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Impact of Estonian distributed profits tax on corporate finances: a literature review¹

ABSTRACT

This paper examines tax aspects related to distributed profits tax (DPT) in Estonia, which was the first country to introduce a corporate income tax on distributed profits (the so-called Estonian CIT). The main area of research centres on Estonian tax reform, with a particular emphasis on understanding their effects on corporate finances. Since its introduction in 2000, Estonia has consistently applied DPT, which has greatly benefited rapidly growing businesses. The DPT system is considered capable of promoting investment; it also fosters economic growth and capital accumulation. Additionally, the Estonian CIT could serve as a model for other countries to consider adopting a distributed profits tax system. It is vital to evaluate the influence of the Estonian tax reform on corporate finances to inform policymaking in this field, in particular in a context where the opaque corporate tax system in Poland urgently requires rational changes. The main area of the research centres on Estonian tax reforms, with a particular emphasis on understanding their implications and effects. This paper makes use of an analysis of legal sources and scholarly literature, complemented, to some extent, by empirical data, in accordance with the nature of the research problem.

Keywords: distributed profits tax, corporate income taxation, Estonian CIT, profit distribution

JEL classification: H26, K34

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Introduction

Taxes play a crucial role in the revenue aspect of a public finance system, impacting both the country's reforms and public financial management, particularly for taxpayers. Numerous countries commonly choose to focus on investment and economic growth by implementing corporate tax preferences as a primary approach [Tanzi, 2001]. Tax base mobility has been enhanced by free movement of goods, capital, services, people, as well as advancements in technology. Governments are feeling the heat to decrease corporate taxes on income and capital that can be easily relocated due to the growing trend of international tax competition. There is an increasing incentive to redistribute the tax burden onto factors that are less adaptable, such as labour or consumption taxes [Blöchliger, Pinero Campos, 2011; Suárez Serrato, Zidar, 2023].

Corporate tax, in general, is seen as one of the major obstacles to economic growth. The key finding of the OECD is that corporate income taxes and capital taxes are the most harmful to economic growth followed by personal income taxes, and then consumption taxes [OECD, 2008]. The Polish corporate tax system, rendered increasingly complex due to the accumulation of successive amendments, updates, and anti-avoidance measures over the years, has become a source not only of rising compliance costs for enterprises but also of significant financial risk for them – both of which hinder entrepreneurial activity in Poland [Felis, Jamroz, 2025]. Regardless of its fiscal functions, the tax system can serve as a catalyst for economic growth and development. Hence, it is worth learning from corporate tax reforms in other countries.

Researchers and policymakers are highly interested in how corporate taxation influences the behaviour of firms. While there is extensive literature on traditional corporate taxes, there is a notable scarcity of research on the consequences of distributed profits tax (DPT) [Devereux et al., 2002]. The DPT allows companies to reinvest their profits without being taxed, and corporate income tax is only applicable to profits that are distributed. This differs from Gross Profit Tax (GPT) which represents the classical corporate income tax (CCIT), taxing profits in their entirety at the moment they are earned. DPT is widely seen as an appealing corporate taxation system that is worth considering to adopt. Classical corporate tax regards corporations and their owners as separate tax entities and, therefore, double-taxes their income – first the corporation and then the owners on distributed profits. However, many EU countries have adopted the approach to regard corporate income tax as a withholding tax of the owners' personal income tax [Kari, Ylä-Liedenpohja, 2002].

The DPT system was introduced in Estonia in 2000. Estonia has consistently achieved high rankings in both the International Tax Competitiveness Index, published annually by the Tax Foundation,² and the Mannheim Tax Index as an indicator for the effective tax levels of companies, developed by the ZEW – Leibniz Centre for European Economic Research

² <https://taxfoundation.org/research/all/global/2025-international-tax-competitiveness-index/> {sccessed: 22.10.2025}.

in Mannheim.³ As a result, the Estonian system is frequently cited as a benchmark for modern, investment-friendly corporate taxation. Both indexes specifically highlight the benefits of the corporate tax system [Devereux et al., 2002].

The primary goal of the reform was twofold: firstly, to encourage investment by offering tax incentives on reinvested profits; secondly, to promote the influx of both domestic and foreign capital to finance investments. The system has gained global recognition since it was put into action. Georgia implemented the system in 2017, followed by Latvia in 2018. Due to the similarities among the three Baltic States, comparisons are often made between developments in Estonia, Latvia, and Lithuania [Staehr, 2014]. Poland adopted it in 2021, however, to a limited extent. The examination of Estonia's 2000 corporate tax reform's impact on corporate decisions holds great significance, as it offers insights relevant to potential tax reforms in other jurisdictions, including Poland.

Distinction between the GPT and DPT systems

Gross Profit Tax (GPT) represents the classical system of corporate income taxation, under which profits are taxed when they are earned, irrespective of whether they are distributed to shareholders or retained within the company. In this model the timing of taxation coincides with the generation of profits, which may limit internal reinvestment opportunities and affect firms' liquidity. As noted by Hazak [2008], the fundamental distinction between the GPT and the Distributed Profits Tax (DPT) lies in the timing of tax payments while GPT taxes undistributed profits, DPT defers taxation until profits are distributed.

Both tax regimes demonstrate that the tax base is primarily earned profit. DPT, in contrast to GPT, can be likened to interest-free loans given by the government to companies. Corporate tax is not collected by the state when profits are made, but income tax is deferred until the profits are distributed. The DPT allows companies to reinvest their profits without being taxed, and corporate income tax is only applicable to profits that are distributed. As a result, the implementation of the DPT system is projected to benefit significantly successful and rapidly expanding businesses. This will be achieved by fortifying their financial standing and promoting increased investment endeavours [Masso, Meriküll, Vahter, 2011].

The Estonian DPT system has gained global recognition since its introduction in 2000. For the twelfth consecutive year, Estonia has been ranked as having the most competitive tax code among OECD countries [Tax Foundation, 2025]. This leading position is driven by several distinctive features, in particular:

- a 22% corporate income tax only on distributed profits, leaving retained earnings untaxed;
- a flat 22% personal income tax rate, which excludes dividend income from additional taxation.

³ <https://www.zew.de/en/mannheim-tax-index> (accessed: 22.10.2025).

- property tax applies solely to land value, rather than to the total value of real estate or capital assets;
- a territorial tax system that exempts 100% of foreign-sourced profits earned by domestic corporations from domestic taxation, subject to limited exceptions.

The concept of profit distribution under the DPT regime also encompasses several other methods of distribution than in the form of dividends, including events such as transfer pricing adjustments, fringe benefits, gifts, donations, or representation expenses. As a result, the tax base can be any transfer of profits to shareholders, as well as any non-deductible expenses under the GPT model. The company itself decides independently which is the best moment to distribute the profit and, as a result, when tax liability arises. This creates an incentive to retain profits in the company, increasing its liquidity and the company's resilience to economic fluctuations. Free funds also provide an incentive for investment activity, thereby facilitating the growth of enterprises. A feature of DPT is low compliance costs for taxpayers and the tax administration. It does not require the periodic determination of profit or loss for tax purposes, removing the need for taxpayers to keep separate accounting for tax purposes, including records for depreciation of fixed assets [Funke, 2002].

Under DPT companies benefit from deferred tax payments, as CIT is due only upon profit distribution. This deferral serves effectively as an interest-free loan from the government, enhancing internal financing capabilities. The DPT system results in less external financing compared to the GPT system for debt-preferring companies. Hazak [2007] demonstrated that when profits are fully distributed and tax rates are comparable, the investor's valuation of the company is equivalent under both DPT and GPT. Alternatively, the optimal timing for dividend distribution varies based on factors such as the likelihood of a loss, tax rates, interest rates, and the investor's spending behaviour. Generally, DPT tends to result in higher retained earnings compared to GPT. The DPT system encourages companies to reinvest their profits instead of distributing them. Nevertheless, according to Hazak's study [2007], companies typically invest their undistributed profits in low-risk assets instead of making strategic investments. The contention put forth is that companies have already made all the investments that generate profit because they are not constrained to solely relying on additional equity capital obtained through the effects of DPT.

The core aspects of the CIT reform in Estonia

Until 1999, Estonia had applied the traditional corporate tax system. Estonia modified its corporate tax laws in 2000, despite already having a relatively low tax burden on companies.

The reform has led to a decrease in the statutory tax rate on retained earnings, from 26% to 0%, resulting in a reduction in the average implicit tax rate as well. Estonia implemented the dividend taxation system due to limited external financing options and underdeveloped capital markets during the Russian crisis. Government financing enabled by corporate tax

deferral helps mitigate the effects of shallow financial markets. Estonia's 2000 corporate income tax reform had a substantial impact on both the financial sector and corporate behaviour. [Staeher, 2014].

Under the new tax legislation, legal entities are not subject to income tax on undistributed profits, regardless of whether they decide to reinvest them. Companies have the option to distribute dividends by utilizing the remaining profits once they have offset any losses from previous periods. The tax reform stipulates that companies are obliged to pay income tax exclusively on the grounds of distributions, including hidden profit distributions such as dividends, fringe benefits, gifts, donations, and non-business-related expenses. Corporate income taxes apply to various types of distributions, including liquidation proceeds, capital reductions, and share buybacks. The tax base encompasses the payment amount beyond the paid-in capital, including capital and share premiums.

Tax preferences apply to both active activities like trading and passive sources such as dividends, interest, and royalties, as well as capital gains from selling assets like securities and real estate. In both cases, taxation is postponed until dividends are paid or profits are recognized [Funke, 2002; Hazak, 2009]. Hence, the reform eliminated the CIT rate on retained earnings, only taxing business profits when they were distributed. For foreign entities deriving income in Estonia but lacking tax residency, the regulations provide an opportunity to benefit from the same simplifications, provided that they have a permanent establishment in Estonia.

The accounting regulations in Estonia align with the International Financial Reporting Standards and facilitate the assessment of distributable profits. There are no specific accounting rules for taxation purposes. In most cases, the tax implications of different types of payments, like dividends or share buybacks, are equal under Estonia's DPT regime, except for specific tax rules such as for foreign controlled companies.

The primary characteristic of the Estonian DPT system is its simplicity and ease of comprehension and its administration. This is achieved through a restricted set of exemptions, alignment with accounting principles, and the deferral of profit taxation. In Estonia, non-deductible expenses and expenses not related to business activities are taxed on a cash basis, in the same manner as profit distributions. Moreover, the absence of traditional tax depreciation regulations in the Estonian DPT system is advantageous. Furthermore, according to the Estonian Commercial Code, profits may be distributed irrespective of losses from previous years, which eliminates the need for specific tax rules on carrying losses forward. Since profits are taxed only upon distribution, any losses accumulated in earlier periods reduce the amount available for distribution, and therefore remain untaxed. As a result, double taxation is fully avoided, the number of tax returns is reduced, and the likelihood of errors and corrections is significantly lower. Consequently, the reduction in administrative burden and compliance costs is also apparent.

Under Estonia's DPT system, dividends distributed by resident companies to Estonian tax-resident individuals are not subject to additional personal income taxation, as the entire tax burden is borne at the corporate level at the moment of profit distribution. Consequently, such

dividends are not treated as taxable income for individuals. In turn, in the case of dividends received by Estonian tax-resident individuals from foreign companies, the same principle applies: additional PIT is generally not imposed, provided that CIT has been paid at the level of the distributing company. Furthermore, with respect to dividends received by Estonian resident companies from foreign subsidiaries, the general rule is that CIT is levied only at the level where the profit initially arises. However, if the Estonian company's shareholding in the foreign subsidiary is below 10%, the dividends received become taxable in Estonia upon their distribution, irrespective of whether the underlying profit has already been taxed abroad. The modifications to the Estonian CIT for 2009 emphasize its alignment with the Parent-Subsidiary Directive [Lehis et al., 2008].

From January 1, 2019, Estonia introduced a reduced 14% CIT rate for companies that regularly distributed dividends. This was aimed at encouraging stable and transparent profit distribution. Dividends paid to individuals were also subject to an additional 7% withholding tax. However, as of January 1, 2025, the standard corporate income tax rate was raised from 20% to 22%. Simultaneously, the reduced 14% rate applicable to regularly distributed profits and the related 7% withholding tax has been abolished. As of 2025, all distributed profits were taxed at the flat rate of 22%, simplifying the CIT system and increasing tax neutrality [OECD, 2024].

In 2026 again, Estonia's DPT system will undergo a partial reform aimed at introducing a higher tax rate increasing it from 22% to 24%. The increase in the tax rate is intended to replace the planned 2% so-called "defence tax," which was scheduled to take effect at the beginning of 2026 to be levied on current profits. The introduction of an increased CIT rate will have both fiscal and administrative effects.

In the impact assessment of raising the corporate income tax rate from 22% to 24%, it is assumed that, similar to the rate increase in 2025, there will be an increase in profit distribution at a lower rate, which will affect 2025 (impact of 27 million) and 2026 (impact of 75 million). In the short term, dividend payouts are expected to decrease by up to 20 percent as a result of the increase in effective taxation. In the long run, however, these changes are expected to lead to a return to previous payout levels, since companies are unable to postpone indefinitely profit distribution. It is estimated that in 2026 CIT revenues will increase by EUR 75 million, and in the following years this growth will range between EUR 51 million and 56 million annually (see Table 1). Maintaining the deferred taxation model, combined with an adjustment of the tax rate, should result in a balanced reform that is aligned with Estonia's current fiscal and economic conditions [Riigikogu, 2025].

Table 1. Impact of the DPT reform 2025 on the government sector position (million €)

Scenario	2025	2026	2027	2028	2029
Baseline scenario: distributed profits decrease by 10%	27	75	51	53	56
Distributed profits decrease by 5%	14	95	85	89	93
Distributed profits decrease by 20%	47	31	–17	–18	–18

Source: Riigikogu, 2025, p. 13.

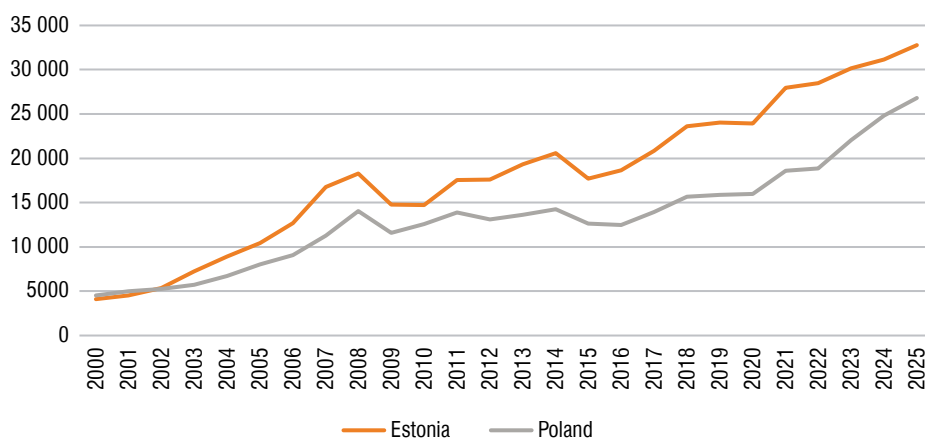
General impact assessment of the Estonian tax reform

Distributed profit taxation can be viewed as the government “injecting” capital into profitable businesses for the purpose of risk-sharing. It may be likened to interest-free loans provided by the government to companies. This generates a so-called positive tax interest effect arising from the deferral of taxation. If a company remains profitable, its owners will eventually seek to distribute the retained earnings, thereby generating budget revenues. Consequently, the Estonian DPT system provides state financing to companies on highly flexible terms, in contrast to the CCIT system. Firms with limited access to commercial financing, due to underdeveloped or distorted capital markets, are expected to benefit from this form of government financing.

The main finding of Staehr’s [2014] research is that adopting DPT in Estonia has wide-ranging benefits, particularly for society as a whole. It is worth noting that in 2025, Estonia’s GDP per capita amounted to USD 32,760, significantly exceeding the corresponding value for Poland, which stood at USD 26,805 (see Figure 1).

The pro-development impulse observed in Estonia did not fade a few years after the reforms were implemented, once companies had satisfied their most urgent investment needs, but instead generated lasting, beneficial effects [Sarnowski, Łożykowski, Domaszczyńska, 2020].

Figure 1. Comparison of GDP per capita in Estonia and Poland (2000–2025)



Source: based on: <https://www.imf.org/external/datamapper/NGDPPDPC@WEO/EST>

Staehr highlights that Estonia’s DPT system has contributed to higher investment rates, reduced opportunities for tax avoidance, and a simplified administrative burden for both taxpayers and authorities. However, it is important to acknowledge that the DPT system entails notable fiscal costs, particularly a decline in tax revenues that are not tied to economic cycles. Consequently, any such reform must be weighed carefully against long-term fiscal sustainability. [Staehr, 2014].

The Estonian CIT reform affected smaller enterprises the most. The political rationale for the Estonian system was that small and medium-sized enterprises in most countries have limited access to capital markets. It is much more accessible for larger companies to raise capital either through bank loans or through debt securities. This is not the case for small and medium-sized enterprises, so they need to fund through equity [Jegorov et al., 2020].

In the period following the introduction of the DPT in Estonia, an increase in investment activity was observed. For example, according to Masso, Meriküll, and Vahter [2013], the corporate investment rate rose by 17.3 percentage points after the implementation of the distributed profits tax. Among the smallest entities, the increase was much more significant, amounting to approximately 62%. However, it is not certain to what extent the DPT contributed to the increase in investment observed in Estonia. The USAID report [2015] does not rule out the possibility that the level of investment observed in Estonia after the reform could have been similar under a traditional corporate income tax system. The authors of the cited studies themselves emphasize that the results should be interpreted with caution [Leszczyłowska, 2025, p. 193].

While the reform had a general positive impact on Estonian businesses, its macroeconomic benefits are harder to ascertain. Estonia has not experienced faster growth in labour productivity and GDP compared to Latvia and Lithuania [Staehr, 2014]. While the Estonian tax reform fosters economic growth and capital accumulation, it may also impose certain welfare costs on the economy. In the contingency policy scenario, the tax rate on retained earnings was reduced from 26% to 0% and the consequences in all scenarios compared to the reference steady-state equilibrium with the initial tax rate. While the welfare effect and the impact effect on consumption was negative, the long-term effect on consumption is generally positive. The results show that the Estonian tax reform led to higher per capita income and investment, but lower welfare. The sensitivity analysis confirms the robustness of these results [Funke, Strulik, 2003].

Paulus and Klein [2019] used the EUROMOD microsimulation modelling approach to study Estonia's tax-benefit policies implemented between 2016 and 2018 on household income distribution and work incentives. The key findings from their study include:

- The tax-benefit policies enacted during 2016–2017 led to an increase in household incomes relative to inflation. These policies contributed to reductions in both poverty and income inequality.
- Among various alternatives considered, increasing the generosity of the subsistence benefit and relaxing its means test by halving the withdrawal rate (which was previously at 100%) demonstrated the most significant first-order impact for a given fiscal cost.
- While the aforementioned measures reduced poverty effectively, they also weakened work incentives.
- There is a potential for enhancing work incentives at low and middle-income levels, which could be achieved alongside modest reductions in poverty and inequality.

Impact evaluations on corporate finances

Hazak's theoretical model, set within a binomial framework, incorporates variables such as company and investor-level taxes, investor consumption patterns, and the probability of financial losses. His analysis reveals that, under DPT, the timing of dividend distributions becomes a critical factor in maximizing company value for investors. The optimal timing varies based on factors including the investor's consumption needs, potential for losses, tax rates, and prevailing interest rates. Contrary to the purpose of the DPT system to encourage profit reinvestment, Hazak's findings suggest that retaining all profits may not always be the most beneficial strategy for investors [Hazak, 2007].

The DPT system reduces the immediate tax burden on retained earnings, encouraging companies to rely more on equity. Consequently, there is a decreased reliance on external debt financing, leading to lower leverage ratios. By alleviating the need for external financing, DPT enhances financial flexibility, allowing companies to manage better their investments without the constraints associated with external debt financing [Hazak, 2008].

Hazak also empirically examined the effects of Estonia's DPT system on corporate financial behaviour [Hazak, 2009]. Analyzing data from approximately 26,000 Estonian companies over the period 1995 to 2004, Hazak identifies several key outcomes:

- The DPT system has led companies to distribute a smaller portion of their profits as dividends, opting to retain earnings instead.
- With the ability to retain more earnings, companies have reduced their dependence on external financing sources.
- A significant portion of the retained earnings is held as surplus cash rather than being reinvested into long-term productive assets.

The regression analysis results, which considered different micro-macro-level control variables, indicate that switching from the GPT to DPT tax system led to a 4.7 percentage point rise in the proportion of retained earnings for the companies in the sample. According to Hazak's study [2009], companies show a lower inclination to seek external financing when operating under the DPT system compared to the GPT system. The adoption of the DPT system caused a 6.5-point decrease in the proportion of credit liabilities in total capital for the companies surveyed. However, the DPT system may also lead to inefficient capital allocation due to the accumulation of idle cash reserves.

However, increased cash reserves were not always allocated effectively. Enterprises reported purchases as business-related expenses, while in reality they were private consumption expenditures of the owners. Funds were often kept in standard bank accounts without being used for investment purposes [Jegorov, Leszczyłowska, Łożykowski, 2020, p. 13].

In a study by Masso, Meriküll, and Vahter [2011], the authors examined the impact of the Estonian tax reform on firms' capital structure, liquidity, investment, and productivity, using firms in Latvia and Lithuania as control groups. Estonia, Latvia, and Lithuania share similar

historical backgrounds, economic challenges, and closely intertwined business cycles. To ensure the robustness of the estimated effects, the authors employed difference-in-differences and propensity score matching methods. Drawing on firm-level financial data from all three countries, the study found that:

- Estonian firms exhibited a significant increase in liquid asset holdings, suggesting enhanced internal financing capacity and reduced reliance on debt;
- the tax reform was also associated with higher investment levels and improved productivity, particularly among smaller enterprises;
- the share of liabilities in total assets in Estonia declined by about 7 percentage points, with the effect being roughly 1 percentage point stronger for small firms (up to 50 employees) than for larger firms;
- the share of loan capital in total assets fell by 7 percentage points on average.

Thus, the reform had a more pronounced impact on smaller firms with regard to liabilities and loan capital, and an even stronger effect on liquid assets and reinvested earnings. Subsequent research confirmed that the impact of the Estonian tax reform was more significant for capital structure and liquidity, while less evident in investment and productivity [Masso, Meriküll, Vahter, 2013].

According to another study by Masso and Meriküll [2011], the Estonian tax reform boosted significantly capital accumulation, as the enterprises could reinvest profits without immediate tax liability. There was a modest positive effect on overall output and consumption, indicating that while investment increased, the immediate impact on broader economic activity was more restrained. Steady-state output witnessed an increase of approximately 4%, while consumption experienced a more modest rise of 1%–2% [Masso, Meriküll, 2011].

Some studies examined how Estonia's shift to the DPT system in 2000 has influenced corporate cash holdings and their valuation. Under the DPT system, a significant increase in the cash-to-assets ratio among Estonian companies can be observed, with nearly one-third of firms exhibiting cash-to-assets ratios exceeding 50% by 2011, as confirmed by empirical data. The proportion of cash and assets varies based on the size and industry of the company. For valuation purposes, cash holdings under the DPT system should be discounted by an amount equivalent to the tax burden associated with profit distribution [Sander et al., 2014].

The impact of the Estonian DPT system on equity valuation is examined by Kantšukov and Sander [2018]. Their findings indicate that, all else being equal, companies operating under the DPT system exhibit higher fundamental equity values than those under the CCIT system. This suggests that conventional valuation models should be adjusted to account for the tax deferral benefits inherent in the DPT system to avoid undervaluing companies operating under such regimes. This is relevant to both unleveraged and leveraged firms alike [Kantšukov, Sander, 2018].

Summary

In 2000, Estonia made amendments to its corporate tax laws, completely removing traditional corporate income tax on profits generated within the specified taxation period, even though the country already had a comparatively low tax burden on businesses. Until 1999, Estonia had employed a traditional corporate income tax system, but since 2000, it has been experimenting with a DPT regime. Advocates of the CIT reform claimed that taxing corporate profit was essentially the same as taxing shareholders' personal income. Corporate income taxes could play a crucial role in determining whether to retain or distribute profits which could affect significantly an economy that heavily relies on internal financing through cash flows.

Thanks to a better company performance and increased investment potential, the Estonian tax reform has been proven effective from a corporate perspective. Estonia's shift to a DPT system led, inter alia, to an increase in equity, improved liquidity, and the capacity for self-funded investment. However, its macroeconomic benefits are harder to ascertain. While the DPT tax system rather fosters economic growth and capital accumulation, it may also impose certain welfare costs on the economy. It should also be noted that tax burdens are only one of many factors considered by enterprises when making corporate decisions.

Estonia's experience with implementing the DPT mechanism should be taken into account when making key decisions regarding the design of corporate tax reform in Poland. The necessity of reform in Poland arises from the opacity of corporate taxation in Poland, resulting from overlapping rules and profit taxation systems.

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