TAX REFORM

SUMMARY: MAIN PRINCIPLES AND OBJECTIVES

The current fundamental tax reform is one of the most important initiatives of the Slovak government toward creating a highly competitive and non-distortive market environment in Slovakia. In its Policy Statement, the government undertook to reduce income tax rates and to analyze the possibility of implementing a flat-rate tax. In fact, the actual reform goes even beyond these original ambitious objectives. Its ultimate goal is to transform the Slovak tax system into the most competitive one in the entire EU and OECD area. By a competitive tax system, the government does not merely mean low degree of taxation – far from it. The Slovak tax system should be competitive mainly because of the unusually high degree of its efficiency, transparency and non-distortiveness.

Designed as fiscally neutral, the reform is intended to achieve the following broad objectives:

- creation of a business and investment friendly environment for both individuals and companies
- elimination of existing weaknesses and distortionary effects of the tax law
- achievement of a high degree of tax fairness by taxing all types and amounts of income equally

These goals should be achieved by a careful implementation of several simple principles on which the tax reform is based:

- shifting of the tax burden from direct toward indirect taxes, from taxing production toward taxing consumption
- introduction of low standard tax rates and elimination of all exceptions, exemptions and special regimes
- introduction of flat tax rate in personal income tax, replacing the regime with different tax brackets
- elimination of distortive roles of tax policy as instruments for achieving non-fiscal goals
- elimination, as much as possible, of double taxation of income

DIRECT INCOME TAXATION

Implementation of flat tax rate

In the area of direct income taxation, the tax reform is centered around the implementation of the flat-rate tax. In accordance with the principle of taxing all incomes of individuals and corporations equally, only one linear percentage rate of 19% is applied since January 1, 2004. The new legislation eliminated the 21 different types of taxation of direct income that were in force in Slovakia until now, including five different personal income tax rates (10%, 20%, 28%, 35% and 38%).

This radical change has several major advantages. First, the flat-rate tax still maintains the progressive nature of effective tax rates faced by individuals with different amounts of income. All personal income of up to 1.6 times the poverty line will be exempt from taxation. As a result, the effective tax rate for individuals below this threshold will be null. However, the average tax rate will start increasing once the individual surpasses this threshold. Hence, the introduction of flat tax on direct income will have no negative impact on low-income earners, negligible impact in the medium range of income distribution and a positive impact on people with the highest incomes. Second, the existence of single marginal tax rate for all income above the standard exemption sharply decreases the distortive effect of personal income taxation and limits the economic disincentives associated with it. This should increase labor productivity both in the short and long term, as it encourages higher work effort at any given point in time, as well more investment in human capital.

Effective January 1, 2004, the corporate tax was reduced to 19% from the previous rate of 25%. At the same time, the new tax system follows the principle of taxing the investment and capital gains income only once as it is transferred from the corporate to the personal level. Thus, dividend taxation has been cancelled and investment income will be taxed only once, at the level of corporate profits.

Radical simplification of the tax law
The Income Tax Act also radically simplifies the taxation of both individual and corporate income. In order to achieve the highest possible degree of tax transparency and to minimize economic distortions, the new tax law eliminates virtually all exceptions, exemptions and special regimes.

In the area of personal income taxation, many exceptions, exemptions, deductions, etc. were instituted in the past with various non-fiscal goals in mind, for instance in the domain of social policy. However, these measures usually generate significant negative side-effects, such as economic inefficiencies and distortions. The tax reform has been coordinated with the social insurance reform, pension reform and healthcare system reform. Virtually all tax deductions and exemptions that were originally intended to achieve non-fiscal policy goals are being replaced by targeted measures in the relevant policy areas. For instance, the child allowance was cancelled and a new form of targeted social compensations and entitlements have been introduced, which should ensure a fairer distribution of income particularly benefiting low-income families with children.

Exceptions and exemptions, including tax holidays, tax brakes, individual tax bases, special tax rates are being eliminated from the corporate tax law as well. Lump-sum taxes for entrepreneurs will be cancelled and a regime of deductible lump-sum expenditures will be introduced.

The simplification of the tax law dramatically improves its transparency and business-friendliness. It eliminates one of the main business barriers identified in Slovakia by business surveys – the excessive complexity and frequent changes in the tax law. Thus, the implementation of the tax reform should positively affect the business environment in the medium-term and long-term and should serve as a major stimulus for further inflow of foreign direct investment. Moreover, the government expects that the low corporate tax rates and high transparency of corporate and investment tax laws should sharply reduce the scope for tax evasion, tax avoidance, and tax arbitrage. As a result, tax collection should improve in medium and long-term in spite of decreased nominal tax rates.

**INDIRECT TAXATION**

**Unification of VAT rates**

The immediate result of the introduction of relatively low flat-rate direct tax would be a lower absolute amount of collected direct taxes. The lost revenue is therefore being compensated by increased indirect tax revenues generated by higher indirect tax rates introduced as a part of the reform.

Prior to the reform, Slovakia had a standard value added tax (VAT) rate of 20% and a reduced rate of 14%. As a part of the reform, the reduced VAT is being cancelled entirely and a unified 19% rate was introduced for all goods and services as of January 1, 2004. In addition to generating increased tax revenues, the unification of VAT rates will also eliminate important economic distortions and inefficiencies associated with taxing the consumption of various goods differently. The existence of reduced VAT rates was usually being justified by non-fiscal arguments. Reduced VAT rates were supposed to lead toward the achievement of non-fiscal policy goals. They were expected to generate lower prices, leading to better access by low income groups to basic food and other selected goods, or increased consumption of goods deemed to be socially desirable. However, there is plentiful evidence casting serious doubt on whether reduced VAT rates truly support the fulfillment of such objectives in spite of the inefficiencies that they introduce. As a result, the Slovak government decided to replace these inefficient fiscal policy instruments with targeted instruments directly in the relevant policy areas, such as social policy and health care.

The tax reform also includes amendments to acts on excise duty on mineral oils, tobacco and tobacco products, and beer, which came into effect 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 regulations earlier than was expected in Slovakia's accession treaty with the European Union. A new act on excise taxes on spirits is also introducing stricter conditions for spirit producers and tax warehouses, which should prevent tax evasion and increase tax collection.

**Elimination of other forms of taxation**

Real estate transfer tax, donation tax and inheritance tax are also being cancelled as a part of the tax reform. Donation tax and inheritance tax was eliminated as of January 1, 2004. With the elimination of the donation tax, donations
are no longer recognized as tax-deductible expenditures. The real estate transfer tax is being eliminated as of January 1, 2005.

The tax reform was followed by fiscal decentralization, which includes significant changes in the structure of local taxes concerning real estate tax, road tax and local fees. In principle, the fiscal decentralization significantly strengthens the fiscal competences of municipalities in the field of local taxes.

The successful realization of the tax and customs administration reform closely depends on a smooth adjustment of the Slovak tax system to the conditions of the tax system in the European Union. Some of the most important activities that are currently being realized include the e-DP project (input of tax declarations via the internet) and e-TAX project (Electronic taxation and electronic communication with tax subjects.)

FISCAL IMPACT OF THE REFORM

The government paid serious attention to ensuring that the tax reform not have a negative impact on its fiscal position. In order to ensure a fiscally neutral outcome in the first year after the reform, the government produced and commissioned five independent estimates of its fiscal impact. A highly precise estimation of these effects was made difficult by complications with estimating precise tax elasticities, due to the lack of detailed data on the structure and development of tax revenues at the household level. In order to mitigate the negative effects associated with this uncertainty, the government based the reform on the most conservative of these estimates, which was also more conservative than that of the International Monetary Fund. The development of tax revenues in 2004 suggests that the estimates were correct. The collected tax revenues correspond to the expectations and direct taxes even slightly surpass the expectations.

The responses from companies and economists from Slovakia and abroad confirm that that the fundamental tax reform concept created in the Slovak Republic one of the most competitive tax systems in the entire EU and OECD area.

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