Tax Reform in the Slovak Republic

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Previous tax systems in Slovakia and their imperfections

Economic policy in Slovakia has undergone a few principal qualitative turns in the course of a 15-year transition from a centrally-planned economy to a market economy. The need to adjust the tax system arose as an accompanying necessary features of such shifts. Besides dozens of parametrical changes, the tax system was subject to two cases of fundamental reconstruction. Both were linked to substantial changes in direction of economic policy. Firstly, the fall of the socialist economy required the creation of a tax system that could be comparable with that in standard market economies. Secondly, the overcoming of non-standard and somehow hybrid economic policy after 1998 and consequent upshifting of the reform process after 2002 called for further fundamental reform. An overview of the reform stages is provided in Box 1.

The tax system at the threshold of the transformation process corresponded to the needs of an administratively managed economy. It served as a tool for direct selection, subsidies and social policy. These functions were incorporated in the sales tax with numerous rates, which enabled an individual approach in accordance with the goals of the centrally planned economy. The sales tax system was marked by individual tax rates for each item and was, thus, in fundamental contradiction with the principles of modern market economy.

The system also included several items with negative sales tax (which in fact represented a subsidy) in order to maintain low prices and ensure affordability to all citizens. Understandably, the first fundamental change in the tax system included abolition of the negative sales tax in 1990. This step resulted in a first inflation shock (increase in prices of food which had benefited from the negative sales tax). This increase was compensated by a special social allowance. The abolition of the negative sales tax was followed by price liberalisation which came into force on 1 January 1991.

The timing of the launch of the first fundamental change of the tax system in January 1993 accidentally coincided with the birth of the Slovak Republic. The establishment of an independent state, however, did not have any direct impact on the shape of the system. The new system incorporated relevant components of the tax system in EU countries. Its basic pillar was a value added tax with two rates, which were later changed a few times. Personal income tax was progressive with six income brackets and rates ranging from 15 to 47 percent. However, the system also included five other tax rates applied to specific sources of income. Corporate income tax was set with linear rate of 45 percent.

Experience has consequently revealed numerous shortcomings of the system: dozens of legislation amendments increased its complexity, numerous exceptions and special regimes clashed with basic taxation principles. Furthermore, the progressivity of personal income taxation was increasing in the course of time: while the tax brackets were kept fixed, rising wages pushed taxpayers towards higher rates. Frequent parametrical adjustments to the system were adopted in response to the needs of public finances and macroeconomic development. Such adjustments were quite common mainly in the course of a macroeconomic stabilisation operation in 1999–2000 when it was necessary to correct the disequilibrium trends set forth by the non-standard economic policy between 1995 and 1998. Typical adjustments included shifting selected commodities from a reduced to a standard VAT rate and an increase in excise taxes. On the other hand, statutory corporate income tax rate was gradually reduced with the goal to promote economic activity.

The second and the most recent fundamental reconstruction of the tax system effective from January 2004 required much more political courage than the previous one because it was no longer copying standard tax systems of Western Europe but was rather based on a fundamental change of some taxation principles. A larger emphasis on competitiveness of the economy called for a more attractive and motivating tax system. The tax reform, with a flat income tax rate applying to all sources of income being its cornerstone, was part of a broader reform package,

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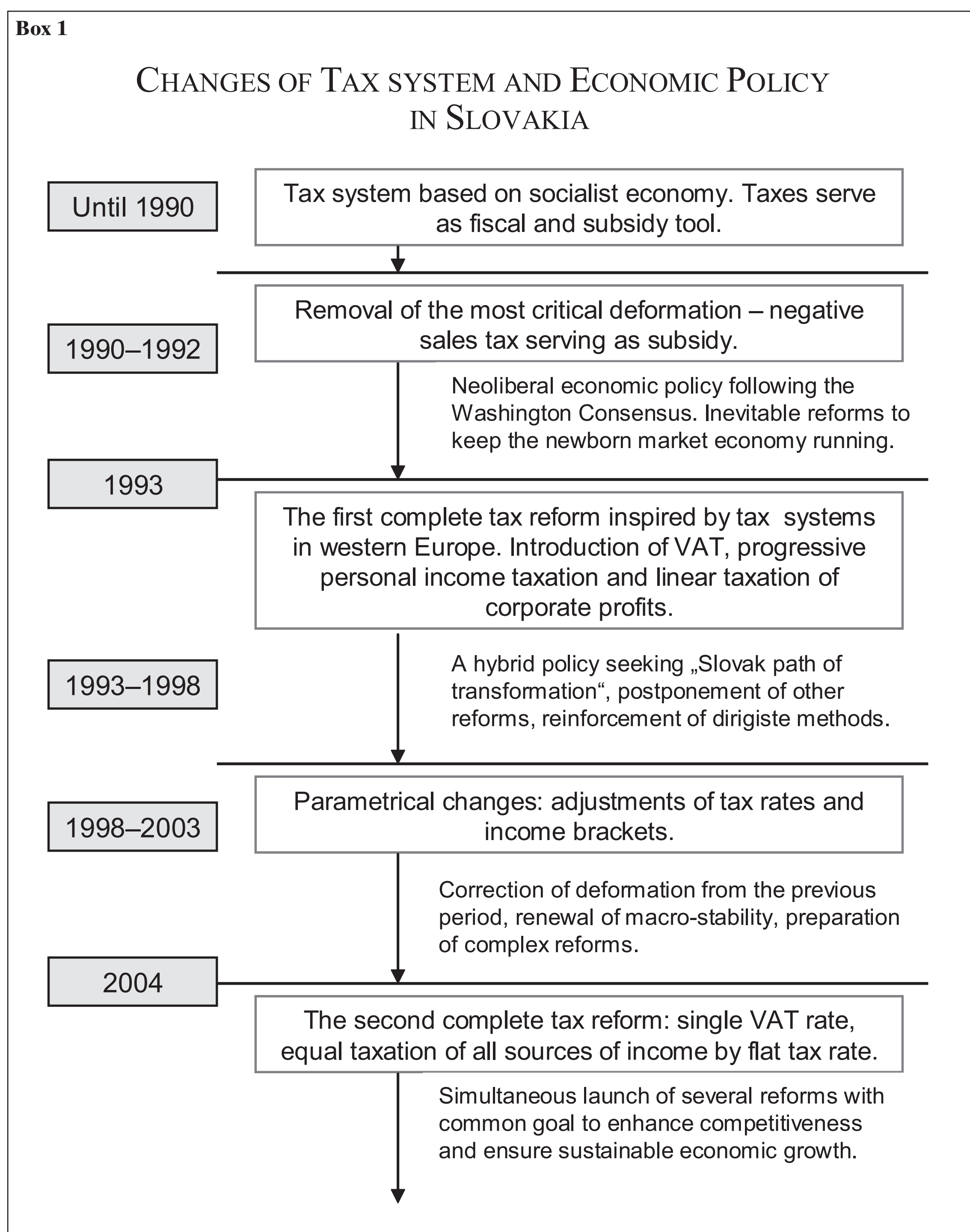
and one has to regard the tax reform as an integral part of the policy aimed at enhancing the competitiveness of the Slovak economy and ensuring its sustainable growth.

Political opposition towards tax reform

The Slovak tax reform was not challenged by opposition on the part of the public. In fact, people could assess the impact well in advance and a large group of winners profiting from the reform was quite clearly visible. The opposition was rather concentrated in those areas where reforms brought about a tangible increase in costs alongside possible future benefits (such as health care reform or an attempt to reform university education by introducing tuition fees). The social acceptance of the tax reform required minimising the group of losers who would not profit from the reform. A substantial increase in a tax-exempt allowance meant that people with low taxable income are not required to pay any income tax.

Box 1



However, the reform was opposed by left-oriented political entities (albeit determination of right and left is quite a problem on the changing Slovak political stage). Their opposition accented three points:

1) Abolition of progressivity allegedly eliminated solidarity.
2) Economic transformation brought sudden and frequently also a non-transparent, illegal or immoral distribution of wealth. Failure of other instruments to rectify such wrongful property acquisition had, in the opinion of the opposition, justified high income taxation of high-income earners. The opposition even put forward a few proposals for selective specific taxation regimes for some industries reporting huge profits (marked as "inadequate" by some politicians).
3) Abolition of reduced VAT which led to higher prices for elementary goods, such as food and medicines, thus negatively affecting mainly low-income households.

Although largely seen as a right-wing reform, it was not spared criticism from the right zone of the political spectrum. The right-wing critics questioned "too high tax rates" and the initial absence of the goal to reduce the overall income redistribution rate in the economy. A guiding principle of the process of setting up the reform parameters was the principle of fiscal neutrality, i.e. to collect as much in tax revenues as in a situation without reform. The critics, on the contrary, assumed that the reform would lead to a more radical decrease in state budget revenues that would consequently exert pressure to reduce expenditures.

However, the Ministry of Finance exercised caution in order to avoid any shocks in the course of implementation of the reform. Although the government set the reduction of the public expenditure/GDP ratio as one of its targets, the idea was not to achieve it by a sudden fall in the initial stage of the new system.

Basic philosophy of the tax reform

Avoiding the need to go into specific details, we can summarise framework principles of the Slovak tax reform (see also Box 2):

Shift from selectivity to universality. The new tax system subjects all kinds of income to equal taxation[1]. The system has thus reduced broad range of exceptions, special rates or special taxation regimes. Simplicity and transparency were thus significantly enhanced.

Enforced incentives to work. The elimination of progressive income taxation eliminated the disincentive to "earn more" and weakened the motivation to conceal one's income. A relatively low income tax rate combined with the absence of special dividend taxation stimulates business activity.

Shift from labour and capital taxation to consumption taxation. A reduced direct taxation leaves the key role to indirect taxes.

As we mentioned above, the tax reform was implemented alongside other reforms. It is therefore useful to point out the complementary effects of different reforms:

1) The tax reform is built on the same principles as the social system and labour market reforms. All these policies share incentives to activity as common feature: Tax policy through lower tax burden on labour income and child tax credit; labour market and social policies reach the same goal by more strict control of registered unemployed and by new social benefit system including work activation components aimed at long-time unemployed.
2) The tax reform supplements the public administration reform. The latter enforces role of self-governments, which enjoy increasing authority over generation of their revenues. The process of fiscal decentralisation included direct allocation of a given percentage of collected personal income tax to cities and municipalities[2]. The self-governments also gained power to set the rates of real estate taxes. Local authorities can thus actively shape the business environment in their respective areas. However, most self-governments used the new power to increase the tax rates dramatically in order to solve liquidity problems.

The government occasionally breaks with the ideological purity of the tax system by a policy aimed at attracting large foreign investments. Selective provision of investment incentives including tax abate-

[1] Except certain kinds of income which are not subject to income tax (inheritance, gifts, etc.) and sources of income explicitly tax exempted (pensions from public system, social benefits, income from the sale of real estate after five years of ownership, state lottery prizes, interest on Slovak eurobonds, etc.)

[2] Effective from January 2005, 70.3 percent of personal income tax is allocated directly to municipalities, 23.5 percent is transferred to regional self-governments and 6.2 percent remain in the state budget.

Box 2

Basic components of the tax reform

1. **Changes in indirect taxes:**
   - *Amendment to the Acts on Excise Taxes* – increase of certain excise tax rates: mineral oils, beer and tobacco products (August 2003)
   - *Amendment of VAT Act* – unification of VAT rates at 19 percent (before: 20 percent and 14 percent) as of January 2004.
2. **Changes in direct taxes:**
   - *New Income Tax Act* – introduction of 19 percent flat tax (January 2004)
     - Basic tax-exempted allowance increased from lump sum (SKK 38,760 in 2003) to 19.2 times the monthly living minimum (80,732 in 2004)
     - The allowance applicable also for non-working spouse with its proportional reduction linked to his/her own taxable income
     - Substitution of tax-exempt allowance per child with child tax credit
   - *New Real Estate Transfer Tax Act* – abolition of gift and inheritance tax and introduction of 3 percent flat rate for real estate transfer tax (January 2004); Abolition of real estate transfer tax (January 2005).
3. **Changes in indirect taxes in compliance with EU tax legislation**
   - *New VAT Act and new Excise Duties Acts* as of 1 May 2004.

ments creates exemptions of the principles of universality and equity. However, we consider this policy, principally motivated by efforts to reduce still high unemployment, to be of a temporary nature, without setting up long-term trends.

Initial effects of the reform

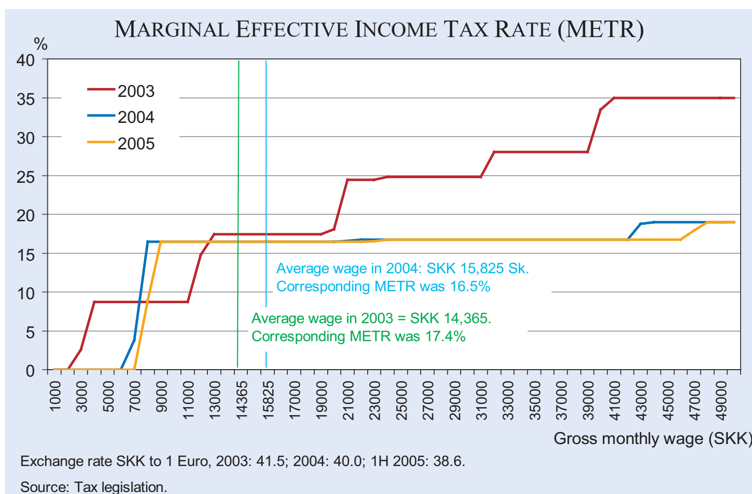
Personal labour income taxation

The tax reform brought a reduction in the effective taxation of personal income as well as of the tax wedge. This reduction, however, was minimal in the income range between 90 and 160 percent of the average wage (Figure 2). Figure 2 also shows that there is still some progressivity in the personal income taxation. Although the marginal income tax increased for people with taxable income in the range 60–90 percent of the average (Figure 1), the overall effect was favourable due to the introduction of a high basic tax-exempt allowance. We have also included 2005 in the comparison in order to compare the shifts resulting from systemic change (2004 vs. 2003) with those resulting from changes of built-in parameters, such as basic tax-exempt allowance (2005 vs. 2004). The taxation curves in 2005 (yellow lines in Figures 1 and 2) are shifted slightly to the right due to the automatically living-minimum-indexed tax-exempt allowance.

It is also worth to note the shift in total payroll tax burden in 2004 (Figure 3). Due to the reduction in social security contributions paid by employers the winners included workers in almost the whole spectrum of income. However, the introduction of an average wage-linked maximum assessment base negatively affected taxpayers who had previously paid contributions from lower assessment base that had been set as a lump-sum.

The introduction of a flat income tax and related features (tax-exempt allowance, tax credit, etc.) thus meant an increase in net income to the majority of

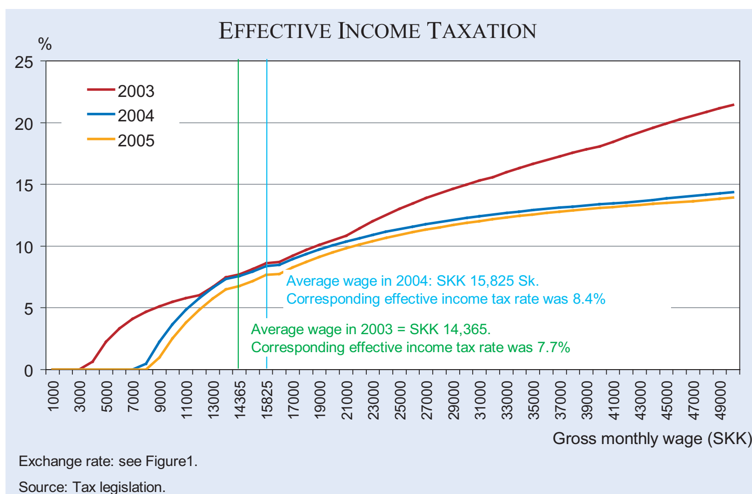
Figure 1



Exchange rate SKK to 1 Euro, 2003: 41.5; 2004: 40.0; 1H 2005: 38.6.

Source: Tax legislation.

Figure 2

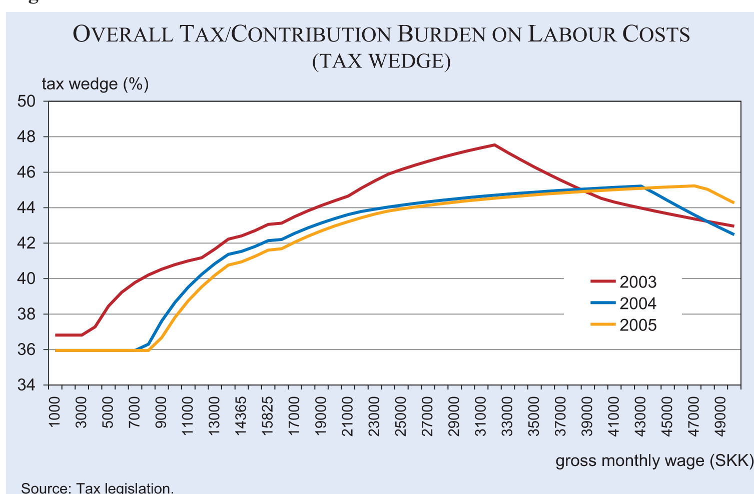


Exchange rate: see Figure1.

Source: Tax legislation.

Figure 3

OVERALL TAX/CONTRIBUTION BURDEN ON LABOUR COSTS
(TAX WEDGE)



Source: Tax legislation.

individual tax payers compared to 2003. As we indicated above, there was a group of taxpayers who experienced no change in their net income from a static point of view. This group consisted mainly of single individuals with monthly gross income ranging from SKK 12,000 to 20,000.

As the income taxation was only one component of the reform, it is necessary to consider indirect taxes to calculate the overall effect of the reform on net real income. The effect on two types of households is presented in Figure 4.

Figure 4 clearly indicates that winners of the tax reform from the point of view of impacts of tax changes on real income included families with children including households with non-working spouses taking care of children. It is also relevant, that any further increase in gross taxable income in the future will bring more in net income to all taxpayers than before the reform. The motivation to earn more in legal ways was thus substantially enhanced.

It is also worth noting that the real consumption of households grew by 3.5 percent in 2004. Although "distribution" of this growth by income segments might show some discrepancies, such robust growth dispelled the fears of the effect that the unification of VAT and increase in excise taxes might have on consumer prices.

While most of the working population was able to absorb the consequent increase in consumer prices with a higher net income, people without taxable income were not able cover higher living costs with tax allowances[3]. Pensioners were therefore compensated in the form of a lump-sum payment (rather non-systemic measure) paid in the autumn of 2004. Although we can say that pensioners were the short-time losers of tax reform, they are now benefiting from the pension reform, which has introduced a new indexation mechanism that provides space for an increase in the real purchasing power of pensions.

Capital income taxation

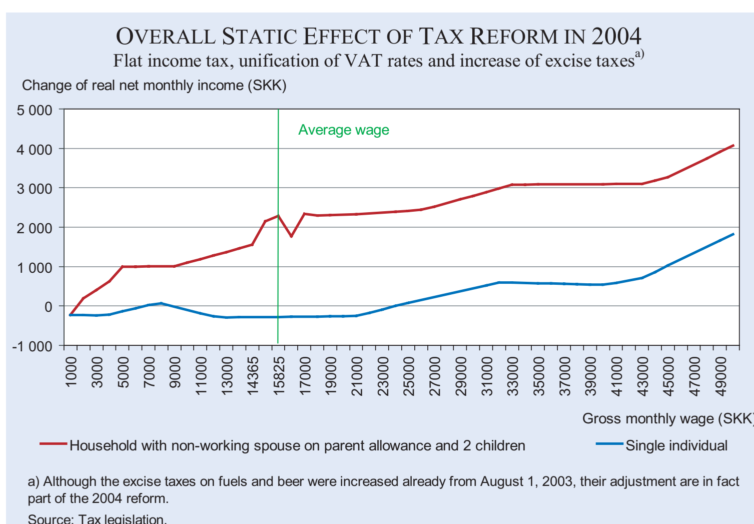
Unlike the case of personal income tax, there are no special indicators measuring the impact of the tax reform on the corporate sector. However, we can still use some (albeit simplified) parameters.

The Slovak tax reform was, beside other principles, based on the idea of significant reduction in capital income. The practical result of the abolition of dividend tax was an annual decrease in the effective taxation of business income from 36.3 to 19 percent (Table).

The reduction of taxation meant increased disposable income in profitable businesses and better values of return on sales. At the same time, more companies became potential bank clients.

Figure 4

OVERALL STATIC EFFECT OF TAX REFORM IN 2004
Flat income tax, unification of VAT rates and increase of excise taxes[a)]



a) Although the excise taxes on fuels and beer were increased already from August 1, 2003, their adjustment are in fact part of the 2004 reform.
Source: Tax legislation.

[3] Neither welfare payments nor pensions from the state-run pension scheme are taxed in Slovakia.

	2003	2004
	in %	
Statutory corporate income tax rate	25	19
Dividend tax	15	0
Effective taxation of distributed corporate profit	36,3	19

Source: Tax legislation; table: authors.

Higher disposable income has enabled more intensive investment activities and was probably one of the important factors behind the robust growth of gross fixed capital formation in 2005 (5.8 percent in constant prices), the highest growth rate since the last quarter of 2001.

Another useful indicator of perception of the tax reform by the corporate sector is the development in the number of businesses. It is significant that with the exception of agriculture (specific sector marked with long-term problematic issues) and the energy sector (dominated by a few large players), all industries reported a robust increase in the number of businesses at the end of 2003 (when the shape of reform was widely known) and in 2004 compared with the previous periods (Figure 5).

Beside lower effective taxation, the business community also welcomed a reduction in the depreciation period of buildings from 30 to 20 years, eliminated the restrictions of the depreciation rate in the first year of the depreciation period and liberalised treatment of loss carry-forward. Goliáš and Kičina (2005) note that private accountants in Slovakia were told by their clients that they were more concerned about their ability to write off legitimate losses than whether statutory corporate income tax rate was 15 or 25 percent. Contrary to the previous system valid until the end of 2003, loss can now be deducted from the tax base in the course of five years following the year when it incurred without even the obligation of write-offs and without the obligation to reinvest the same amount in capital goods.

Figure 5

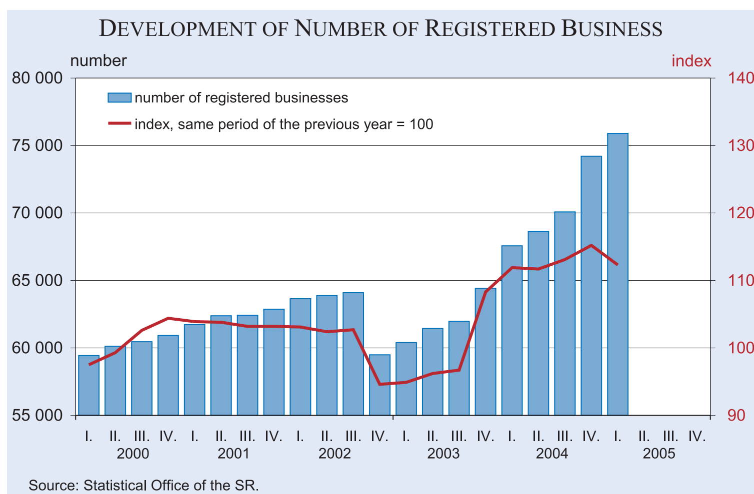
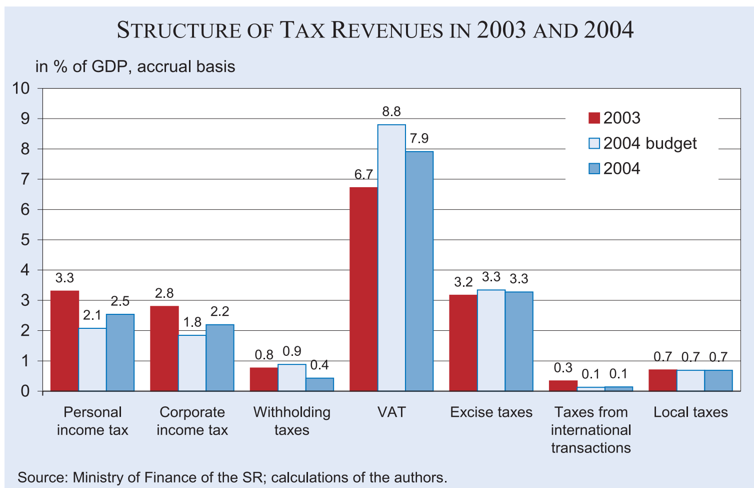


Figure 6



Fiscal implications

Total tax revenues in 2004, the first year of the new tax system, were in line with projections of the Ministry of Finance. The basic fiscal condition of the tax reform – fiscal neutrality – was thus met. At the same time, however, some shifts occurred in the structure of tax revenues. While the collection of personal as well as corporate income tax measured as a share of GDP exceeded the planned level (possibly as a result of higher motivation among taxpayers to report their income as well as postponement of some payments from 2003 to 2004), VAT collection failed to reach the projected value (Figure 6). However, the shortfall was probably at least partially affected by the entry of Slovakia into the EU and consequent problems with the collection of VAT from cross-border transactions.

A similar development of tax revenues is also visible in 2005,

with corporate tax being the "frontrunner". By the end of June, Slovak business paid SKK 10 billion (70 percent) more in corporate tax than projected.

Reactions from abroad

The Slovak tax reform has also become a frequently cited factor enhancing the attractiveness of Slovakia in the eyes of foreign investors. Although it is difficult to precisely specify the importance of the new tax system in the decision-making process of investors coming to Slovakia, it is quite obvious that the number of investors considering or already planning to invest in Slovakia increased in 2004. A hint in this context can be provided by the number of projects developed by the state investment agency SARIO. While the number was 22 in 2003 (with a total value of projected invested amount USD 1.44 billion), in 2004 the agency reported 47 accomplished projects worth USD 2.26 billion. However, we assume that the factors behind this increase are rather complex and include probably the whole spectrum of business-friendly reforms (such as more flexible labour legislation, more efficient business set up procedures) along with improving the infrastructure and a favourable labour cost/productivity ratio.

It is also significant, that Slovakia competes with other countries of the region for large investors offering generous state aid packages which in most cases also include partial or full corporate income tax holidays for up to ten years.

The Slovak tax reform provoked strong reactions from the foreign business community, and dozens of companies from the "old" EU member countries declared their intention to move headquarters or even independent units to "more favourable tax environments". While one has to understand such declarations as a highly useful and effective tool to exert pressure on domestic governments to carry out similar reforms, the highly competitive level of corporate profit taxation and relative simplicity and transparency resulted in a higher number of foreign businesses being registered in Slovakia.

Some top politicians in countries with traditionally high income taxation reacted in an irritated manner accusing Slovakia as well as other "flat-tax countries" of "tax dumping". Some of them consequently questioned the right of these countries to draw from the EU structural funds. Such argumentation is, however, built on completely wrong premises. As one of the strategic goals of similar tax reforms is to boost the economic growth by a lower tax burden on economic activity, their implementation in fact leads to higher GDP per capita and consequently to more limited space to offset the handicap of falling behind the EU average with structural funds.

It is worth noting that the reduction in income taxation along with the reduction in the tax burden measured both in relation to labour cost (tax wedge) as well as to GDP had been a long-term trend in most OECD countries already from the end of 1990s (Tax Foundation, 2004).

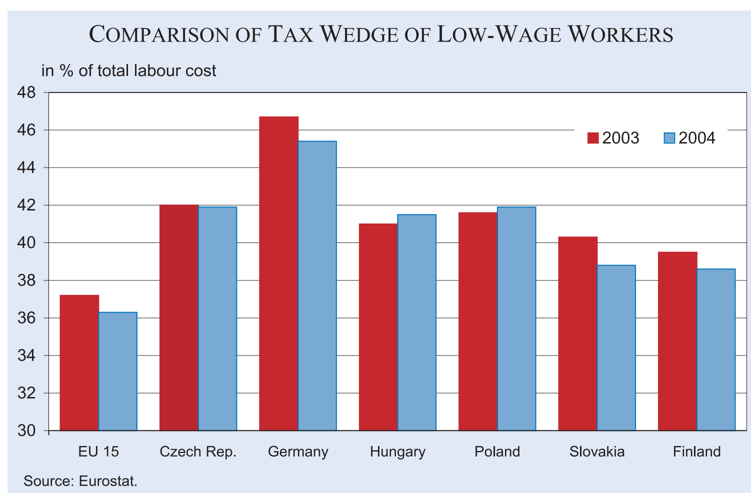
Still, however, the Slovak reform contributed to speeding up the process and fuelling the debates on radical tax reform in many other countries. Goliáš and Kičina (2005) note that the reform evoked fierce tax competition among central European countries, which continued to spread further to the west. They point at a reduction in the corporate tax rate in Austria from 34 to 25 percent (while the original plan was to "stop" at 31 percent), the reduction of the standard VAT rate in the Czech Republic from 22 to 19 percent in 2004, and the plan to decrease the corporate tax rate from 28 to 24 percent in 2006 and reductions in the statutory corporate tax rate in Poland and Hungary from 27 to 19 percent and from 18 to 16 percent, respectively.

Outlook on further reform steps

Increasing tax competition raises a simple question: what comes next? Fortunately, Slovak reformers do not consider the tax reform a one-off issue. It comes as a matter of course that adjustments are being made or planned. At the same time, the experts are considering modifications to some basic components of the new system. One of the most recent proposals of the Ministry of Finance is to replace the basic tax-exempt allowance with a tax credit. Such a step would lead to a higher net income for low-wage earners and consequently to higher incentives to create more jobs for people with lower qualifications. Such people make up most of the long-term unemployed in Slovakia and the goal to reduce substantially long-term unemployment presents one of the most important challenges to economic policy.

While the introduction of tax credit can contribute to some improvement, policymakers will have to look

Figure 7



Source: Eurostat.

closely at social contributions. Although total labour costs in Slovakia are still lowest from among the "V4" countries[4], it is obvious that the high contribution burden paid by both employers and employees from the first koruna of earned income (reaching 36 percent of total labour cost) effectively hampers the creation of low-wage jobs. While some improvement was achieved in 2004 (Figure 7) and a reduction in employer's contributions resulted in a moderate reduction of the tax wedge for low-wage earners (with monthly wages corresponding to 67 per cent of average wages in manufacturing), much has to be done in the entire system of social contributions, with due attention paid to the overall balance of individual components.

Despite the proposed adjustments, the modification of tax rates (income tax, VAT) is not the question of the day. If, however, public finances develop favourably (the basic requirement is to keep the general government deficit below 3 percent of the GDP from 2006), toughening tax competition in the region might exert pressure to further reduce the flat income tax. There is one negative scenario as well, though. The strongest opposition party, SMER, has officially declared a negative attitude to the flat income tax and declared ambitions to reintroduce income tax progressivity to the system. The next parliamentary election due in September 2006 will provide the answer to the future fate of the Slovak reform.

[4] V4 – four „Visegrád" countries – Czech Republic, Hungary, Poland, Slovakia.

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