Can Slovakia afford an increase in tax rates?

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Recent study of the European Commission on taxation trends confirmed the position of Slovakia among the countries with the lowest tax burden in European Union[1]. With total 29,4 % share on GDP, Slovak government imposed the second lowest taxes upon its economy in 2007. Share of direct taxes on GDP has been the lowest in the whole union. Have this study been published in the summer of 2008, it would be probably warmly welcomed by the government, confirming its successful strategy on being very effective in terms of not increasing the tax burden and developing the welfare state. But its release in autumn of this year found the government in completely different position.
While the government predicted in autumn 2008 the growth of economy by 6,5% in 2009, the reality for the first half of 2009 was -5,5% in real prices. The state coffers are empty due to sharp drop in tax income. Budget expenses are almost unchangeable due to huge share of mandatory expenditures and there was no effort to cut the rest. All of this results in the highest public finance deficit ever recorded in the Slovak history, ironically only six months after joining Euro zone and fulfillment of tough The Stability and Growth conditions for the entering the euro zone.
There will hardly be a better time for politicians to raise a question: Having one of the lowest tax burden and facing huge deficit, isn't it proper time to increase the tax rates?
Twelve months before national elections in June 2010 it would not be very strategic decision to propose substantially higher taxes for the electorate, which is already suffering from growing unemployment. Fortunately for the government, the debt to GDP ratio under 30% provides comfortable cushion for at least two years postponement of either tax increase or sharp cuts in public expenses. Although the government has already raised some rates for excise taxes, this was rather a symbolic increase, hardly responding to a need to consolidate public finances. As a matter of fact,, having the argument based on intra union comparison in hands, the question regarding an increase of total tax burden has been raised not by officials but by the analytical troops at Ministry of finance.

First of all it should be stressed, that any international comparison cannot provide legitimate reason for a change in taxes. Any change in taxes should be subject to analysis of local conditions and

[1] Taxation trends in the European Union, 2009 edition, European Commission — Taxation and customs union http://ec.europa.eu/taxation_customs/taxation/gen_info/economic_analysis/tax_structures/index_en.htm

alternatives. International comparison may provide partial explanation, e.g. why the country is out of the focus of foreign investors, but cannot provide an excuse for a tax increase.

Secondly, I argue that under current conditions an increase in tax rates would not bring the desired results.

In my analysis I will not elaborate on different methods how to reach maximum potential tax gain by the government. I will rather list several important reasons, which necessarily impact its ability to raise the tax revenues.

The tax reform adopted in 2003 established flat tax rate of 19 %. Not only for personal and corporate income tax, but also for value added tax. In combination with abolishment of dividend tax and simplification of tax code it has significantly positively influenced decisions of foreign investors whether to invest in Slovakia. In terms of personal income tax (PIT) currently only Bulgaria and Romania apply lower rates. But low tax rate powered by high deductible per person and GDP based on high capital intensity rather than value added by workers, resulted in the lowest PIT/GDP share in the union as of 2007. In terms of corporate income tax, the government raises few millions of euro more than revenues from PIT, granting Slovakia 19th place in the European Union comparison. In international comparison relatively low income tax rates combined with low tax income therefore stand out as a potential target for tax increasing urges of the government. But there are several reasons, why this is not such an easy deal. First of all, we have to admit an emotional power of the flat tax rate. Since the tax reform, only VAT for certain goods (books, medicaments) has been decreased to 10%, otherwise the flat tax still stands firmly. Every voter knows the tax rate. Any increase in the rates would be much more widely perceived by public than it would be in a system with progressive rates, where most of low and middle income earners do not know the highest income tax rate. Regarding PIT, the government could find support for readopting of progressive rates among the public, as most of the employees are currently taxed by an effective rate about 10% and about 20% of employees do not pay any taxes thanks to the high deductible entitled to every individual. Nevertheless large chunk of high income earners (a third of the employees covers 80% of taxes) operate in internationally valuable services, as business and IT services, which are known for their flexibility which materializes in two ways. First is the ability to leave the country because of increasing tax burden, second the ability to find friendlier tax regime within the country by changing the status for self employed or establishing own business. Both alternatives provide possibilities how to decrease the effective tax burden.

Corporate income tax (CIT) is even riskier toy to play with. First of all, the tax rate plays significant role in the international competition for foreign direct investments in central and Eastern Europe.

Secondly, despite the huge growth in tax income recorded till 2008 (15% average annual growth in the years 2006-2008) the tax base is not robust enough. Despite the fact, that Slovak banking sector did not suffer substantially from the financial crises and remains rather healthy, according to last estimates, the revenues from the CIT should drop by 14% in 2009, the highest drop from all taxes as shown in Table 1. The reason is hidden in high dependence of Slovak economy on exports. The recession in European Union hit the economy markedly. Still relatively low purchasing power of Slovak consumers cannot compensate for the loss of external demand and the basis for sufficient tax income from locally generated profits. Furthermore, the CIT revenues are complicated to forecast and hence rely on. Re introducing of dividend tax would not only discourage new and existing investors but also would not help much, as most of the dividends are paid to companies located in countries with which the government signed an agreement prohibiting double taxation.

In general, ability of government to raise more money taxing the income is rather low. Even if the government would be able to raise 20% more from direct taxation, it would be of little help, as total revenues from direct taxes account for less than this year and next year deficit in public finances.

Table 1: Revenues from selected taxes in mil. eur, ESA 95

	2 008	**2009-prediction**	**% change**
Personal income tax	1 819 884	1 651 239	-9%
Corporate income tax	2 107 948	1 804 352	-14%
VAT	4 621 418	4 429 160	-4%
Excise taxes	1 809 243	1 745 307	-4%
Social contributions	4 519 606	4 365 550	-3%
Health contributions	2 232 822	2 195 610	-2%
Total	17 110 921	16 191 218	-5%

Source: Ministry of Finance SR

Low taxation of direct income introduced by the tax reform in 2004had to be compensated by higher indirect taxes. Slovakia is one of the few countries without reduced VAT rate for food. The share of excise duties and consumption taxes on GDP ranked Slovakia 7th in Union comparison as of 2007. In total, indirect taxation generates double the income from direct taxes. An increase in VAT could be more useful when trying to fill the budget hole. Nevertheless, such a step is hard to imagine from political perspective. The disadvantage of indirect taxes is the fact, that the rates cannot be progressive. An increase in VAT rate would therefore hit every citizen what is for leftist government

the least desirable situation. Furthermore, even if the government adopts this option, there would still be limits on the increase of tax revenues. It was proved by the behavior of consumers during the first quarter of 2009. Adoption of euro at strong parity and decrease of exchange rates in the neighboring currencies led to decision of many Slovaks to purchase basic goods across the border. “Successful” increase of VAT rate would therefore have to be small, bringing important but not sufficient amount of money to state budget.

Another source of higher government income could stem from higher social security contributions. Currently almost 40% of tax revenues of public sector come from this area (including health contributions). It is necessary to mention that the revenues are not sufficient to cover costs of the social security system. The deficit of agency responsible for the pension’s payments should exceed 2% of GDP in 2010 due to lack of income from contributions. Although around half of the gap results from existence of private pension saving scheme introduced in 2005 (compulsory contributions are not income of government agency, but remain as a private property at the accounts of contributors), and this dropout has to be financed from the state budget, an increase of contributions rates to cover the other half can be expected. But again, the space for maneuvering for government is rather limited, as the contributions rates are already high, creating artificial barriers in a struggle with high rate of long term unemployment. Increasing contributions rates would hinder creation of new jobs and diminish existing comparative advantage of rather cheap labor force compared to developed western part of the union. For this reason, the government would need to choose from other two other options how to increase the revenues without raising contribution rates. The first option is to broaden the contribution base. At the moment, there are several kinds of income, which are not the subject of contributions (e.g. income from rent, or dividends of owners of ltd. companies). Some analysts prefer this option as it would increase the neutrality in taxation of income. The other option would be to suspend contributions to private pension scheme. Current government does not consider private pensions scheme as a preferable option, and so far adopted amendments to this system, like significant decrease of maximum fees for pension funds, or conditioning the payment of fees by achieving positive return, prove that. Despite univocal long term positive effects of private pension scheme for the stability of public finance system, this option seems to be more likely, especially due to its administrative simplicity.

The portion of taxes on stocks /wealth reached 0,6% of GDP in2007. Despite the fact, that EU 27 average is about five times as high, this kind of taxes does not present a relevant option for a revenues increase. First of all, the amount of stocks of capital held by Slovak households is

considerably lower, second, the history of wealth generation after the fall of iron curtain is too short to provide sufficiently large basis.

Conclusion

The ability of Slovak government to increase tax revenues, sufficient to cover 2009 deficit of approximately 6% of GDP, is rather limited if not impossible. Additional income might be reached from adjustments of social security contributions system. Nevertheless, any increase of taxation brings about negative effects of redistribution costs, hindering the GDP growth and rather low effectiveness of government expenditure. For this reason, rather than responding the deficit by increasing taxes, the government should seek reserves in its spending aimed at overall decrease of expenditure. The overall low ratio of government expenses on GDP when compared to other countries should be sustained if not lowered as it is worth to mention studies[2] showing negative correlation between the share of expenditures on GDP and the effectiveness of its use. On the contrary, expecting future recovery and restructuring aimed at optimization of costs in developed countries, Slovakia should sustain as low tax rates as possible, to keep its attractiveness for foreign investment. Lower taxes could also compensate for increased unit labor costs compared to neighboring countries due to decrease of exchange rate of their currencies. That is the only way how can an export oriented developing economy recover previous growth, bringing the general living of standard closer to European average.

[2] Public sector efficiency: An international comparison, European Central Bank, 2003, http://composite-indicators.jrc.ec.europa.eu/Document/ecbwp242.pdf