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ORGANISATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT

Tax Policy Reforms in the Slovak Republic

CTPA

CENTRE FOR TAX POLICY AND ADMINISTRATION

3. TAX REFORM IN THE SLOVAK REPUBLIC

3.1 Tax structure and trends

The evolution of tax revenue as a percentage of GDP in the Slovak Republic, compared to the development in the OECD countries and the EU since 2000, is shown in table 3.1.

The tax burden in the Slovak Republic has been reduced in recent years. The reduction in the tax burden has been larger than the reduction in the OECD average which peaked at 37.1 per cent in 2000 and then fell to 36.7 per cent in 2001 and 36.3 per cent in 2003.

Table 3.1: Total tax revenue as a per cent of GDP. 2000 -2004. Figures for 2004 are provisional.

	2000	2002	2003	2004 (prov.)
The Slovak Republic	34.3	33.0	31.1	30.8
OECD-average (unweighted)	37.1	36.4	36.3	-
EU15-average (unweighted)	41.7	40.6	40.5	-

Source: OECD Revenue Statistics 1965-2004.

The tax structure of the Slovak Republic is shown in table 3.2. The Slovak Republic relies relatively little on personal income taxation as compared to the OECD-average. The same is the case for property taxes. The Slovak Republic, however, relies relatively much on social security contributions (including payroll taxes) compared to the rest of the OECD.

Table 3.2: Tax structure in the Slovak Republic compared to some other OECD countries and the average OECD and EU15 (unweighted). Revenue of major taxes as a percentage of total tax revenue 2003

	Austria	Czech Republic	Hungary	Slovak Republic	OECD (2003)	EU15 (2003)
Personal income taxes	23.1	13.0	18.9	10.8	24.9	25
Corporate income taxes	5.1	12.3	5.8	9.1	9.3	8.1
Social sec. and other payroll	39.9	43.6	32.9	39.6	27.0	29.8
Property taxes	1.3	1.4	2.2	1.8	5.6	5.2
Goods and services taxes	28.2	29.7	39.4	36.2	32.1	30.4

Source: OECD Revenue Statistics 1965-2004.

3.2 Recent tax reform initiatives

The tax reform in the Slovak Republic is often referred to as the example of a flat tax reform. In 2003, the personal income tax system in the Slovak Republic had five income brackets, with tax rates varying from 10 per cent to 38 per cent. A taxpayer at average earnings would face a marginal tax rate of 20 per cent. The corporate tax rate was 25 per cent. (Dividends were subject to a final withholding tax of 15 per cent, while the final withholding tax on interest payments was 25 per cent.) The VAT had a standard rate of 20 per cent and a reduced rate of 14 per cent. The personal income tax system in the Slovak Republic before the tax reform was then in fact a semi-dual personal income tax system.

In 2004, all of these rates were replaced with a flat tax rate of 19 per cent. The introduction of the flat rate was combined with a large increase of the basic allowance and with a significant elimination of tax relief

measures which led to a broadening of the tax base. At the same time, the government reduced social assistance benefits and shifted the tax burden from direct to indirect taxation[1].

The tax reform turns out to be broadly revenue neutral as a result of the shift from direct to indirect taxation. A comparison of the estimated tax revenues that would have been received in 2004 in the absence of the tax reform and the actually received tax revenues in 2004 in per cent of GDP[2] demonstrates that the decline in personal income tax revenues (from an estimated 3.5 per cent of GDP to 2.6 per cent of GDP) and corporate income tax revenues (from an estimated 3.1 per cent of GDP to 2.5 per cent of GDP) has almost entirely been compensated by the increase in VAT revenues (from an estimated 7.1 per cent of GDP to 7.9 per cent of GDP) and excise revenues (from an estimated 3.0 per cent of GDP to 3.4 per cent of GDP). In total it is estimated that the flat tax reform will have reduced the tax burden in the Slovak Republic from above 30 per cent in 2003 to about 29.5 per cent in 2007.

3.3 Tax reforms in detail

3.3.1 PIT reform

The existing five-band rate schedule on labour income was abolished and replaced by the flat rate of 19 per cent. Existing allowances were abolished and were replaced by one (high) basic allowance for taxpayers (80,832 SKK[3]). As part of a new child support system and a policy focused on providing work incentives, an annual tax credit of SKK 4,800 per child[4] was introduced. From 2005 a purpose-oriented allowance of 12,000 is also introduced for tax-free savings.

The Slovak authorities continue to levy high health and social security contributions. The joint rate of employee health and social security contributions in 2005 is 13.4 per cent and is levied on gross wage income; the joint employer social security contributions are 35.2 per cent of gross earnings. (In 2003, the rate of employee and employer social security contributions was respectively 12.8 per cent and 38.2 per cent). However, the health and social security contributions paid by the employee can be deducted from the personal income tax base. This implies that the personal income tax as a revenue source for the Slovak Republic is of minor importance both prior to and after the introduction of the flat tax. The heavy reliance on social security contributions also implies that labour income still is taxed more heavily than capital and corporate income. However, employee and employer social security contributions are subject to a ceiling of about 3 times the average production wage. Only labour income in excess of 3 times the average wage is therefore taxed at the flat 19 per cent rate, which is also levied on capital and corporate income.

Table 3.3: Average income tax and tax wedge as a per cent of gross earnings for a single individual. Before and after Slovak reform (2003 versus 2005)

	67% of APW		100% of APW		167% of APW	
	2003	*2005*	*2003*	*2005*	*2003*	*2005*

1 The inheritance and gift tax were abolished; the real estate transfer tax is abolished as from 1 January 2005.

2 Information provided by the Slovak Ministry of Finance. For detailed evaluation of Slovak tax reform see document published by Institute of Financial Policy: “First Year of the Tax Reform, or 19 Percent at Work”.

Available on http://www.finance.gov.sk/EN/Documents/IFP/Publications/TAXREFORM_EN.pdf

3 Defined as 19.2 times the minimum subsistence level for one individual (4,210 SKK in 2004). The minimum subsistence level is indexed every year by increase in living costs (close to CPI).

4 Tax credit was increased to 5,000 SKK in 2005 and to 6,480 SKK in 2006. Since 2007 tax credit will be indexed by increase in minimum subsistence level.

Income tax	5.5	4.9	8.2	8.7	13.1	11.9
Tax wedge	40.9	35.3	42.9	38.3	46.3	40.3

Source: Taxing Wages 2004-2005.

Table 3.3 compares tax rates in 2003 and 2005 using the OECD's Taxing Wages framework for single individuals at different income levels. It illustrates that the average income tax fell at 67 per cent and 167 per cent of APW earnings and that it increased at 100 per cent of APW earnings. The tax wedges strongly exceed the average income taxes due to the heavy reliance on social security contributions in the Slovak Republic. However, tax wedges decreased by 5.6, 4.6 and 6 percentage points for single individuals at respectively 67 per cent, 100 per cent and 167 per cent of average production wage when 2003 and 2005 are compared. Table 3.4 presents a similar analysis for married couples with 2 dependent children. The negative average income tax rate for couples on low incomes results from the non-wastable child tax credit and the dependent spouse allowance.

Table 3.4: Average income tax and tax wedge as a per cent of gross earnings for a married couple (one partner earns 100% of APW, other partner earns 0%, 33% or 67% of APW) with two dependent children. Before and after Slovak reform (2003 versus 2005)

	0% of APW		33% of APW		67% of APW	
	2003	*2005*	*2003*	*2005*	*2003*	*2005*
Income tax	4.1	-3.4	4.1	2.2	5.1	4.6
Tax wedge	31.9	23.2	35.7	29.0	37.2	31.7

Source: Taxing Wages 2004-2005.

Tables 3.3 and 3.4 imply that the reduction in the personal income tax rates have not caused the strong increase in incentives for unemployed people in the Slovak Republic to accept work. However, the Slovak government has also reduced social assistance benefits and introduced some other reforms that "make work pay".

Because of the high social security contributions, labour income continues to be taxed at higher rates than capital and corporate income. As a result, taxpayers continue to face incentives for shifting highly taxed labour income into lower taxed capital income. These incentives only disappear for labour income in excess of three times the average production wage, as no additional social security contributions are levied on these earnings.

3.3.2 Corporate tax reform

The corporate tax rate of 25 per cent was reduced to the flat rate of 19 per cent. The tax base was broadened through the abolishment of most income tax exemptions as, for instance, for newly established firms and abolishment of reduced rates for certain sectors. To alleviate the tax burden on businesses, the depreciation period of some groups of assets was shortened and loss carry-forward rules were relaxed. Limits on tax deductibility of advertising and of vehicle depreciation were cancelled.

The taxation of dividends at shareholder level was abolished. Together with the reductions of the statutory corporate tax rate, the top statutory tax rate on dividend income was reduced from above 36 per cent in 2003 to 19 per cent in 2004.

The Slovak tax reform has increased the return to saving and investment by reducing the statutory tax rates on capital income and by abolishing the double taxation of distributed dividends. The tax reform also reduced the distortion to financing decisions. As distributed dividends are no longer taxed at the household

level and because the corporate tax rate is equal to the 19 per cent tax rate on interest payments, the tax reform resolves the distortion between newly issued equity and debt as tax-preferred source of finance. However, as retained earnings are taxed under the corporate tax and the resulting capital gains are taxed again at the household level when the shares are sold (if the gains exceed five times the subsistence level); the Slovak tax system distorts the choice between newly issued equity and retained earnings as source of finance even after the tax reform.

3.3.3 Indirect tax reform

The level of goods and services taxation in the Slovak Republic of 36.2 per cent of total tax revenue is higher than the OECD-average, as shown in table 3.2. Regarding the Value Added Tax, the reform abolished the low rate of 14 per cent and a reduced the general rate from 20 to 19 per cent. This increased the VAT revenue by about 0.8 per cent of GDP. As a part of the reform, excise duties were increased, which increased tax revenue by about 0.3 per cent of GDP.