

Slovak tax reform: one year after

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Abstract

This paper presents detailed information on the Slovak tax reform adopted in 2004 and the first results it brings after one year in place. Most apparent is the increased attractiveness of Slovakia for foreign investors. Slovak Investment and Trade Development Agency contracted EUR1.7 billion foreign direct investment in 2004 what is 47% increase on a yearly basis. In terms of new FDI jobs the increase is even higher – 69%. In 2005, the surge of foreign investment continues. The agency claims the suitable business environment and the tax system among the most important factors referred by investors when choosing Slovakia. They especially welcome the lower corporate income tax and the abolished tax on dividends. However, the investors prefer good infrastructure as the most important factor, when deciding where to invest, followed by cheap and qualified work force, and generous state aid.

Foreign investors in Slovakia

	2002	2003	2004	2005 (Est.)
Number of projects signed	25	22	47	40
Number of new jobs projected	5,400	7,970	13,500	20,000
FDI contracted (mil. EUR)	311	1,164	1,707	1,951 – 2,073

Source: Slovak Investment and Trade Development Agency

Another important outcome is the fierce international tax competition evoked by the reform. Slovakia was the 7th country in Europe introducing the flat tax on personal income (19%). Soon after, two other countries joined the club: Georgia and Romania going down to 12% and 16% respectively. The largest opposition parties in the Czech Republic and Poland are also agitating for a flat tax and have promised to implement one if victorious at the polls. Austria reacted swiftly by reducing its corporate tax rate from 34% to 25% from 2005 even though it intended to go down “only” to 31% originally. In 2004, the Czech Republic decreased its upper VAT tax rate from 22% to 19% and its corporate taxes are falling from 28% to 24% in 2006. Hungary reduced its corporate tax rate from 18% to 16%; and Poland from 27% to 19%. Western democracies with much higher corporate taxation (Germany 38.3%, France 34.3%, Netherlands 34.5%, Italy 37%, and UK 30%) blame Slovakia for “tax dumping” and call for “tax harmonization” within the EU. They point out, that new members are able to lower taxes only thanks to the massive regional aid received from richer EU countries.

European countries with flat-tax regime

	Estonia	Lithuania	Latvia	Russia	Serbia	Ukraine	Slovakia	Georgia	Romania
	1994	1994	1995	2001	2003	2004	2004	2005	2005
PIT	26%	33%	25%	13%	14%	13%	19%	12%	16%
CIT	26%	15%	15%	24%	14%	25%	19%	20%	16%

Source: Grecu (2004), INEKO

PIT – personal income tax, CIT – corporate income tax

From fiscal perspective, better than expected tax revenues in 2004, especially for direct taxes, arouse enthusiasm, however, this development will have to be confirmed in 2005 yet.

Tax revenues in 2003 and 2004 (in SKK billion, ESA 95, on accrual basis)

	2003 (before reform)		2004 (after reform)			
	Reality	Share on total	Plan	Share on total	Reality	Share on total
Tax revenues	217.6	100.0%	232.0	100.0%	233.5	100.0%
Direct taxes (PIT & CIT & WIT)	82.7	38.0%	62.2	26.8%	68.9	29.5%
Personal income tax (PIT)	39.9	18.3%	27.1	11.7%	34.1	14.6%
Corporate income tax (CIT)	33.6	15.4%	23.7	10.2%	29.1	12.5%
Withholding income tax (WIT)	9.1	4.2%	11.4	4.9%	5.7	2.4%
Indirect taxes (VAT & Excise)	118.3	60.9%	157.0	67.7%	149.5	64.0%
VAT	80.7	41.9%	113.8	49.1%	104.9	44.9%
Excise duties	37.6	19.0%	43.2	18.6%	44.6	19.1%

Source: Ministry of Finance of the Slovak Republic

It might be assumed, that the tax reform together with the entry to the EU played the crucial role in the fast improvement of the Slovak economy in 2004. The expected negative influence of higher indirect taxes on price level and household consumption was not confirmed by the evidence. The household consumption grew by strong 3.5% in 2004 compared to the expected 2.0%. However, the definite impetus of the reform for the overall macroeconomic development including the growth in employment will show up after a longer time period.

P.S. EUR 1 = SKK 39.05, April 18, 2005, National Bank of Slovakia

Abbreviations

CIT: Corporate income tax

ESA 95: European System of Accounts 1995

Est.: Estimation

EU: European Union

EUR: Euro

FDI: Foreign direct investment

GDP: Gross domestic product

INEKO: Institute for Economic and Social Reforms

IMF: International Monetary Fund

MW: Megawatt

NGO: Non-governmental organization

OECD: Organization for Economic Co-operation and Development

PAS: Business Alliance of Slovakia

PAYG: Pay-as-you-go pension system

PIT: Personal income tax

SARIO: Slovak Investment and Trade Development Agency

SKK: Slovak koruna

SR: Slovak Republic

UK: United Kingdom

VAT: Value added tax

WIT: Withholding income tax

Introduction

In autumn 2002, a new centre-right government came into power in Slovakia. At that time, there was a tax system generally considered as unsustainable, too complicated, changing too often, bringing in more exemptions and special rates, and thus distorting the business environment. The tax reform became one of the most important initiatives of the new government. From among four coalition parties only one – Christian Democrats – called for a radical reform - the introduction of flat tax on personal income. The Policy Statement of a new government undertook only to “*reduce income tax rates and to analyze the possibility of implementing a flat-rate tax*”. In fact, the actual reform pushed by the Finance Minister Ivan Mikloš introduced the flat tax and went far beyond these original objectives. **The new tax system became effective as of January 2004.** The goal was to create a simple, fair, non-distortive, pro-active, and business friendly system. This should have been achieved through:

1. **Shifting the tax burden from direct to indirect taxes¹**; i.e. taxing consumption rather than production. This should support incentive to work. Moreover, in the era of globalization and increasing labor mobility the collection of direct taxes becomes more difficult to control and it is easier to avoid paying them compared to the indirect taxes. As a result, the relatively high direct taxes are harming country’s fiscal position and competitiveness - people “escape” to a shadow economy or to countries with lower direct taxation. The shift towards the indirect taxes should reduce tax evasion.
2. **Elimination of all exceptions, exemptions and special regimes.** The business surveys quoted the excessive complexity and frequent changes in the old tax law as one of the major business barriers². The old system included 90 exceptions, 19 sources of un-taxed income, 66 tax-exempt items, and 37 items with specific tax rates (Table 1). The reform virtually abolished all of them³, making the tax system much simpler and transparent, and eliminated speculation aimed at paying lower tax rates.
3. **Introduction of flat tax rate on personal income:** This measure limits the economic disincentives caused by higher taxation of higher income cohorts. The equal opportunities imposed by a new system should increase labor productivity, as it encourages higher work effort at any income level.
4. **Elimination of tax instruments aimed at achieving non-fiscal goals:** Many of such instruments aimed at providing social policy objectives. However, tax instruments usually address everybody and not only those in need. Thus, they have only little to do with solidarity. The reform intended to clearly separate solidarity, when it replaced virtually all such instruments by targeted measures helping those really in need.⁴ For instance, the child allowance has been cancelled and a new form of targeted social compensations and entitlements has been introduced, which should ensure a fairer distribution of income particularly benefiting low-income families with children.
5. **Elimination of double taxation of income** (such as tax on dividend)

Table 1: Some of special tax rates cancelled by the reform

Tax rate	Type of income
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¹ However, even before the reform, Slovakia had one of the lowest direct tax burdens relative to GDP (Eurostat 2005): In 2003, Poland (19.7%), Slovenia (20.8%) and Slovakia (23.2%) recorded the lowest shares of direct taxes in the total tax burden, compared to the EU25 average of 31.6%.

² PAS (2003)

³ For instance, contributions to voluntary pension schemes up to SKK12, 000 yearly remained un-taxed.

⁴ Tax reform has been complimented by welfare reform aimed at (1) curbing the abuse of social benefits, (2) careful targeting of social aid to those really in need, and (3) insuring work incentives.

0%	Income of small hydro-electric power stations (up to 1 MW)
1%	Rent, when the agreement on buying the rented object has been made
2%	Lump-sum tax on income up to SKK500 thousand yearly*
2,25%	Lump-sum tax on income up to SKK1 million yearly*
2,5%	Lump-sum tax on income up to SKK1.5 million yearly*
2,75%	Lump-sum tax on income up to SKK2 million yearly*
5%	Bank interest on personal long-term deposits (above 3 years)
15%	Return on equities, profit sharing in Ltd. companies, agriculture
18%	Income of tax payer employing more than 50% of handicapped persons
20%	Interests, prizes and awards
25%	Corporate income, consultancy
28%	Personal income SKK180 – 396 thousand yearly
35%	Personal income SKK396 – 564 thousand yearly
38%	Personal income above SKK564 thousand yearly

Source: Ministry of Finance of the SR

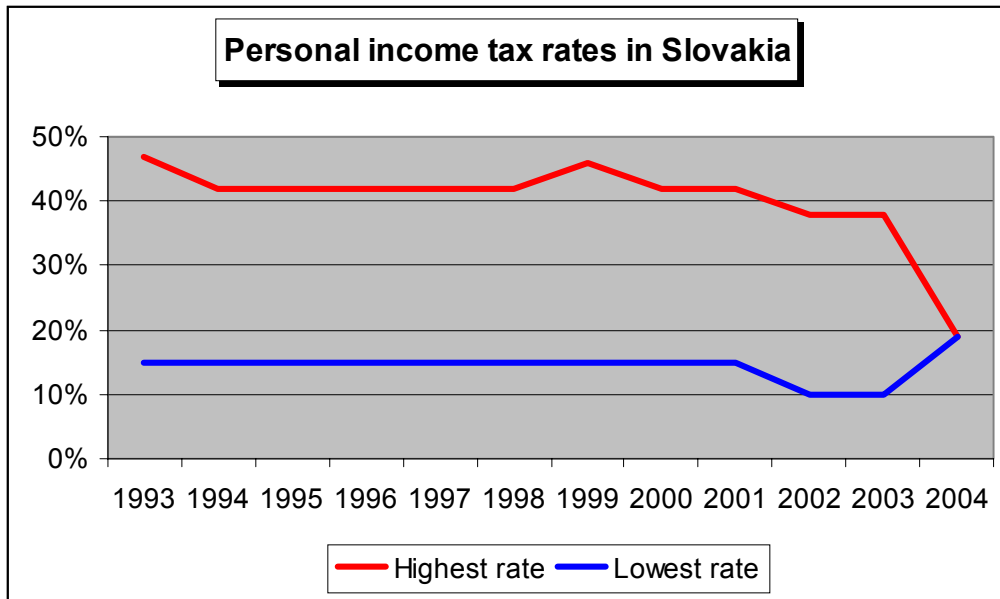
*selected self-employed entrepreneurs, based on their trade

To assure tax fairness and simplicity the Ministry of Finance decided to tax all types and all amounts of income equally. **Searching for the best rates the government applied the same 19% rate for personal income tax, corporate income tax, and value-added tax (VAT).**

Personal income tax

The old system was strongly progressive with five tax rates for different incomes: 10% (for the lowest), 20%, 28%, 35% and 38% (for the highest). The new system introduced one flat rate – 19% for all incomes. It also increased a tax-free income (i.e. basic tax allowance deductible from the tax base) from SKK 38,760 or EUR 968 per tax payer yearly to 19.2 times living minimum (SKK 80,832 in 2004, or EUR 2,021) per tax payer yearly. As a consequence, everybody with wage below approximately half the average wage in the economy is not paying any taxes at all. Others are paying 19% from the difference between their income and tax-free income. Thus, a new system is tax-free for low income brackets but it still ensures slightly progressive taxation for middle and high income brackets. Raising the basic tax allowance was an important precondition for viability of the whole reform as it compensates low income brackets for higher imposed flat tax rate. Besides basic tax allowance, the new act replaced a child allowance deductible from the tax base (SKK 16,800 yearly) by a tax bonus deductible from the tax (SKK 4,800 yearly) or payable in case of too low or negative tax – which is conditional on at least one parent being employed; and increased a non-working spouse allowance from SKK 12,000 to SKK 80,832 per tax payer yearly.

Figure 1: Personal income tax rates in Slovakia



Data: 1993: 6 rates ranging between 15-47%; 1994: 6 rates ranging between 15-42%; 1999: 7 rates ranging between 15-46%; 2000: 7 rates ranging between 15-42%; 2002: 5 rates ranging between 10-38%; 2004: one flat rate 19%.

Source: INEKO

Corporate income tax

The corporate income tax (CIT) rate has been decreased from 25% to 19% (Figure 2). The dividend tax (15% in the old system) perceived as a double taxation of profit has been cancelled - 2004 was the last year of paying dividend tax. Thus, Slovakia appeared to have one of the lowest effective taxation on investment income faced by a private investor (combined corporate tax and dividend tax) in the OECD (Figure 3).

Figure 2: Corporate income tax in Slovakia



Data: 1993: 45%; 1994: 40%; 2000: 29%; 2001: 25%; 2004: 19%

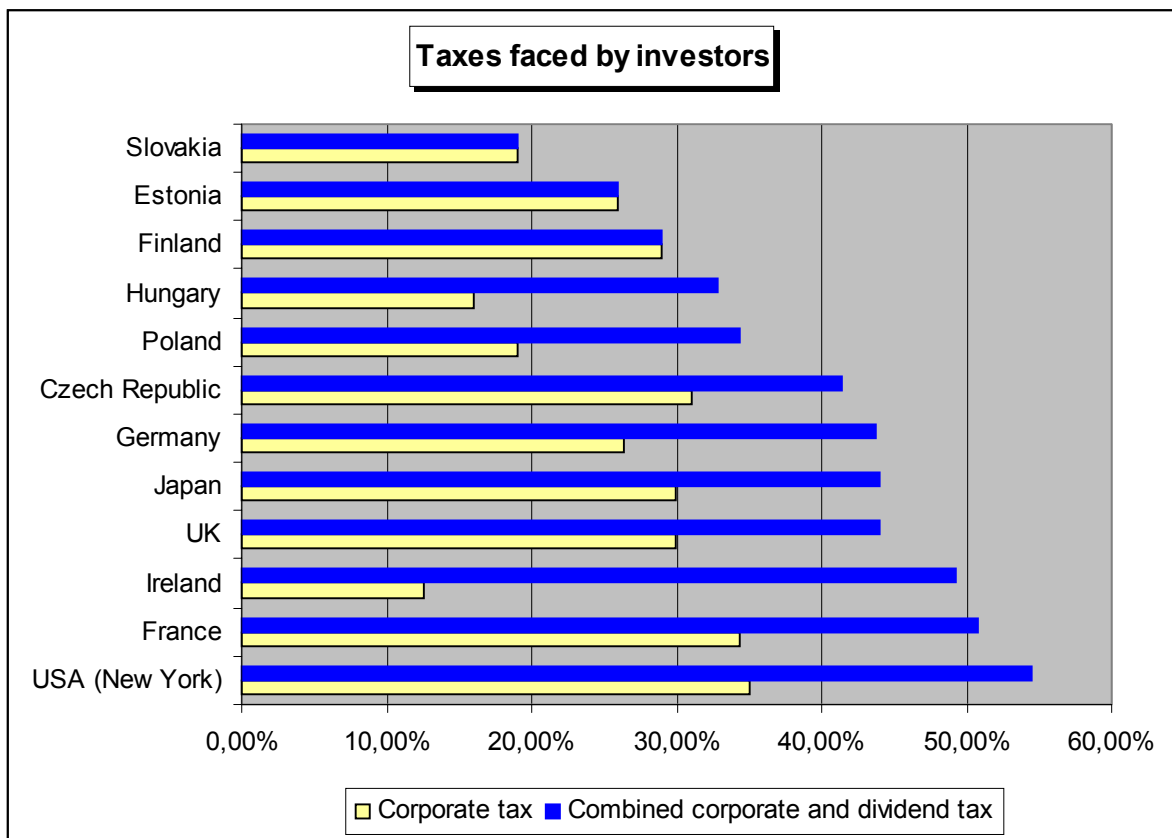
Source: INEKO

IMF (2005) notes, that besides the low CIT rate, the liberalized treatment of loss carry-forwards assists businesses. Losses can now be deducted from taxable income over the following five years, and annual write-off installments are no longer required to be equal. The previous treatment of losses had detracted significantly from the competitiveness of the CIT law. Private accountants in Slovakia informed in 2003 that their clients were more concerned about their inability to write off legitimate losses, than whether the CIT rate was 15 or 25 percent. Including the inability to write off advertising expenses and limits on the tax deductibility of vehicle depreciation, some clients faced effective tax rates of 35 percent or more (in some cases reaching 80 percent), despite the then statutory CIT rate of 25 percent. The new CIT law remedies this problem.

Pushing through tax fairness and simplicity the reform has also abolished majority of exemptions, tax relieves, special tax bases and rates. For instance, lump sum tax for small-businesses has been abolished and replaced by lump-sum expenses of 25% of total revenues (60% for craftsmen). As the IMF (2005) notes, tax base reductions for certain sectors, such as agriculture and forestry, have been cancelled; and investment incentives have also been scaled back: the reform cancels legislation providing for tax holidays (of up to 10 years) for newly established firms. However, the government may still individually grant investment incentives, in compliance with the EU law on state aid.

The Parliament approved a new Income Tax Act in October 2003 and repeatedly in December 2003 after President’s veto. It came into force on January 1, 2004.

Figure 3: Effective taxation on investment income faced by a private investor

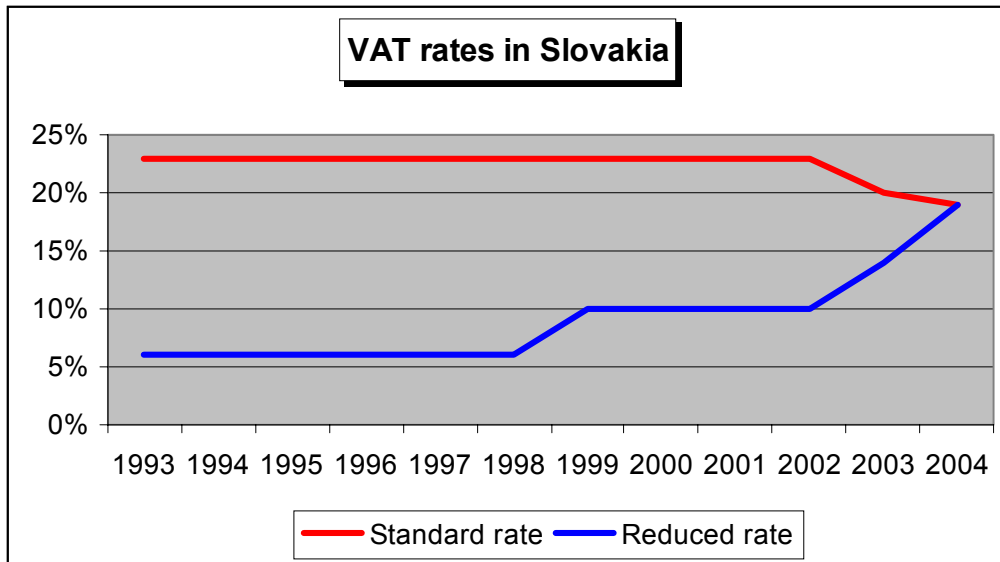


Source: INEKO based on Ministry of Finance of the SR, and KPMG (2004)

Value added tax

In the old system there were two VAT rates: standard rate of 20% and reduced rate of 14%. Tax reform unified both and introduced one VAT rate of 19% (Figure 4). This was politically and socially the most difficult reform decision, as it directly conveyed into higher prices of goods and services taxed formerly at a reduced rate. These included, for example, basic food, medicaments, electricity, coal, construction works, books, newspapers, magazines or hotel and restaurant services. The unification intended to reduce speculation aimed at paying tax at a lower rate. Another argument proposed by the Ministry of Finance was that keeping the reduced rate the state is endowing everybody and not only those who really need it. Furthermore, higher taxation was aimed at assuring fiscal viability of the reform as it compensated for the expected loss of direct tax revenues. The Parliament approved the amendment to the VAT Act in June 2003 as a first tax reform measure, coming into force on January 1, 2004. Timely approval of this unpopular measure was a key precondition for success of the whole reform.

Figure 4: VAT rates in Slovakia



Data: 1993: standard rate 23%, reduced rate: 6%; 1999: reduced rate: 10%; 2003: standard rate 20%, reduced rate 14%; 2004: one unified rate 19%.

Source: INEKO

Excise duties and some other taxes

With effect from August 1, 2003, the tax reform included increase in the excise duty tax rates on mineral oils, tobacco and tobacco products, spirits and beer. These changes were basically on demand and in compliance with the EU regulations. However, as a consequence of shifting the tax burden onto the consumption, the new rates exceeded the minimum required by the EU in all cases with the exception of tobacco products, where Slovakia agreed to phase in the increases by 2007.

With effect from January 1, 2004, gift tax and inheritance tax have been abolished. Real estate transfer tax was cut from 6% to 3% and abolished with effect from January 1, 2005. All these taxes presented multiple taxation of the property. Another reason for their abolition was the especially low revenue they generated (gift tax accounted for 0.08%; inheritance tax for 0.04%; and real estate transfer tax for 1.21% of total tax revenue in 2003).

Shortly after tax reform, the government approved the fiscal decentralization which included transfer of 70.3% of total personal income tax revenues to municipalities and 23.5% to eight regional self-governments (only 6.2% goes further to the central government with effect from 2005), and significant changes in the structure of local taxes concerning real estate tax, road tax and local fees. In principle, the fiscal decentralization significantly strengthened the fiscal competences of municipalities, especially in the field of local taxes. As the IMF (2005) notes, the decentralization defines 12 local taxes and one local fee which municipalities are free to set themselves; central-government ceilings no longer apply to these taxes.

Fiscal implications

When deciding about the final tax rates, the government's goal was to ensure a fiscally neutral outcome in the first year after the reform. To keep the same tax revenues, the reduction of direct taxes required higher indirect taxation. By 2006, tax revenues should go down relative to GDP with stronger proportion of indirect taxes and weaker of direct taxes (Table 2).

Table 2: Fiscal impacts of the tax reform (ESA 95, in % of GDP)

	2002 (reality, before reform)	2006 (forecast, after reform)
Total tax revenues	19.0	17.3
Personal income tax	3.4	2.4
Corporate tax	2.7	2.2
Withholding income tax (incl. dividend tax)	0.9	0.4
VAT	7.6	8.4
Excise duties	3.1	3.2
Gift, inheritance, real estate transfer taxes	0.2	0.0

Source: Ministry of Finance of the Slovak Republic

Choosing 19% rates the government took more conservative estimate in order not to underestimate the revenues. The outcome was hardly predictable, as the major changes in taxation evoke new behavioral patterns of individuals and firms. Lowering taxes usually means lower tax revenues; however, as long as it brings more people to work, the effect may be exactly opposite. The actual tax revenues in 2004 exceeded both plans and revenues collected in 2003 (Table 3). Especially the direct tax revenues were higher than plans, although the tax rates decreased substantially. However, this optimistic development can not be attributed solely to the tax reform. Among other reasons these have played the crucial role:

1. Direct taxes paid in 2004 were counted out of the tax bases from the previous year. Hence, higher revenues in 2004 result to a large extent from high tax bases in 2003.
2. All firms and self-employed individuals paid the old tax rates until the end of March 2004, which is also the deadline for submitting the tax declaration. Thus, a large part of direct taxes in 2004 has been paid under the old rates. Even the regular employees paid the old rates from their January 2004 wages.
3. Better than expected development of economy - higher economic growth transferred to higher wages and consumption, and higher tax revenues in 2004.

Table 3: Tax revenues in 2003 and 2004 (in SKK billion, ESA 95, on accrual basis)

	2003 (before reform)		2004 (after reform)			
	Reality	Share on total	Plan	Share on total	Reality	Share on total
Tax revenues	217.6	100.0%	232.0	100.0%	233.5	100.0%
Direct taxes (PIT & CIT & WIT)	82.7	38.0%	62.2	26.8%	68.9	29.5%

Personal income tax (PIT)	39.9	18.3%	27.1	11.7%	34.1	14.6%
Corporate income tax (CIT)	33.6	15.4%	23.7	10.2%	29.1	12.5%
Withholding income tax (WIT)*	9.1	4.2%	11.4	4.9%	5.7	2.4%
Indirect taxes (VAT & Excise)	118.3	60.9%	157.0	67.7%	149.5	64.0%
VAT	80.7	41.9%	113.8	49.1%	104.9	44.9%
Excise duties	37.6	19.0%	43.2	18.6%	44.6	19.1%

Source: Ministry of Finance of the Slovak Republic

* includes revenues on dividend tax

Regarding the sharp decrease in the revenues on withholding income tax, following factors need to be taken into account (IMF, 2005):

1. Some of these taxes may have been diverted to CIT collections: Firms may now be reporting as profits, income previously taxed at a lower rate as capital income.
2. Companies may have retained earnings in 2004 rather than paying out dividends, to avoid the final year of dividend tax.

Collections of indirect taxes have risen in 2004 confirming the projections. However, these results have been affected by other factors, which are difficult to disentangle from the tax reform (IMF, 2005). Among them, tax administration changes required upon EU accession played a special role. For instance, the shift in responsibilities for tax collections from custom offices to tax offices resulted in delays in collections from mid-2004. Also, the basis for 2003 has been distorted - VAT collections for 2003 were lower by 1% of GDP, owing to one-off refunds paid following a change in the VAT law in 2002.

Based on the above reasoning, it is still impossible to conclude final remarks on the fiscal implications. The promising results of 2004 must be definitely confirmed in 2005 yet.

Macroeconomic implications

As mentioned before, better than expected macroeconomic development helped the overall fiscal balance in 2004. This is partly due to the better than expected outcome of the tax reform. Particularly, the Ministry of Finance projected only 2% growth of household consumption as a consequence of the tax reform as higher indirect taxes, especially increase of the lower VAT rate should have conveyed into the rise in prices. But in fact, the household consumption went up by 3.5% in real terms. Taking also into account the final phase in price deregulation⁵, the ministry projected the average inflation rate at 8.1%. In reality, the average inflation was 7.5%. This contributed heavily to the better than expected growth of GDP and wages (Table 4). It might be assumed, that the tax reform together with Slovakia's entry to the EU in May 2004 played the crucial role in fast improvement of the whole economy. However, positive impacts of the tax reform relate mainly to the overestimated inflation. The definite impetus for the macroeconomics including the employment will show up after a longer time period.

Table 4: Performance of the Slovak economy

	2003 (reality)	2004 (plan)	2004 (reality)
Inflation	8.5%	8.1%	7.5%
Change in household consumption	-0.8%	+2.0%	+3.5%
GDP growth	4.5%	4.1%	5.5%

⁵ With effect from January 1st, 2004, the formerly state-regulated prices of several goods went up, among them mainly the price of electricity, gas, water, and public transport. This has had the major effect on inflation.

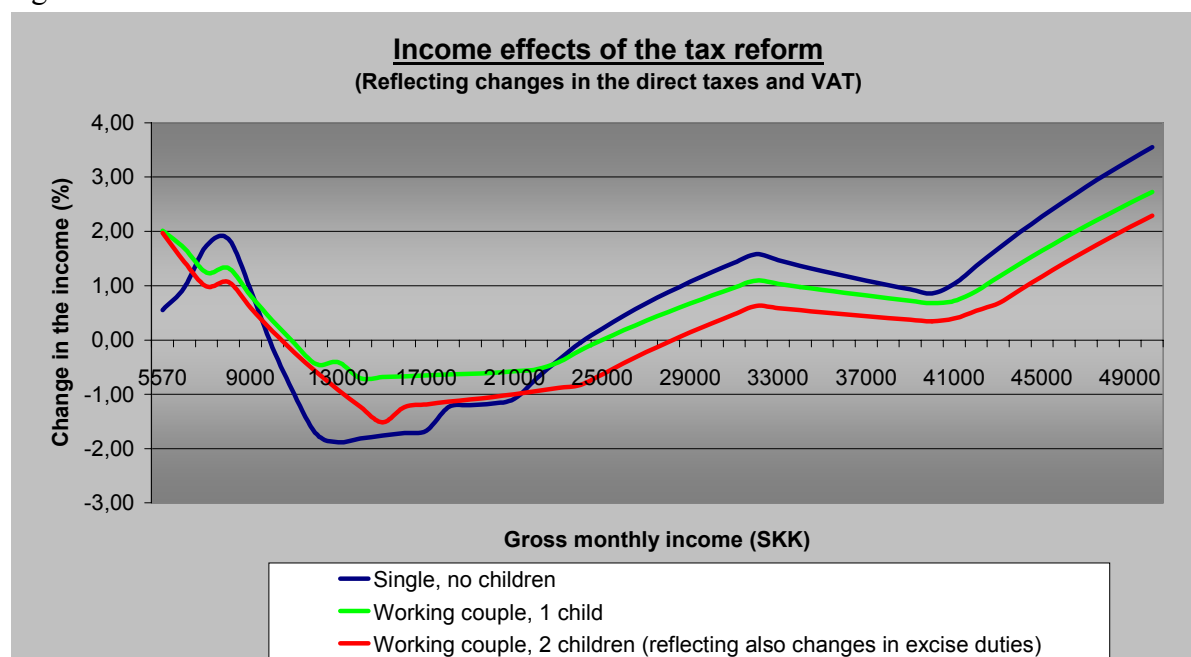
Change in real wages	-2.0%	-0.6%	+2.5%
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Source: Statistical Office of the SR (reality), State budget for 2004 (plan)

Income distribution effects

The introduction of flat personal income tax eased people with high income. Higher tax deductibles eased mainly people with low income. The unification of VAT and rise in excise duties burdened everybody almost equally, depending on the structure of consumption. As a result, low- and high-income brackets are better-off after the reform; middle-income brackets are worse-off (Figure 5). Generally, all people with monthly income of SKK10 thousand to SKK23 thousand are immediate losers. With the average wage of SKK15,825 in 2004, the majority of population falls within losers. However, the loss is relatively mild with maximum of 2% of income for singles without children. Families with children have lower losses thanks to the new child bonuses. Moreover, the model counting the income effects of the reform is static and reflects only immediate changes. It does not reflect dynamic changes such as higher economic activity surging the GDP growth, wages, and employment in the short and long run.

Figure 5: Income distribution effects of the tax reform



Source: INEKO, Business Alliance of Slovakia

Foreign direct investment

Slovak Investment and Trade Development Agency (SARIO) reports increased interest of foreign investors to operate their businesses in Slovakia. In 2004, it contracted EUR1.7 billion foreign direct investment what is a 47% increase on a yearly basis. In terms of new jobs projected the increase is even higher – 69%. In 2005, the surge of foreign investment inflow continues (Table 5). The agency claims the suitable business environment and the tax system among the most important factors referred by investors when choosing Slovakia. They especially welcome the lower CIT and the abolished tax on dividends. However, the investors prefer good infrastructure as the most important factor when deciding about where to invest, followed by cheap and qualified work force, and generous state aid (Table 6).

Table 5: Foreign investors in Slovakia

	2002	2003	2004	2005 (Est.)
Number of projects signed	25	22	47	40
Number of new jobs projected	5,400	7,970	13,500	20,000
FDI contracted (mil. EUR)	311	1,164	1,707	1,951 – 2,073

Source: SARIO

Table 6: Ranking of the most important factors to foreign investors

1.	Locality (utilities network, transport infrastructure)
2.	Work force (cost, structure)
3.	State aid (investment incentives)
4.	Business environment (taxes, payroll taxes, Labor Code)
5.	Geography (distance to customers)

Source: SARIO

International reactions

Slovakia was the 7th country in Europe introducing the flat tax on personal income. Soon after, two other countries joined the club: Georgia and Romania going down to 12% and 16% respectively (Table 7). The largest opposition parties in the Czech Republic and Poland are also agitating for a flat tax and have promised to implement one if victorious at the polls.

Table 7: European countries with flat-tax regime

	Estonia	Lithuania	Latvia	Russia	Serbia	Ukraine	Slovakia	Georgia	Romania
	1994	1994	1995	2001	2003	2004	2004	2005	2005
PIT	26%	33%	25%	13%	14%	13%	19%	12%	16%
CIT	26%	15%	15%	24%	14%	25%	19%	20%	16%

Source: Greco (2004), INEKO

Notes:

Estonia has ratified legislation to lower its flat rate from 26% to 24% in 2005 and 20% by 2007. Further, it has 0% tax rate on re-invested corporate profits.

Latvia lowered its corporate tax from 19% in 2003 to 15% in 2004

PIT – personal income tax

CIT – corporate income tax

After reducing corporate income tax and canceling dividend tax, the Slovak tax system became one of the most attractive for foreign investors and residents within the OECD. Most of foreign managers of Slovak subsidiaries and affiliates of international banks and enterprises started to pay taxes in Slovakia. The reform evoked fierce tax competition among Central-European countries spreading further to the west. Austria reacted swiftly by reducing its corporate tax rate from 34% to 25% from 2005 even though it intended to go down “only” to 31% originally. In 2004, the Czech Republic decreased its upper VAT tax rate from 22% to 19% and its corporate taxes are falling from 28% to 24% in 2006. Hungary reduced its corporate tax rate from 18% to 16%; and Poland from 27% to 19%. Western democracies with much higher corporate taxation (Germany 38.3%, France 34.3%, Netherlands 34.5%, Italy 37%, and UK 30%) blame Slovakia for “tax dumping” and call for “tax harmonization” within the EU. They point out, that new members are able to lower taxes only thanks to the massive regional aid received from richer EU countries. However, any “tax harmonization” would require un-anonymous voting in the EU structures what makes it hardly applicable.

Political considerations

Based on February 2003 poll of opinion ordered by the Ministry of Finance, three quarters of respondents considered the tax reform necessary. Among the main reasons people mentioned high complexity of the old legislation, high tax rates, and high administrative complexity of the tax system. Majority was willing to accept 15% tax rate on income, only one fifth was willing to accept a higher rate. Asked to judge the fairness of taxation only 21.6% preferred flat tax and 70.9% preferred progressive taxation. Respondents generally agreed that the taxes should be low in order to support business and employment, and to reduce tax evasion.

Advocating the reform proposal, the Ministry of Finance claimed that the lower direct taxes support the investment in the middle and the long run, attract foreign investors, and improve production potential of the economy. Together with milder progressiveness they should better motivate people to work and bring positive effects on economic growth and employment. On the other hand some opposition parties, the trade unions and the President criticized negative short term effects on income mainly for the middle class, the “injustice” of weak progressiveness, the need for more solidarity, the need to use taxes as a tool for social policy, and the threat that the reform will deepen social imbalances. Even after the reform the main opposition party Smer proclaims, that if successful in the following elections it will renew the standard VAT rate and the progressiveness in the income taxation. According to public opinion polls, Smer has the greatest support from among political parties in Slovakia.

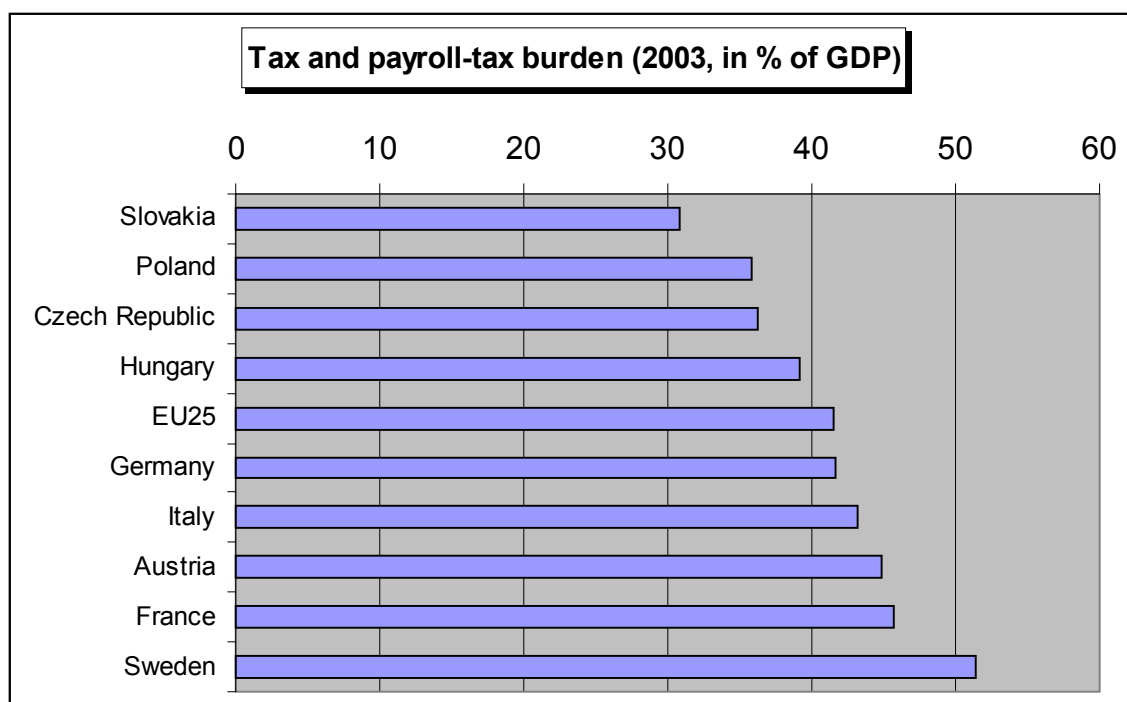
Key preconditions for successful reform were good timing (unpopular first, i.e. approving of the VAT rates unification), compensation for low income people (i.e. increase of the basic tax allowance deductible from the tax base; introduction of re-payable child bonuses in case of low or negative taxes; etc.), and gaining support from key target groups:

1. Entrepreneurs – communication, positive impacts of the reduction of corporate income tax, and abolishment of dividend tax
2. Bank analysts and NGOs – involvement in the reform process (joint organization of seminars and conferences, inviting to calculate the fiscal impacts of the reform)
3. Journalists and public – transparency, special web page, inviting foreign experts advocating the flat tax, positive reform evaluation by international organizations.
4. Opposition Members of Parliament, the President – communication, especially after the “veto” after the first approving of the Income Tax Act.

Changes in payroll-tax system

Slovakia has one of the lowest tax and payroll-tax burden in the EU measured as a % of GDP (Figure 6). However, the payroll-tax contributions measured as a % of gross labor income belong among the highest in the European Union (Table 8). Moreover, the payroll taxes (social contributions) total almost 40% of the overall tax and payroll-tax burden.

Figure 6: Tax and Payroll-tax burden



Source: Eurostat

Table 8: Social contribution rates (2003, in % of the gross wage)

	Employee	Employer	Total
Slovakia (2003)	12.8	38.2	51.0
Slovakia (2004)	13.4	35.2	48.6
Czech Republic	12.5	35.0	47.5
Hungary	12.5	32.0	44.5
Poland	25.0	20.4	45.4
EU-15 average	12.5	24.1	36.6

Sources: Ministry of Finance of the SR (2004); and OECD statistics

Effective from 2004, Slovakia substantially changed its payroll-tax system. Nominally the rates decreased just slightly but their character shifted heavily. Formerly, almost all benefits based on payroll-tax contributions were distributed equally or with only small regard on the amount of paid contributions. This is typical for taxes. Because people do not see the link between their payment and future benefits, they usually tend to avoid paying such kind of contributions. After the reform, mainly the pension contributions constituting almost half of payroll-taxes started to reflect the payment-benefit link much closely (Table 9). The reform also raised the ceilings for paying the social contributions from fixed SKK32 thousand monthly to 3-times the average monthly wage in the economy (SKK43,095 since July 2004).

Table 9: Payroll-tax burden (employee plus employer's contributions as % of the gross wage)

	2003	2005	Change	Character
Pensions	28% (tax)	28.75%	+0.75%	
- old-age*	n	19%	n	insurance/saving
- disability	n	6%	n	insurance
- reserve fund	n	4.75%	n	tax
Health	14%	14%	0%	tax
Sickness	4.8%	2.8%	-2.0%	insurance

Unemployment	3.75%	2.0%	-1.75%	insurance
Guarantee**	0.25%	0.25%	0%	insurance
Accident***	0.2% to 1.2%	0.3% to 2.1%	+0.1 to + 0.9%	insurance
Total pay-roll taxes	51% to 52%	48.1% to 49.9%	-2.9% to - 2.1%	

* Old-age insurance is being reduced by 0.5% for every nourished child for one of parents

** Guarantee insurance serves for covering unpaid wages for employees of insolvent firms

*** Actual percentage depends on a job risk grade

Source: INEKO

Pensions: Accepting the World Bank's recommendations and learning from similar reforms in Hungary and Poland, the new government decided to build a pension system based on three pillars: mandatory social insurance (pay-as-you-go or PAYG - 1st pillar), mandatory saving (Funded - 2nd pillar), and voluntary saving (Funded - 3rd pillar). First stage - the reform of the old PAYG system - became effective as from January 2004 and changed calculation of new pensions. Compared to the old formula, the new one gives higher pension to those who earned more and paid higher contributions during their working life and vice versa. The highest-to-lowest new pension ratio rises from 1.8 to 5.8 in a three-year transition period. This should increase the motivation to pay contributions and eliminate evasion. However, it also endangers people with too low income, who will receive much lower pensions and will have to be supported directly from the state budget. Second stage of the reform – the introduction of mandatory saving – became effective as from January 1, 2005. Until the end of June 2006, virtually all citizens may decide whether to divert 9% of their gross wage from the PAYG to their personal accounts managed by private pension companies competing on the market. Money saved on the accounts remain private ownership of savers and may be inherited.

Sickness: In the old system, all sickness benefits have been paid by the state. After reform, the period has split into a short-term and long-term part. First ten days of a sickness leave is being paid by an employer – the benefit in the first three days is 25% of daily gross wages; in the other days (4 through 10), it is 55%. From the eleventh day onwards, sickness benefits are being paid, as before, by the state, at 55% of gross wages. The aim of such changes was to eliminate abuse of the sickness benefit – people often pretended to be ill as their loss of income was not so high, firms often recommended their employees to take a sickness leave when they had no work for them. In a new system, the employers lost motivation to send people on sickness leave and started to watch their employees and control the reasons of their sickness. As a result the average length of a sickness leave measured as a percentage of the working-time shortened substantially from 5.1% in 2003 to 3.7% in 2004. On the other hand, even sick people tend to stay at work now or take a holiday instead of a sickness leave.

Unemployment: Eligibility period for benefits has been cut from 9 to 6 months. As the IMF (2005) notes, the benefits are paid on condition that the unemployed has contributed for 24 of the previous 36 months. The replacement rate is 50% of past gross income; previously, this has been 55% for the first six months, falling to 45% for the last three months. Benefits remain subject to a ceiling raised from about 50% to 60% of the economy-wide average wage.

Conclusions

After one year in place, Slovak tax reform brings both firm and tentative conclusions – increased attractiveness of Slovakia for foreign investors, increased international tax

competition, and better than expected impact on household consumption are among firm ones; better than expected fiscal implications still need to be confirmed in the following years.

Compensation for low income people is one of key preconditions for successful reform – the flat personal income tax includes large tax-free thresholds. As a consequence, the low income brackets do not pay taxes at all and the middle income brackets pay taxes slightly increasing with their income. Moreover, the tax reform has been complemented by welfare reform aimed, among others, at careful targeting of social aid to those really in need.

Flat tax brings simplicity – the elimination of virtually all exemptions makes system better to administer for the government and easier to understand for the tax payers.

Foreign investors welcome lower corporate taxation – however, even more important factors for deciding about the allocation of foreign direct investment seem to be a good infrastructure, cheap labor force, and generous state aid.

High direct taxes have negative impact on work incentives and vice versa – as a consequence, lower direct taxes bring more people to work, and must not necessarily mean lower state budget revenues.

Lower direct taxes and stronger payment-benefit link in payroll taxes help fight the shadow economy and reduce tax and payroll tax evasion – in a global economy the collection of direct taxes and payroll taxes becomes more difficult to control and it is easier to avoid paying them compared to the indirect taxes. As a result, the relatively high direct and payroll taxes are harming country's fiscal position and competitiveness - people "escape" to a shadow economy or to countries with lower taxation. The shift towards indirect taxation and stronger payment-benefit link in payroll taxes should reduce this evasion.

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