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Report on Reforms of Business Environment in Slovakia

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Abstract

This paper presents the experience of the labour market reform, the social welfare reform and the tax reform in Slovakia. It gives an overview of the major changes adopted after 2003 and how they influenced the business environment and the overall economy in Slovakia. The paper was written mainly based on the experience of the Bratislava-based NGOs the Institute for Economic and Social Reforms (INEKO) and the Business Alliance of Slovakia (BAS). The authors were drawing mainly from the research summarised in following studies:

1. GOLIAŠ, Peter – KIČINA, Róbert: *Experience of the 2003-2004 Labour Market Reform in Slovakia*, INEKO, BAS, 2007
2. GOLIAŠ, Peter – KIČINA, Róbert: *Slovak tax reform: one year after*, INEKO, BAS, 2005
3. ZACHAR, Dušan: *Evaluation of Economic and Social Measures in Slovakia: The HESO Project*, INEKO, 2000 - 2009

Abbreviations

BAS: Business Alliance of Slovakia
CIT: Corporate income tax
CPI: Consumer Price Index
CPI: Corruption Perceptions Index
ESA 95: European System of Accounts 1995
Est.: Estimation
EU: European Union
EUR: Euro
FDI: Foreign direct investment
GDP: Gross domestic product
HESO: Evaluation of Economic and Social Measures Project
INEKO: Institute for Economic and Social Reforms
IMF: International Monetary Fund
MW: Megawatt
NGO: Non-governmental organisation
OECD: Organisation for Economic Co-operation and Development
PIT: Personal income tax
SARIO: Slovak Investment and Trade Development Agency
SKK: Slovak Koruna
SR: Slovak Republic
UK: United Kingdom
VAT: Value added tax
WIT: Withholding income tax

Contents

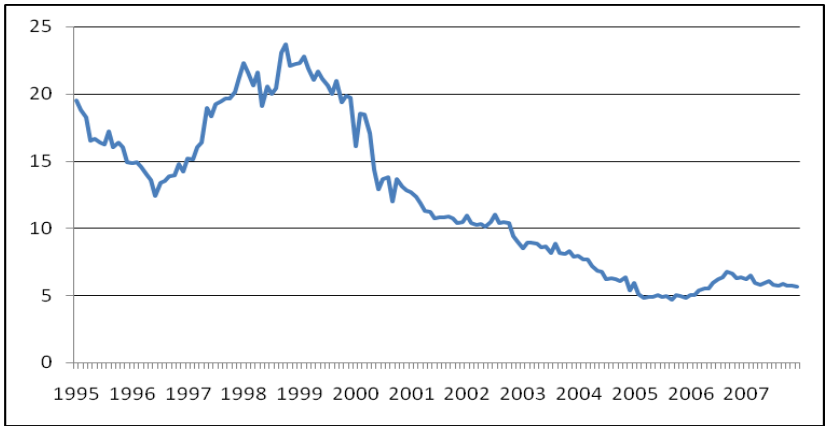
Note: Slovakia adopted Euro in 2009 with the conversion rate: EUR 1 = SKK 30.126

Introduction

After the constitution of the independent Slovak Republic in 1993, the authoritarian "Mečiar-Era"[1] begun. It was characterised by an expansive fiscal policy, soft budget constraints, rent-seeking behaviour, intransparent privatisation[2], inefficient public policy, to say nothing of deficits in democracy, which slowed down the integration process of Slovakia into the OECD, NATO, and the European Union. Corruption and lack of transparency were widespread in the public administration. The reform process stagnated until the Mečiar Government was replaced after the 1998 elections.

The parliamentary elections in September 1998 introduced a new governing constellation. The country improved its image immediately and pro-market reforms began. Broad left-right democratic coalition had to adopt stabilising measures in order to reach macroeconomic equilibrium. Restructuring the banking sector and the transparent privatisation of almost all banks, which got serious foreign shareholders, were realised. The banking sector in Slovakia in ´90s was characterised by insufficient assets, undercapitalisation, bad debts (in amount of more than SKK 100 billion), permanent losses, and incompetent and unmotivated management of state banks. Access to bank credits worsened. In 1998, the average interest rate on business loans almost reached 21.5% *(see Figure 1)*. Thus, the bank loans to Slovak companies dropped significantly. The banking sector was before the collapse.

Figure 1: **Average Interest Rates on Business Loans** *(in %)*



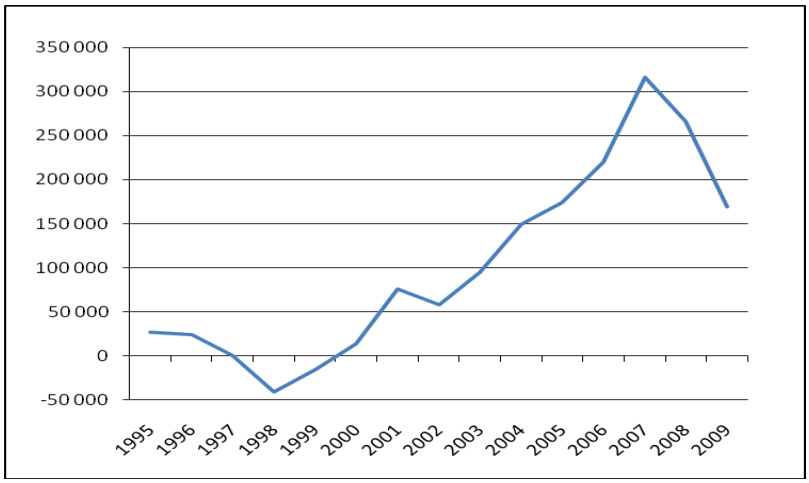
Source: National Bank of Slovakia

[1] *Vladimír Mečiar was the Slovak Prime Minister in 1990-1991, 1992-1994, 1994-1998.*
[2] *In the large-scale privatisation the Mečiar Government laid focus on direct sales to a pre-designated bidder in order to create a "domestic capital-producing class" and replaced the second wave of the "voucher privatisation" with the "bond method".*

In 1999, the Slovak Government decided to stabilise state banks and after that to privatise them using transparent international public tenders promoted in prominent international business journals. Firstly, the share capital of banks was increased. Then the Government moved bad debts of state banks to a state restructuring bank. In banks´ portfolios, bad debts were replaced with state bonds. The cost of bank recapitalisation and restructuring amounted approximately SKK 124 billion. Nevertheless, Bačišin (2008) says that the restructuring of the banking sector in Slovakia was one of the most successful in the world – especially in terms of quickness and costs. Restructuring costs as percentage of GDP reached 14% in Slovakia, e.g. in comparison with 20% in Slovenia, 29% in Chile and Indonesia, 30% in Turkey, and 32% in Thailand.

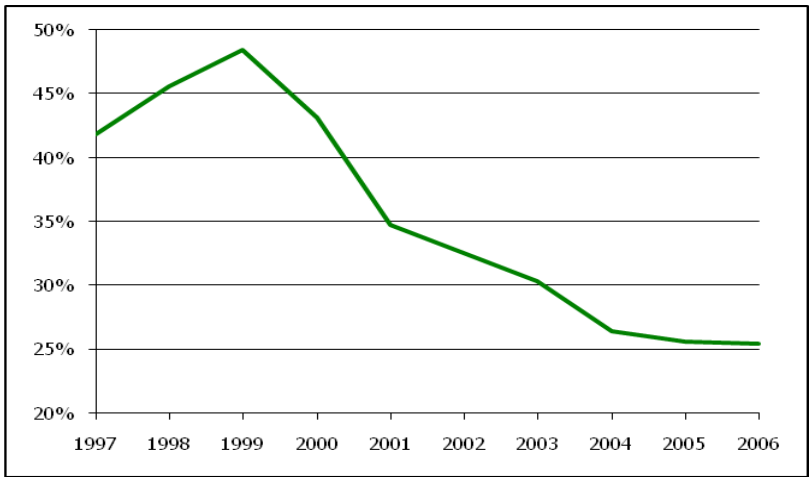
In 2000-2001, privatisation of state banks took place. Two biggest Slovak banks (Slovenská sporiteľňa and VÚB) were privatised by respected foreign banks (Erste Bank and IntesaBCI). The main criterion for privatisation decisions was the highest bid price. Interest rates fell down *(see Figure 1)* and the provision of bank loans to entrepreneurs improved. The business sector started to grow, became profitable *(see Figure 2)* and less indebted *(see Figure 3)*.

Figure 2: **Profits of Non-financial Companies in Slovakia** *(in SKK million)*



Source: Statistical Office of the Slovak Republic
Note: In 2008 and 2009, negative impacts of the global financial crisis and anti-market policies (e.g. price regulation in some sectors, prohibition of health insurance companies´ profits) and declarations of the leftist Government of Mr. Robert Fico which were unfriendly to businesses (e.g. proclaimed introduction of dividend tax or special tax on banks) have occurred.

Figure 3: **Indebtedness of Slovak Companies** *(in %)*



Source: Business Alliance of Slovakia; Survey among 15 biggest companies – members of BAS

The sound banking sector was very important and along with many laws and measures[3] led to a significant improvement of business and investment environment in Slovakia. However, deficient knowledge and practical experiences, limited financial sources but also low political acceptance were main reasons, why some essential but very difficult reforms had not been passed in the period of 1998-2002.

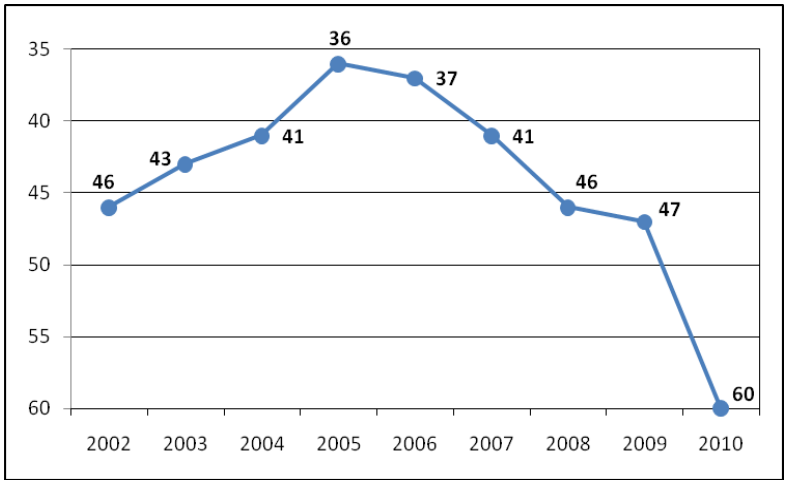
To get a mandate from the public that things have to change is one of the main preconditions for initiating major economic reforms. This precondition was fulfilled after the 2002 elections, when the centre-right coalition Government of Mr. Mikuláš Dzurinda took the initiative. The fact, that the governing political parties had a common stance on key economic and social issues, played a big role for the following outstanding reform progress. The Slovak Government coming into power in autumn 2002 launched an ambitious program of deep structural changes. Slovakia started to introduce broad-range second- or third-generation reforms. Most of them – notably labour market reform, social welfare reform, tax reform, and pension reform – have been designed and adopted during 2003 and early 2004, i.e. in the first half of the four-year electoral period. It allowed to avoid negative consequences of the so-called political business cycle[4]. Together with reforms of public finance management, health care as well as fiscal decentralisation all these reforms dramatically changed the face of a

[3] *e.g., Slovakia introduced one of the world's best rules on collateral in secured lending (see The Economist, January 23, 2003)*

[4] *Next advantage of reform measures adopted within the first half of the electoral term is that their possible imperfections, which are revealed in the course of their application in practice, may be rectified within the second half.*

country and brought it closer to the standard market economy. The global competitiveness of the Slovak economy also improved *(see Figure 4)*.

Figure 4: **Global Competitiveness Index Rankings of Slovakia**



Source: World Economic Forum
Note: In mid-2006, the Government of Mr. Robert Fico came into power. Policies and activities of this Government significantly worsened the business environment in Slovakia. Along with relatively strong negative impacts of the global financial and economic crisis on the Slovak economy, they were negatively reflected in international rankings, too.

During 2002-2006, Slovakia gained the hallmark of a reform country. A great number of renowned international business leaders, economists, analysts, international institutions and foreign media pronounced Slovakia an "economic tiger" (The New York Times, December 28, 2004), "investors´ paradise" (Forbes Magazine, August 11, 2003), "a model for change" (The Wall Street Journal, January 12, 2005), "one of the most attractive business climates in the region" (Fitch Ratings), "Europe´s fastest reformer" (Newsweek, November 29, 2004), "the most reform-minded country in the world" (World Bank 2005), from a country that lagged behind in reforms and its Visegrad neighbours[5]. In most cases, experts commended Slovakia for its public finance stabilisation, tax reform, labour market reform, pension reform, and public finance management reform *(see Table 1)*.

[5] *Visegrad countries (V4) = Slovakia, the Czech Republic, Poland, and Hungary.*

Table 1: **Expert Evaluation of 2002-2004 Reforms in Slovakia**

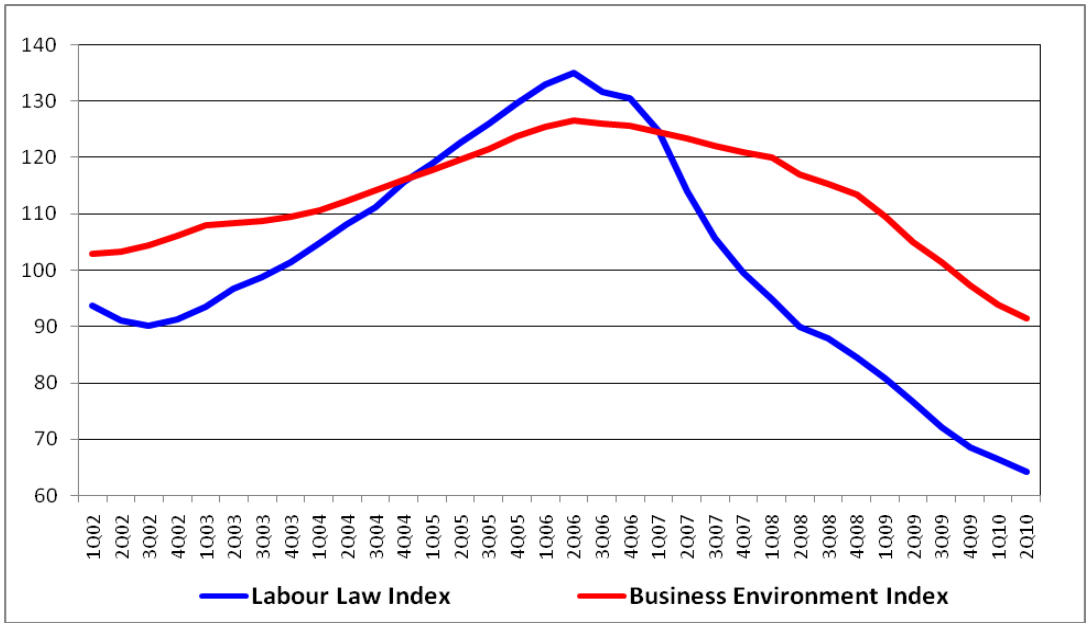
Reforms Ranked by RATING Values *(i.e. Contribution to the Economic and Social Development of the Country)*	**RATING** *[-300; 300]*	**Quality** *[-3 ; 3]*	**Importance** *%*
Public Finance Stabilisation	**171.5**	2.28	75.1
Tax Reform	**160.4**	2.09	76.9
Labour Market Reform	**122.4**	1.77	69.1
Pension Reform	**120.7**	1.55	77.9
Public Finance Management Reform	**114.4**	1.78	64.2
Social Benefits Reform	**80.9**	1.33	60.7
Public Administration Reform (incl. Fiscal Decentralisation)	**76.2**	1.16	65.7
Health Care Reform	**73.2**	0.99	74.0
Judiciary Reform	**62.7**	0.94	66.5
Changes in Police Force	**40.4**	0.81	49.6
Changes in the Slovak Television	**26.6**	0.74	36.0
Education Reform	**-6.2**	-0.09	71.4

Note: Rating = Quality x Importance x 100

Source: INEKO; HESO Survey, May 2005

The reforms helped to improve the business environment in Slovakia *(see Figure 5)*. This resulted in an unprecedented growth of GDP in 2006 (+8.5%) and 2007 (+10.4%) and in reducing the unemployment *(see Figure 6)* as well as in attracting foreign investors *(see Figures 7 and 8)*. All these reforms also significantly helped Slovakia to successfully enter the European Union in 2004 and to become the first Visegrad country that managed to adopt the Euro in 2009.

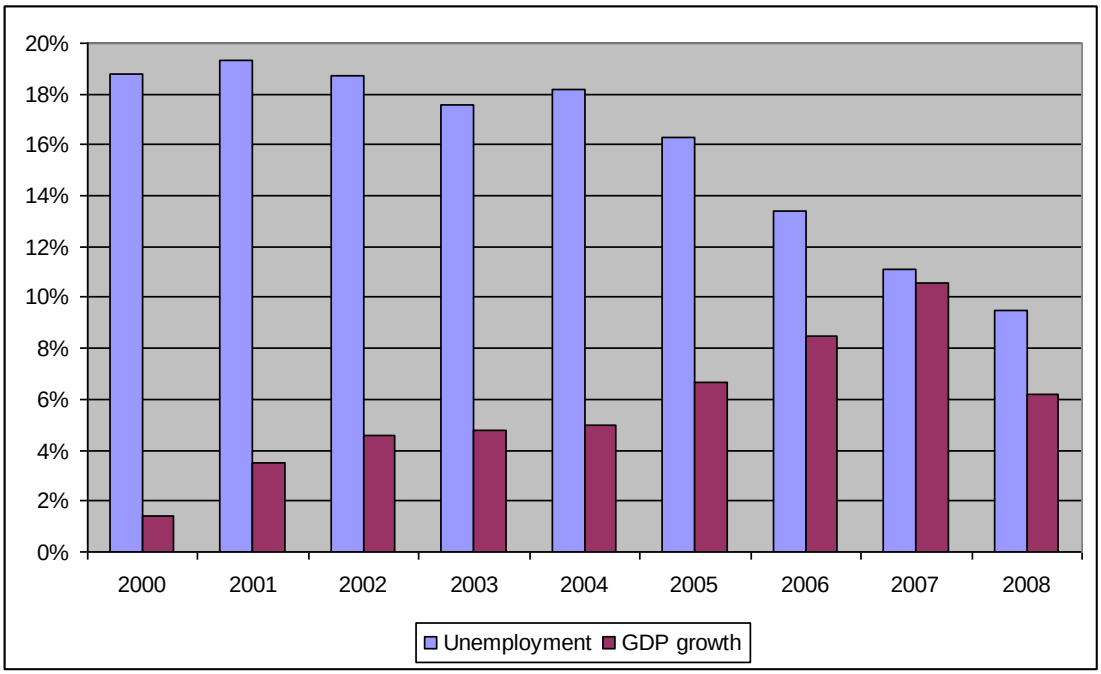
Figure 5: **Business Environment and Labour Law Indices in Slovakia** *(Base 2Q2001=100)*



Source: Business Alliance of Slovakia

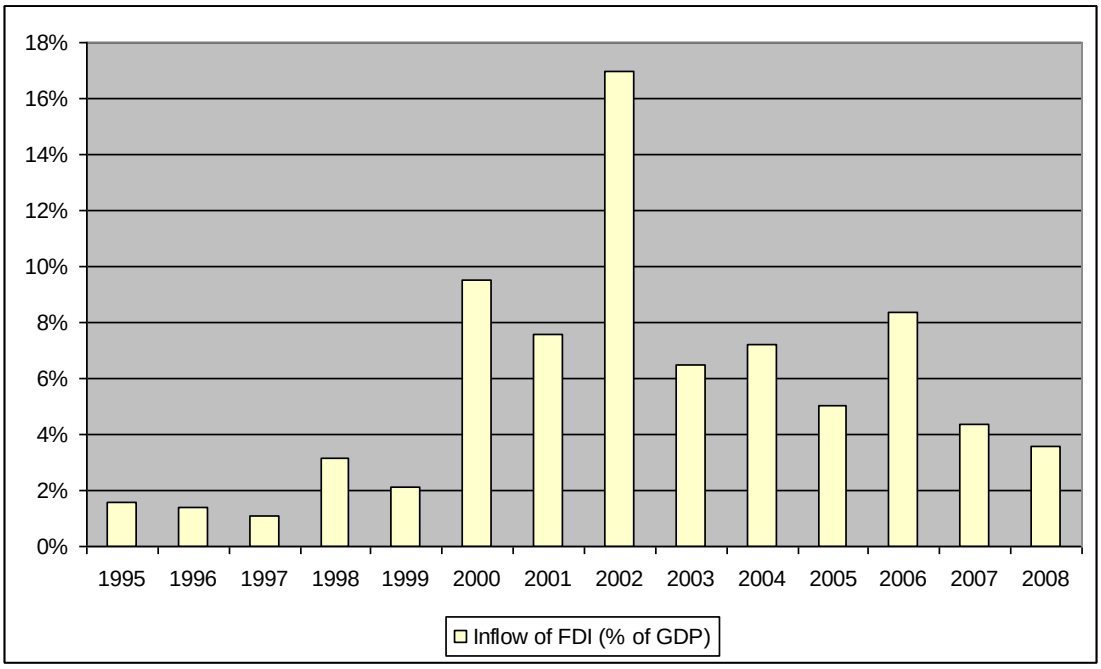
Notes: The Business Environment Index is based on data collected by the Business Alliance of Slovakia in regular surveys among managers in Slovakia. Thus, it displays the managers' perception of changes in their business environment. The Labour Law Index is partial indicator of the whole Business Environment Index. The chart shows steady improvement in the business environment after 2003 and 2004 reforms and a steady decline after mid-2006 when the anti-reformist Government led by Mr. Fico came to power. The steep decline in the Labour Law Index after 2006 reflects mainly the proposal of the 2007 Labour Code Amendment discussed later in this paper. In autumn 2008, the global financial crisis has begun.

Figure 6: **Unemployment Rate and GDP Growth** *(in %)*



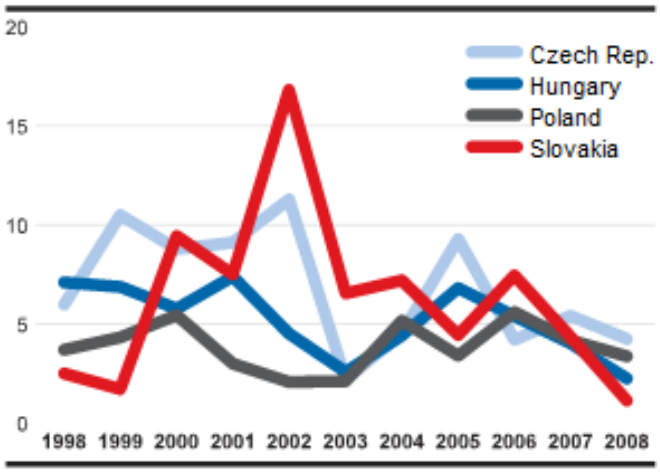
Source: Eurostat

Figure 7: **Inflow of Foreign Direct Investment** *(in % of GDP)*



Source: National Bank of Slovakia, Statistical Office of the SR
Note: FDI in 1998 – 2002 reflect mainly a large-scale privatisation of financial institutions, telecommunications and energy sector. Later, the "green field investment" in automobile and electronic industry dominates, with major investors being KIA, PSA Peugeot Citroën, Volkswagen, Samsung and Sony.

Figure 8: **FDI Inflow in V4 Countries** *(in % of GDP)*

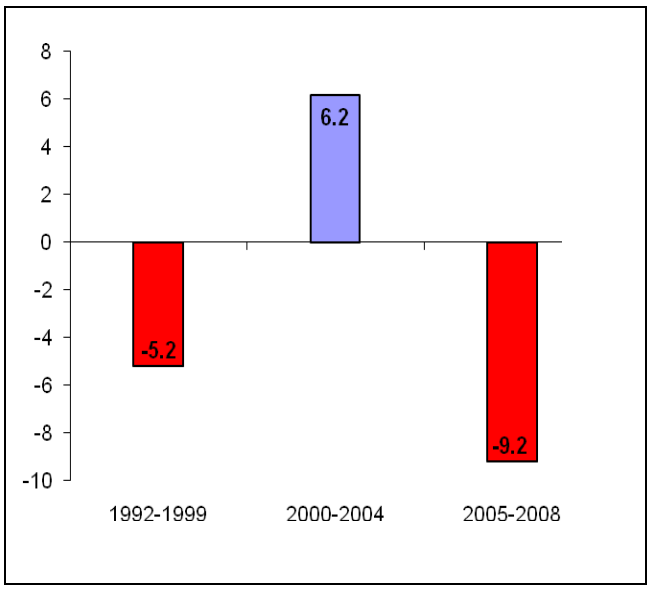


Sources: TREND Analyses; The World Bank and national central banks
Note: 2008 Data = 1st Half of 2008

However, Jurzyca (2005) remarks that implications of the reforms on morals and order in the country are even more important than the effects on economic growth. He illustrates the

improvement on an example of rising trust among people in the period of 2000-2004 *(see Figure 9)*.

Figure 9: **Changes in the Level of Trust among People in Slovakia** *(in %)*



Source: Institute for Sociology of the Slovak Academy of Sciences

In March 2007, think-tank INEKO organised a survey among local economists asking about the sources of a rapid economic growth in 2006 and 2007. They assigned 21% weight to the tax reform, 17% to the privatisation in 1998-2002, 12% to the EU entry, and 10% to the new Labour Code *(see Table 2)*.

Table 2: **Sources of Rapid Economic Growth in Slovakia in 2006 and 2007** *(in %)*

Sources	***Weight***
Tax reform	**21%**
Privatisation by foreign investors (1998 – 2002)	17%
Entry to the EU	12%
Labour Code (2003 amendment)	**10%**
Pension reform	4%
Others	36%
Total weight	*100%*

Source: INEKO, March 2007; opinion survey among 12 local economic analysts

In November 2004, the INEKO Institute conducted an opinion survey[6], in which it asked the expert public who or what had acted most in favour of adoption of extensive reforms in Slovakia over preceding years. Participants had a choice of three predefined options. Over **62%** of them expressed the opinion that **results of the 2002 Parliamentary Elections** and a **pro-reform orientation of a small but influential group of people** were the most substantial factors of the reform progress. The following were the other ones:

26 % - 29 %	*Bad starting point (breeding ground for reforms)* *Low level of democracy in Slovakia (has allowed implementation of reforms even without wide public support)* *Weak political and expert opposition against reforms*
14 % - 18 %	*Results of the 1998 Parliamentary Elections* *Slovakia is a small country (in which implementation of reforms is relatively easy)* *Adoption of the clear governmental programme immediately after the 2002 elections* *Other (specified by respondents)*
4 % - 9 %	*Pro-reform orientation of the majority of the Slovak society* *Good technical preparation of reforms* *Media*
0 % - 3 %	*Foreign investors acting in Slovakia* *Domestic business associations* *Short history of the country* *Quality reform know-how from abroad* *Good communication/advocacy of reforms* *The coincidence of circumstances* *International organisations* *Non-profit organisations*

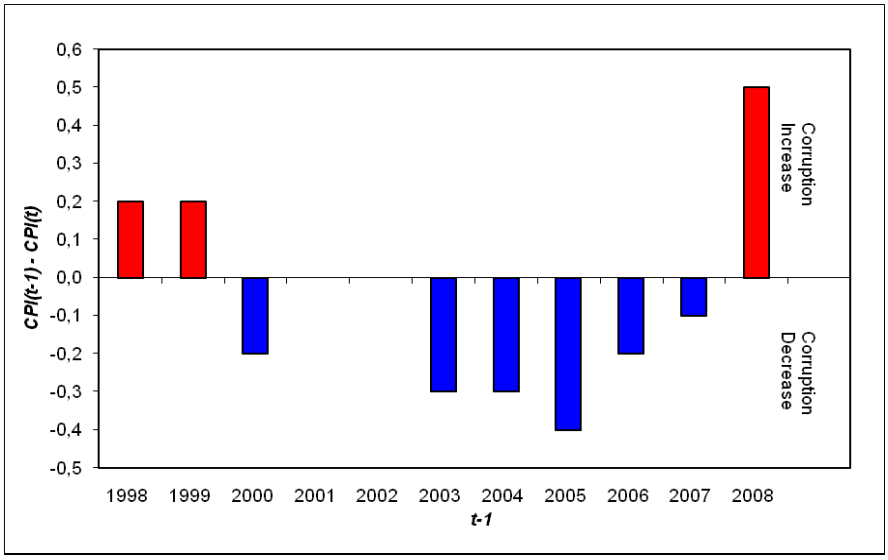
[6] *among 45 local experts (economists, analysts, lawyers, sociologists, political scientists, journalists, academics, people from business community, representatives of trade unions, employers´ associations and NGOs)*

Box 1: ***Transparency Improvement as a Precondition for a Sound Business Environment***

In several business surveys[7] identifying the most affective obstructions in doing business in Slovakia, corruption, inefficient bureaucracy and low law enforceability are topped on the list. Thus, improvements in transparency of the public sector are one of the most crucial factors of a good functioning business sector.

Far-reaching economic and social reforms, which took place in Slovakia during the time period of 2000 – 2006, have shown that they are able to decrease corruption (see Figure 10).

Figure 10: **Year-to-Year Changes in the Corruption Perceptions Index (CPI)**



Source: Transparency International; INEKO calculations
Note: In 2001 and 2002, there was no year-to-year CPI change.

<u>Some examples of transparency-friendly measures implemented in Slovakia</u>:

In 2000, Slovakia passed the ***Free Access to Information Act*** *which allows everybody to demand almost all information from public institutions, organisations, from municipalities, individuals and legal entities financed by public budgets. The Slovak Free Access to Information Act counts to the most progressive laws in Europe.*

Improved business-registration proceedings of entering data on business entities in the Slovak ***Business Registry*** *have made judicial proceedings more effective. The Registry has implemented standardised forms and is obliged to certificate the incorporation within 5 days. Comprehensive electronic services of the Registry have been launched.*

Information from the Collection of Laws of the Slovak Republic and ***official gazettes*** *- the Commercial Journal and the Public Procurement Journal - can be viewed on the Internet.*

[7] *e.g. Business Environment Reports provided by the Business Alliance of Slovakia or Global Competitiveness Reports provided by the World Economic Forum*

*Many information from the **Real Estate Cadastre** have been published free of charge on the Internet.*

*Almost all **contracts with public institutions** do not come into effect until they are published on the Internet. This measure has been passed by the current Government and is planned to come into effect from January 2011.*

***Electronic auctions,** as a valuable public procurement instrument, are rising. Moreover, it is planned that they will be obligatory for all public bodies from 2011.*

*The **Court Management Project**, under the supervision of the Swiss Ministry of Justice, has implemented the so-called Electronic Register which should improve transparency and efficiency of court processes. It has to prove reception of a file, to select a judge, to file the case and the court register within 2 minutes. Cases are assigned to judges electronically, by a random selection.*

*Final **judgments of courts** in some case categories have to be published on the Internet. The current Government of Ms. Iveta Radičová has approved a law which says that all judgments will be published on the Internet.*

Chapter 1: Labour Market Reform

In 2002, Slovakia was confronted by huge problems on its labour market. Foreign investors were present mainly thanks to the large-scale privatisation of the financial, telecommunication, and energy sectors during 1998-2002. Just a few of them started on a "green field". The unemployment rate was almost 20% and people considered it to be the most serious problem of the Slovak society. By 2008, the unemployment rate fell to less than 9% and in 2007 people felt it to be the 3rd most serious problem *(see Table 3)*. During 2002-2008, almost 220 thousand of jobs were created directly in Slovakia and other 90 thousand Slovaks were employed abroad *(see Table 4)*. Since 2009, Slovakia has registered a rise in unemployment rate and a decline of people employed both in Slovakia and abroad. This has been mainly due to the global financial and economic crisis. However, Slovaks working abroad have contributed to the employment decline more than people working in Slovakia, even in nominal terms *(see Table 4 and Figure 11)*.

Table 3: **The Most Serious Problems of the Slovak Society**

2002	2007
1. Unemployment	1. Living costs
2. Living costs	2. Differences among people
3. Differences among people	3. Unemployment
4. Criminality	4. Criminality
5. Health care	5. Health care

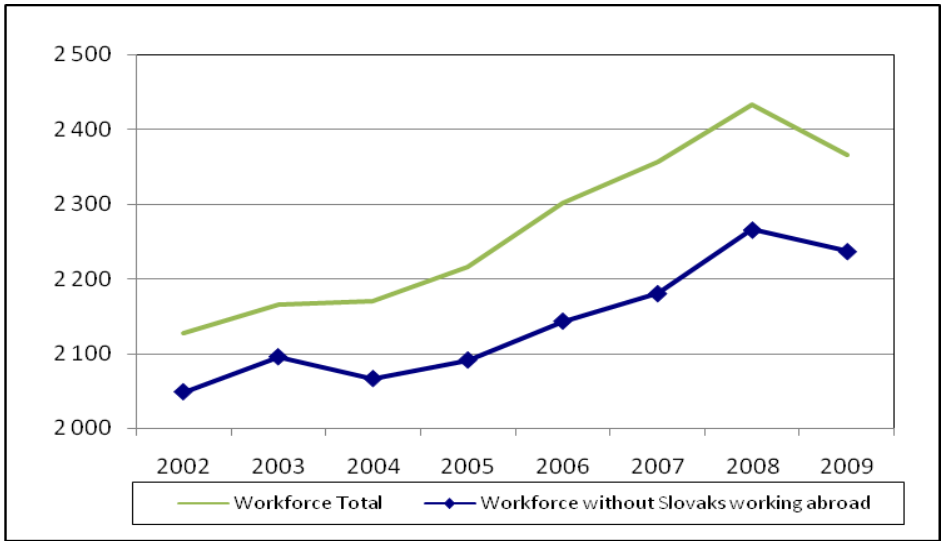
Source: MVK Agency; public opinion polls

Table 4: **Average Number of People working abroad** *(in thousands of people)*

	2002	2003	2004	2005	2006	2007	2008	2009
Working population total	2,127	2,165	2,170	2,216	2,301	2,357	2,434	2,366
Working abroad	78	69	104	125	158	177	168	129
Difference	2,049	2,096	2,066	2,091	2,143	2,180	2,266	2,237
Share *(in %)*	3.7%	3.2%	4.8%	5.7%	6.9%	7.5%	6.9%	5.5%

Source: Statistical Office of the Slovak Republic

Figure 11: **Employment of Slovaks in 2002-2010** *(in thousands of people)*



Source: Statistical Office of the Slovak Republic

Labour Code Reform

In July 2003, sweeping amendment to the Labour Code came into effect. It brought up over 200 amended provisions and thus represented a large change to the original Code. In general, the amendment strengthened the flexibility in employment relations, and weakened power of trade unions. It also restricted the coercive character of the Labour Code – it only set basic frameworks and assumed that respective employment relations would further be specified at the corporate level, depending on specific circumstances of employers, regions and industries.

Proponents and Opponents

For the reform period of 2003-2005, the 2003 Labour Code Amendment was evaluated as the most positive law contributing to the economic and social development of Slovakia by a committee of 50 respectable local experts[8]. In the opinion of many experts, the pre-reform Labour Code, as a result of many bans, was a major hindrance to people's opportunities to get employed and to increase their life standard. Restrictive labour regulations, as one of the most problematic factors for doing business in Slovakia, were named in the 2003 Executive Opinion Survey provided by the World Economic Forum. The old Labour Code was also often avoided which resulted in the lower protection of employees. Thus, the amended Labour Code was expected to encourage the creation of new jobs.

The new Labour Code was also welcomed by the business community as it gave wider freedom in hiring and firing procedures. The business community expressed their satisfaction with decreased powers of trade unions in companies. As they proposed, the amendment was aimed to bring new drivers for competition, to encourage investment and to allow launching production with higher added value, the fruit of which would be secure jobs. As revealed in January 2004, polls conducted by the Business Alliance of Slovakia with selected businesses

[8] *mainly economists, analysts, lawyers, sociologists, political scientists, journalists, academics, people from business community, representatives of trade unions, employers´ associations, and NGOs; the HESO Project, INEKO*

operating in Slovakia, the amended Labour Code was clearly beneficial to Slovakia's business environment and slightly stimulated the creation of new jobs.

The main opponents to the new Labour Code were trade unions represented by the Confederation of Trade Unions of the Slovak Republic. Trade unions called for an alert and threatened with strikes. They argued that the new Labour Code was unconstitutional, providing employers with a big chance to use the new changes to the detriment of employees. Disputes led to January 2003 protests of trade unions outside the Ministry of Labour premises. As Jurajda and Maternová (2004) depict it:

> *"A factor that helped in withstanding the pressure was the popular demand for changes in the labour legislation. Fuelled by the media, it was based on the widely perceived feeling that the 2001 Code "went too far" in setting too rigid rules and gave too much power to the trade unions that are otherwise playing an ever-decreasing role in the society. Once the unions saw the government was determined to push through the new Code and had the public support for it, they agreed to the language and the Parliament adopted it very rapidly thereafter."*

However, before the Parliamentary Elections in 2006, trade unions agreed with the leftist party SMER-SD led by Mr. Robert Fico about reversing some of the changes adopted by the 2003 amendment. Eventually, SMER-SD won the elections and became the leading party in the government coalition with Mr. Fico as the Prime Minister. In September 2007, a new Labour Code Amendment came into effect. It reversed some of the changes of the 2003 labour market reform. However, most of reform changes remained untouched. Both, the experts and the businesses criticised the changes brought by the 2007 amendment.[9] They argued that it would increase the labour costs, weaken the flexibility of employment relations, and thus hinder job creation.

Major Changes

A. Lowering firing costs

Before 2003 reform, the Labour Code ordered 3-month notice period in the case of the employment termination for organisational reasons (in other cases, it was 2 months) plus a compensation (severance payment) in the amount of a 2-month wage. Thus, a termination of contract cost 5-month wages (or 4-month wages in case of other than organisational reasons for contract termination).

Costs of contract termination for organisational reasons
(before 2003 reform; in monthly wages)

Notice period ...			... plus Compensation/Severance	
1st month	2nd month	3rd month	4th month	5th month

After 2003 reform, the Labour Code ordered to option between taking a notice period and taking compensation after termination of contract. It was not possible to take both the notice period and the compensation. The Code ordered 2-month notice period and 2-month compensation for employees who have been working with their employer for less than 5 years; and 3-month notice period and 3-month compensation for employees who have been working with their employer for over 5 years. These were the minimum limits valid if not agreed otherwise in a collective agreement. Thus, a termination of contract cost 2-month

[9] *The 2007 Labour Code Amendment was evaluated by experts within the HESO Project provided by the INEKO institute as the 2nd worst socio-economic measure adopted in 2007.*

wages in case of employment lasting under 5 years and 3-month wages in case of employment over 5 years.

Costs of contract termination
(after 2003 reform; employment under 5 years; in monthly wages)

Notice period ...	
1st month	2nd month
... or Compensation	
1st month	2nd month

Costs of contract termination
(after 2003 reform; employment over 5 years; in monthly wages)

Notice period ...		
1st month	2nd month	3rd month
... or Compensation		
1st month	2nd month	3rd month

After 2007 reversal, the Labour Code has cancelled optioning between a notice period and compensation. It has ordered 2-month notice period plus 2-month compensation for employees who have been working with their employer for less than 5 years; and 3-month notice period plus 3-month compensation for employees who have been working with their employer for over 5 years. Thus, the costs of contract termination went up to 4-month wages in case of employment lasting under 5 years and to 6-month wages in case of employment lasting over 5 years.

Costs of contract termination
(after 2007 reversal; employment under 5 years; in monthly wages)

Notice period ...		... plus Compensation	
1st month	2nd month	3rd month	4th month

Costs of contract termination
(after 2007 reversal; employment over 5 years; in monthly wages)

Notice period ...			... plus Compensation		
1st month	2nd month	3rd month	4th month	5th month	6th month

B. More flexible overtime and working hours

Before 2003 reform, the Labour Code ordered maximum limits for required overtime 150 hours a year plus 150 hours a year based on an agreement with a respective trade union and after having received permission from the National Labour Office.

After 2003 reform, the Code ordered maximum limits for required overtime 150 hours a year plus additional 250 hours a year overtime agreed upon with employees. The agreement about overtime was in the sole discretion of employers and employees, i.e. the former did not have to ask for permission from trade unions nor the National Labour Office. The 2003 amendment also deregulated working time: depending on the nature of a job and the type of work, the new Labour Code allowed employers to design the working time accordingly, which means either evenly or unevenly across weeks.

Before 2003 reform, the Code ordered maximum working time hours with all employers of 58 hours per week including overtime.

After 2003 reform, the Code ordered maximum working time hours with one employer of 48 hours per week including overtime. However, the employee was allowed to work longer for other employers. Moreover, exceptions were possible in the case of agricultural seasonal works. The new Labour Code also made it possible that a pregnant woman, a woman or a man permanently looking after a child under 3 years of age, a lone woman or a man permanently looking after a child under 15 may only work overtime if they agree to it (it was not possible before at all). They could also agree with their employers that they would be on standby duty if necessary.

The 2007 amendment left the above mentioned provisions almost unchanged. However, it included standby duty into overtime hours causing a labour shortage of some employees, especially nurses and physicians in hospitals. Most of them started to avoid new provisions.

The 2009 amendment has introduced a flexible working time account (in Slovak so called Flexikonto). Its introduction was motivated by problems in sales and in maintaining production and employment which have employers due to the global economic crisis. When a company announces a production break, flexible working time arrangements valid until the end of 2012 help to retain skilled workforce and avoid mass layoffs. The "Flexikonto" allows employees to stay at home on full basic pay, with the un-worked hours being recorded in individual employee accounts. Later, after the economic difficulties are over, the employee is obliged to work those missing hours in the form of overtime and free of charge. At that time, legal overtime limits are not applied. Some companies, mainly in the automotive (Volkswagen Slovakia) and electric industries used the above mentioned flexible working time account several times in 2009, when their production was stopped for some weeks.

C. More flexible fixed-term and part-time contracts

Before 2003 reform, the Labour Code ordered maximum duration of the fixed-term contracts to 3 years. No extension was allowed.

After 2003 reform, the Code did not change the maximum duration of the single fixed-term contract (3 years), but the employers were allowed to prolong and renew them. Practically, the maximum duration was indefinite. The Code also expanded the applicability of the fixed-term contract to allow firms dependent on the cycle to hire a necessary number of employees in the time of recovery and then to lay them off in the time of recession. Further, the Code defined anew the fixed-term employment and part-time work such that an employer could ensure the fulfilment of all his tasks, depending on whether they are long-term or interim tasks.

After 2007 reversal, the Code restricted possibilities to prolong and renew fixed-term contracts to once upon 3 years (no limits before). The provision aimed to ban so called chaining of the fixed-term contracts (for example consecutive renewal of a 1-year fixed-term contract, which allowed for practically indefinite duration of the fixed-term contracts).

D. Easing the firing procedures

Weaker protection of a fixed-term employee:

After 2003 reform, an employer could terminate a fixed-term employment contract without giving any reason immediately. In that case, an employee was entitled to a compensation totalling to the amount of a 1-month salary he or she would receive under the contract.

After 2007 reversal, it was not possible to terminate a fixed-term employment contract immediately, the employer had to follow regular firing procedures.

Weaker protection of an employee with shorter working time:

After 2003 reform, both employers and employees could terminate the employment concluded for a shorter working time than 20 hours a week for any reason or without giving any reason. This type of a contract termination required a 15-day notice.

After 2007 reversal, the restriction of protection reduced to a working time shorter than 15 hours a week. The statutory notice period was prolonged to 30 days.

Weaker protection of unduly employees:

Before 2003 reform, the Labour Code allowed employers to terminate an employment contract (among other reasons) in the case of serious breach. In the case of less serious violation, this violation would have to be recurring on a permanent basis.

After 2003 reform, the Code allowed employers to terminate an employment contract in a simpler manner if the employee was not able to duly perform his or her duties. If an employee violated the terms and conditions in a less serious manner, the employer was allowed to terminate the contract as soon as this repeated and the employee had been notified of his or her misdemeanour within the previous six months.

The 2007 amendment did not change this provision.

E. Weakening power of trade unions

After 2003 reform, the Labour Code abolished compensation for wages for trade union representatives in the time of performing their trade union duties.

Further, as Jurajda and Maternová (2004) explain:

> *"The new (2003) Code also significantly constraints the powers of the trade unions. While under the 2001 regime they had an effective veto power over the organisational changes or firing of workers, under the 2003 Code they only need to get notified. The law puts the workers councils and trade unions on an equal footing (with the exception that the trade unions do collective bargaining and workers councils do not). Workers councils are found in an increasing number of businesses, especially with foreign investment, where trade unions do not exist. Essentially, under the new Code, trade unions need to bargain for all their powers and rights with the employers; very little is granted as a matter of law."*

After 2007 reversal, the trade unions received back some of the compensations for wages for their representatives. The Code also allowed them to co-decide about flexible working time.

The World Bank´s Doing Business in 2005 Report

Slovakia was named as the leading reformer in the World Bank´s Doing Business in 2005 Report. The annual report investigated *"the scope and manner of regulations that enhance business activity and those that constrain it"* (The World Bank 2005). It compared 145 countries based on several indicators of the business environment. Slovakia was number 1 reformer thanks to the following measures (most of them adopted in 2003):

- Introducing flexible working hours
- Easing the hiring of first-time workers
- Opening a private credit registry
- Cutting the time to start a business in half
- New collateral law, reducing the time to recover debt by three-quarters

The Report praised especially measures introduced by the 2003 Labour Code Amendment. As it concludes, reforming its employment regulation, *"Slovakia introduced the most far-reaching changes"*. The Report summarised them in the following table:

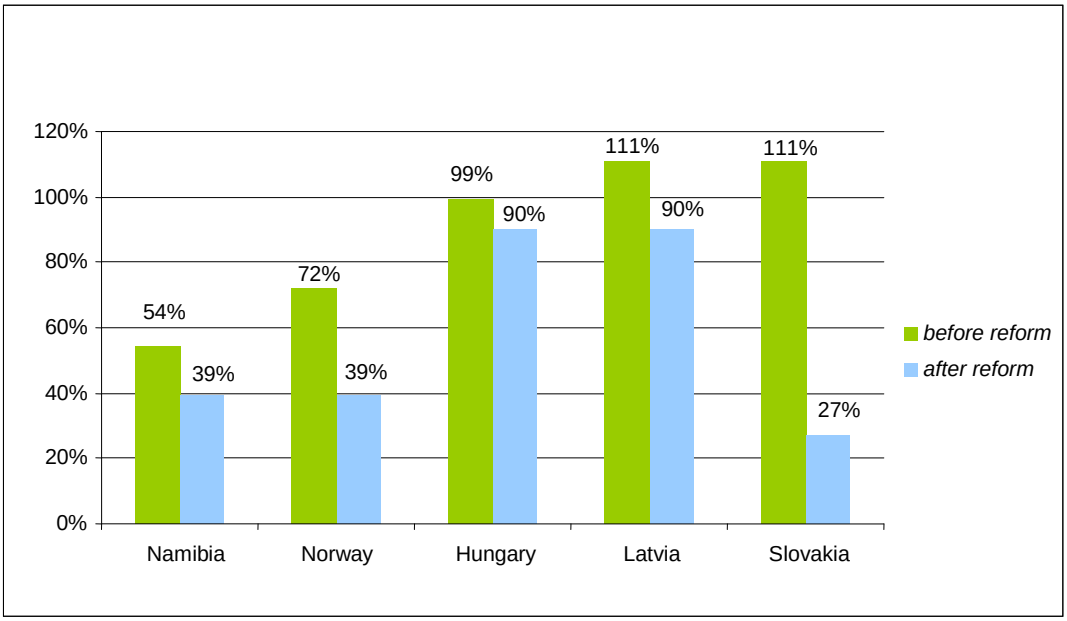
Table 5: **Employment Regulation - Sweeping Reforms in Slovakia in 2003**

Before Reform	***After Reform***
No part-time contracts	Part-time contracts for students, women and retirees
Term contracts could not be extended	Extensions of term contracts possible
Limit of 150 hours of overtime a year	Limit of 400 hours of overtime, with worker consent
Approval by trade union for firing a worker	No requirement
Retraining before dismissal	No requirement
Trade union approval for flexible work time	No approval for shifting hours in a 4-month period
Approval by trade union for group dismissals	Notification for group dismissals

Source: Doing Business in 2005, The World Bank

The Report also considered how the labour costs would change if a firm increases its production in a reaction to a temporary increase in demand. It counted the change in labour costs in case of the 50% output increase. *"Countries that move to more flexible work hours can bring those labour costs down considerably"*, explained the Report. As shown in the following *Figure 12*, Slovakia cut those costs down from 111% to 27% - thanks to the 2003 Labour Code reform which brought more flexible hiring and firing practices.

Figure 12: **Cost to Temporarily Expand Production by 50%** *(percentage increase in labour cost)*

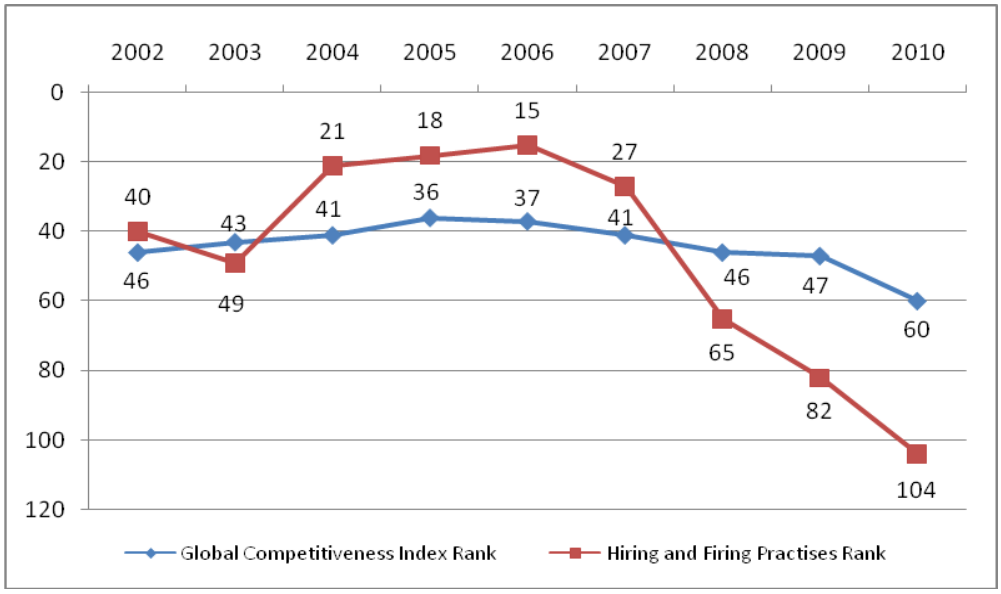


Source: Doing Business in 2005, The World Bank

Global Competitiveness Report

The introduction of new hiring and firing practices in the 2003 Labour Code reform has been positively evaluated also by the World Economic Forum. The following *Figure 13* shows ranking of Slovakia according to the Global Competitiveness Report which evaluates competitiveness of more than 130 countries. However, after the 2007 Labour Code amendment, which has limited labour market flexibility, a steep decline in hiring and firing practices ranking is visible.

Figure 13: **Global Competitiveness Ranking**



Source: Global Competitiveness Reports, World Economic Forum

Social Welfare Reform

"It pays off to work" was the principle of the social welfare reform adopted in 2004. The goal was to improve work incentives and pro-active approach of the unemployed when searching for a job. The previous system was blamed for creating too high dependency on social benefits and discouraging people with lower income to work. One of reasons was that the benefits had been high relative to wages. For example, for a family with two children, welfare payments could exceed the net average wage (OECD 2002). Such a system was expensive and demotivating. In 2001 and 2002, spending on state benefits and social assistance ran over budget by about 0.3-0.4 percent of GDP annually, reflecting benefit abuse as well as underbudgeting (IMF, 2005).

Generosity of the social system has been abused particularly by some Roma communities. The Roma minority constitutes about 8% of the total Slovak population (though exact census data do not exist) but accounted for a half of all long-term unemployed (Jurajda and Mathernová 2004), and up to a fifth of overall unemployment in Slovakia (OECD 2002). Data from 1997 showed as many as 80% of Roma were dependent on social assistance benefits (Ministry of Labour 2003), and 70% of Roma were unemployed (UNDP 2003).

On the other hand, the pre-reform social assistance system had been rather effective at mitigating poverty. IMF (2005) explains:

> *"The World Bank (2001) Living Standards study found that the social transfer system alleviated poverty significantly. The study estimated on the basis of the 1996 Microcensus that cancelling social transfers except for pensions would imply a poverty rate of 19 percent of all individuals, compared to an actual rate of 10 percent. For households whose main income earner is unemployed, cancelling non-pension social transfers would imply nearly a poverty rate of 80 percent, compared to an actual poverty rate of 45 percent."*

As IMF (2005) concludes, the reform had to face a difficult trade-off between addressing benefit dependency, and risking deteriorating poverty.

New structure of Social Benefits

Effective from 2004, a new structure of social benefits has been introduced. It consisted of the basic social assistance benefit depending on the number of people in the household (SKK 1,450 – SKK 4,210 monthly[10]), plus following benefits:

Activation benefit (SKK 1,000 monthly): Recipients were required to demonstrate effort to improve their situation, for example by active seeking a job, studying, participation in retraining programs or engaging in short-term public works organised by municipality, schools, non-governmental organisations, etc. In case of public works, the benefit was paid, if these last a minimum of 10 hours a week. The activation benefit accounted for a significant share of the basic benefit, creating an obvious incentive for the effort to qualify. Its main aim was to decrease long-term unemployment. Long-term unemployed, who found a job, were allowed to take this benefit for 6 months into the job's duration, regardless of their income.

Protection benefit (SKK 1,000 monthly): Designed for people who are unable to qualify for the activation benefit, such as pensioners, disabled, people on a sickness leave longer that 30 days, people caring for handicapped persons, people caring for new-born children, etc.

Accommodation benefit (SKK 780 for single person or SKK 1,330 for families, monthly): Covering costs of accommodation (rent, electricity, heating, etc.).

Health care benefit (SKK 50 monthly): Covered direct payments in hospitals and ambulances.

Lump sum benefit (up to 3-times subsistence minimum, i.e. SKK 12,620 for a single person): Payable only on special need, covering costs of clothes, furniture, school accessories, etc.

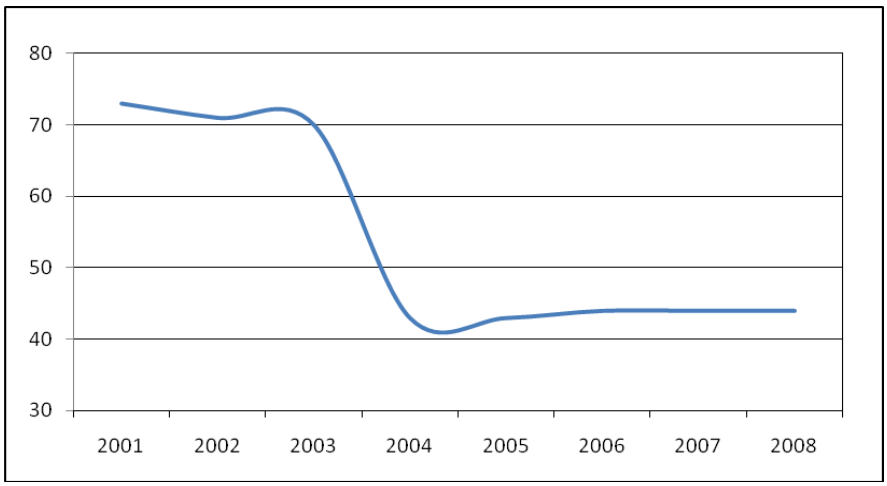
"It pays off to work" principle was strengthened also by less abrupt reduction of social assistance benefits in case the recipient earns a labour income. In general, social assistance benefits are paid to individuals and families with incomes below the national poverty line, the "subsistence minimum" (in 2003 it was SKK 4,210 monthly for a single person). The previous social assistance scheme was a simple top-up of income to the benefit level; any additional earnings resulted in a correspondingly lower benefit (IMF 2005). In the new scheme, as much as 25% of a worker's salary was allowed to be deducted for the purpose of determining whether a household is below the subsistence minimum. Besides, there were other types of income that were able to be deducted: 25% of pension, child bonuses, scholarship, part of student's wage, etc.

These measures together with an increased tax-free income *(see Chapter 2: Tax Reform)* were the main reasons for a sharp reduction of the unemployment trap, i.e. the barrier faced by unemployed when they enter labour market *(see Figure 14)*. By Eurostat definition, *"the*

[10] *Here and in the following text, we mention the amounts of benefits valid at the time of reform (2004). Today, they are different due to later valorisation.*

unemployment trap measures the percentage of gross earnings which is "taxed away" through higher tax and social security contributions and the withdrawal of unemployment and other benefits when an unemployed person returns to employment."

Figure 14: **The Unemployment Trap** *(in % of gross earnings; single person without children; earning, when in work, 67% of the average earnings)*



Source: Eurostat

In summary, the reformed system increased the span between the minimum and the maximum levels of social assistance. Minimum level has been set significantly lower than in the previous system *(see Table 6)*. To achieve higher assistance, people had to be active in searching for a new job, educate themselves, participate in training activities, or in public work programmes. To illustrate the reduction in the level of benefits, consider a family with 2 jobless parents and 10 children. Under the old scheme it received in total SKK 28,640, under the new scheme it received SKK 13,420 without the "activation" bonuses (Jurajda and Mathernová 2004).

IMF includes:

> *"Assuming participation in activation programs, smaller families can maintain benefit levels near the pre-reform levels, even increasing their household income if they earn the minimum wage. However, for families with 4 or more children, benefit reductions are greater. (...) For families with 5 children, Ministry of Labor staff estimate typical benefit reductions of around 10-20 percent if parents participate in activation programs; if the parents do not participate, the benefit reductions—and the gap with the subsistence minimum—can exceed 50 percent."*

Table 6: **Minimum and Maximum Levels of Social Benefits** ***(in SKK)***

	Number of children	Average amount in old system	Minimum in new system	Maximum in new system
Single unemployed	0	1,974	1,500	3,280
	1	3,171	2,260	4,590
	2	4,218	2,310	4,640
Couple, both unemployed	0	3,281	2,630	5,960
	1	4,382	3,360	6,690
	2	5,782	3,410	6,740

Note: Since April 2004, higher activation benefit increased maximum levels by SKK 500.
Source: The HESO Project, INEKO, 2004

Sharp decrease in social benefits for large families had very strong impact particularly on Roma population. Their reaction came almost immediately, in late February 2004. Jurajda and Mathernová (2004) describe it:

> *"The socially excluded, predominantly jobless Roma minority, which relies heavily on social transfers, staged a number of protests against the new low level of social assistance benefits. In many instances, the protests turned into riots and resulted in looting of stores. The army and extended police forces were called to suppress the lootings. As a reaction to these events, the government amended some of the recently adopted legislation. For example, the "activation" bonus was raised from SKK 1,000 to 1,500."*

The raising of activation benefit came into effect on April 1st, 2004. The protection benefit went up to SKK 1,500 as well.

Beside activation benefit, the social welfare reform introduced several other active labour market policy instruments (the list does not include all of them):

Activation benefit for employers (up to SKK 900 monthly) – this benefit was intended to cover part of costs of municipalities, schools, NGOs, etc., which engage unemployed in short-term public works or other activation programmes.

More frequent registration at the Labour Office – the registration is a precondition for collecting many types of social benefits including the unemployment benefit. Basically, at least one personal visit every 2 weeks was required; one visit per week for inactive long-term unemployed (not participating in activation programmes); and one visit per month for active long-term unemployed. The measure was aimed to activate unemployed and curb the abuse of the social system by people taking benefits and, at the same time, working abroad or in a shadow economy.

Private employment and personal agencies – these agencies were designed to offer a complete service to the unemployed searching for a job (consulting, training, identifying and contacting potential employers, etc.). Personal agencies can conclude an employment contract with the unemployed and consequently place them on a labour market. These are usually temporary placements and serve for higher flexibility in meeting seasonal demand for labour.

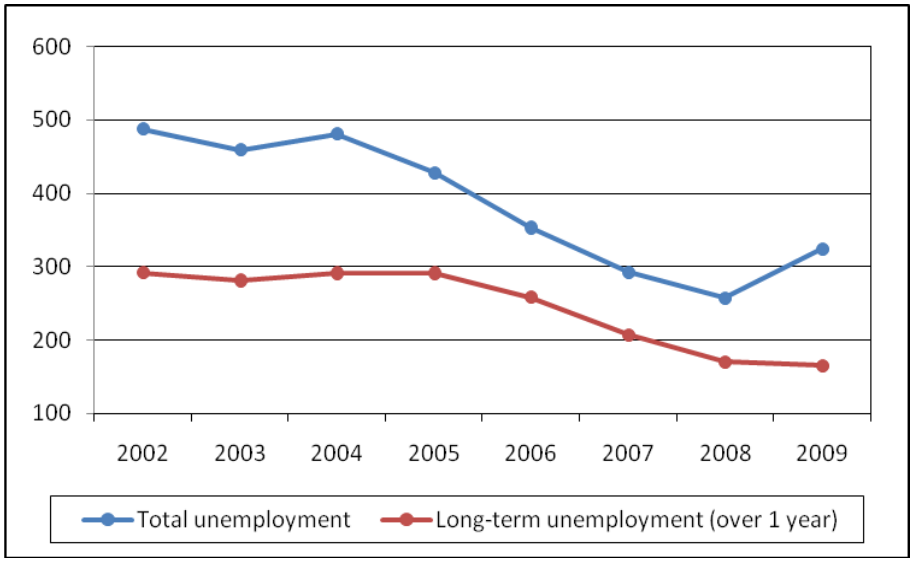
Relocation benefit (up to SKK 10,000) – lump sum benefit available for people changing their place of living due to moving at least 30 kilometres in order to acquire a job.

Benefit for self-employment (up to SKK 197,000) – lump sum benefit available for unemployed people who become self-employees. They should work at least 2-years.

Individual action plan – every unemployed should have an assessment of personal abilities, capacities, skills, etc. and determining the approach necessary for his or her employment.

Despite wide variety of active labour market policy instruments, the long-term unemployment in Slovakia remained unchanged during 2004 and 2005 and started to decline in 2006 *(see Figure 15)*. On the other hand, total unemployment has been falling since 2004 (with an exception of 2009 when first impacts of the global financial crisis on unemployment in Slovakia have appeared). This is probably a consequence of the fact, that the labour market has better absorbed qualified short-term unemployed at first, and, consequently, less qualified long-term unemployed people.

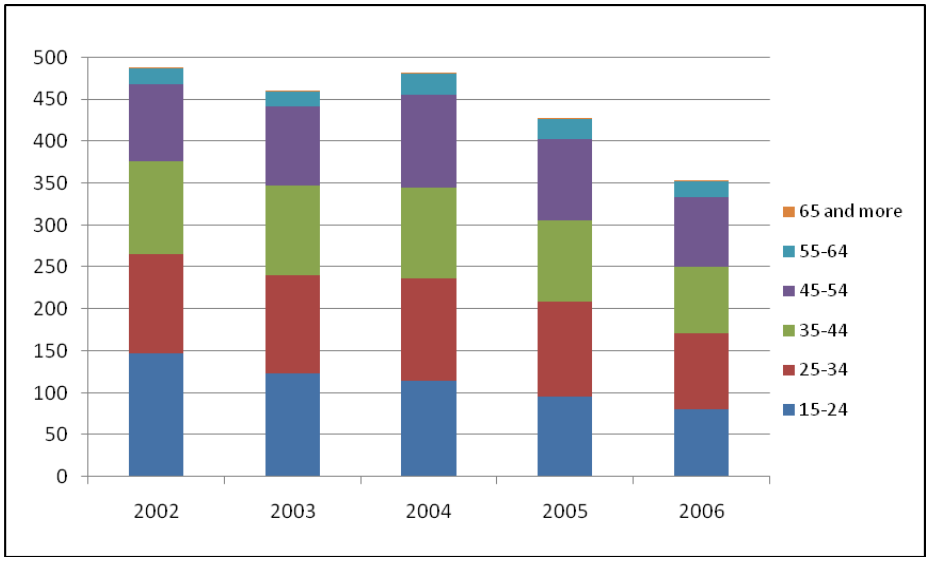
Figure 15: **Total and Long-term Unemployment** *(in thousands of people)*



Source: Statistical Office of the Slovak Republic

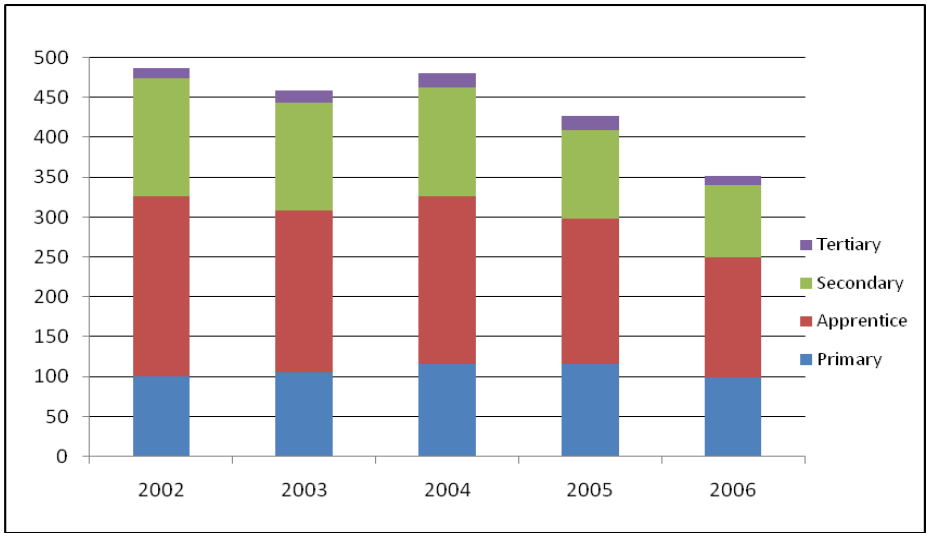
As shown in the following *Figure 16*, the number of unemployed at the age of 15–44 decreased by more than 100,000 between 2002 and 2006. The number of unemployed older than 45 years remained almost unchanged. Regarding the education, the number of unemployed with the primary education remained almost unchanged between 2002 and 2006 *(see Figure 17)*. The most of jobs have been taken by people with apprentice and secondary education. This proves the assumption, that the older and low qualified people have the biggest problems to find jobs.

Figure 16: **Unemployment by Age** *(in thousands of people)*



Source: Statistical Office of the Slovak Republic

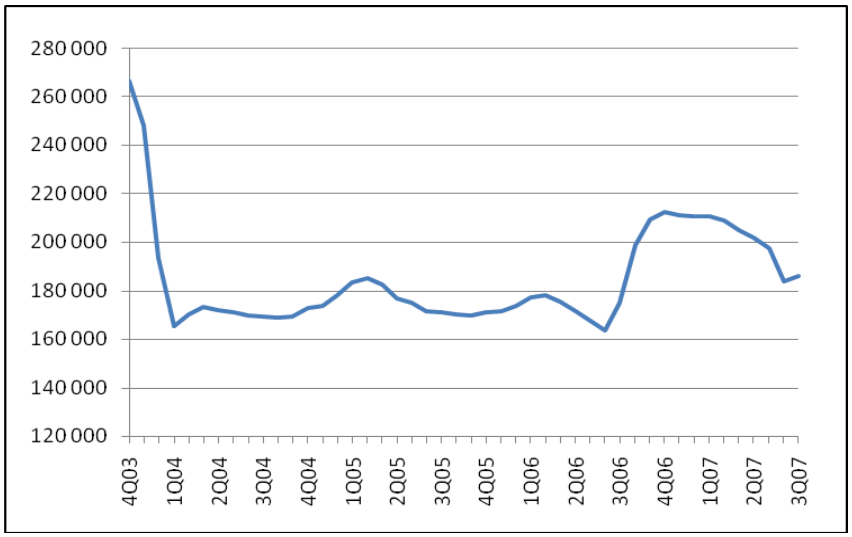
Figure 17: **Unemployment by Education** *(in thousands of people)*



Source: Statistical Office of the Slovak Republic

The new structure of social benefits together with pro-active labour market instruments led to a sharp decrease in the number of people taking social benefits. In the first quarter of 2004, more than 100 thousand people (or 38%) left the system *(see Figure 18)*. This was probably a result of new motivations brought by the reform, when particularly people abusing the social scheme and unwilling to adapt to new pro-active policies were discouraged.

Figure 18: **Number of Social Benefits Recipients**



Note: Older data are not available.
Source: Central Office of Labour, Social Affairs and Family

Child Benefits

Before 2004, every family received child benefits consisting of three parts:

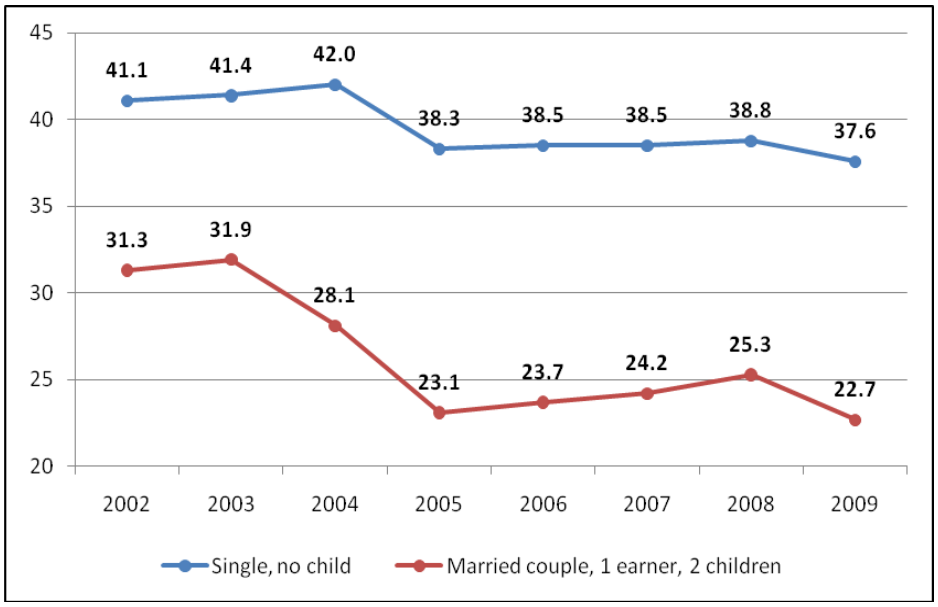
(1) Flat benefit (SKK 270 per child, monthly) – universal payment regardless the income
(2) Means-tested benefit (SKK 210 – SKK 620 per child, monthly) – benefit depending on family's income and child's age. The lower was the income, the higher was the benefit.
(3) Tax-free child allowance (SKK 16,800 per child, yearly) – deductible from the income tax base

Since 2004, the child benefit has been split into two parts:

(1) Flat benefit (SKK 500 per child, monthly) – universal payment regardless the income
(2) Child tax bonus (tax credit) (SKK 400 per child, monthly) – bonus deductible from the income tax. It was designed as a negative tax, which means, that if the tax is lower than the child tax bonus, the family receives the difference. The tax bonus is conditional on at least one parent being employed. This condition was aimed at increasing incentives to work.

The means-testing was cancelled mainly due to its complexity and administrative burden. In 2004, the total average child benefit was SKK 900 per child monthly, compared to SKK 762 before the reform. The introduction of child tax bonus contributed to a decrease in the tax wedge on working families *(see Figure 19)*. The tax wedge is defined as income tax on gross wage earnings plus social contributions paid by employee and employer less cash social transfers, expressed as a percentage of the earner´s total labour costs.

Figure 19: **Total Tax Wedge in Slovakia** *(in % of total labour costs)*



Source: Taxing Wages, OECD

Sickness Benefits

In the pre-reform system, all sickness benefits were paid by the state. After reform, the period has split into a short-term and long-term part. First 10 days of a sickness leave is being paid by an employer – the benefit in the first 3 days is 25% of daily gross wages; in the other days

(4 through 10), it is 55%. From the 11th day onwards, sickness benefits are being paid, as before, by the state, at 55% of the gross wage. The aim of such changes was to eliminate abuse of the sickness benefit – people often pretended to be ill as their loss of income was not so high, firms often recommended their employees to take a sickness leave when they had no work for them. In the reformed system, the employers lost motivation to send people on sickness leave and started to watch their employees and control the reasons of their sickness. As a result, the average length of a sickness leave measured as a percentage of the working-time shortened substantially from 5.1% in 2003 to 3.7% in 2004. On the other hand, even sick people tend to stay at work now or take a holiday instead of a sickness leave.

Unemployment Benefits

Eligibility period for benefits has been cut from 9 to 6 months. IMF (2005) notes, the benefits are paid on condition that the unemployed has contributed for at least 24 of the previous 36 months (later changed to 36 of the previous 48 months). The replacement rate is 50% of past gross income; previously, this had been 55% for the first 6 months, falling to 45% for the last 3 months. Unemployment benefits are subject to a ceiling raised from about 50% to 60% of the economy-wide average wage.

Poverty

It is difficult to assess the impact of reforms on poverty, because there are no reliable data measuring poverty in Slovakia before 2004. However, later data show, that the poverty risk rate (percentage of people living in poverty) decreased from 13.3% in 2004 to 10.7% in 2006 *(see Table 7)*. Thus it seems that the reforms had rather positive impact on the poverty.

Table 7: **Poverty Risk Rate** *(in %)*

2004	2005	2006
13.3	11.6	10.7

Note: Older data are not available or reliable.
Source: Statistical Office of the Slovak Republic; EU-SILC

Minimum Wage

Generally, the economists agree, that the high minimum wage leads to higher unemployment, weakens chances to find employment especially for the poor, unskilled, and young people. As shown in the *Table 8*, the Slovak governments keep the minimum wage on a stable level of approx. 40% of the average wage in the economy.[11]

In 2008, fewer than 8 months, there was a regulation in force which was intended to introduce a new system for regular and automatic increase of the minimum wage. The aim was following: if social partners do not agree on the minimum wage amount it will be increased automatically by the government resolution by the year-on-year nominal average wage growth in the Slovak economy. Unfortunately, politicians have changed this rule very soon. It could not have even been implemented. Now, if the minimum wage adjustment is not agreed between the social partners, the government will determine the minimum wage increase by

[11] *In 2007, less than 2% of employees worked for the minimum wage in Slovakia.*

at least the year-on-year nominal increase of the average wage in the Slovak economy. I.e., there is no automatic and exactly predictable valorisation anymore.

Table 8: **Minimum Wage in Slovakia** *(in SKK)*

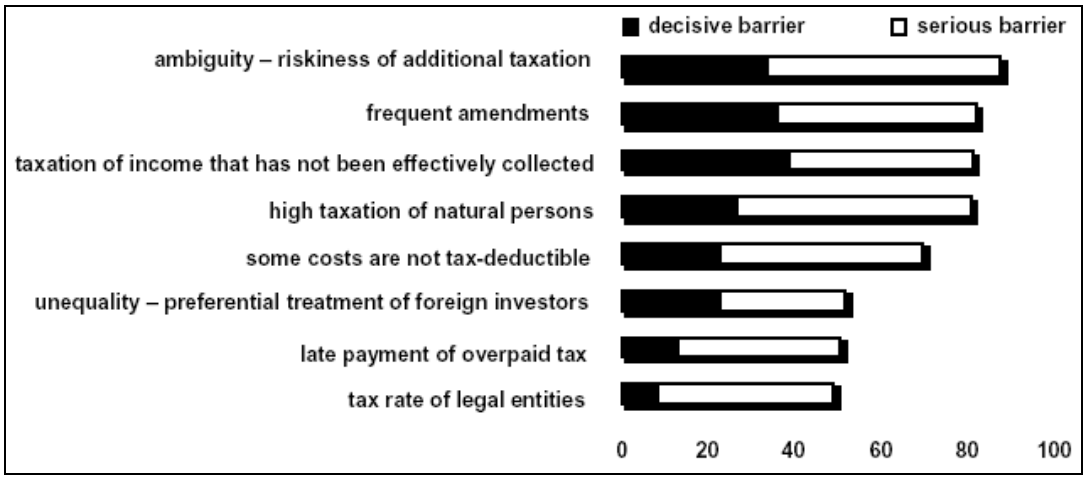
	2002	2003	2004	2005	2006	2007	2008	2009	2010
Minimum wage	5570	6080	6500	6900	7600	8100	8100	8902	9270
Average wage	13511	14365	15825	17274	18761	20146	21782	22429	22788*
Share of minimum wage on average wage *(in %)*	**41.2%**	**42.3%**	**41.1%**	**39.9%**	**40.5%**	**40.2%**	**37.2%**	**39.7%**	**40.7%***

** Forecast of the Ministry of Finance of the Slovak Republic*
Source: Ministry of Labour, Social Affairs and Family of the Slovak Republic

Chapter 2: Tax Reform

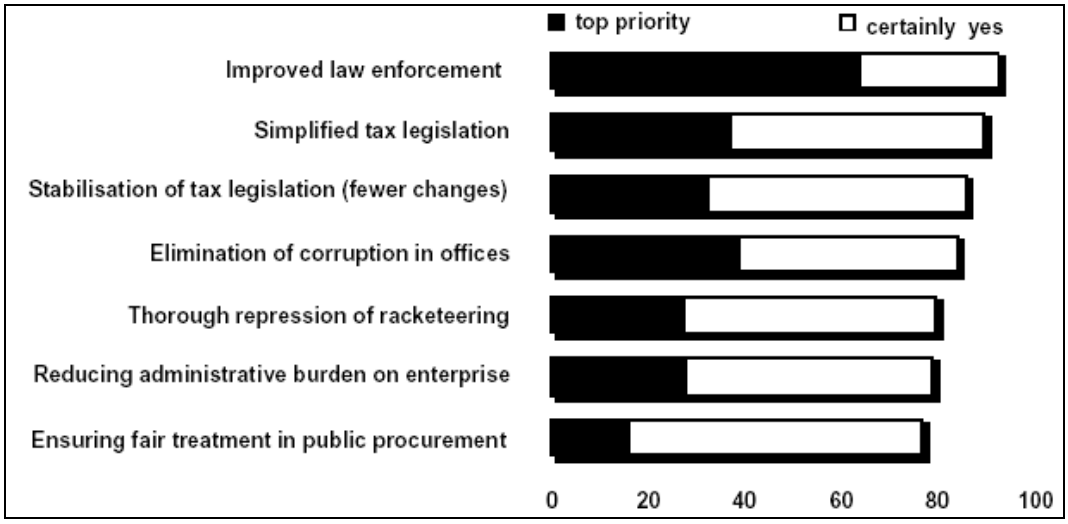
In 2002, the Slovak tax system was generally considered as unsustainable, too complicated, and changing too often, bringing in more exemptions and special rates, and thus distorting the business environment *(see Figures 20 and 21)*.

Figure 20: **The Most Serious Shortcomings of the Income Tax Law according to Slovak Managers, in 2002** *(in %)*



Source: Business Environment Report – Slovak Republic 2002, BAS, 2002

Figure 21: **Measures with Strongest Support among Slovak Managers, in 2002** *(in %)*



Source: Business Environment Report – Slovak Republic 2002, BAS, 2002

The tax reform became one of the most important initiatives of the centre-right Government of Mr. Dzurinda that came to the power in autumn 2002. From among four coalition parties only one – Christian Democrats – called for a radical reform – the introduction of flat tax on personal income. The Policy Statement of the Government undertook only to *"reduce income*

tax rates and to analyse the possibility of implementing a flat-rate tax". In fact, the implemented reform pushed by the Finance Minister Mr. Ivan Mikloš introduced the flat tax and went far beyond these original objectives. The new tax system became effective as of January 2004. The goal was to create a simple, fair, non-distortive, pro-active, and business friendly system. This was intended to achieve through:

1. **Shifting the tax burden from direct to indirect taxes**[12]; i.e. taxing consumption rather than production. The aim was to support incentives to work. Moreover, in the era of globalisation and increasing labour mobility the collection of direct taxes becomes more difficult to control and it is easier to avoid paying them compared to the indirect taxes. As a result, the relatively high direct taxes are harming country's fiscal position and competitiveness - people "escape" to a shadow economy or to countries with lower direct taxation. The shift towards indirect taxes was supposed to reduce tax evasion.
2. **Elimination of all exceptions, exemptions and special regimes**. The business surveys quoted the excessive complexity and frequent changes in the old tax law as one of the major business barriers[13]. The old system included 90 exceptions, 19 sources of un-taxed income, 66 tax-exempt items, and 37 items with specific tax rates *(see Table 9)*. The reform virtually abolished all of them, making the tax system much simpler and transparent, and eliminated speculation aimed at paying lower tax rates.
3. **Introduction of flat tax rate on personal income:** This measure limits the economic disincentives caused by higher taxation of higher income cohorts. The equal opportunities imposed by the new system should increase labour productivity, as it encourages higher work effort at any income level.
4. **Elimination of tax instruments aimed at achieving non-fiscal goals:** Many of such instruments aimed at providing social policy objectives. However, tax instruments usually address everybody and not only those in need. Thus, they have only little to do with solidarity. The reform intended to clearly separate solidarity, when it replaced virtually all such instruments by targeted measures helping those really in need.[14] For instance, the child allowance has been cancelled and a new form of targeted social compensations and entitlements has been introduced, which should ensure a fairer distribution of income particularly benefiting low-income families with children.
5. **Elimination of double taxation of income** (such as tax on dividends)

Table 9: **Some of Special Income Tax Rates Cancelled by the Reform**

Tax rate	Type of income
0%	Income of small hydro-electric power stations (up to 1 MW)
1%	Rent, when the agreement on buying the rented object has been made
2%	Lump-sum tax on income up to SKK 500 thousand yearly*
2.25%	Lump-sum tax on income up to SKK 1 million yearly*
2.5%	Lump-sum tax on income up to SKK 1.5 million yearly*

[12] *However, even before the reform, Slovakia had one of the lowest direct tax burdens relative to GDP (Eurostat, 2005): In 2003, Poland (19.7%), Slovenia (20.8%) and Slovakia (23.2%) recorded the lowest shares of direct taxes in the total tax burden, compared to the EU25 average of 31.6%.*
[13] *e.g., Business Environment Reports – Slovak Republic 2002 and 2003, BAS (see Figure 20)*
[14] *Tax reform has been complimented by welfare reform aimed at (1) curbing the abuse of social benefits, (2) careful targeting of social aid to those really in need, and (3) insuring work incentives.*

2.75%	Lump-sum tax on income up to SKK 2 million yearly*
5%	Bank interest on personal long-term deposits (above 3 years)
15%	Return on equities, profit sharing in Ltd. companies, agriculture
18%	Income of tax payer employing more than 50% of handicapped persons
20%	Interests, prizes and awards
25%	Corporate income, consultancy
28%	Personal income SKK 180 – 396 thousand yearly
35%	Personal income SKK 396 – 564 thousand yearly
38%	Personal income above SKK 564 thousand yearly

Source: Ministry of Finance of the Slovak Republic
**selected self-employed entrepreneurs, based on the type of their trade*

To assure tax fairness and simplicity the Ministry of Finance decided to tax all types and all amounts of income equally. Searching for the best rates the Government applied the same 19% rate for personal income tax, corporate income tax, and value-added tax.

Personal Income Tax (PIT)

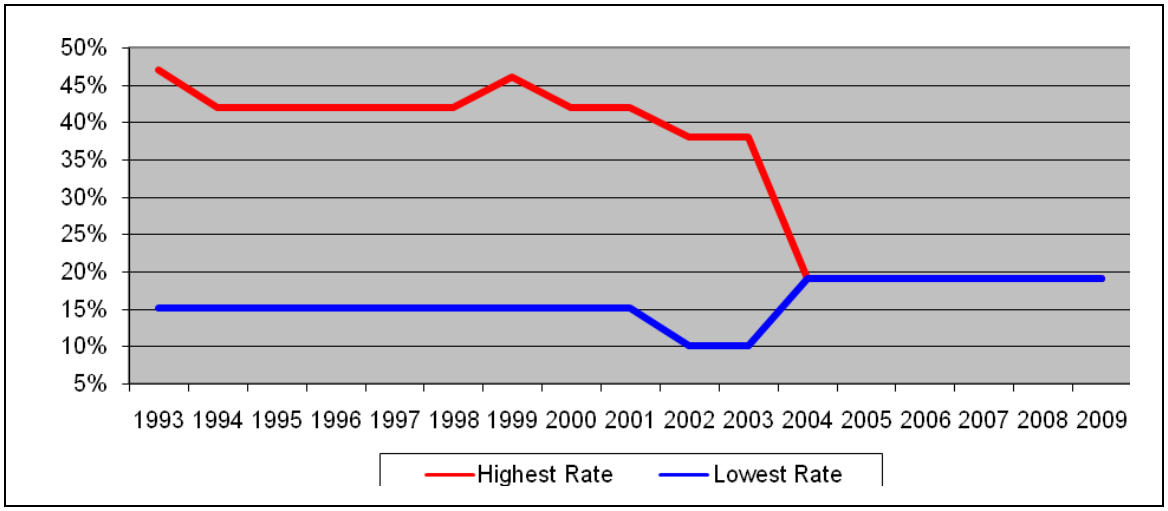
The old system was strongly progressive with 5 tax rates for different incomes: 10% (for the lowest), 20%, 28%, 35% and 38% (for the highest) *(see Table 10)*. The new system introduced one flat rate – 19% for all incomes *(see Figure 22)*. It also increased a tax-free income (i.e. basic personal allowance deductible from the tax base) from SKK 38,760 or EUR 968 per taxpayer and year to 19.2 times the subsistence minimum (SKK 80,832 in 2004, or EUR 2,021) per taxpayer and year in 2004. As a consequence, everybody with wage below approximately half the average wage in the economy did not pay any income tax at all. Others pay a uniform tax of 19% on the difference between their income and the tax-free income. Thus, the reformed system is tax-free for low income brackets but it still ensures slightly progressive taxation for middle and high income brackets. Raising the basic personal allowance was an important precondition for viability of the whole reform as it compensates low income brackets for higher imposed flat tax rate. The reform replaced the child allowance deductible from the tax base (SKK 16,800 yearly) by a tax bonus deductible directly from the tax (SKK 4,800 yearly) or payable in case of too low or negative tax – which is conditional on at least one parent being employed. Besides basic personal allowance, the tax reform also increased the non-working spouse allowance from SKK 12,000 to SKK 80,832 per taxpayer yearly *(see Table 11)*.

Table 10: **Tax Brackets and Marginal Tax Rates before and after the Tax Reform**

Before Reform (2003)		After Reform (2004)	
Taxable Income *(in SKK per month)*	**Marginal Tax Rate**	**Taxable Income** *(in SKK per month)*	**Marginal Tax Rate**
Under 3,230	0 %	Under 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 by the subsistence minimum growth*	

Source: Ministry of Finance of the Slovak Republic

Figure 22: **Personal Income Tax Rates in Slovakia** *(in %)*



Data: 1993: 6 rates ranging between 15-47%; 1994: 6 rates ranging between 15-42%; 1999: 7 rates ranging between 15-46%; 2000: 7 rates ranging between 15-42%; 2002: 5 rates ranging between 10-38%; 2004: one flat rate 19%.
Source: INEKO

Table 11: **Tax-free Allowances and Deductions before and after the Tax Reform**

	Before Reform (2003) *(in SKK per year)*	**After Reform (2004)** *(in SKK per year)*
Basic personal allowance	38,760	80,832*
Non-working spouse allowance	12,000	80,832*
Child allowance	16,800**	-
Partial disability allowance	8,400	-
Disability allowance	16,800	-
Deduction for contributions to supplementary private pension insurance	max 24,000	max 24,000 (max 12,000 in 2005)***

** An equivalent of 19.2 times the subsistence minimum (before the reform, the law set fix amounts of allowances). Temporarily for 2009 and 2010, as an anti-crisis measure, the basic personal allowance is set as 22.5 times the subsistence minimum.*
*** After the reform, a child tax bonus (tax credit) in amount of SKK 400 per month was introduced (SKK 4,800 per year).*
**** As of January 2011, this deduction should be cancelled.*

Source: Ministry of Finance of the Slovak Republic

With effect from January 2007, the leftist Government of Mr. Fico has adopted the so called millionaire income tax - a gradual decrease of the basic personal tax-free allowance. The decrease starts from the gross monthly income of SKK 47,571 (annual tax base in the sum of 100-multiples of the subsistence minimum) up to an income of SKK 79,952 when the tax-free allowance is zero.[15] Intention of this measure was to burden the highest-income groups of the population with a higher tax burden, and thus to achieve a bigger solidarity in the society

[15] *Amounts valid for 2007.*

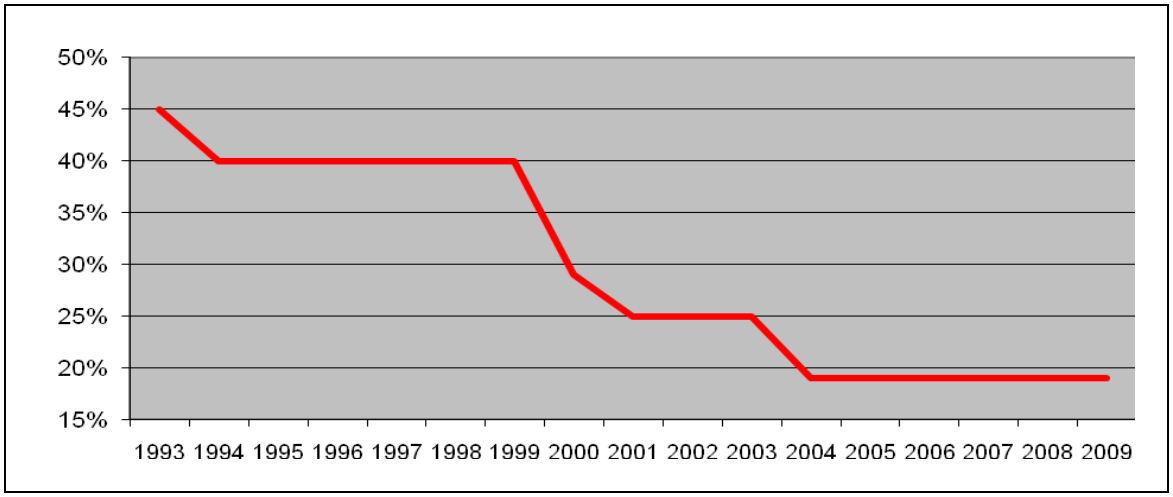
through tax policy instruments. The "millionaire income tax" should affect approximately 90,000 people, i.e. approximately 4-5% of employed persons.

In 2008, an employment bonus - a negative tax for employees with low income (from half the minimum wage up to a net income at the level of the tax-free personal allowance) - has been introduced. Valid for 2009: when the gross annual income is EUR 1,773 - EUR 3,546, the employment bonus equals EUR 181.02. If the income is higher, the bonus is proportionally lower. And finally, when the gross annual income of an employee is higher than EUR 4,646 (EUR 387.16 per month), i.e. higher than personal allowance set for 2009, the employment bonus is zero. Intention of this measure was to increase employment and to improve the social situation of long-term unemployed who have a real chance to find a job only with a low wage. This should increase the motivation to work also for a lower remuneration and support those citizens who work only for some part of the taxation period.

Corporate income tax (CIT)

The corporate income tax rate has been decreased from 25% to 19% *(see Figure 23)*. A flat-rate corporate income tax was in force in the old system as well. The dividend tax (15% in the old system), perceived as a double taxation of income, has been cancelled - 2004 was the last year of paying dividend tax. Thus, Slovakia had one of the lowest composite taxation of capital income faced by a private investor (combined statutory corporate income tax rate and dividend tax rate) in the EU and OECD countries *(see Figure 24)*. After cancelling the tax on dividends in Slovakia, the composite taxation of capital income has been significantly dropped from 36.3% in 2003 to 19% in 2004, which is logically equal to the statutory corporate income tax rate.[16]

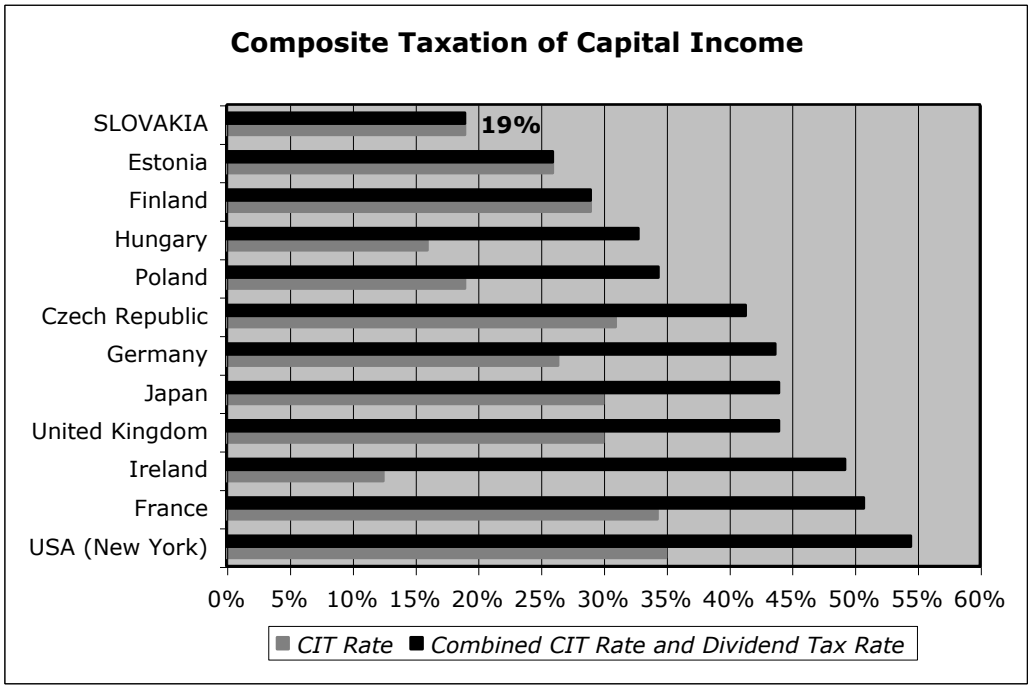
Figure 23: **Corporate Income Tax Rates in Slovakia** *(in %)*



Data: 1993: 45%; 1994: 40%; 2000: 29%; 2001: 25%; 2004: 19%
Source: INEKO

[16] *Krajčír and Ódor 2005*

Figure 24: **Composite Taxation of Capital Income in Selected Countries** *(in %)*



Source: Ministry of Finance of the Slovak Republic; KPMG (2004)

The tax reform has improved the overall incentives for business investment in several respects. IMF (2005) notes, that besides the low CIT rate, the liberalised treatment of loss carry-forwards assists businesses. Losses can now be deducted from taxable income over the following 5 years and annual write-off instalments are no longer required to be equal. The previous treatment of losses had detracted significantly from the competitiveness of the CIT law. Private accountants in Slovakia informed in 2003 that their clients were more concerned about their inability to write off legitimate losses, than whether the CIT rate was 15 or 25%. Including the inability to write off advertising expenses and limits on the tax deductibility of vehicle depreciation, some clients faced effective tax rates of 35% or more (in some cases reaching 80%), despite the statutory CIT rate of 25%. The new CIT law remedied this problem. According to "microeconomic" calculations of the German research institute ZEW (Jacobs et al. 2004), the combination of the cut in the statutory corporate income tax rate, liberalised treatment of loss carry-forwards and increased depreciation allowances reduced the average effective tax rate on investment[17] in Slovakia *(see Table 12)* to internationally low levels *(see Figure 25)*. This was supposed to provide more incentives for investment, including FDI, and to entrepreneurial activity in general. First positive sign was that the number of profit making companies as well as the total amount of legal entities have been raised.

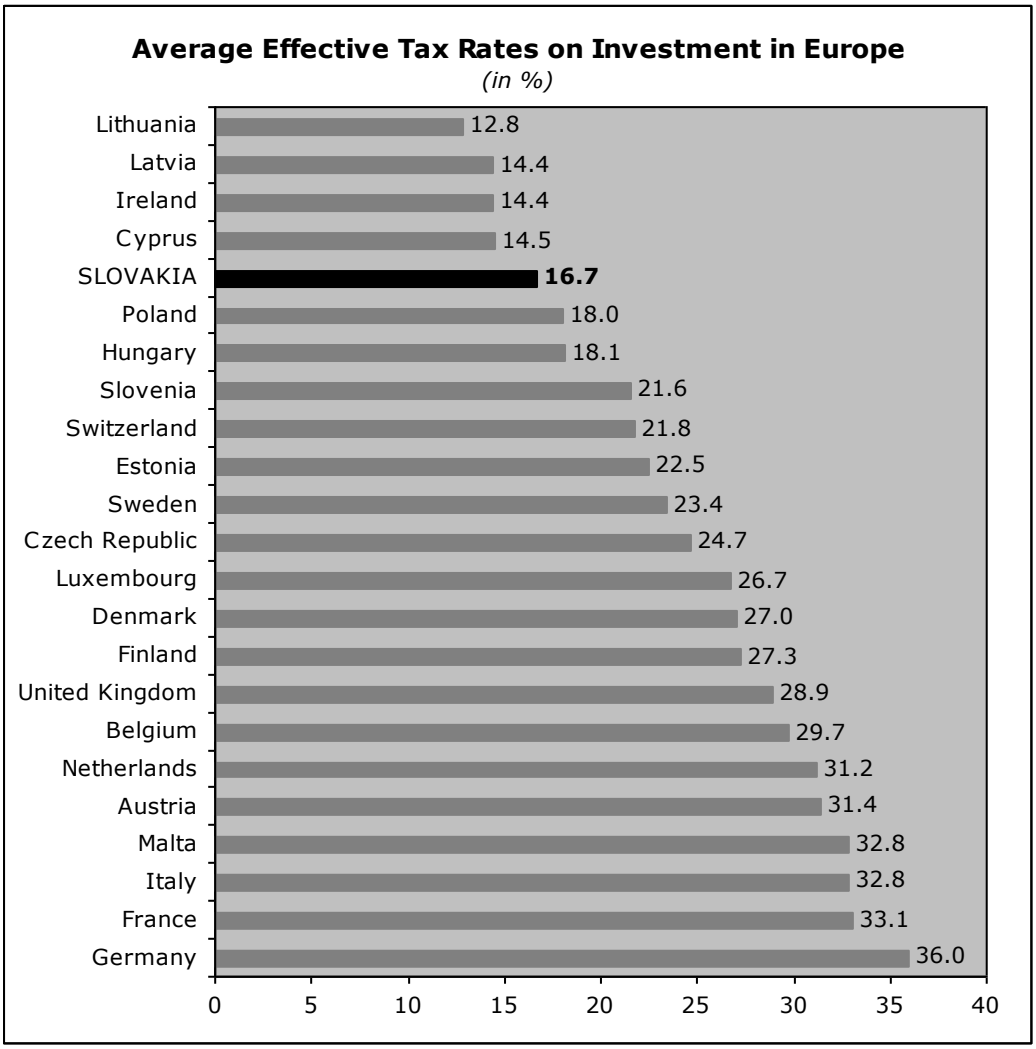
[17] *The average effective tax rate measures the effective corporate tax burden on profitable investments. The lower this rate, the more attractive is (ceteris paribus) the country as a location for international companies.*

Table 12: **Average Effective Tax Rates on Investment at Corporate Level in Slovakia before and after the Tax Reform** *(in %)*

(in %)	**2003** *(before reform)*	**2004** *(after reform)*
Overall Average	***22.1***	***16.7***
Average for Each Source of Financing		
Retained Profits	25.0	18.9
New Equity	25.0	18.9
Debt	16.3	12.3
Average for Each Asset		
Buildings	21.3	15.5
Intangibles	20.5	15.6
Machinery	20.9	15.9
Financial Assets	24.6	18.7
Inventories	23.3	17.7

Source: Jacobs et al. (2003, 2004), ZEW

Figure 25: **Average Effective Income Tax Burden of Companies in Europe** *(in %)*



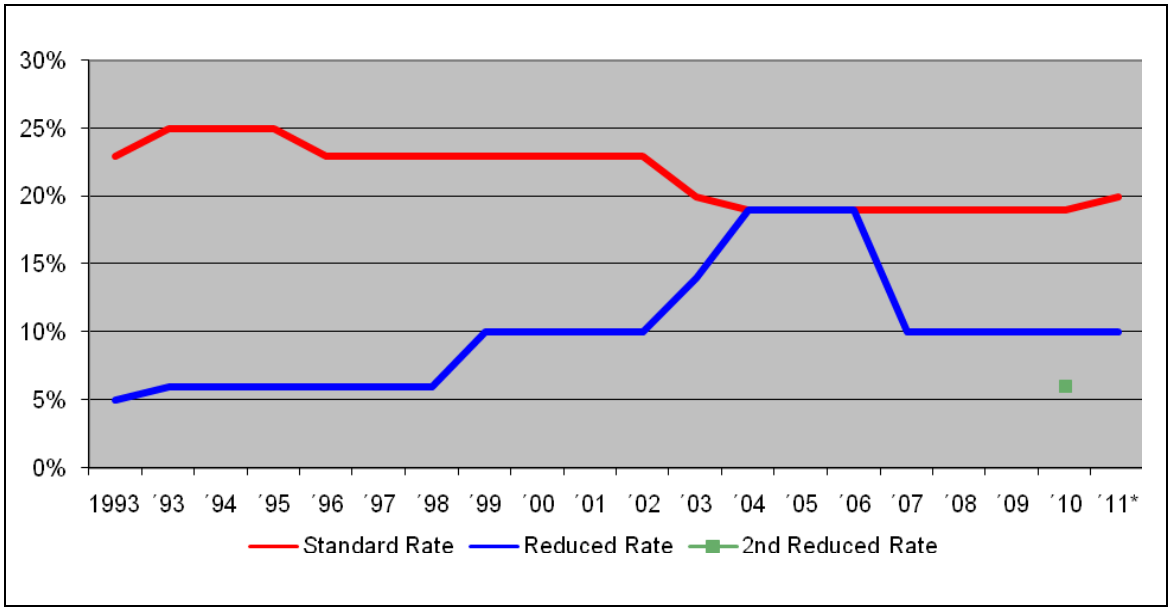
Note: 2004 data - 10 new EU Member States, 2003 data - other countries
Source: Jacobs et al. (2004), ZEW

Pushing through tax fairness and simplicity the reform has also abolished majority of exemptions, tax relieves, special tax bases and rates. For instance, lump sum tax for small-businesses has been abolished and replaced by lump-sum expenses of 25% of total revenues (60% for craftsmen)[18]. As the IMF (2005) notes, tax base reductions for certain sectors, such as agriculture and forestry, have been cancelled; and investment incentives have also been scaled back: the reform cancelled legislation providing for tax holidays (of up to 10 years) for newly established firms. However, the Government may still individually grant investment incentives, in compliance with the EU law on state aid.

Value Added Tax (VAT)

In the old system there were two VAT rates: standard rate of 20% and reduced rate of 14%. Tax reform unified both and introduced a single VAT rate of 19% *(see Figure 26)*. This was politically and socially the most difficult reform decision, as it directly conveyed into higher prices of goods and services taxed formerly at a reduced rate. These included, for example, basic food, medicaments, electricity, coal, construction works, books, newspapers, magazines or hotel and restaurant services. The unification intended to reduce speculation aimed at paying tax at a lower rate. Another argument proposed by the Ministry of Finance was that keeping the reduced rate the state is endowing everybody and not only those who really need it. Furthermore, higher taxation was aimed at assuring fiscal viability of the reform as it compensated for the expected loss of direct tax revenues. The Parliament approved the amendment to the VAT Act as a first tax reform measure. Timely approval of this unpopular measure was a key precondition for success of the whole reform.

Figure 26: **Value Added Tax Rates in Slovakia** *(in %)*



Data: 1993 (January): standard rate 23%, reduced rate: 5%; 1993 (August): standard rate 25%, reduced rate: 6%; 1999: reduced rate: 10%; 2003: standard rate 20%, reduced rate 14%; 2004: one unified rate 19%; 2007: standard rate 19%, reduced rate: 10% (for medicaments; as of 2008 for

[18] *Now, the lump-sum expenses equal 40% and 60% for craftsmen. As of January 2011, unification for both groups at the level of 40% is planned.*

books, too); 2010: second reduced rate: 6% (for the sale by farmers directly on farms); 2011(forecasted): standard rate 20%, reduced rate: 10% (for medicaments and books)*
**Note: As of January 2011, the current Government proposes temporally (until the public finance deficit will amount 3% of GDP; the revised 2009 deficit was 8%) to increase the standard VAT rate to 20%.*
Source: INEKO

Excise Taxes

The tax reform included an increase in the excise tax rates on mineral oils, tobacco, and tobacco products, spirits and beer. These changes were basically on demand and in compliance with the EU regulations. However, as a consequence of shifting the tax burden onto the consumption, the new rates exceeded the minimum required by the EU in all cases with the exception of tobacco products, where Slovakia negotiated a transition period until December 31, 2008.

Table 13: **Excise Tax Rates on Selected Products before and after the Tax Reform**

	Before Reform (Jan. 2003)	After Reform (Aug. 2003)	*Percent Change*	Minimum EU Rate *
Beer – big breweries *(SKK/hl/degree Plato)*	30	50	*66.7 %*	32.4
Beer - small breweries *(SKK/hl/degree Pato)*	23	37	*60.9 %*	9
Still wine *(SKK/l)*	0	0	*0.0 %*	0
Sparkling wine *(SKK/l)*	24	24	*0.0 %*	0
Unleaded petrol *(SKK/l)*	12.4	15.5	*25.0 %*	11.81
Leaded petrol *(SKK/l)*	14.5	18.0	*24.1 %*	13.87
Kerosene *(SKK/l)*	11.8	14.5	*22.9 %*	10.08
Motor oil *(SKK/l)*	11.8	14.5	*22.9 %*	10.08
Heating oil *(SKK/kg)*	0.6	0.8	*33.3 %*	0.53
LPG *(SKK/kg)*	4.3	7.8	*81.4 %*	4.12
Spirit *(SKK/l)*	250	250	*0.0 %*	226
Cigarettes - short *(SKK/pcs)*	0.95	1.4	*47.4 %*	1.5
Cigarettes - long *(SKK/pcs)*	0.95	1.4	*47.4 %*	1.5

** at the exchange rate of EUR 1 = SKK 41.16*
Source: INEKO; Ministry of Finance of the SR

Other Taxes

Due to the tax reform, gift tax and inheritance tax have been abolished. Real estate transfer tax was cut from 6% to 3% and later, with effect from January 2005, abolished. All these taxes presented multiple taxation of the property. Another reason for their abolition was the especially low revenue they generated (gift tax accounted for 0.08%; inheritance tax for 0.04%; and real estate transfer tax for 1.21% of total tax revenue in 2003).

Shortly after the tax reform, the Slovak Government approved the fiscal decentralisation which included transfer of 70.3% of total personal income tax revenues to municipalities, and 23.5% to eight regional self-governments. To the central government go the remaining 6.2%. The fiscal decentralisation included significant changes in the structure of local taxes concerning real estate tax, road tax and local fees. In principle, the fiscal decentralisation

significantly strengthened the fiscal competences of municipalities, especially in the field of local taxes. As the IMF (2005) notes, the fiscal decentralisation has defined 12 local taxes and one local fee which municipalities are free to set themselves. Thus, central-government ceilings no longer apply to these taxes.

Fiscal Implications

When deciding about the final tax rates, the Government's goal was to ensure a fiscally neutral outcome in the first year after the reform. To keep the same tax revenues, the reduction of direct taxes required higher indirect taxation *(see Tables 14 and 15)*.

Choosing 19% rates, the Government took more conservative estimate in order not to underestimate the revenues. The outcome was hardly predictable, as the major changes in taxation evoke new behavioural patterns of individuals and firms. Lowering taxes usually means lower tax revenues; however, as long as it brings more people to work, the effect may be exactly opposite. Data for 2004 showed only a modest overall impact on total tax revenues following the tax reform. The 2004 tax revenues exceeded Government´s plans *(see Table 15)*. Especially the direct tax revenues were higher than plans, although the tax rates decreased substantially. However, this optimistic development cannot be attributed solely to the tax reform. Among other reasons these have played the crucial role:

1. Direct taxes paid in 2004 were counted out of the tax bases from the previous year. Hence, higher revenues in 2004 resulted to a large extent from high tax bases in 2003.
2. All firms and self-employed individuals paid the old tax rates until the end of March 2004, which is also the deadline for submitting the tax declaration. Thus, a large part of direct taxes in 2004 were paid under the old rates.
3. Better than expected development of economy - higher economic growth transferred to higher wages and consumption, and higher tax revenues in 2004.

Regarding the sharp decrease in the WIT revenues, following factors need to be taken into account (IMF, 2005):

1. Some proportion of former WIT revenues may have been diverted to CIT collections: firms may now be reporting as profits, income previously taxed at a lower rate as capital income.
2. Companies may have retained earnings in 2004 rather than paying out dividends, to avoid the final year of dividend tax.

Table 14: **Fiscal Impacts of the Tax Reform** *(ESA 95; in % of GDP)*

	2003 *(before reform)*	**2004** *(after reform)*	**2005** *(after reform)*
Total tax revenues	**18.8**	**18.0**	**18.2**
Direct taxes *(PIT & CIT & WIT)*	**6.7**	**5.7**	**5.6**
PIT	3.2	2.7	2.6
CIT	2.8	2.6	2.7
WIT (incl. dividend tax)	0.7	0.4	0.3
Indirect taxes *(VAT & Excise taxes)*	**10.6**	**11.1**	**11.6**
VAT	7.5	7.8	7.9
Excise taxes	3.1	3.3	3.7

Source: Ministry of Finance of the Slovak Republic

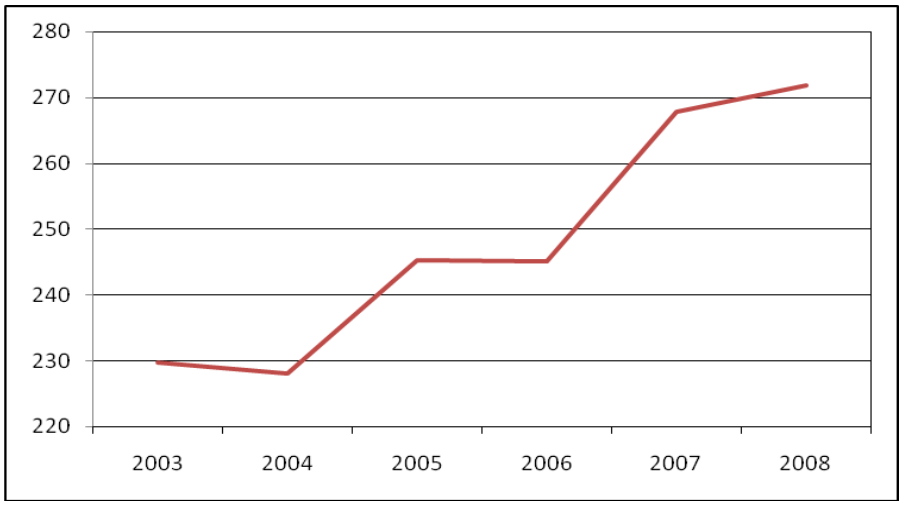
Table 15: **Tax Revenues before and after the Tax Reform** *(ESA 95, on accrual basis, nominal; in SKK billion)*

	2003 *(before reform)*		2004 *(after reform)*				2005 *(after reform)*	
	Reality	*Share on total*	*Plan*	*Share on total*	*Reality*	*Share on total*	*Reality*	*Share on total*
Total tax revenues	**229.8**	**100.0%**	***232.0***	***100.0%***	**245.2**	**100.0%**	**270.8**	**100%**
Direct taxes *(PIT & CIT & WIT)*	**82.1**	**35.7%**	***62.2***	***26.8%***	**77.4**	**31.6%**	**83.6**	**30.9%**
PIT	39.3	17.1%	*27.1*	*11.7%*	36.4	14.8%	39.2	14.5%
CIT	33.7	14.7%	*23.7*	*10.2%*	35.3	14.4%	40.5	15.0%
WIT*	9.1	4.0%	*11.4*	*4.9%*	5.7	2.3%	3.9	1.4%
Indirect taxes *(VAT & Excise tax)*	**129.5**	**56.4%**	***157.0***	***67.7%***	**150.8**	**61.5%**	**171.2**	**63.2%**
VAT	91.3	39.7%	*113.8*	*49.1%*	105.7	43.1%	116.9	43.2%
Excise taxes	38.2	16.6%	*43.2*	*18.6%*	45.2	18.4%	54.4	20.1%

** includes dividend tax revenues*
Source: Ministry of Finance of the Slovak Republic; INEKO calculations

In real terms, i.e. adjusted for inflation, we can say that with a fractional exception of 2004 higher tax collection with a growing trend in years after the tax reform was reality *(see Figure 27 and Table 16).*

Figure 27: **Real Tax Revenues** *(in SKK billion)*



Note: reference year = 2003
Source: Ministry of Finance of the Slovak Republic; INEKO calculations

Table 16: **Real Tax Revenues Growth after the Tax Reform, in Comparison with the Reference Year 2003** *(in %)*

2004	2005	2006	2007	2008
-0.8	6.7	6.6	16.5	18.3

Note: reference year = 2003
Source: Ministry of Finance of the Slovak Republic; INEKO calculations

Macroeconomic Implications

As mentioned before, better than expected macroeconomic development helped the overall fiscal balance in 2004. This is partly due to the better than expected outcome of the tax reform. Particularly, the Ministry of Finance projected only 2% growth of household consumption as a consequence of higher indirect taxes. Especially increase of the lower VAT rate was supposed to convey into the rise in prices. But in fact, the household consumption went up by 4.6% in real terms. Taking also into account the final phase of price deregulation[19], the Ministry projected the average inflation rate at 8.1%. In reality, the average inflation was 7.5%. This contributed heavily to the better than expected growth of GDP and wages. It might be assumed, that the tax reform together with Slovakia's entry to the EU in May 2004 played the crucial role in fast improvement of the whole economy. Positive impacts of reforms on macroeconomic environment in Slovakia can definitively be observed in following years, as well *(see Table 17)*.

Table 17: **Selected Macroeconomic Indicators of the Slovak Economy before and after the Tax Reform** *(in %)*

	2003 *(before reform)*	2004 *(after reform)*		2005	2006	2007	2008
	Reality	*Plan*	*Reality*	*Reality*	*Reality*	*Reality*	*Reality*
Real GDP Growth	4.8	4.1	5.0	6.7	8.5	10.6	6.2
Average Nominal Wage Growth	6.3	7.9	10.2	9.2	8.6	7.4	8.1
Average Real Wage Growth	-2.1	-0.6	2.4	6.3	3.9	4.5	3.3
Household Consumption Growth *(in constant prices)*	1.7	2.0	4.6	6.5	5.9	6.9	6.0
Inflation (CPI)	8.5	8.1	7.5	2.7	4.5	2.8	4.6

Sources: Statistical Office of the SR; Ministry of Finance of the SR

Income Distribution Effects

Many analysts say that the Slovak tax reform did not introduce a pure flat tax, i.e., a proportional tax, but a flat-rate tax which retains the progressivity (i.e. solidarity) of income taxation. Thus, average personal income tax rates rise with income. The World Bank (2005) states that the Slovak personal income tax system was slightly progressive before the tax reform and has become slightly more progressive after 2004, despite the introduction of a single flat tax rate. The increased progressivity was due to a combined effect of the introduction of the deductible or payable child tax bonus (allows a negative tax) and of the increase in the value and the change in the structure of deductible items (e.g. higher tax-free personal allowance and non-working spouse allowance), which more than compensated for the reduction in progressivity associated with the move from a graduated tax-rate structure to a single tax rate.

Table 18 shows the impact of the personal income tax reform on the tax burden for different income deciles. It is evident that in 2004 the PIT burden was reduced for everybody (except a very small range of income), particularly for households on lower incomes. This confirms the conclusion that the poorest households benefited most from changes in income taxation.

[19] *With effect from January 2004, the formerly state-regulated prices of several goods went up, among them mainly the price of electricity, gas, water, and public transport. This has had the major effect on inflation.*

According to the simulations of the World Bank (2005), the change in the personal income tax structure, ceteris paribus, reduced the tax burden on households on average by 37% (comparison between 2002 and 2004).

Table 19 also confirms the statement that the reformed personal income tax system is more solidary and socially fair than the previous one because the bottom half of all employees have participated with only 4% on total PIT revenues after the tax reform, in comparison with 13% before the reform.

Table 18: **Personal Income Tax Paid before and after the Tax Reform**
(in % of household gross income)

Income Deciles	**2003** *(before reform)*	**2004** *(after reform)*	***Percent Change***
1	0.38	0.13	***-65.8 %***
2	0.87	0.27	***-69.0 %***
3	1.62	0.58	***-64.2 %***
4	3.11	1.45	***-53.4 %***
5	3.53	2.89	***-18.1 %***
6	3.88	2.98	***-23.2 %***
7	4.27	3.77	***-11.7 %***
8	4.54	4.62	***+1.8 %***
9	5.16	4.79	***-7.2 %***
10	6.67	6.17	***-7.5 %***
Average	***3.40***	***2.77***	***-18.7%***

Source: Ministry of Finance of the SR (data from Family Accounts Statistics); INEKO calculations

Table 19: **Share on Total PIT Revenues by Bottom Income Brackets** *(employees; in %)*

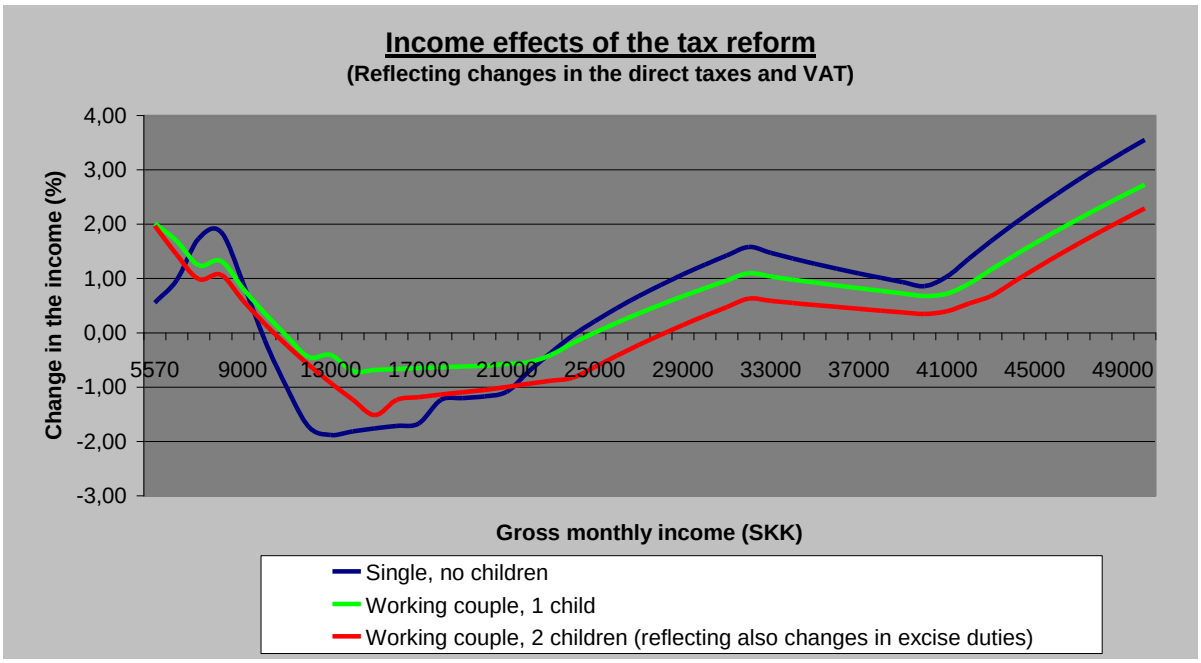
Bottom	**2001 – 2003** *(before reform)*	**2004 – 2006** *(after reform)*
10%	0.5%	-2.0%
20%	2.0%	-3.5%
30%	5.0%	-3.0%
40%	8.0%	-0.5%
50%	13.0%	4.0%
60%	17.0%	9.5%

Source: richardsulik.blog.sme.sk, January 16, 2008

However, before making conclusions on the full distributional impact of the whole tax reform, it is important to analyse the impacts of other than income taxes as well. Goliaš and Kičina (2005) state that the introduction of a single flat PIT rate eased people with high income. Higher tax deductibles eased mainly people with low income. The unification of VAT and rise in excise taxes burdened everybody almost equally, depending on the individual structure of consumption. As a result, according to Goliaš and Kičina (2005), low- and high-income brackets were better-off after the reform; middle-income brackets were worse-off. Generally, all people with monthly income of SKK 10,000 to SKK 23,000 were immediate losers *(see Figure 28)*. With the average wage of SKK 15,825 in 2004, the majority of population fell within losers. However, Goliaš and Kičina (2005) note that the after-tax income loss was

relatively mild, with a maximum of 2 % of net income for medium-income singles without children. Families with children had lower losses thanks to the new child tax bonus.

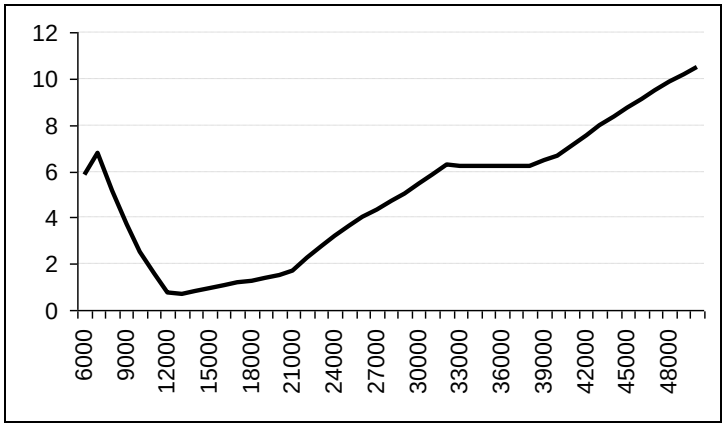
Figure 28: **Income Distribution Effects of the Tax Reform on Selected Types of Taxpayers** *(% changes in after-tax income)*



Source: INEKO and BAS

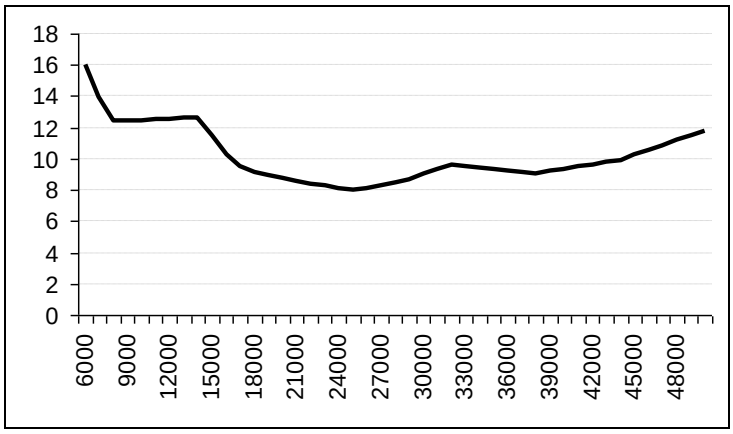
However, it should be noted that the above *Figure 28* represents only a static impact model (immediate changes) and does not reflect dynamic economic effects such as higher economic activity surging the GDP growth, higher wages and employment in the short and long run. The Ministry of Finance analysed various income typologies even with respect to dynamic changes (e.g., real wage growth, real GDP growth) and concluded that all income categories have benefited from the tax reform even in the short run *(see Figures 29 and 30).* The positive effects should be much more evident after a longer period of time. Nevertheless, the Ministry of Finance did not exclude the possibility that in isolated cases some immediate losers of the tax reform may occur.

Figure 29: **Real Net Income Growth – Single Taxpayer, in 2004** *(in %)*



Source: Krajčír and Ódor (2005), Ministry of Finance of the SR

Figure 30: **Real Net Income Growth – Married Taxpayer, Non-working Spouse, and 2 Children, in 2004** *(in %)*



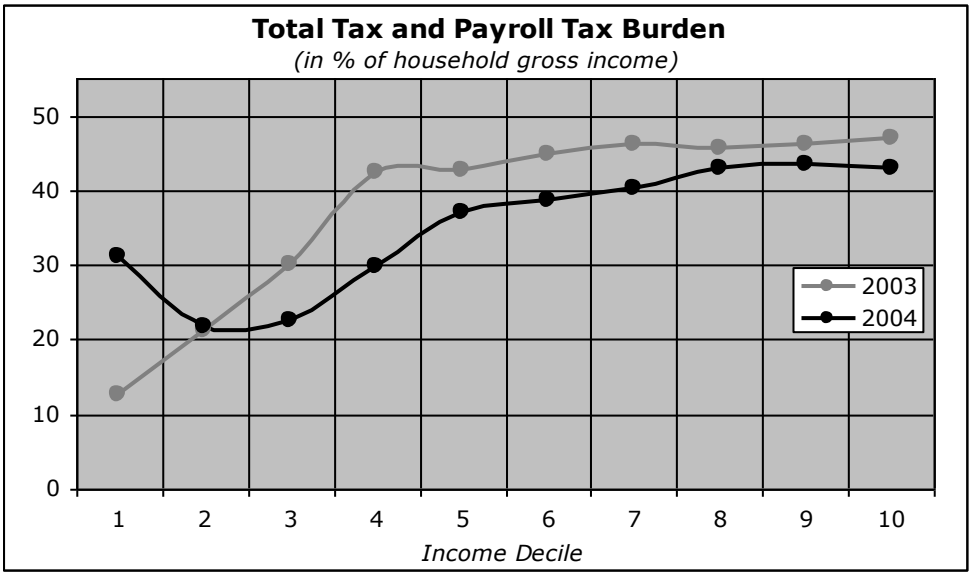
Source: Krajčír and Ódor (2005), Ministry of Finance of the SR

Of course, the tax reform has caused some income distribution effects, but the welfare reform has had a much larger impact on income distribution. It is in accordance with the objective not to use the tax policy as an instrument for achieving non-fiscal goals (e.g., social policy goals). Almost all tax deductions and exemptions that were originally intended to achieve non-fiscal policy goals were replaced by targeted measures in the relevant policy areas, which should ensure a fairer and more efficient distribution of income. The welfare reform, in particular the cuts in social assistance benefits have lowered the degree of redistribution, what was mainly in disfavour of long-term and inactive unemployed.

Changes in Payroll Tax System

Figure 31 shows that the overall tax and payroll tax burden of households decreased after the reform. The Slovak Ministry of Finance stated that the lower total tax and payroll tax burden in 2004, when compared with 2003, was due to the fall in income tax and payroll tax burdens which more than compensated the increased VAT and excise tax burdens. *Figure 31* also illustrates that the progressivity has retained.

Figure 31: **Distribution of the Total Tax and Payroll Tax Burden across Household Income Deciles in 2003 and 2004** *(in % of household gross income)*

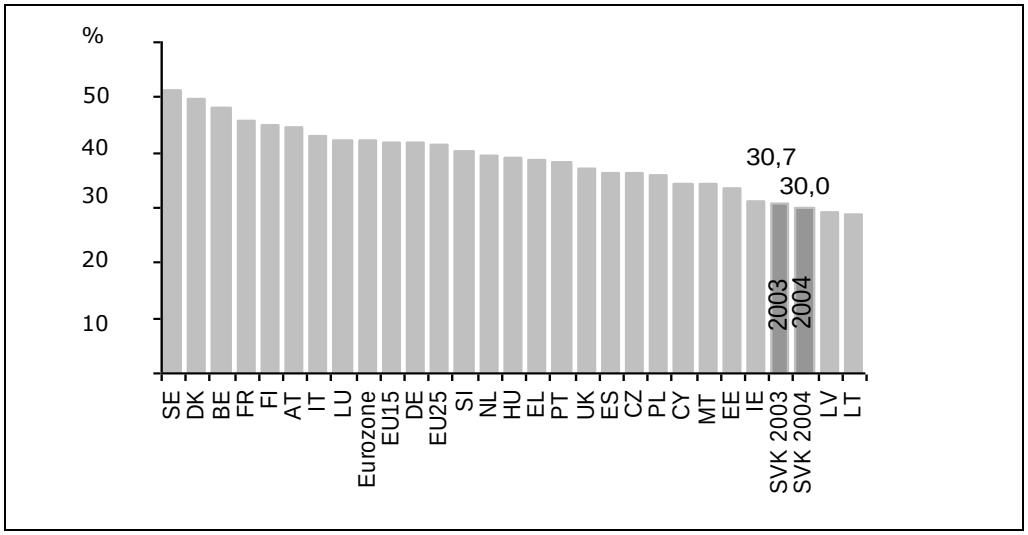


Notes: First three income deciles contain mostly households of old-age pensioners which do not pay any income taxes and social contributions, i.e. were not affected by PIT burden decrease but were negatively affected mainly by VAT burden increase. The gross income does not include social benefits which usually receive bottom income deciles.
Source: Ministry of Finance of the SR; household spending data

The overall tax and payroll tax burden can also be seen from the macroeconomic point of view, as a share of taxes and payroll taxes of GDP. It allows an international comparison. Slovakia had one of the lowest total tax and payroll-tax burden in the EU *(see Figure 32)*. After reforms, social contributions as a percentage of GDP have fallen under the EU average *see Figure 33)*. However, the payroll-tax contributions measured as a percentage of gross labour income belong among the highest in the EU *(see Table 20)*. Among OECD members, Slovakia has the 4th highest burden of all compulsory social contributions on labour costs *(see Figure 34)*.[20]

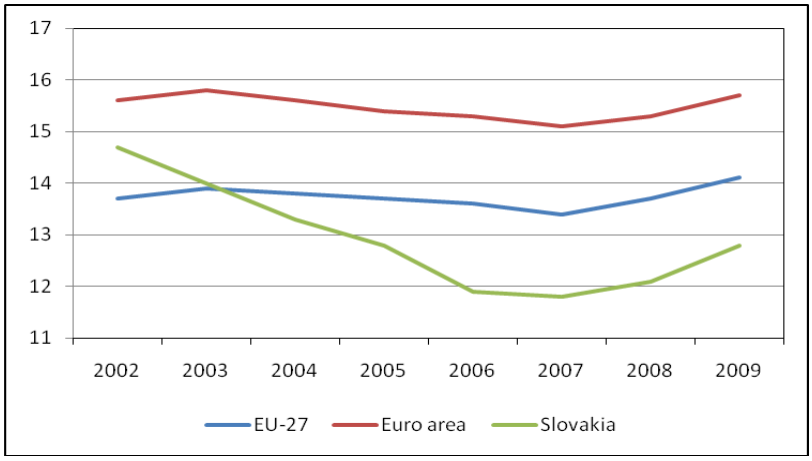
[20] *Top 3 countries are France, Hungary, and Austria.*

Figure 32: **Total Tax and Payroll Tax Burden in EU Countries in 2003** *(ESA 95; in % of GDP)*



Sources: Ministry of Finance of the SR; Eurostat

Figure 33: **Social Contributions** *(in % of GDP)*



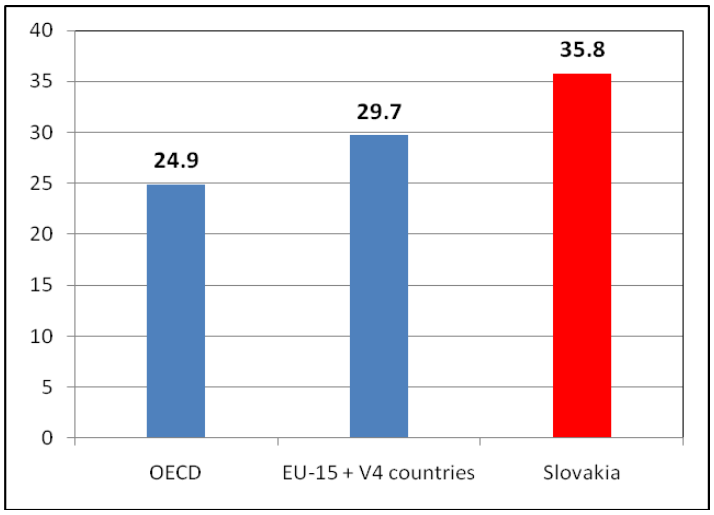
Source: Eurostat

Table 20: **Social Contribution Rates in Visegrad Countries** *(2003; in % of gross wage)*

	Employee	Employer	Total
Slovakia (2003)	12.8	38.2	51.0
Slovakia (2004)	13.4	35.2	48.6
Czech Republic	12.5	35.0	47.5
Hungary	12.5	32.0	44.5
Poland	25.0	20.4	45.4
EU-15 Average	12.5	24.1	36.6

Sources: Ministry of Finance of the SR; OECD (2005)

Figure 34: **Average Social Contributions Wedge** (incl. compulsory contributions to privately-managed fully funded pension scheme (i.e. second pillar) *(in 2009, single average worker without children; in % of total labour costs)*



Source: Taxing Wages 2008-2009, OECD, 2010; INEKO calculations

Effective from 2004, Slovakia substantially changed its payroll-tax system. Nominally the rates decreased just slightly but their character shifted heavily. Formerly, almost all benefits based on payroll-tax contributions were distributed equally or with only small regard on the amount of paid contributions. This is typical for taxes. Because people do not see the link between their payment and future benefits, they usually tend to avoid paying such kind of contributions. After the reform, mainly the pension contributions constituting almost half of payroll-taxes started to reflect the payment-benefit link much closely *(see Table 21)*. The reform also raised the ceilings for paying the social contributions from fixed SKK 32,000 monthly to 3-times the average monthly wage in the economy (SKK 43,095 since July 2004).

Table 21: **Payroll Tax Burden** *(employee's plus employer's contributions as % of the gross wage)*

	2003 *(before reform)*	**2005** *(after reform)*	***Change***	**Character**
Pensions	28 (tax)	28.75	*+0.75*	
- old-age*	-	19	-	insurance/saving
- disability	-	6	-	insurance
- reserve fund	-	4.75	-	tax
Health	14	14	*0*	tax
Sickness	4.8	2.8	*-2.0*	insurance
Unemployment	3.75	2.0	*-1.75*	insurance
Guarantee**	0.25	0.25	*0*	insurance
Accident***	0.2 - 1.2	0.3 - 2.1	*+0.1 to + 0.9*	insurance
Total payroll taxes	**51% - 52%**	**48.1 - 49.9**	***-2.9 to -2.1***	

** Old-age insurance rates had been reduced by 0.5% for every nourished child for one of parents. This regulation is not in force anymore.*
*** Guarantee insurance serves for covering unpaid wages for employees of insolvent firms.*
**** Actual percentage depends on a job risk grade.*
Source: INEKO

Foreign Direct Investment (FDI)

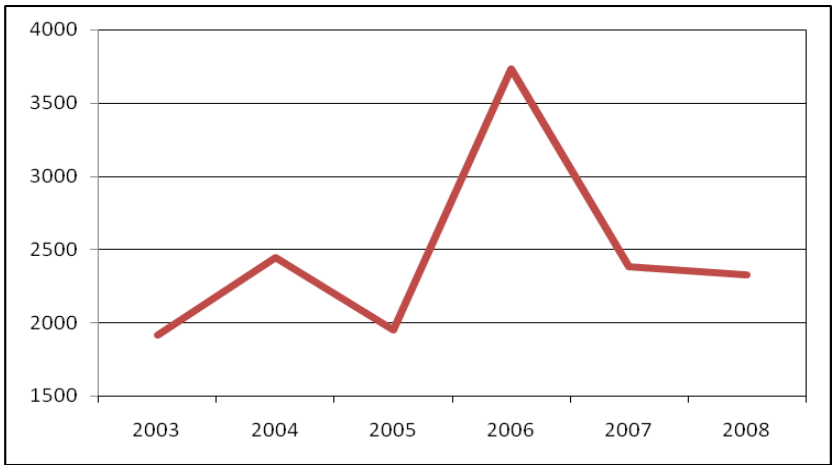
After the tax reform, the Slovak Investment and Trade Development Agency (SARIO) reported an increased interest of foreign investors to operate their businesses in Slovakia. In 2004, the Agency contracted EUR 1.7 billion foreign direct investment what was a 47% increase on a yearly basis. In terms of new jobs projected the increase was even higher – 69%. In 2005, the surge of foreign investment inflow continued *(see Table 22)*. In 2006, there was the highest FDI inflow of the period after introducing the tax reform *(see Figure 35)*.

Table 22: **Foreign Direct Investment in Slovakia**

	2002	**2003**	**2004**	**2005** (Est.)
Number of projects signed	25	22	47	40
FDI contracted *(in EUR million)*	311	1,164	1,707	1,951 – 2,073
Number of new jobs projected	5,400	7,970	13,500	20,000

Source: SARIO

Figure 35: **FDI Inflow in Slovakia** *(in EUR million)*



Source: The Vienna Institute for International Economic Studies (wiiw)

The SARIO Agency claimed the suitable business environment and the tax system among the most important factors referred by investors when choosing Slovakia. According to SARIO, they especially welcomed the lower CIT and the abolished tax on dividends. However, in the opinion survey provided by SARIO, the investors preferred locations with proper infrastructure as the most important factor when deciding about where to invest, followed by cheap and qualified workforce, and generous state aid (investment incentives) *(see Table 23)*.

Table 23: **Ranking of the Most Important Factors of Decision to Invest in Slovakia, named by Foreign Investors**

1.	Locality (utilities network, transport infrastructure)
2.	Workforce (cost, structure)
3.	State aid (investment incentives)
4.	Business environment (taxes, payroll taxes, Labour Code)
5.	Geography (distance to customers)

Source: SARIO, 2005

International Reactions

Slovakia was the 7th country in Europe introducing the flat tax on personal income and the 1st OECD country introducing a single tax rate on all personal and corporate income. Soon after, two other countries joined the club: Georgia and Romania going down to 12% and 16% respectively *(see Table 24)*. Flat-tax proposals were also debated in Czech and Poland´s election campaigns. According to the Wall Street Journal (2005), Bulgaria, Croatia and Hungary also prepared tax reforms in favour of simpler, lower and flatter taxes.

Table 24: **European Countries with Income Flat-tax Regimes**

	Estonia	Lithuania	Latvia	Russia	Serbia	Ukraine	Slovakia	Georgia	Romania
	1994	1994	1995	2001	2003	2004	2004	2005	2005
PIT	26%	33%	25%	13%	14%	13%	19%	12%	16%
CIT	26%	15%	15%	24%	14%	25%	19%	20%	16%

Notes: Estonia ratified legislation to lower its flat rate from 26% to 24% in 2005 and 20% by 2007. Furthermore, Estonia introduced 0% tax rate on re-invested corporate profits. Latvia lowered its corporate tax from 19% in 2003 to 15% in 2004. Lithuania planned to reduce the PIT rate from 33% to 24%. Russia introduced its CIT rate of 24% with effect from 2002.

Sources: Grecu (2004); The Economist (2005); The Wall Street Journal (2005); INEKO

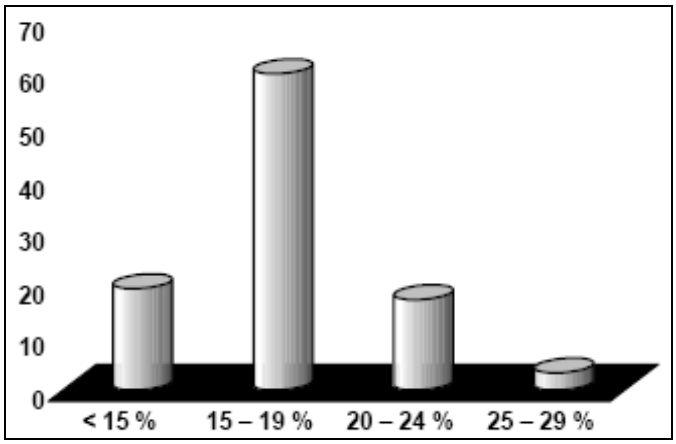
After reducing corporate income tax and cancelling dividend tax, the Slovak tax system became one of the most attractive for foreign investors and residents within the OECD. Most of foreign managers of Slovak subsidiaries and affiliates of international banks and enterprises started to pay taxes in Slovakia. The reform evoked fierce tax competition among Central-European countries spreading further to the west. Austria reacted swiftly by reducing its corporate tax rate from 34% to 25% from 2005 even though it intended to go down "only" to 31% originally. In 2004, the Czech Republic decreased its upper VAT rate from 22% to 19% and its corporate taxes were falling from 28% to 24% in 2006. In 2005, the Czech Parliament approved reduction in the bottom personal income tax rate from 15% to 12%. Hungary reduced its corporate tax rate from 18% to 16% and Poland from 27% to 19%.

Western democracies with much higher corporate taxation (Germany 38.3%, France 34.3%, Netherlands 34.5%, Italy 37%, and UK 30%) blamed Slovakia for "tax dumping" and called for "tax harmonisation" within the EU. They pointed out, that new EU members are able to lower taxes only thanks to the massive EU regional aid received from richer EU countries.

Political Considerations

Based on February 2003 poll of opinion ordered by the Slovak Ministry of Finance, three quarters of respondents considered the tax reform necessary. Among the main reasons people mentioned high complexity of the pre-reform legislation, high tax rates, and high administrative complexity of the tax system. Majority was willing to accept 15% tax rate on income, only one fifth was willing to accept a higher rate (similar results was given by an opinion survey among Slovak managers *(see Figure36))*. Asked to judge the fairness of taxation, only 21.6% of people preferred flat tax and 70.9% preferred progressive taxation. Respondents generally agreed that the taxes should be low in order to support business and employment, and to reduce tax evasion.

Figure 36: **Maximum Corporate Income Tax Rate at which Companies in Slovakia Would Start Declaring Higher Profits because the "Tax Optimisation" Would No Longer Be Attractive** *(in % of respondents´ answers)*



Source: Business Environment Report – Slovak Republic 2002, BAS, 2002

Advocating the reform proposal, the Ministry of Finance of the SR claimed that lower direct taxes support the investment in the middle and the long run, attract foreign investors, and improve production potential of the economy. Together with milder progressiveness they were supposed to better motivate people to work and to bring positive effects on economic growth and employment. On the other hand some opposition parties, trade unions and the President of the SR criticised negative short-term effects on income mainly for the middle class, the "injustice" of weak progressiveness, the need for more solidarity, the need to use taxes as a tool for social policy, and the threat that the tax reform will deepen social imbalances. Although the then main opposition party SMER-Social Democracy proclaimed, that it will in some parts significantly change the reformed tax system towards pre-reform status, only few changes were made after SMER-SD became the ruling party in mid-2006. Dividend tax and gift tax have not been renewed, the standard VAT rate has not been decreased, the newly introduced reduced VAT rate is applicable only for minor items, and the progressiveness in the income taxation has been only slightly raised by introduction of the employment bonus (i.e. a negative tax for low-income employees) and the so-called millionaire income tax (i.e. a gradual decrease of the basic personal tax-free allowance).

Key preconditions for successful reform were good timing (unpopular first, i.e. approving of the VAT rates unification), compensation for low income people (i.e. increase in the basic personal allowance deductible from the tax base; introduction of re-payable child bonuses in case of low or negative taxes; etc.), and gaining support from key target groups:

1. Entrepreneurs – communication, positive impacts of the reduction of corporate income tax, and abolishment of dividend tax.
2. Bank analysts and NGOs – involvement in the reform process (joint organisation of seminars and conferences, inviting to calculate the fiscal impacts of the reform).
3. Journalists and public – transparency, special web page, inviting foreign experts advocating the flat tax, positive reform evaluation by international organisations.

Conclusion

Slovakia introduced deep structural economic and social reforms in a short time, mostly through 2003 and 2004. Some of them took place at the same time. Therefore, identifying the impact of individual reforms is difficult. Local experts think that the tax reform and the labour market reform had the major influence on Slovakia´s rapid economic growth. Social welfare reform helped to decrease unemployment, too.

There is one common feature of all reforms and that is an "**it-pays-off-to-work principle**". All reforms were constructed as pro-active. They improved incentives to work and not to rely on support from the state. The reformed Labour Code improved flexibility in employment relations, the tax reform brought simplicity to the tax legislation and lowered taxes on income. All this helped to improve business environment and to attract foreign investors. The results are clear – rapid economic growth, decreasing unemployment (even in long term), and rising employment.

Even after the Government change in 2006, the key reform measures remained untouched. However, in that time, mainly negative interventions have been made. Perhaps the biggest reversal has been made to the Labour Code. This resulted in a constant decline of the Business Environment Index realised by the Business Alliance of Slovakia which reflects managers' opinions.

Regarding policy implications, Jurajda and Mathernová (2004) note, that *"Slovakia's experience illustrates how a large set of best practice solutions can be implemented in a short time span by even a very small reform team. While the lack of key personnel did lead to some unnecessary losses for the pro-reform movement, the lack of human capacity was generally overcome using few key advisors with access to key Cabinet members and taking advantage of targeted foreign assistance and advice of international financial institutions."*

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