for the special use of water/water abstraction charge

The right to use groundwater and surface water is taxed at the national level only in Estonia, Latvia and Lithuania, and in comparison of these countries, Estonian rates are generally higher than in other countries.

3.3. Waste/landfill tax

In Estonia, a pollution charge must be paid for waste disposal. Waste is taxed at a flat rate, as is the case in Finland and Sweden. The rate for the waste disposal in Estonia is also relatively low for both non-hazardous and hazardous waste. Non-hazardous waste is subject to a significantly lower rate in Lithuania when compared with other countries involved in the study. Sweden has the most comprehensive list of exemptions from waste disposal fees.

4. Packaging excise duty and recycling organization's service charges

In terms of packaging excise duty rates, Estonia has the highest excise duty rates in each type of packaging, especially in the taxation of paper, cardboard and wood, where Estonian tax rates exceed those of other countries by twice or more. The payment of packaging excise duties can be avoided by organizing the reuse of packaging to the required extent. Arranging the latter is generally more financially advantageous for the company. Thus, the high rates of excise duty on packaging should not be seen in isolation from the integrated system, but together with the fees charged by recovery organizations. Compared to Lithuania and Poland, the service fees for the recycling of paper and cardboard, plastic and metal packaging are significantly higher in Estonia.

In summary, based on the collected comparative data, it can be concluded that in view of the costs of Estonian industrial input, Estonia has higher rates of environmental charges than other reference countries in the region, and the competitiveness of Estonian industrial companies is lower than that of other countries. The only difference in this context is the waste disposal fee, which is relatively low in Estonia compared to the reference countries.

5. Heavy goods vehicles tax and road toll

The obligation to impose a heavy goods vehicle tax is imposed on EU Member States by Directive 1999/62 / EC, according to which trucks with a registered or laden weight of more than 12 tons and road trains must be taxed. The purpose of the Directive is to eliminate distortions of competition between transport undertakings in the Member States. However, when looking at the differences in the transposition of the Directive by the Member States and the differences in the application of the tax, it is questionable whether the Directive actually fulfills its purpose. In Germany, for example, the Directive has been formally transposed, but at the same time there are reductions provided in the amount of tax payable, so that the tax burden is not actually borne.

From 1 January 2018, it is required to pay road toll for all heavy goods vehicles that weigh over 3.5 tons and are used on the public road network. The toll rate depends on the maximum authorized mass of the heavy goods vehicle and its trailer, the number of axles, and the emission class of the heavy goods vehicle. Road tolls have been set in all reference countries except for Finland and Sweden.

Case study solution

In addition to a comparative analysis of the tax base, tax rate, administration and foreseeable differences in taxes and charges, a case study has been constructed covering most of the taxes and charges in question.

The solution of the case study first shows how the tax expense for an Estonian production company is formed in the production process and what share of the total production costs are formed by taxes. The case study has been prepared on the basis of the actual financial indicators of an industrial company operating in Estonia in 2019. We have placed the producer in the tax environment of the six reference countries and allowed the same amount of production to be produced there, assuming that other production input costs are identical to Estonia. Thus, the only variables for the producer are taxes and levies payable to the state budget within the production process. The case study allows us to analyze and compare the tax burden of the production activities of one Estonian production company in the tax systems of other countries and shows how big the difference is between the taxes and fees paid to the state budget in the production process. The case study methodology has been validated with 5 CFOs of Estonian production companies in five different sectors to make sure that the chosen format ensures a comparable result.

The case study is based on an electro-intensive production company that produces wood pulp.

In conclusion, the performed analysis indicated that Estonia is in a better position (more competitive) in terms of taxes and fees covered by the analysis than other Baltic countries (Latvia, Lithuania). Only Poland and Sweden were more competitive than Estonia, but on the assumption that raw materials and services are equivalent and fixed.

In the case of an industrial company with a different profile, the situation may change. For instance, although Sweden favors more electricity-intensive companies, the same does not apply to gas-intensive companies. Thus, in terms of Estonia's competitiveness, it is quite balanced in terms of the most important cost components.

In order to assess whether and how the competitiveness of the Estonian industrial sector could be improved, the main factors are either other operating costs (which were fixed in this analysis) or costs determined on the basis of the market price (electricity and gas basic tariff). State-controlled costs make up only 9% of the total costs of the Estonian case study company.

Therefore, although it is possible to increase competitiveness to some extent precisely through energy taxes (in particular the reduction of the renewable energy charge and excise duty rates), it has a rather small effect on the company's costs in the overall picture.

Political suggestions

The comparative data collected showed that the competitiveness of Estonian industrial sector companies is generally average. In the rankings of most of the compared taxes and fees, Estonia ranks in the middle.

Estonia is in a significantly worse competitive situation only in terms of the tax rate on diesel fuel used as a heating fuel for business purposes, and in terms of most environmental fees. In the case of the latter, Estonia generally has higher fee rates than other reference countries in the region, and no exceptions for the industrial sector are envisaged. The only difference in this

context is the waste disposal fee, which is relatively low in Estonia compared to the reference countries.

Among the countries included in the comparison, Estonia stands within almost all taxes and fees discussed in the impact analysis in terms of the small amount of tax exemptions/reliefs targeted at the industrial sector. It can be concluded from this that, at the request of policy makers, there is room in Estonia to make differences in favor of the industrial sector both in the case of diesel fuel used as a heating fuel for business purposes, and in terms of environmental fees. On the other hand, the share of these taxes and fees are still low enough for the vast majority of companies to question whether they could increase the competitiveness of companies as a whole. For example, according to the Ministry of Finance, the share of companies in the industrial sector that use diesel fuel as a heating fuel is marginal. Thus, in this case, it would not be possible to increase the competitiveness of the Estonian industrial sector by significantly lowering the excise duty rate. However, in terms of specific sectors, lowering environmental taxes would improve position of the sector most burdened by environmental levies: producers of construction materials and mining.

A comparative analysis of the case study, which focuses on the electro-intensive company, shows that the share of production costs that could be affected by tax policy represents a total of 9% of the company's total production costs. Of these 9%, in turn, the vast majority are electricity and gas taxes. The share of other taxes and charges, i.e. fuel, transport and waste, is so small that it is not possible to affect the competitiveness of companies by lowering them.

Therefore, if it is desired to increase the competitiveness of the Estonian industrial sector through tax policy options, electricity costs and gas costs should be considered first and foremost. When analyzing electricity costs, it appears that the component of renewable energy charge is the factor that could help improve the competitive position

It should be noted, however, that the case study company is subject to the reduced rate of excise duty on electricity, which only recently became applicable. If the company falls below the limits necessary for the application of the reduced rate, it should (before the temporary lower rate of €1/MWh that came into force on the 1st of May 2020) pay the standard rate of €4.47/MWh. As a result, production costs would increase by €841,000 and the company would fall by two places in the ranking of the comparison countries, coming 5th after Latvia and Germany.

Thus, an option for consideration could be to lower the requirements for qualifying for the reduced electricity excise duty rate (electricity-intensive rate), as the EU Directive would allow to do so. This would ensure a more moderately competitive environment for more Estonian production companies (currently only nine companies qualify for this benefit) even after the current temporary reduced excise duty rate of 01.05.2020-30.04.2022 expires.