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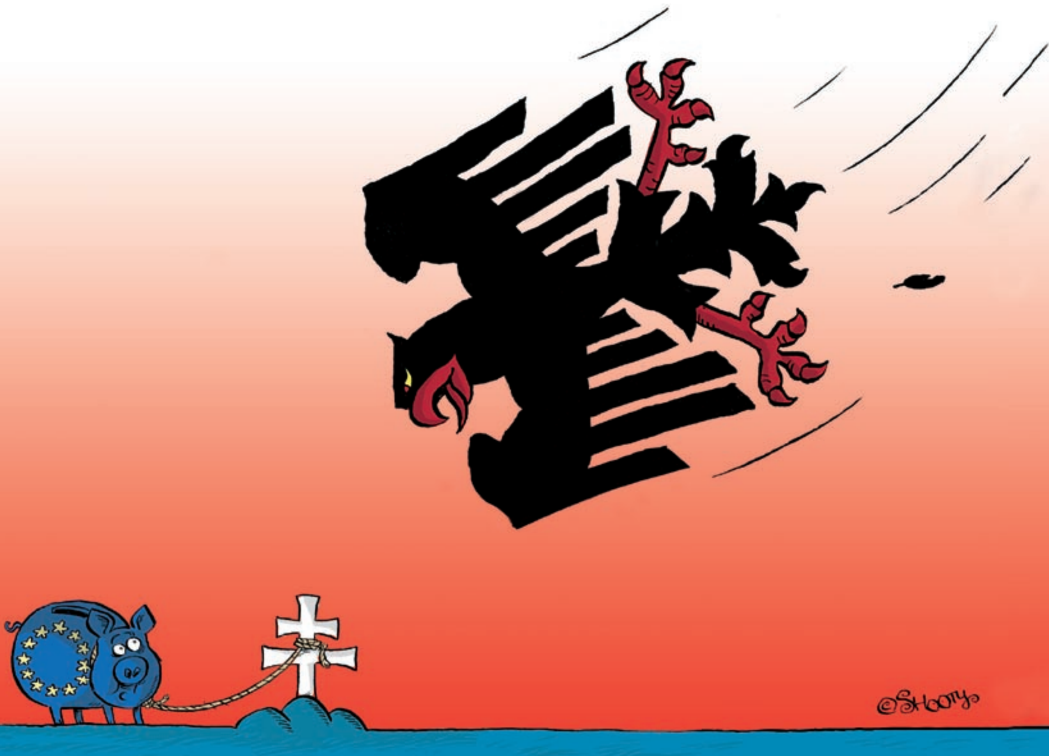
Martin Chren

Unfair Competition? Slovakia´s Tax Policy



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Unfair Competition? Slovakia´s Tax Policy

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1. Introduction

Now, more than a year and a half after joining the European Union (EU), countries of the so-called „New Europe" – countries of the Central and Eastern Europe that joined the EU in May 2004 – have to prepare for the new times ahead. Even if today they are approaching the end of their transition from centrally planned to market economies, their economic situation is still far behind the western European countries.

For example, according to European Union's statistical authority the Eurostat, the per capita Gross Domestic Product in Purchasing Power Standards in Slovakia is estimated to be just some 54 percent of the EU-25 average. Other countries of the New Europe group post very similar results, such as the Czech Republic with 72 percent, Estonia with 54 percent, Latvia with 46 percent, Lithuania with 51 percent, Poland with 47 percent, or Hungary with 62 percent (all data are estimations for 2005).

Therefore, it should be of no surprise that the Central European countries are trying to do their best to catch up the „Old Europe" countries in their economic performance. One way of doing so is through introduction of simple and transparent tax systems, based on a „flat" income tax – a tax system with just one single rate for taxing incomes. Such tax systems are aimed to increase the competitiveness of transition economies that should lead to more robust economic growth and development.

The question we are trying to answer today is whether lower tax rates are an efficient tool how to achieve this goal, and whether the „tax competition" they started can be considered as a harmful for the international economy.

In my short presentation, I will try to talk about particular experience from Slovakia, the country which I am coming from. I will try to explain why Slovak economists and politicians decided to undertake the tax reform that got Slovakia to appear on front pages of international business magazines, and why I cannot agree with the opinion that this tax reform could impose a „harmful tax competition" on countries like Germany, Sweden, or France.

2. Does Europe need a „wind of change"?

First of all, I would like to mention that not only the Eastern European countries are much worse off (in terms of economic situation) than their western allies, but even the European Union as whole is facing an unpleasant state if compared to, for example, the United States of America.

A recent World Competitive Yearbook, a study annually published by Swiss Institute for Management Development, shows that the competitiveness level of Germany, which is the most competitive country of Europe, is only 70 per cent of the USA competitiveness.

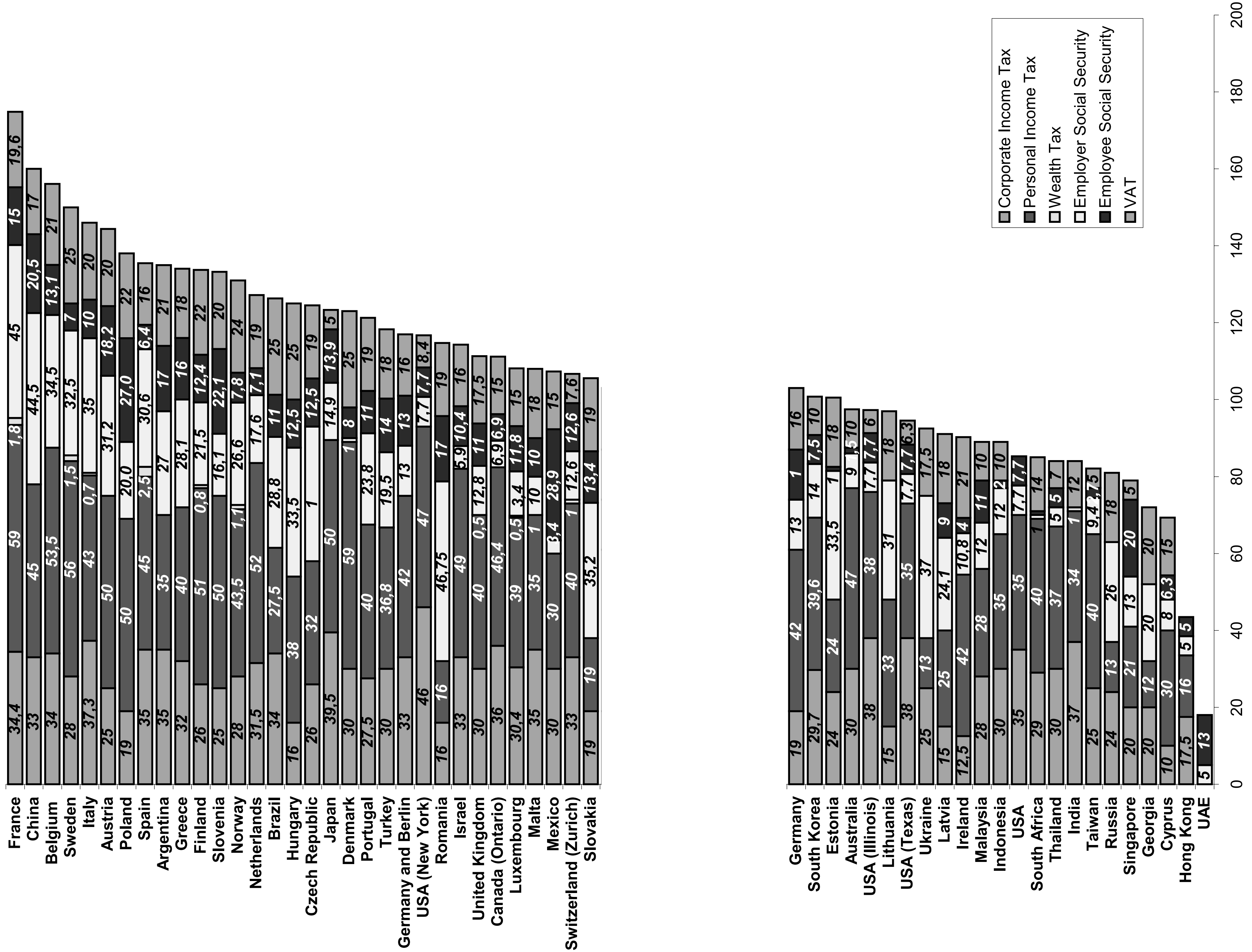
Another study, from the Swedish Timbro Institute, shows that the European Union comes out to be significantly poorer if compared to the United States of America. Measured in the terms of Gross Domestic Product per capita, would France, Germany, and Italy be among the states of the North American Union, they would find themselves be among the poorest ones. Actually, all but five of the states of the USA have higher GDP per capita than the three „motors" of the European Integration.

In March 2000, the EU Heads of States and Governments agreed to make the EU „the most competitive and dynamic knowledge-driven economy by 2010". Later, last year and just several weeks prior to the EU enlargement, European leaders discussed the Lisbon Agenda and reasons why EU countries fail to achieve its ambitious goals in the area of European competitiveness. It is with most sincere and utmost regret that we note that they were not able to identify tax systems as a significant reason. Tax systems that destroy incentives for profit making activities, that destroy incentives to save, to invest, to create employment-excessive taxes are among the most critical factors preventing EU countries from becoming the most competitive economy of the world, and from achieving other goals set by the Lisbon Agenda.

A good comparison of the elementary approach of governments to taxation of their people can be provided by the so-called „*Tax misery index*", regularly published by the Forbes Magazine. It does not provide an overview of the tax burden imposed by government and cannot be used as a relevant statistic tool to measure how much do citizens in every particular country pay on taxes and social security. Instead, it is based on a simple sum of the marginal - highest - tax rates existing in the economy, thus providing a clear view on what is the *general approach* of each and every government to taxing its own people.

As may be noticed from the following chart, the highest marginal tax rates do exist in countries like France, Belgium, Sweden, and Italy - almost all of them the „old Europe". Slovakia also used to be in this group of countries, but it moved to the upper part of the chart thanks to its comprehensive tax reform.

Chart: Forbes Magazine Tax Misery Index 2005



Source: Forbes Magazine Global Edition

3. The Slovak Tax Reform

3.1 A concise description of the tax system in Slovakia

Slovakia's current tax system consists of taxes as described in the following table:

Table: Structure of the tax system in Slovakia

Direct Taxes	Indirect Taxes
Personal Income Tax	Value Added Tax (VAT)
Corporate Income Tax	Excise Taxes (on liquor, beer, wine, mineral oils, and cigarettes and tobacco products)
Real Estate Tax	
Motor Vehicles Tax	
A set of Municipal Taxes	

This structure of taxes is effective in Slovakia as of January 1, 2004 (with one exception: the Real Estate Transfer Tax was eliminated only as of January 1, 2005). January 1, 2004, was also the date recorded as the introduction of a new reformed tax code.

While the most significant part of tax revenues for public budget is collected through the indirect taxation, it was the direct taxation that was mostly touched by the tax reform. The reason why is simple: the whole system of indirect taxes, including the Value Added Tax (VAT) and Excise Taxes, is fully harmonized across the European Union. The legislation framework for these indirect taxes is standardized in several directives issued by the European Commission, and EU-member countries (Slovakia being an EU-member since May, 2004) have little or no space to modify or adapt their tax laws in other way than the Brussels-based bureaucracy allows them to. In most cases, the space for modifications is limited to setting tax rates within a restricted limit (such as 15 to 25 percent in the case of VAT).

Similarly to many other countries of the continental Europe, it is important not to limit the attention to taxes when talking about the tax system, as in addition to the taxes, both employees and employers have to carry the burden of

mandatory payroll taxes (also called mandatory insurance premiums, or mandatory contributions). In case of Slovakia, this contribution burden is significantly bigger, if calculating it on wages. The list of all mandatory contributions is included in the following table:

Table: Mandatory contributions as a percentage of gross salary

Type of mandatory insurance	Employee's contribution	Employer's contribution	Maximum computation base
Sickness	1.4	1.4	1.5 times the average monthly salary
Retirement[1]	4	14	3 times the average monthly salary
Reserve fund[2]	–	4.75	
Disability	3	3	
Unemployment	1	1	
Health	4	10	
Guarantee fund	–	0.25	1.5 times the average monthly salary
Accident	–	0.8	
TOTAL	**13.4**	**35.2**	**48.6**

Note: Rates may vary for self-employed persons, students, pensioners, etc.

1 As of January 1, 2005, a new retirement scheme was adopted in Slovakia, based on the idea of personal retirement accounts (i.e. a fully-funded pension system). Therefore, all Slovak citizens who have less than ten years till reaching their retirement age may choose whether they will stay in the old, unfunded, pension scheme, or whether they will start sending part of their mandatory retirement insurance contribution (9 % of gross wage) to their personal retirement account (in such case, instead of the employer's 16 % contribution to government, employer sends 9 % to personal retirement account and just the remaining 7 % to the government's Social Insurance Agency). More information on the Slovak Pension Reform may be found at http://www.hayek.sk/en/modules.php?name=News&file=article&sid=57&mode=&order=0&thold=0

2 The „Reserve Fund" is in fact a transition tax, introduced to finance the cash flow deficit in the retirement trust fund of social security after the introduction of personal retirement accounts.

3.2 Overview of the 2003 Slovak tax reform

The 2003 fundamental tax reform was one of the prime initiatives of the Slovak government in fulfilling its aim of creating a highly competitive and non-distortive market environment in Slovakia. The whole process of drafting and implementing the reform was rapid-fast by international standards: after the new government started works at the new tax laws after the autumn-2002 elections, the new Income Tax Act was approved in Parliament in October 2003, and then repeatedly (after the President's veto) in December 2003; it went fully into force on January 1, 2004.

The actual tax reform meant much more than just changes in the tax rates. Its ultimate aim was to transform the Slovak tax system into one the most competitive ones among the developed countries. Today, the new Slovak tax system is competitive mainly because of the unusually high degree of its efficiency, transparency and non-distortiveness.

Changes in the personal income taxation

In the area of direct income taxation, the Slovak tax reform was focused on the implementation of a single rate tax, also known as „flat tax". In accordance with the principle of taxing all incomes of individuals and corporations equally, just one linear percentage rate of 19 percent is applied in Slovakia since January 1, 2004. The new legislation eliminated 21 different types of taxation of direct income that had been in force in Slovakia until 2003, including various personal income tax rates in five tax brackets (10 %, 20 %, 28 %, 35 %, and 38 %), different tax treatment of selected segments of economy (agriculture, forestry, large foreign investors, etc.). The existence of a single marginal tax rate for all income above the standard exemption sharply decreases the distortive effects of income taxation.

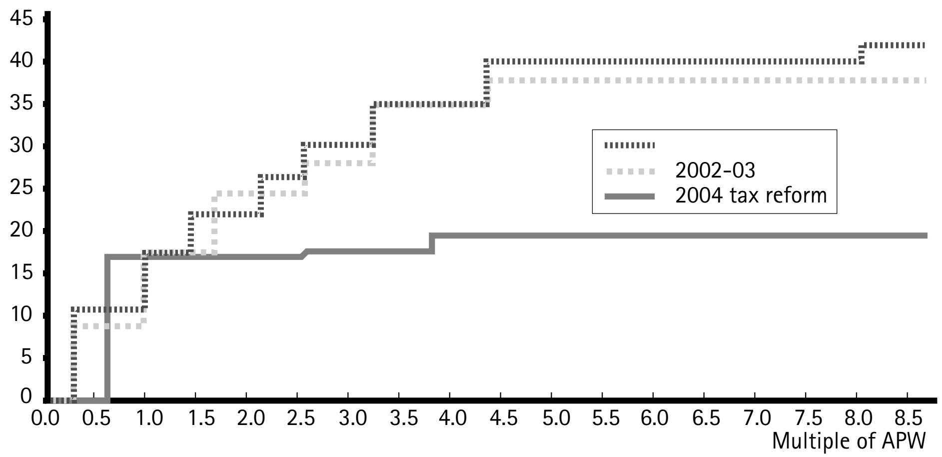
Despite obvious economic pros of flat tax, several countries have failed to introduce a similar system because of political obstacles. Therefore, the Slovak reformists had paid special attention to design the reform in a politically acceptable manner. The revolutionary breakthrough in income taxation in Slovakia was only made politically possible by including and actively advertising several important features of the new tax system.

First, the non-taxable threshold for every individual was significantly increased, from the original fixed amount of SKK 38,760 to a 1.6 multiple of the poverty line, i.e. SKK 80,832 in 2004. The hike in the non-taxable threshold was adopted in order to compensate the low-income earners who had benefited from the lowest, 10 percent marginal tax rate in the previous system.

Moreover, the definition of non-taxable minimum as a multiple of poverty line - an amount annually increased proportionately to inflation - serves as a tool for automatic adjustment of non-taxable minimum, thus preventing the „hidden" or „inflationary" gradual increase of real tax burden due to inflation of nominal income. For instance, the non-taxable amount of SKK 80,832 in 2004 was automatically increased to SKK 87,936 in 2005, reflecting the 8 percent 2004 rate of inflation in Slovakia.

Other features of the reform included an increase of the spouse allowance, which was increased from the original SKK 12,000 to the same amount as the non-taxable threshold per individual. Therefore, if the sum of incomes of a taxpayer's spouse in a married couple is lower than 1.6 times the poverty line, the employed taxpayer may deduct the difference between the 1.6 times the poverty line and the actual spouse's income in addition to his/her own non-taxable threshold.

Chart: Effective tax rate of the today's personal income tax in Slovakia as a percentage of gross wage compared to the state before the 2004 tax reform



Note: The scale shown on the horizontal axis is based on the 2003 APW of 150 000 SKK per year. For 2004, the two steps in the marginal effective tax rate for workers whose income exceed the basic tax exemption reflect the different income assessment bases for income tax deductibility of health insurance and social security contributions.

Source: OECD

Also the tax deduction for each child has been changed from the original fixed amount of SKK 16,800; however, this change was of a different nature than the above-mentioned cases. The children allowance was substituted for a so-called „children bonus", being in fact a tax credit of SKK 4,800 for each child. This means that after the reform, a taxpayer (one of a married couple only) may deduct SKK 4,800 per child directly from his/her tax to be paid, instead of deducting SKK 16,800 per child from his/her tax base.

Last, but not least of the arguments that helped to pursue the idea of a flat tax in Slovakia was the fact that despite having just a single tax rate, the basic tax exemption ensures that the tax system retains an element of progressivity of effective tax rates faced by individuals with different amounts of income. All personal income of up to 1.6 times the poverty line is exempt from taxation. As a result, the effective tax rate for individuals below this threshold will be zero. However, the effective tax rate starts increasing once the individual has exceeded this threshold.

Changes in the corporate income taxation

Hand in hand with changes in the personal income tax, effective as of January 1, 2004, the corporate tax rate in Slovakia was also reduced to 19 percent from the previous rate of 25 percent.

At the same time, the new tax system follows the principle of taxing the investment and capital gains income only once, even if it is transferred from the corporate to the personal level. Thus, dividend taxation has been cancelled and investment income is taxed only once, at the level of corporate profits. Thanks to this, the effective tax rate on investments in Slovakia faced by private investors (which represents the combined impact of corporate income tax on profits and tax on dividends) is among the lowest in the Europe, if not even in the world.

Another important step was the easing of rules pertaining to the carrying forward of business losses. The new tax law permits losses to be deducted from taxable income over a 5 year period, with unequally sized annual write-offs permitted.

Slovak companies are, however, not allowed to deduct all investment expenses at the very year when they occur – instead of this, depreciation models are set in the tax code. This means that for each investment expense (expense in amount higher than approximately USD 1,000), only a given fraction of its costs may be deducted every year. Depending on the type of the investment or property, the

Table: Overview of the changes applied to tax base and tax rates of the Slovakia's income taxation

	Former tax system (until the end of 2003)	New tax system (since 2004)
Personal Income Tax	5 rates (brackets) 10, 20, 28, 35, 38 %	19 %
Corporate Income Tax	25 %	19 %
Basic tax allowance (non-taxable minimum)	SKK 38 760 / year	1.6-times the annual minimum living standard amount (poverty line)
Child allowance (per child)	SKK 16 800 / year deductible from tax base	replaced by tax „bonus" deductible from tax 4 800 SKK / year
Spouse allowance	SKK 12 000	1.6-times the annual minimum living standard amount

depreciation period is 4, 6, 12, or 20 years – which means that the tax reform also increased depreciation allowances for industrial buildings compared to the previous legislation.

Simplification of the Income Tax Act

Introduction of flat tax in Slovakia went far beyond simple tax rates standardisation and changes in the non-taxable threshold. The main idea of flat tax is not just making taxing flat; even more important is to make is as simple as possible.

Therefore, perhaps the most notable – and also radical – change in the Slovak tax code was the simplification of both individual and corporate income taxation.

In order to achieve the highest possible degree of tax transparency and to minimize economic distortions, the new tax code eliminates as many exemptions and special regimes as possible (around 80 percent of all)[1]. Thus, the reform addressed distortions that created rents for those who were in position to exploit them.

1 Calculation by the Institute for Economic and Social Reforms, Bratislava

Type of departure from the rules:	Number:
Exceptions:	90 items
Income that is not a part of the tax base:	19 items
Deductions:	7 items
Items free of tax:	66 items
Special tax rates:	37 items

Table: Overview of the number of different tax exceptions and special tax regimes in the old income tax law in Slovakia (before the reform)

Source: Author's calculation

The tax reform was coordinated with reforms in social security and healthcare system. Almost all tax deductions and exemptions that had originally been intended to achieve non-fiscal policy goals were replaced by targeted measures in the relevant policy areas. New forms of targeted social compensations have been introduced to ensure a fairer distribution of income, particularly benefiting low and medium income households and families with children. There has been virtually only one departure from the rule that survived in the tax code until today - voluntary retirement savings of up to SKK 24,000 a year per person are deductible from the tax base.

Changes in the indirect taxation – VAT and excise taxes

The introduction of a relatively low flat-rate income tax would normally result in a lower absolute amount of income tax collected in a short term. Although the designers of the tax reform regarded such a linear relation between tax rate and budget revenue even in the short run as most unlikely, the most conservative approach was followed in order to avoid fiscal problems. The budget revenue expected to be lost was therefore compensated by increased indirect tax revenues generated by higher indirect tax rates introduced as a part of the reform. The tax reform drafters believed that even if the actual tax revenues would be higher than planned, the structure of the new tax system with higher proportion of indirect taxation would have a positive overall impact on the economy.

It is important to mention that the laws and regulations on VAT, as well as on the excise taxes, are fully harmonized with the EU standards, and therefore there was not much maneuvering space for the Slovak government in the area of the indirect taxation - frankly, almost the only space for „tax reform" in indirect taxation was setting the tax rates in these types of taxes.

Prior to the reform, Slovakia had a standard value added tax (VAT) rate of 20 percent and a reduced rate of 14 percent on selected products and services (such as basic food, medicaments, electricity, construction works, books, newspapers, magazines or hotel and restaurant services). As a part of the reform, the reduced VAT was cancelled entirely and a unified 19 percent rate was introduced for all goods and services from January 1, 2004. Due to Slovakia's accession to the European Union, the compulsory exemptions prescribed by the EU Directives have been preserved - all others have been abolished. In addition to generating increased tax revenues, the unification of VAT rates is also expected to eliminate the economic distortions and inefficiencies associated with taxing the consumption of various goods and services differently.

The tax reform also included amendments to Acts on excise duty on mineral oils, tobacco and tobacco products, wine and beer, entering into force on August 1, 2003. The amendments increased excise duty rates on these types of products. The increased excise taxes on tobacco products have harmonized the Slovak tax law with EU minimum rate requirements earlier than was expected in Slovakia's Accession Treaty to the European Union.

Changes in other types of taxes in Slovakia

Three other types of taxes, collected at the national level, were eliminated as a part of the tax reform in Slovakia: the inheritance tax, the donation tax, and the real estate transfer tax. Donation tax and inheritance tax were eliminated completely from January 1, 2004 (even before 2004, there was no inheritance tax for closest relatives). Simultaneously with the elimination of the donation tax, charitable donations are no longer treated as tax-deductible expenses. The real estate transfer tax has been abolished as of January 1, 2005.

The tax reform was followed by fiscal decentralization which included significant changes in the structure of municipal, or local, taxes concerning real estate tax, road tax and other local taxes. Fiscal decentralization was following the decentralization of state administration, when in addition to their original policy role, several other authorities of the central government, especially in the area of education, social policy, culture, health care, roads maintenance, etc. were transferred from the central government to municipalities and administrative regions.

In principle, the fiscal decentralization significantly strengthened the fiscal powers of municipalities and of administrative regions in the field of local taxes. After the fiscal decentralization, since 2005, the whole revenue from personal income tax, despite being still collected by the central government, is allocated exclusively among the municipalities and administrative region. The former road tax was transformed to tax on motor vehicles, and is collected and administered by the self-governing regional administrations; the real estate tax is collected and administered by municipalities (towns and cities). In addition to this, municipalities in Slovakia may collect several other types of taxes since January 2005, namely tax on dogs, tax on using public areas, „tourist" tax (tax on accommodation facilities), tax on vending machines, tax on gambling machines (only machines not providing financial wins), tax on entering historical core of towns by motor vehicle, and tax on nuclear facilities (only in towns situated closely to nuclear power plants).

Strengthening the taxation powers of municipalities is, however, sometimes criticized, as the municipalities and administrative regions are, at least according

Table: A brief summary of the main features of the fundamental tax reform in Slovakia, effective since January 1, 2004

Flat tax	Introduction of a single, 19 percent rate of personal income tax, corporate income tax, and value added tax
Simplification of the Income Tax Act	Elimination of more than 80 % of all exceptions, special tax regimes, and special treatments from the Tax Code
No double taxation	Elimination of tax on dividends
No death tax	Elimination of the inheritance tax
No taxation of goodwill	Elimination of the gift tax
No taxation of real estates transfers	Elimination of the real estate transfer tax
Fiscal decentralization	Strengthening of competencies, including taxation competencies, of municipalities and regional governments; Real estate tax collected by municipalities and motor vehicles tax collected by regional governments

Source: Author's calculation

to some economists, expected to substantially increase the level of local taxation in a longer term. The main problem is that in most of the taxes administered by the regions and municipalities, the legislation does not state any minimum or maximum tax rates. This has already leaded to some skyrocketing tax hikes, especially in the real estate tax rates, often by more than 100 percent.

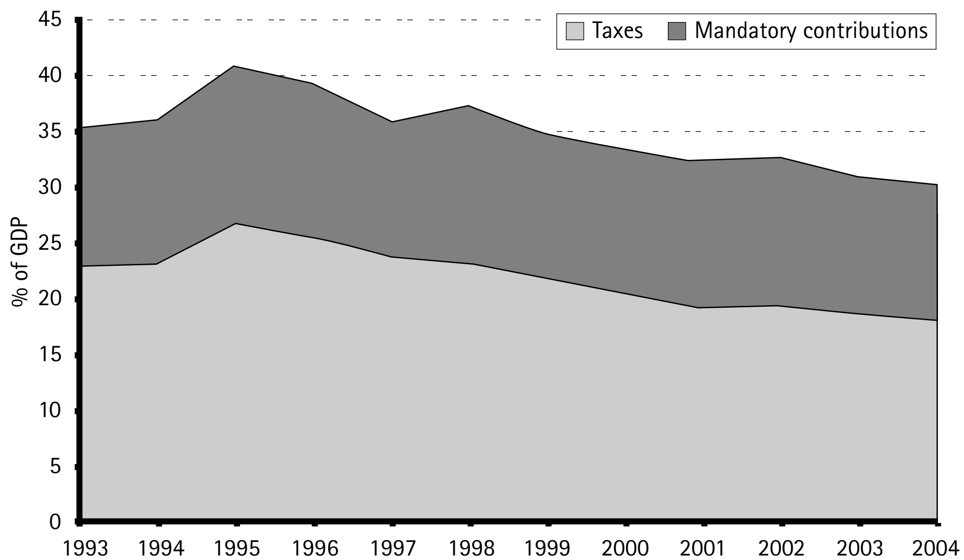
A short description of all reform steps introduced into Slovakia's tax code in the recent past is provided in the following table:

4. The Total Tax and Contribution Burden in Slovakia

To compare the total level of tax and mandatory contributions burden in Slovakia, it is important to provide at least two views: the overall macroeconomic view, and the view of an average employee.

From the macroeconomic perspective, the tax burden in Slovakia is not too high. Measured as a percentage of government revenues from taxes and social

Chart: Share of tax revenues and mandatory social contributions on GDP in Slovakia

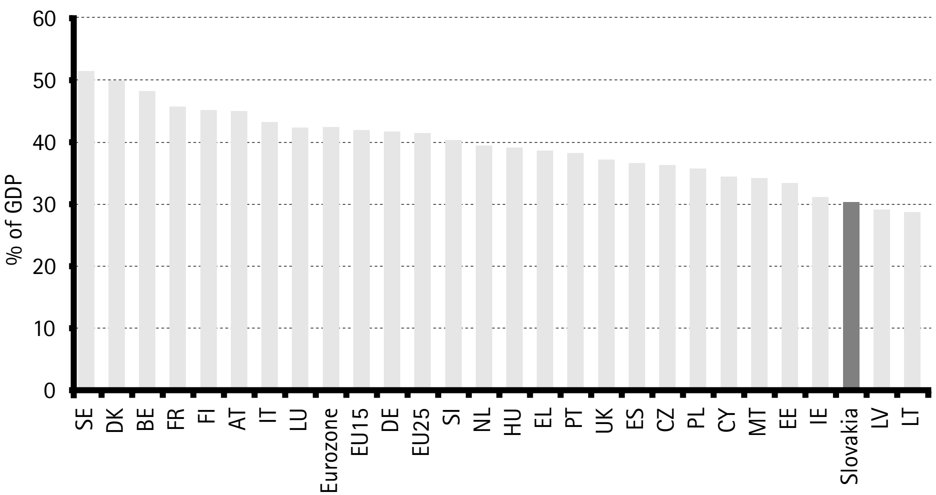


Source: Ministry of Finance of the Slovak Republic contributions on the gross domestic product, it has dropped significantly from the first year of Slovakia's independence, 1993. Today, the government collects on taxes and mandatory social contributions revenues that equal to approximately 30 percent of GDP. Compared to other countries of the European Union, it is the third lowest burden - after Latvia and Lithuania - significantly lower than the EU-average.

However, the dimensions of tax burden are somehow different if seen from the perspective of workers. Due to high mandatory contributions, the real net income of an average worker in Slovakia is less than one half of his total labor costs. Too high mandatory contributions are generally considered to be one of the major obstacles for higher employment and growth in Slovakia today.

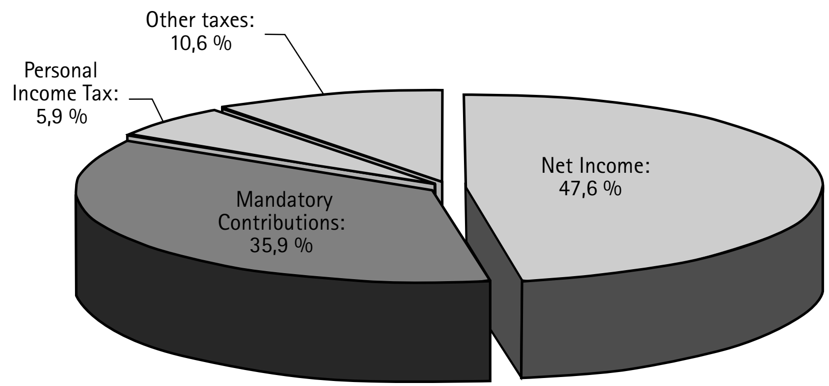
While the issue of burden levied on Slovak workers is therefore somehow questionable, companies doing business in Slovakia are in a much better situation. Their profits are taxed only once, with a flat 19 percent rate of corporate income tax. As the tax on dividends was eliminated from the Slovakia's tax code, this is probably one of the lowest effective tax rates on investment in the developed world. If the burden levied by the corporate income tax is adjusted by different

Chart: Total tax and mandatory contributions burden within the European Union



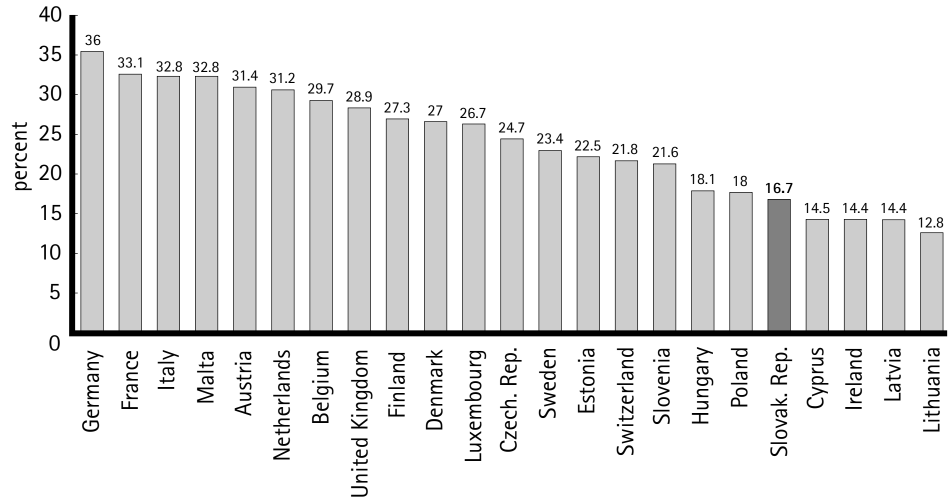
Source: Ministry of Finance of the Slovak Republic

Chart: Share of mandatory contributions, taxes and net income on the total labor costs in Slovakia (Employee with no children, average wage)



Source: Author's calculation.

Chart: Effective Average Tax Burden of Companies in Europe



Note: 2004 data for Slovak Republic, Germany, Malta, Czech Republic, Estonia, Slovenia, Hungary, Poland, Cyprus, Latvia, and Lithuania; 2003 for other countries.

Source: ZEW Economic Studies Vol. 28.

tax bases of different countries, it seems that companies running business in Slovakia face the fifth lowest effective tax burden in Europe.

Such an approach has already started bringing its fruits in Slovakia: the investment activity and inflow of foreign direct investments to the country reaches its record levels today.

5. Five Arguments in Favor of the Sound Slovak Tax Policy

Besides bringing about significant attention among economists, journalists and politicians, the Slovak tax reform gained also some strong criticism, mainly from some European politicians, namely German Chancellor Gerhard Schroeder, Swedish Prime Minister Goran Persson, and others. They accused Slovakia of „unfair" and „harmful" tax competition and called for retributive actions from the European Parliament and European Commission.

The Slovak public was, moreover, distinctly disillusioned by the reaction of the new German Chancellor, Ms. Angela Merkel. Ms. Merkel visited Slovakia a couple of weeks before the parliamentary elections in Germany and spoke highly about the Slovak tax reform, mentioning her plans to fight for similar improvements in her homeland. However, just a couple of days after being named the new Chancellor, she introduced a new agenda of her Cabinet, that included - for the first time as an official goal and statement of any European Cabinet - the effort to punish Slovakia and other countries for their efforts to improve tax systems and general economic and business environments.

Are the arguments of German, Swedish and French politicians true? I do not think so and through the following five arguments, I will try to explain why.

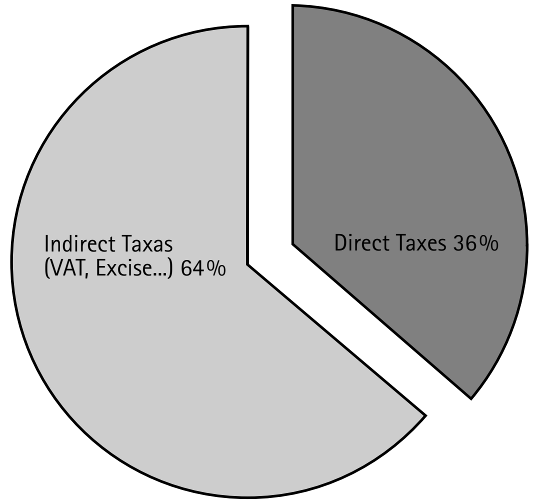
Argument 1:

There is almost no tax competition remaining in the EU (and in Slovakia) today.

First of all, - a general argument - if we are aiming to defend tax competition within the European continent today, we are not really trying to fight for a real tax competition - instead we are trying to defend the last pieces of tax competition that remain within the European Union.

If you look at the total public budget of the Slovak government, you see that out of the total tax income, almost 65 % comes from the indirect taxes - VAT

Chart: Share of indirect (harmonized) and direct („competitive") taxes on total tax revenues in Slovakia



Source: Ministry of Finance of the Slovak Republic, 2006 estimations

and consumption taxes - that are fully harmonized with the EU legislation. That means that in fact two thirds of the taxes in Slovakia are prevented from any competition today[2].

Argument 2:
The Slovak tax reform was fiscally neutral.

Another point to mention is that with the tax reform that was adopted in Slovakia, the share of indirect taxes was significantly increased, while the amount of tax revenues from direct taxes has dropped. However, as the Slovak tax reform was designed to be fiscally neutral, the total tax revenues remained unchanged. Two important conclusions for my argumentation may thus be drawn out of this: First, the tax reform has actually brought more tax harmonization to Slovakia

2 This number expresses the share of indirect taxes (Value Added Tax, or VAT, and Excise Taxes, on the total tax revenues of the whole public sector in Slovakia. Would the share be calculated only on those tax revenues that are coming directly to the state budget (not the budgets of municipalities, regional governments, etc.), it would be even higher.

(increasing the importance of indirect, and thus harmonized, taxes). Second, saying that countries like Slovakia have low taxes after the reforms they have undertaken, and the rest of Europe has to pay them more money for this luxury, is simply untrue.

Let me explain the fiscal neutrality of the Slovak tax reform in more depth:

As any reform-minded politician may know, drafting a tax reform proposal is much easier than putting the show on the road. The way from the first draft to the adoption of the final reformatory amendments is not paved with marble; instead, it is long and thorny.

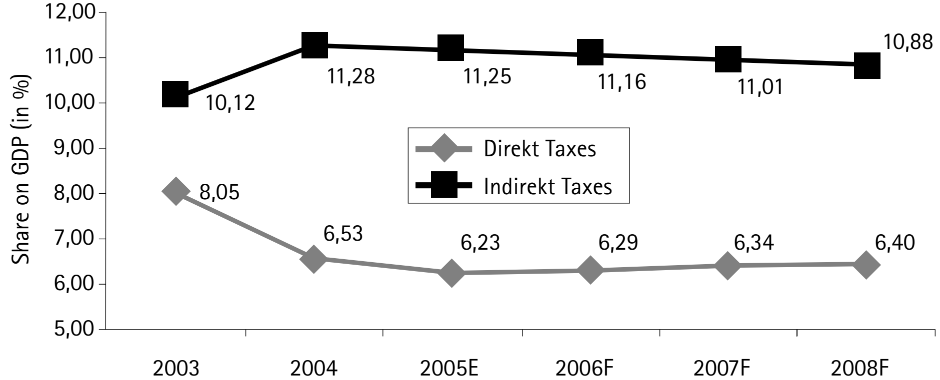
The success of Slovakia in adopting a set of major economic and social reforms during a short period of time was still not sufficiently explained. Vaclav Klaus, economist and president of the neighboring Czech Republic, once said that such a situation would not be imaginable in any country with longer developing institutions of democracy. Perhaps this might be part of the truth; the success of the Slovak tax reform, however, was clearly made possible chiefly by fully responding to the two main pressures that any tax reform has to face: the fiscal impacts and income effects that the tax reform poses for the government, companies and individuals.

The most significant limits for the depth of the tax reform carried out in Slovakia were set by the fiscal constraints. The Slovak government, following a goal of entering the Euro zone as soon as possible, has set a target of reducing the public finance deficit below 3 percent of gross domestic product until 2006. This objective was put in its importance above the tax reform, and therefore, authors of the reform had to accept the principle of its fiscal (or better to say, revenue) neutrality. In other words, a political condition for the tax reform to gain support from the political leaders was that its overall impact on the fiscal position of the Slovak government will not be negative.

In order to fulfill this condition, during the process of redesigning all the elements of the tax code, the Ministry of Finance paid a serious attention to its fiscal impact calculations It produced and commissioned five independent estimates of the fiscal impact of the newly-designed tax system (estimates were prepared by the International Monetary Fund; Institute of Financial Policy of the Slovak Ministry of Finance; a special high-level advisory group consisting of prominent Slovak economists and analysts; Slovakia's Statistics Office; and Slovak Academy of Sciences). In order to eliminate any possible negative effects associated with the uncertainty of all estimations, for all purposes, only the conservative scenarios of the estimations were used (i.e. the negative scenarios of the tax reform's impact).

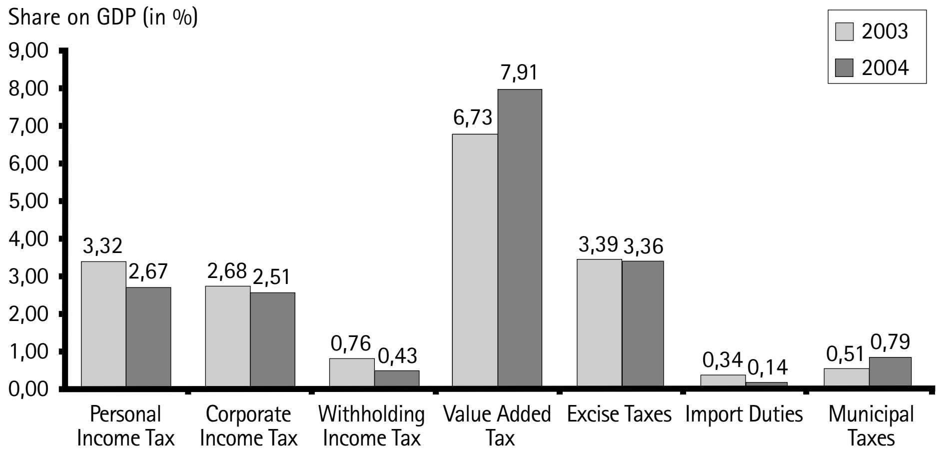
One of the basic consequences of adopting a fiscally neutral flat tax without negative income effects was that the drop in revenues from income taxes will

Chart: Estimations of the share of different tax revenues on GDP in Slovakia



Source: Author's calculation; data from Ministry of Finance of the Slovak Republic

Chart: Comparison of the share of different tax revenues on GDP in Slovakia (before and after the tax reform)



Source: Author's calculation; data from Ministry of Finance of the Slovak Republic have to be replaced by an increase in revenues from indirect taxes, especially the VAT. This was also one of the main reasons why reformers decided to adopt one single unified VAT rate of 19 % in Slovakia, giving up the previous 14-percent lowered VAT rate for products of everyday consumption.

The move towards indirect taxation while simultaneously reducing revenues from direct (income) taxes is clear in Slovakia today. While in 2003 revenues from indirect taxes accounted for 10.12 percent of GDP and direct taxes accounted for 8.05 percent of GDP, the latest estimations for 2004 (first year of the new tax system) show that the share of indirect taxes on GDP went up to 11.28 percent, while the share of direct taxes fell to 6.53 percent.

The development of tax revenues in 2004 suggests that the assumptions the authors of the tax reform used were correct. The collected tax revenues correspond to the expectations. Despite the collection of revenues from VAT was lower than budgeted, revenues from income taxes exceeded expectations, and the total fiscal impact of the complex tax reform remained neutral:

Table: Comparison of budgeted and real tax revenues as a share on GDP in Slovakia in 2004 (revenue impacts of tax reform in the first year)[3]

(ESA95, % of GDP)	2003	2004B	2004	2004NR
Tax incomes total	18.1	17.9	18.0	18.0
Personal Income Tax	3.3	2.1	2.6	3.5
Corporate Income Tax	2.7	1.8	2.5	3.1
Withholding Income Tax	0.8	0.9	0.4	0.6
Value Added Tax	6.7	8.8	7.9	7.1
Excise Taxes	3.4	3.3	3.4	3.0
Other Taxes	1.1	1.0	1.1	1.1

3 2003 – real share of revenues from different types of taxes on GDP in 2003; 2004B – budgeted share of revenues from different types of taxes on GDP after the tax reform; 2004 – real share of revenues from different types of taxes on GDP after the tax reform; 2004NR – estimated scenario of revenues from different types of taxes on GDP in case if no tax reform was adopted. Total tax income does not equal to a simple sum of partial tax incomes because of rounding.

It is important to note that apart from its direct fiscal impacts, the Slovak tax reform had some indirect consequences that led or should lead to improved fiscal position of the country. The flat tax rate and simplification of the Slovak tax system, together with other structural reforms have attributed to the international perception of Slovakia as a country with deep structural reforms. So far the set of reforms has been reflected in improving rating position that led to cheaper state debt service, increased competitiveness and in growing interest of foreign investors.

Argument 3:
Lower taxes = more growth = less EU money needed for Slovakia.

Having the Slovak tax reform designed as fiscally neutral from its very beginning does mean that even if the low corporate income tax rates can make Slovakia more competitive and can attract many foreign investors, the total tax burden and tax income for state budget remained stable.

Several European politicians were claiming that low tax rates in Slovakia mean that their countries have to send more money from the European structural funds, because our local government is „not taxing its own people enough". For example, Gerhard Schröder, the former German Chancellor, thundered in April that it was unacceptable „that Germany, as the EU's biggest net payer, finances unfair tax competition against itself". Germany has openly threatened to cut EU regional aid unless the new members rethink their tax policies (and is continuing in this effort as a part of the official government's agenda). Germany and France have dusted off old plans to introduce a minimum rate of corporation tax in the EU.

Are the two governments right to push for tax harmonisation in the enlarged EU? No, because their claims of ‚tax dumping' rest on three highly questionable assumptions. Or, to be more straight, their claims are simply not true.

First of all, as was already said, the Slovak tax reform did not decrease the tax burden in Slovakia. There was no drop in our tax revenues that would have to be financed by Germany, France, or anyone else.

Actually, just a short glance at the EU's budget proves that the member states can't be paying for tax cuts of any of the newcomers' countries. The EU has put aside only € 40 billion for enlargement in 2004-06, while the newcomers also have to pay their dues into the EU budget, leaving them with a net balance closer to € 25 billion. The EU money is earmarked for regional development and farm support, which means that it will only help to keep East European taxes low insofar as it replaces national budget spending.

Second, the amount of EU accession funds sent to Slovakia and other countries does not depend on government's tax income – it depends on the GDP of each country. This means that the best way to save German funds being sent every year to Slovakia is making Slovakia growing thanks to its increased competitiveness – even through low Corporate Income Tax Rates.

Argument 4:
Tax rates are not the only issue to consider

If you look at the list of tax rate changes during last five years, undertaken in the developed countries of the world, you can see that the trend towards lower tax rates is slowly prevailing over higher marginal taxation of income or consumption. Does this however mean that the total tax and contribution burden in the world is falling? The answer is – not necessarily.

It would be highly incorrect from the economic point of view to limit the taxation debate just to the tax rates, without considering the broadness of tax bases. Slovakia has chosen the way of radical tax rate cuts, however hand-in-hand with implementation of a very broad tax base. Lower tax rate with broader tax base does not necessarily mean that less tax revenues are collected – in the same way as higher tax rates with narrow tax base do not mean that the state treasury will be filled with additional tax money.

As a part of the tax reform, most of all exceptions, exemptions and special tax regimes were eliminated from the Slovak tax laws. We believe that a simple, clear and just tax system is not only the fairest one, but also one that promotes our economic growth and improves our business environment to the biggest extend. Abolishing distortions also means less incentives and opportunities for rent-seeking activities from those individuals who can afford looking for loopholes in tax laws. It happens very often in countries with high marginal tax rates that high-income individuals, who use services of tax consultants, use different legal ways and special taxation rules to lower the amount of taxes they pay. This is, however, simply impossible when the tax system contains no „shadow zones". The more complicated the rules of game are, the more space for tax avoidance they offer – and vice versa.

Moreover, when looking at the total tax burden, we should not forget about mandatory contributions that cover the costs of state-run sickness, health, old-age, unemployment, disability, survivorship, and other insurance schemes. When talking about the height of total tax burden, it should also be considered to what extend does the government provide these insurance schemes and services (thus needing more tax funds to finance them).

In the past years, Slovakia has done much in implementing market oriented reforms to these areas. Slovak workers are able to save part of their social security taxes at their own personal retirement accounts, managed by private pension companies. Several measures were implemented to fight the misuse of governmental social programs, which effectively saved the Slovak taxpayers a fortune.

It is an option of each and every country whether it will choose the so-called „European social model" where the government provides services for its citizens from cradle to grave, or whether it will opt for a more efficient, market-oriented system, limiting the amount of services provided by the state to a social safety net. In the past years, Slovakia was choosing the latter, and the failures of welfare state we could recently see in France prove that promoting responsibility of citizens for their own destinies brings much better results than building a culture of government dependency.

Nevertheless, in Slovakia we still do believe that people in other countries have all rights to vote themselves poor in the long run, as they seem to be doing for many years in Sweden, France, or Germany. However, we also do believe that politicians of these countries should respect our right to undertake every effort to increase the Slovak economic growth and living standards, to solve the welfare state crisis in our country, to solve the problems of our pension and health systems and labor market.

If taxpayers in other countries believe that politicians know better what is good for them than they know by themselves - it's their decision. However, our experience has taught us by today that the truth is often different.

Argument 5:
Slovak taxes are not „unfair" according to European standards

According to the current laws, the European Union does not have any right to impose a unified design of tax systems to its member-states. It only sets rules for those tax laws that affect the functioning of the single market, such as value-added tax. But the EU does have the right to clamp down on industrial subsidies and other state aids and individual tax incentives that undermine competition.

In the past, the European Commission has classified several kinds of tax incentives as a form of illegal state aid. In particular, tax incentives providing selective advantages to restricted sectors or limited number of companies were marked as „harmful". Over sixty of such harmful tax measures existing in the fifteen EU-countries were listed by a group of experts in 1999. In line with a voluntary EU

‚code of conduct', the particular member-states have phased out most of them and refrained from introducing any new ones.

Similarly, in the process of joining the European Union, all newcomers from Central and Eastern Europe were asked to eliminate all discriminatory tax incentives, particularly those for foreign investors. All the countries did do so. However, to keep their economies attractive, many of them have also responded by cutting the overall tax rates for both domestic and foreign companies. Since these cuts are general, they can't be viewed as discriminatory, and there is nothing the European Commission could or should do about them.

Governments, not only in Eastern Europe, but around the world, can and do use their tax system to attract investors from abroad. Large companies have at times played off one European country against another in an attempt to get the most favourable tax treatment. The same situation can be found anywhere in the world - struggles for luring investors take place among the Asian tigers, among the poor African countries, but also among different states in the United States of America. However, taxes are rarely the only factor in determining companies' investment plans. As Jack Anderson, author of the Forbes Magazine's Tax Misery Index once noted, „...the lowest rates in mainland Europe are found in Georgia, but we'd recommend a visit first". „The tax tail does not wag the dog" and is never the sole factor in a corporate or personal location or expansion decision. Markets, logistics, physical and labor infrastructure, quality of life, incentives--all these play often a more significant role, with tax rates being only the tiebreaker among equally attractive competing locations.

6. Conclusion

What is my conclusion? Well, as we in Slovakia see it, there are two paths the Europe can choose today. The worse solution would be if some European politicians would succeed in their efforts to steamroller reforms of Slovakia, Estonia, and other countries. Harmonization of income taxes would mean that Old Europe is taking away our possibility to reach its levels of standard of living. The better way would be if Slovakia would start a kind of „domino effect", that would lead to lower tax rates all across the Europe (we have already seen Austria's decision to cut its corporate income tax rate). Governments in countries of the „Old Europe" would be forced to stop diverting public attention from the pressing need to clean up their own tax systems. The tax competition then could become not the harm, but the medicine to EU's economic problems and overall competitiveness.

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Appendix 1:
GDP per capita in Purchasing Power Standards

	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007
EU (25 countries)	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0
EU (15 countries)	109.4	109.3	109.3	109.3	108.9	108.7	108.5	108.3(f)	108.1(f)	107.7(f)	107.4(f)	107.1(f)
Belgium	119.8	118.6	117.3	116.2	117.4	117.8	118.2	118.5	119.5	119.4(f)	119.4(f)	119.0(f)
Czech Republic	71.2(e)	69.0(e)	66.5(e)	65.2	64.2	65.2	66.8	68.0	70.1	72.4(f)	74.1(f)	75.6(f)
Denmark	125.6	125.9	124.6	127.1	126.9	125.5	121.2	121.6	122.1	123.7(f)	124.1(f)	124.0(f)
Germany	119.9	117.4	115.5	114.5	112.6	110.5	109.3	108.5	108.7	108.3(f)	107.6(f)	107.0(f)
Estonia	36.7(e)	40.3(e)	41.3(e)	40.9	43.1	44.2	46.1	48.5	50.4	54.1(f)	57.2(f)	60.3(f)
Greece	70.9	71.5	71.2	71.3	71.7	73.0	77.0	80.4	81.7	82.3(f)	82.9(f)	:
Spain	87.3	87.3	88.9	92.0	92.1	92.7	94.8	97.5(f)	96.8(f)	97.3(f)	97.2(f)	96.7(f)
France	114.5	115.1	115.2	114.4	114.3	114.6	112.8	111.1	109.7	109.5(f)	108.9(f)	108.5(f)
Ireland	103.8	113.3	117.7	122.9	126.8	129.5	133.7	135.0	139.9	141.1(f)	142.6(f)	144.2(f)
Italy	113.8	111.9	112.7	111.3	110.1	109.8(e)	107.7(e)	105.6(f)	104.1(f)	102.4(f)	101.9(f)	101.1(f)
Cyprus	84.3(e)	82.8(e)	84.1(e)	85.1	86.1	88.9	82.3	81.4	81.7	82.9(f)	83.8(f)	84.5(f)
Latvia	30.5(e)	32.5(e)	33.5(e)	34.0	35.1	36.9	38.5	40.4	42.8	46.3(f)	49.0(f)	51.5(f)
Lithuania	35.0(e)	36.9(e)	38.8(e)	37.4	38.4	40.3	42.1	45.7	48.0	51.0(f)	53.2(f)	55.2(f)
Luxembourg	176.0	183.0	191.2	206.7	216.2	210.3	210.1	212.1	221.2(f)	226.0(f)	230.1(f)	234.0(f)
Hungary	49.0(e)	50.1(e)	51.2(e)	52.2	52.9	55.6	58.5	60.0	60.8	62.4(f)	63.8(f)	65.1(f)
Malta	:	:	:	76.4	76.6	72.5	72.3	71.8	70.2	69.6(f)	68.4(f)	67.4(f)

	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007
Netherlands	119.2	19.9	120.2	119.8	120.3	127.7	126.0	125.3	124.3	123.1(f)	123.0(f)	123.1(f)
Austria	128.4	125.5	124.4	126.0	126.5	122.7	120.6	120.9	121.4	121.2(f)	120.6(f)	120.3(f)
Poland	42.1(e)	43.8(e)	44.6(e)	45.3	45.8	45.2	45.1	45.4	46.5	47.5(f)	48.7(f)	49.9(f)
Portugal	76.0	77.2	78.8	81.0	80.9	80.2	79.7	77.4	76.0(f)	74.9(f)	73.7(f)	72.6(f)
Slovenia	70.1(e)	71.6(e)	72.0(e)	74.3	73.3	74.3	75.0	76.7	78.2	80.2(f)	81.8(f)	83.5(f)
Slovakia	45.9(e)	46.8(e)	47.4(e)	46.9	47.4	48.2	50.7	51.7	51.8	53.8(f)	55.6(f)	57.9(f)
Finland	105.6	110.6	113.7	111.8	113.7	113.3	112.9	112.6	113.8	114.3(f)	115.9(f)	116.8(f)
Sweden	117.5	116.2	114.9	118.7	119.7	115.8	114.3	114.8	116.7	117.6(f)	118.5(f)	118.8(f)
United Kingdom	110.7	113.1	113.0	112.7	113.2	113.7	116.7	118.0	117.9(f)	117.6(f)	117.5(f)	117.7(f)

(:) Not available
(f) Forecast
(e) Estimated value

Source: EUROSTAT

Appendix 2:
Overview and Forecast of Tax Revenues in Slovakia (cash basis)

	(millions of SKK) EUR 1 = about SKK 38,5	2004	2005	2005	2006	2007	2008
			Budget	Estima-tion	Forecast	Forecast	Forecast
A.	**Tax Revenues in total**	**229,195**	**243,121**	**258,475**	**260,427**	**282,842**	**303,060**
	– into the State budget	209,458	201,994	212,783	209,780	228,334	243,915
	– into municipal budgets	19,737	30,829	34,702	38,421	41,313	44,788
	– into the regional governments' budgets	0	10,298	10,960	12,197	13,167	14,328
A.1	**Income, profit and capital gains taxes**	**71,195**	**69,651**	**80,477**	**81,348**	**89,378**	**98,400**
	Personal Income Tax	34,224	33,185	37,923	40,697	44,782	49,553
	Corporate Income Tax	31,297	30,066	38,238	36,181	39,950	44,040
	Withholding Tax	5,675	6,400	4,317	4,470	4,646	4,806
A.2	**Domestic Taxes on Goods and Services**	**142,976**	**162,710**	**164,296**	**165,944**	**180,120**	**191,103**
	Value Added Tax	99,576	117,339	117,060	115,201	127,679	136,569
	Excise Taxes	43,401	45,371	47,236	50,743	52,441	54,534
A.3.	**Other Taxes**	**4,610**	**760**	**1,401**	**635**	**644**	**657**
A.4.	**Local and Munici-pal Taxes**	**10,413**	**10,000**	**12,300**	**12,500**	**12,700**	**12,900**
	Taxes for specific services	3,703	2,600	3,800	3,850	3,900	3,950
	Motor Vehicles Tax	2,464	2,500	2,600	2,650	2,700	2,750
	Property Tax	4,246	4,900	5,900	6,000	6,100	6,200

Source: Ministry of Finance of the Slovak Republic

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