Ministry of Finance
of the Slovak Republic
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TAX REFORM
in Slovakia

October 2005

Ljubljana, Symposium on Tax Reform in Slovenia

OUTLINE

- General economic and policy environment in Slovakia
- Flat income tax
  - Legislative changes
  - Tax burden distribution
- Assessment tax reform impact on
  - Public finances
  - Macroeconomic environment
  - Selected tax payers
- Remaining policy challenges
  - Capital vs. labour taxation
  - Ageing issue
- Policy conclusions and implications

Slovak economy – key characteristics

- Lower middle income country
  - 2004 GDP/head in PPP: 54% EU25, 50% EU15, 52% OECD
  - Room for real convergence and catching-up
- Small and open economy
  - 2004 - Export: 77% GDP, Import: 80% GDP
  - Sensitive to changes in external environment
  - Sound macroeconomic policy is prerequisite for sustainable development
- Economic policy agenda – structural reforms
  - 2003-2004: pensions, labour market, welfare, education, tax reform
  - International authorities praise Slovakia for reforming effort (OECD, WB, rating agencies, FDI inflow)

FISCAL OBJECTIVES

- Medium term – Fiscal Consolidation
  - Reduction of the deficit to 3% of GDP in 2007

    → meet Maastricht criterion

    → adopt euro in 2009
  - Meet the ultimate SGP goal in 2010 (close to balance or in surpluse position)
- Long term – Ensure Fiscal Sustainability
  - Inter-temporal constrain of public debt under 60% of GDP
  - Ageing issue
  - Contingent liabilities

Macroeconomic indicators

growth in %	2003	2004	2005F	2006F	2007F	Average 2003 - 2007
GDP	4.5	5.5	4.9	5.3	6.1	5.2
Real wage	-2.0	2.5	4.1	3.9	3.7	2.4
Employment	0.8	0.3	0.7	0.9	0.8	0.7
Unemployment rate	15.2	14.3	13.4	13.0	12.7	13.7
Inflation	8.5	7.5	3.3	2.5	2.0	4.8
Average exchange rate SKK/EUR	41.5	40.0	38.2	37.6	36.8	38.8
Balance of current account (% of GDP)	-2.0	-3.5	-4.2	-4.7	-1.0	-3.1

Fiscal indicators

% of GDP	2002	2003	2004	2005	2006B	2007B
DEFICIT	**7.8**	**3.8**	**3.1**	**4.0**	**4.2**	**3.0**
GROSS DEBT	43.7	43.1	42.5	36.7	38.4	37.9
DEFICIT (excluding PAYG pillar shortfall)	**7.8**	**3.8**	**3.1**	**3.2**	**2.9**	**1.6**

Source: Convergence Programme, State budget draft 2006-2008, MoF, 2004, 2005

TAX REFORM – main objectives and principles

- Flat income tax - simplicity, fairness, proporcionality
  - Cutting number of tax rates 18 → 1
  - Broadening tax base (eliminating special treatments and exemptions)
    - → Allows low standard tax rates
    - → Minimizes distortions in the economy
  - Eliminating double taxation (dividends)
  - Progressivity of taxation reduced but not eliminated (high tax free treshold, tax credit on children)
- Efficiency – growth oriented
  - Incentives to work (lowering of effective taxation of low and high income groups)
  - Support of business environment (lowering tax burden)
- Broad revenue neutrality
  - Primary government objective: fiscal consolidation allowing for euro adoption in 2009

    => shifting tax burden from direct towards indirect taxes
    - ↘ Direct taxes: Flat personal and corporate tax, abolishment of inheritance, gift and real estate transfer tax
    - ↗ Indirect taxes: unification of VAT rates 14%, 20% → 19%, tobacco, beer and mineral oil tax rates)

FLAT TAX – legislative changes (1)

Income tax rates in %		
	2003	**2004**
Personal income tax	2; 2.25; 2.5; 2.75; 10; 20; 28; 35; 38	19
Corporate tax	15; 18; 25	19
Witholding tax	1; 5; 10; 15; 20; 25	19

FLAT TAX – legislative changes (2)

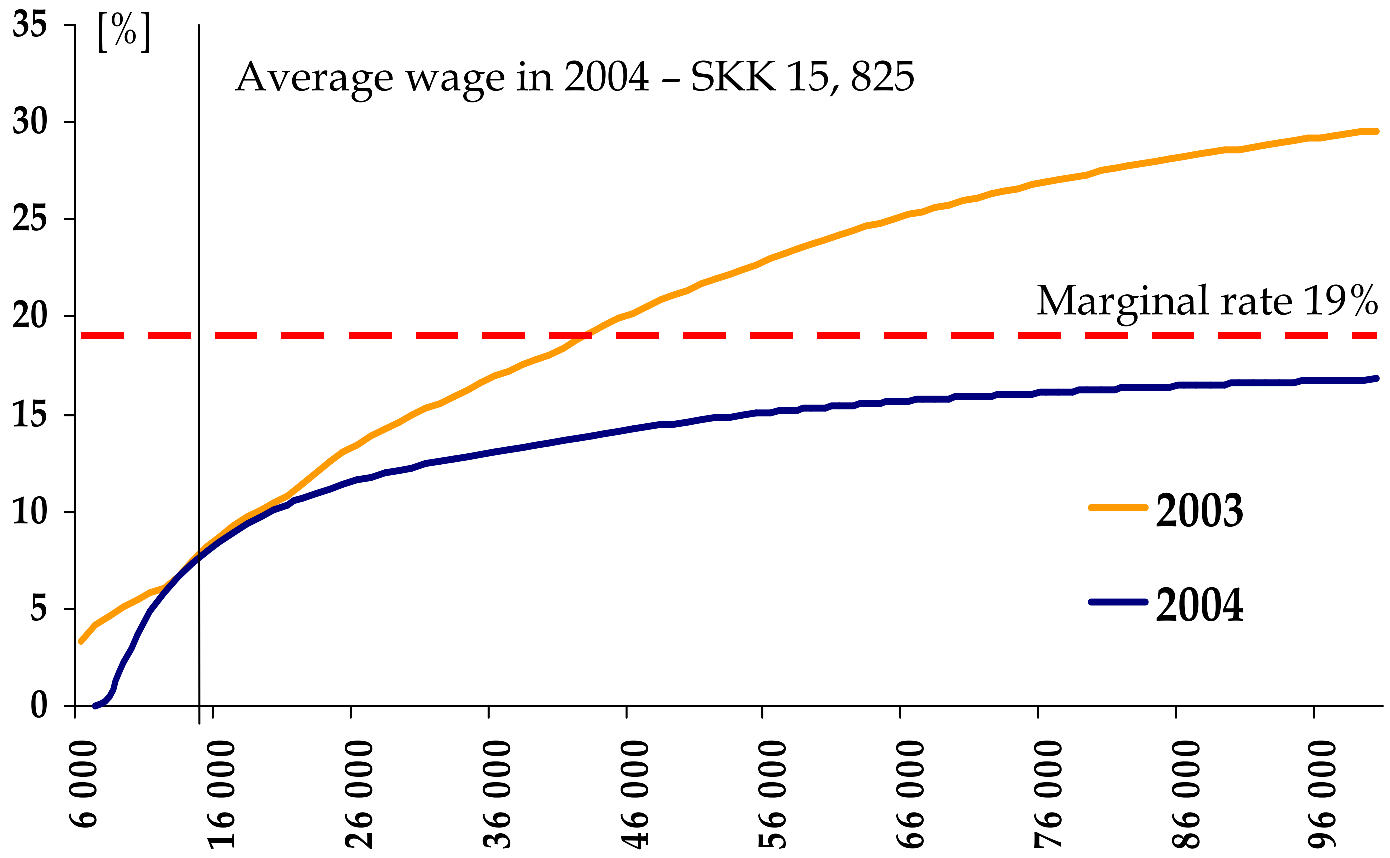
- **Personal income tax**
  - Abolishment of multiple tax rates including five-band rate structure on labour income
  - Only one but much higher tax-free treshold
    - Basic tax allowance for tax payer (SKK 38,760 → SKK 80,832)
    - Spousal allowance (SKK 12,000 → SKK 80,832)
    - tax free treshold automaticly indexed to minimum substince (poverty-line income treshold)
  - Introducing annual tax credit of SKK 4,800 per child (part of new child support and working incentives policy)
  - Since 2005 introducing purpose-oriented allowance of SKK 12,000 (tax-free savings, ageing issue)
  - Tax exemption on income from the sale of securities held for 3 years or more cancelled

Personal income tax rate structure for individual tax payer

2003		2004R	
SKK/month	Marginal rate (%)	SKK/month	Marginal rate (%)
to 3,230	0	to 6,736*	0
3,230 – 10,730	10	over 6,736*	19
10,730 – 18,230	20		
18,230 – 36,230	28		
36,230 – 50,230	35		
over 50,230	38		

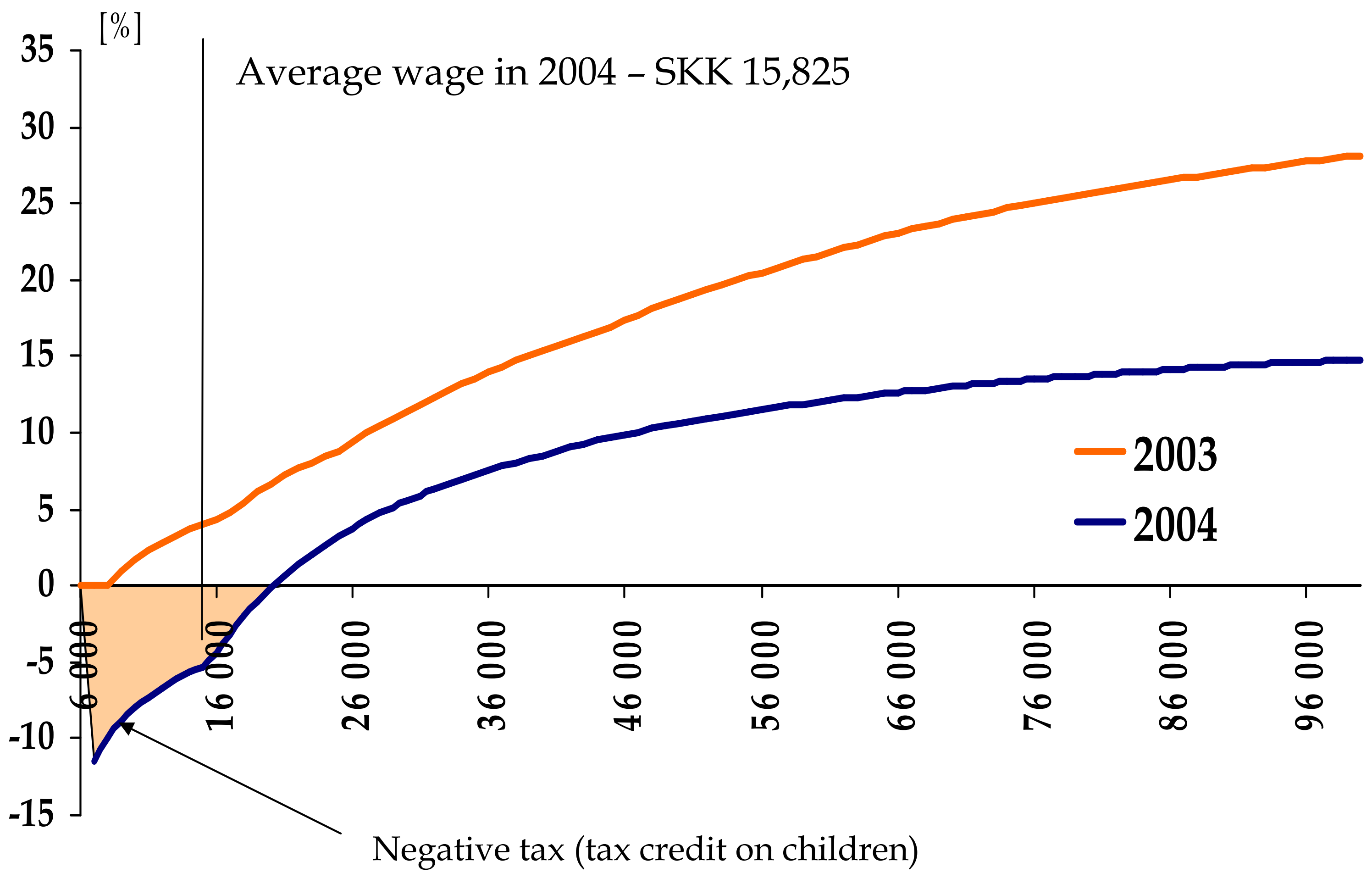
* Indexed to subsistence minimum

Impact on tax payers (1) - average effective tax of individual in %



Minimum wage since January 2004 – SKK 6,080

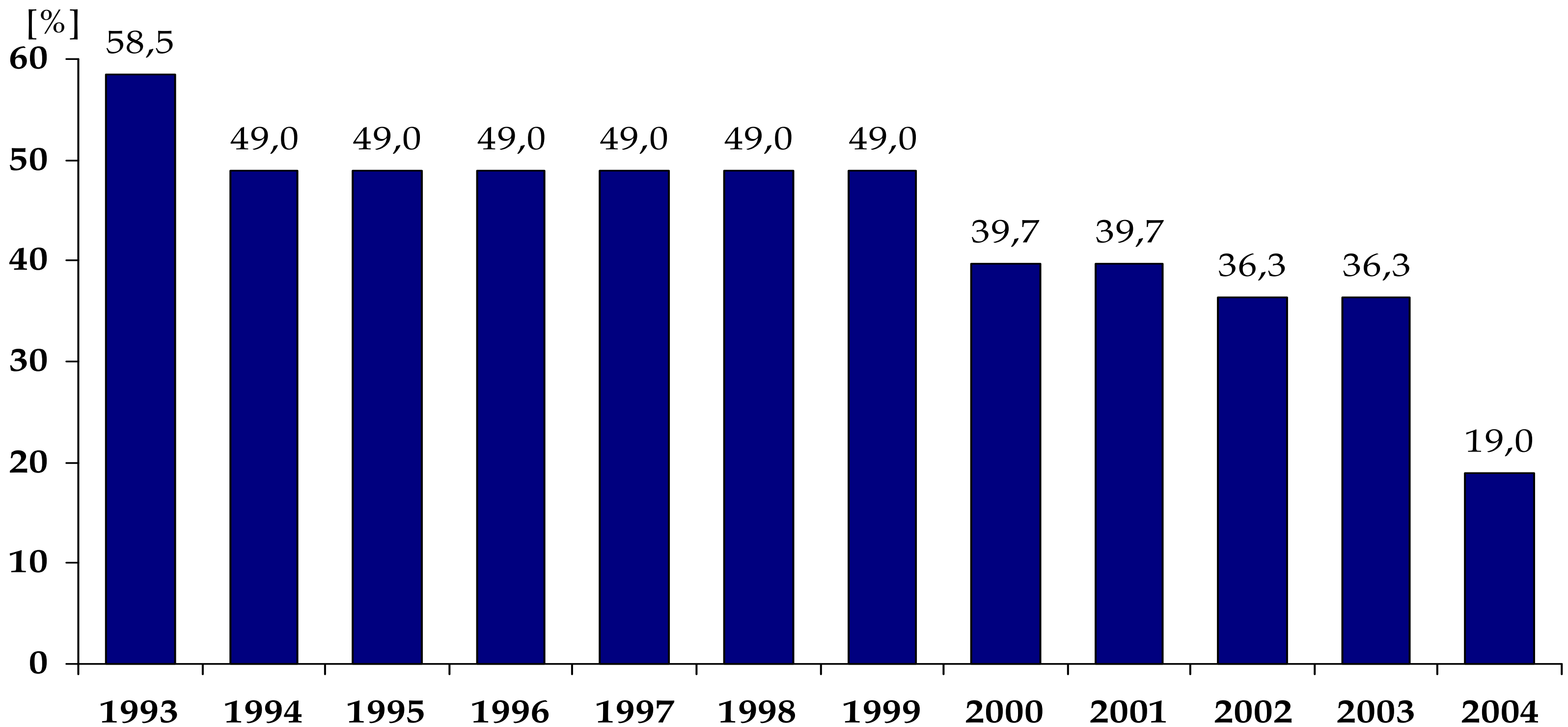
Impact on tax payers (2) - average effective tax of individual with non-working spouse and 2 children in %



FLAT TAX – legislative changes (3)

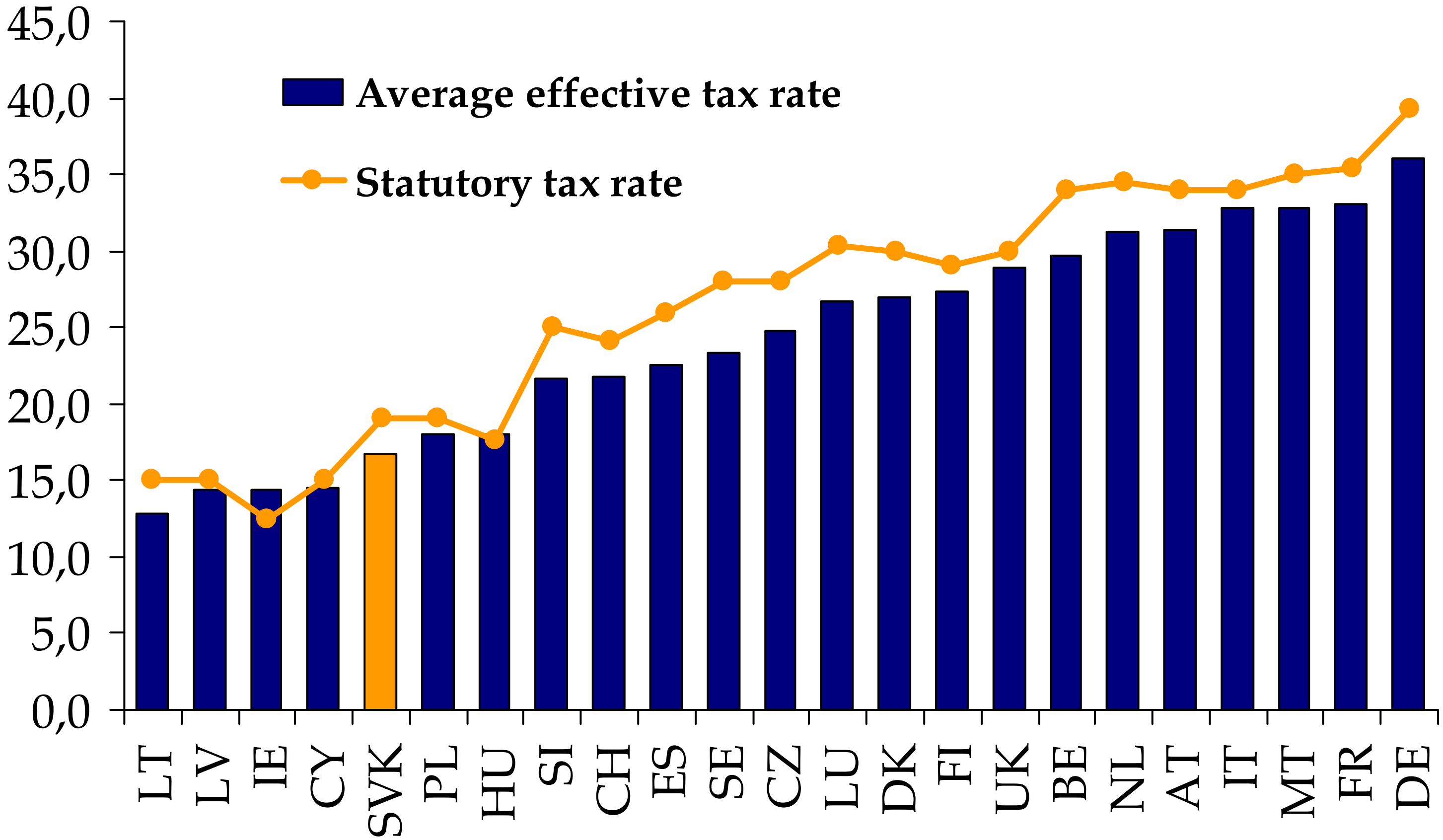
- **Corporate tax**
  - Most income tax exemptions cancelled (tax holidays for newly established firms, tax base reductions for certain sectors)
  - Remaining investment incentives in compliance with the EU law on state aid
  - Dividend tax abolished
  - Reduction of effective tax burden on businesses
    - Depreciation period on some groups of tangible assets shortened (property and buildings 30y → 20y)
    - Loss carry-forward rules relaxed
    - Limits on tax deductibility of advertising and of vehicle depreciation cancelled

Effective corporate tax rate in Slovakia



Effective corporate tax rate = statutory corporate tax rate X dividend tax rate

Company effective tax burden in 2004



Source: ZEW Economic Studies Vol.28, OECD Tax Database

Tax reform – impact on government revenues (1)

ESA 95, % HDP	2004 Budget	2004 Actual	Difference
PIT	2.1	2.6	0.5
CIT	1.8	2.5	0.7
Withholding IT	0.9	0.4	-0.5
FLAT TAX	4.8	5.5	0.7
Total taxes	17.9	18.0	0.1

Tax reform – impact on government revenues (2)

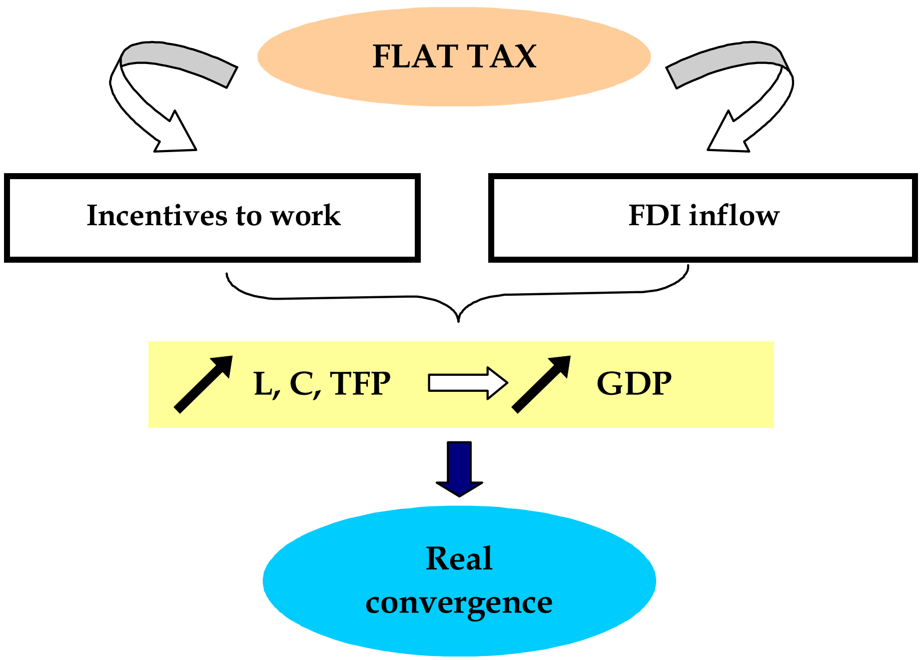
ESA 95, % HDP	2004 NON-REFORM scenario	2004 Actual	Difference
PIT	3.5	2.6	-0.9
CIT	3.1	2.5	-0.6
Withholding IT	0.6	0.4	-0.2
FLAT TAX	7.2	5.5	-1.7
Total taxes	18.4	18.0	-0.5

Flat tax - positive bugetary impact in 2004

- Sources
  - Macroeconomic development (+)
  - Conservative approach to budgeting revenues (+)
  - **Tax planning? (+)**
- Assessment limitations
  - Corporate tax: cyclical upturn or reducing of tax planning?
  - Reliability of wage distribution data
- Subject for future research
  - Tax planning
  - Compliance and administration costs

Tax reform – impact on macroeconomic environment

- **Short-term period – minimum effect (broadly budgetary neutral)**
- **Medium-term period – expected scenario**



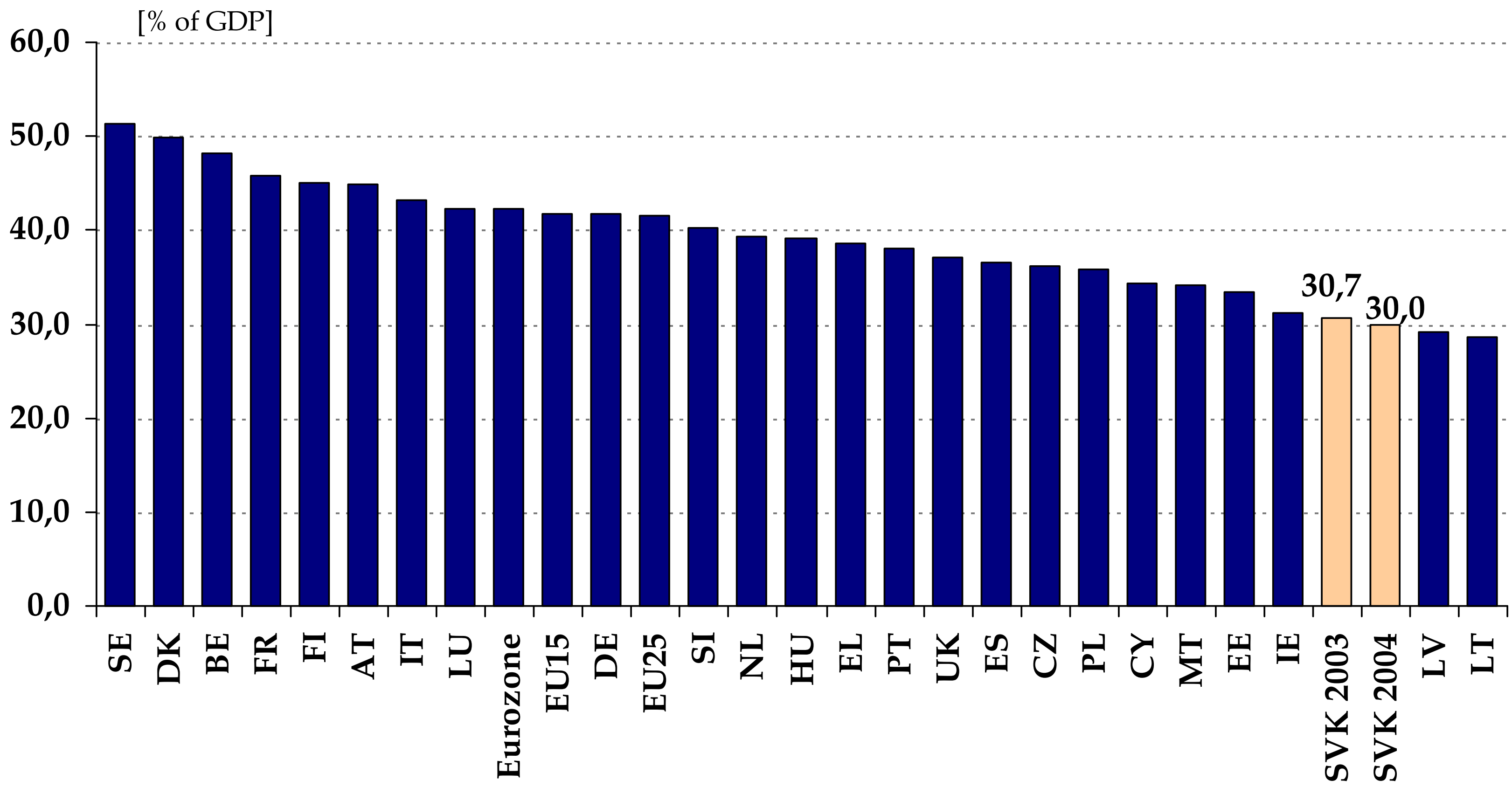
Tax reform – impact on selected tax payers

change in net income in %	STATIC APPROACH		DYNAMIC APPROACH
	PIT	Overall tax burden	Real disposable income
INDIVIDUAL			
Minimum wage	3,5	1,4	**3,1**
Average wage (AW)	-0,4	-2,4	**0,9**
3 x Average wage	6,5	4,5	**8,3**
FAMILY			
Employee (AW) + 2 children	2,7	0,7	**3,9**
Employee (AW) + Non-working spouse + 2 children	7,8	5,7	**8,9**
Employee (AW) + Spouse (AW) +2 children	2,9	0,9	**5,9**

Remaining policy challenges

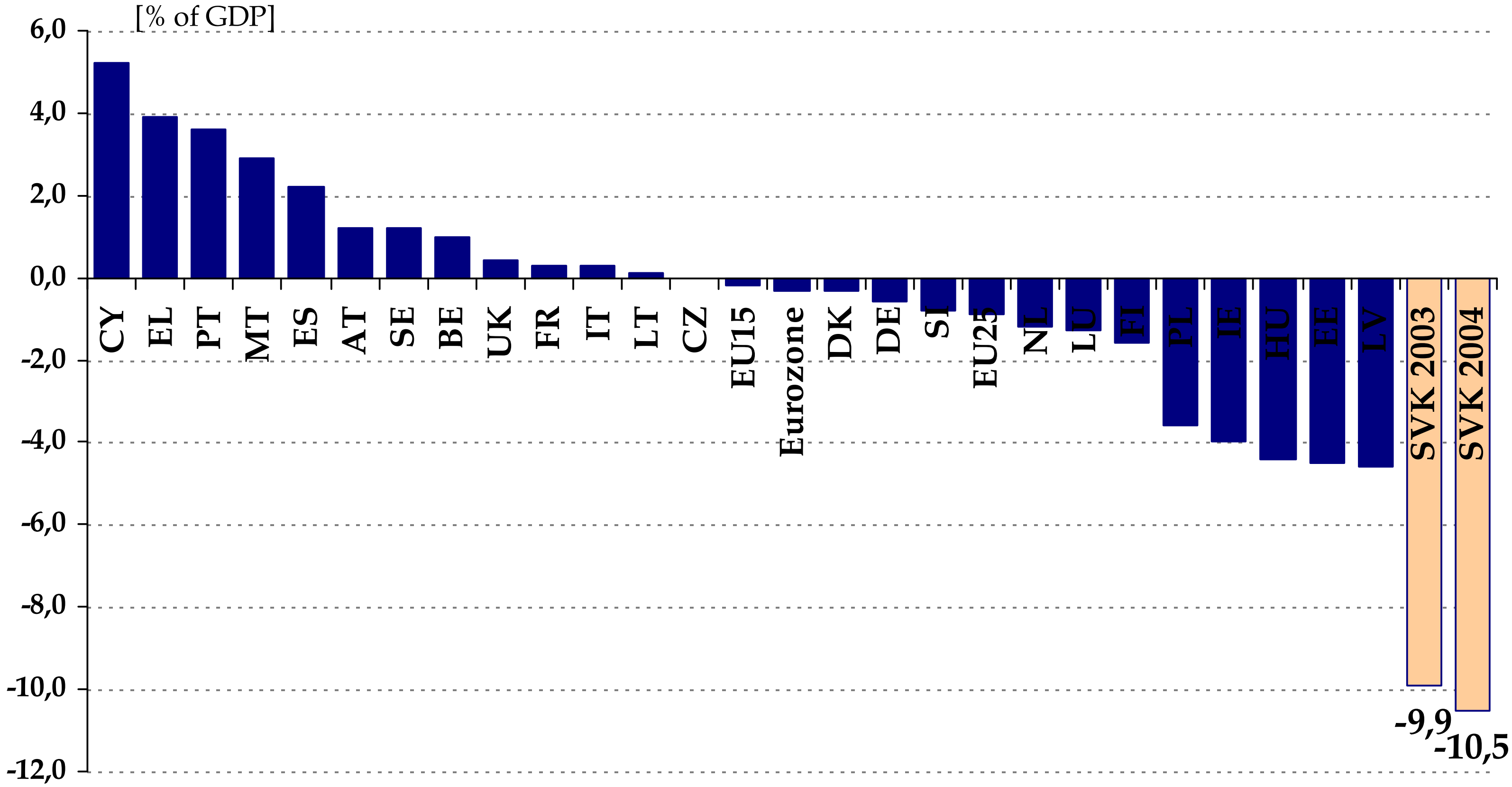
- Any future fiscal and tax policy will have to address two crucial issues
  - TAXATION OF CAPITAL vs. LABOUR
  - AGEING OF POPULATION

Overall tax burden in EU25 (% of GDP, ESA 95), 2003



Note:
Eurostat published 30,9% of GDP for Slovakia in 2003 but GDP was revised upward since then.

Change in overall tax burden in EU25 in the period 1995-2003 (% of GDP, ESA 95)



Taxing labour income in Slovakia: 2003 vs. 2004

in %	I	I	I	I-2	C-2	C-2
	(67%)	(100%)	(167%)	(67%)	(100%,0%)	(100%,33%)
Tax wedge 2003	40.3	41.4	44.6	27.8	32.3	34.0
Tax wedge 2004	38.8	42.0	44.5	25.4	27.2	29.4
Marginal tax wedge 2003	43.1	49.4	49.4	43.1	43.1	43.1
Marginal tax wedge 2004	48.3	48.3	48.3	48.3	36.1	36.1

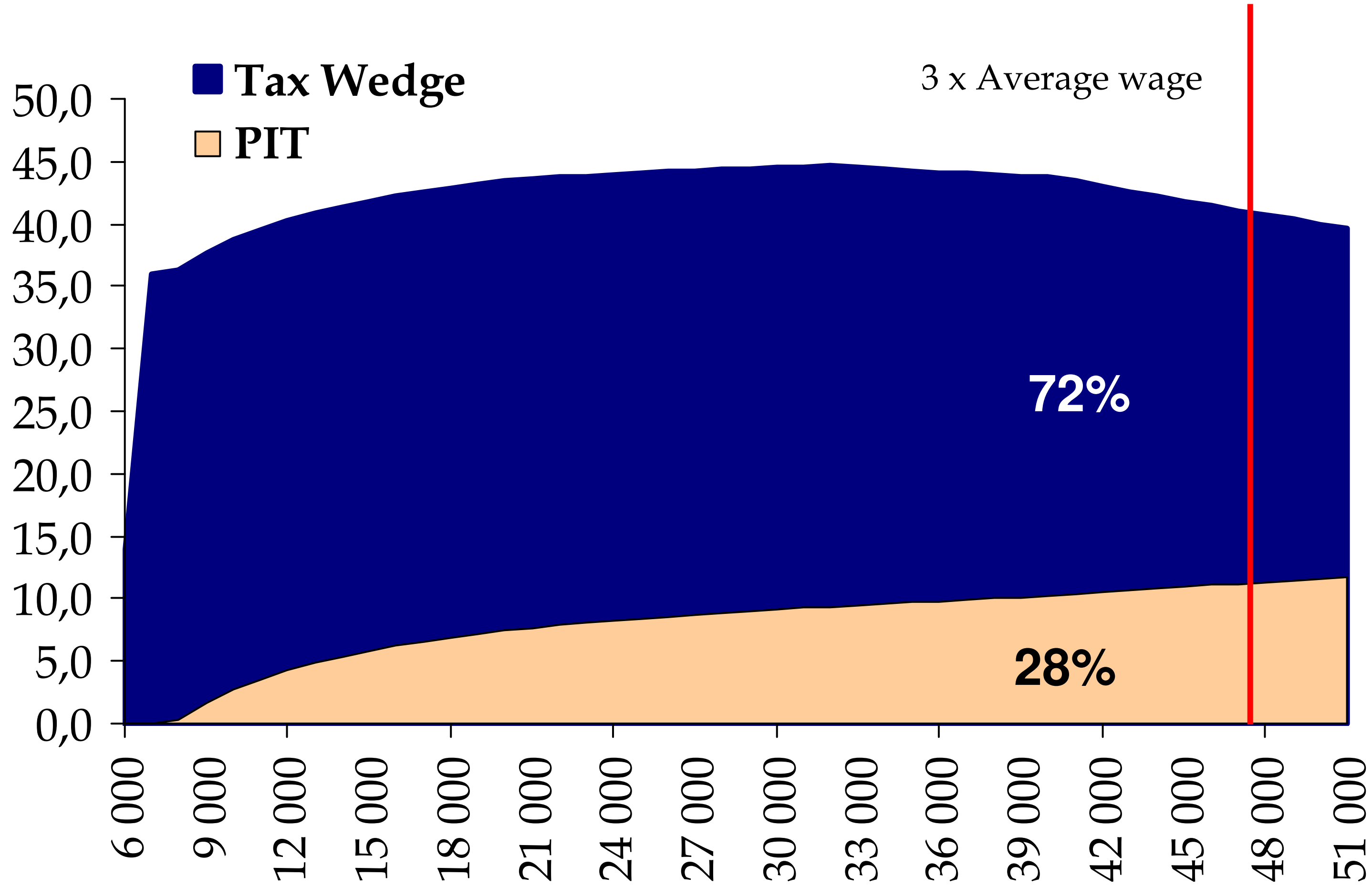
Source: OECD, I = individual; C = couple; number of children; % in average wage in industry

Taxing labour income – Slovakia vis-a-vis OECD in 2004

in %	I	I	I	I-2	C-2	C-2
	(67%)	(100%)	(167%)	(67%)	(100%,0%)	(100%,33%)
Tax wedge						
Average OECD	32.5	36.5	41.4	16.8	26.6	28.7
Slovakia	38.8	42.0	44.5	25.4	27.2	29.4
Marginal tax wedge						
Average OECD	42.3	44.8	50.1	44.7	45.7	43.1
Slovakia	48.3	48.3	48.3	48.3	36.1	36.1

Source: OECD, I = individual; C = couple; number of children; % in average wage in industry

Tax Wedge on labour income



Demography – increase in the old-age dependency ratio for 2004 – 2050 period

- Drop in total population by 12%
- Population aged 65+ will double
- Population aged 15-64 will drop by 33%
- 2004 - 6 workers on 1 pensioner
  → 2050 - 2 workers on 1 pensioner

Enourmous fiscal implications

2050: Health + Long term care + Old age pensions
increase by 5% of GDP

Remaining policy challenges and conclusions (1)

- Q: Overall tax burden is low but tax reform shifted tax burden from capital to labour; tax reform removed majority of exemptions, however, government still provides individually investment incentives. Is it fair, non-distortive and employment supporting approach?
- A1: No proved empirical relationship between overall tax wedge size and employment, nevertheless lowering TW for low income groups seems desirable
- A2: At this stage Slovakia faces a problem of low vacancies generation and FDI inflow is considered as a main driving force in medium term

Remaining policy challenges and conclusions (2)

- Q: Is there still room for lowering overall tax burden in the near future, in particular high social contributions?
- A1: Long term sustainability of public finances should be an ultimate goal for responsible fiscal policy
- A2: Present overal tax/GDP ratio in Slovakia is relatively low by international comparison
- A3: Role of government in economy (solidarity, equity) and ageing issue should be addressed before deciding on overall tax burden
- A4: According MoF analysis there is still need for consolidation effort in order to ensure long term sustainability in public finances

Thank you for attention

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