13th July 2016

Higher revenues from corporations and labour market

Latest update of tax revenues - comparison with previous forecast from February 2016

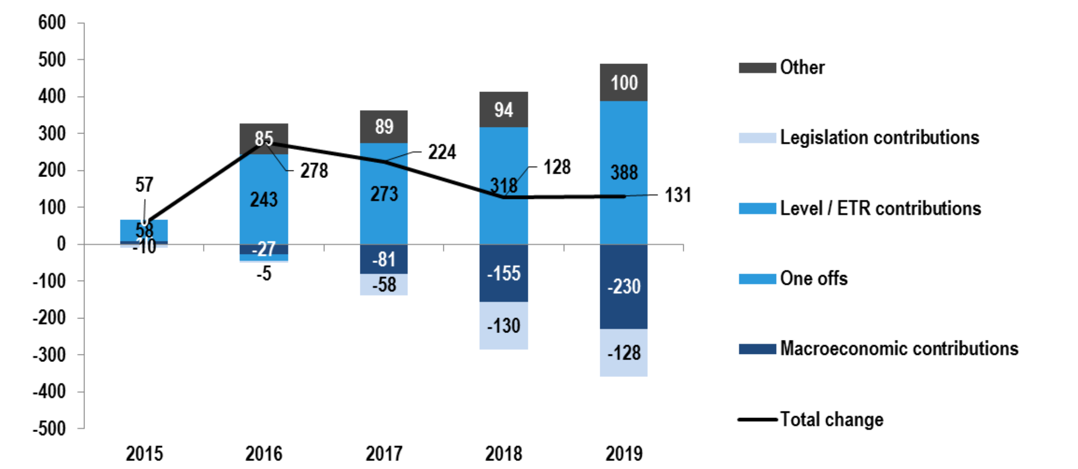
Dušan Paur

In comparison with previous forecast we expect higher accrued tax revenues[1] for 2016, by EUR 278 mil. (0.4 % GDP) due to better CIT collection and strengthening labour market. The revision has increased tax revenues by EUR 224 mil. for 2017, EUR 128 mil. for 2018 and EUR 131 mil. for 2019. Main contributions to the revision are higher effectiveness in CIT, VAT and mineral oil collection. Revision of macroeconomic fundaments and new legislative measures partly offset increase of tax revenues in 2017 to 2019. Macroeconomic impacts arising from Brexit are not covered within the actual forecast.

Ongoing increase of tax revenue forecast since June 2014

Higher effectiveness in tax collection and ongoing strengthening of the labour market[2] increased general governments revenues in first quarter of 2016. Lower expectations about growth of macroeconomic fundaments[3] than in previous forecast partly offset the tax revenue increase. Based on that assumptions **accrual tax revenues for 2016 are expected to be higher by EUR 278 mil (0.4 % GDP).** New legislative measures will negatively affect accrual revenues since 2017. Better settlements of CIT is reflected in higher tax revenues for 2015.

Figure 1: Change of GG tax revenue forecast compared to February 2016[4] (EUR million)



Source: *IFP UloziskoIFP*

Macroeconomic development partly offsets higher tax revenues

The revised macroeconomic development had a negative impact on tax revenues (Figure 2). The positive effect of stronger labour market development on tax revenues is fully offset

[1] Including social security contributions (SSC) – sum of social insurance contributions (SIC) and health insurance contributions (HIC). Taxes are categorized as follows: PIT = Personal income tax, CIT=corporate income tax,, VAT=Value added tax ,ED = excise duty, ED MO = excise duty on mineral oil

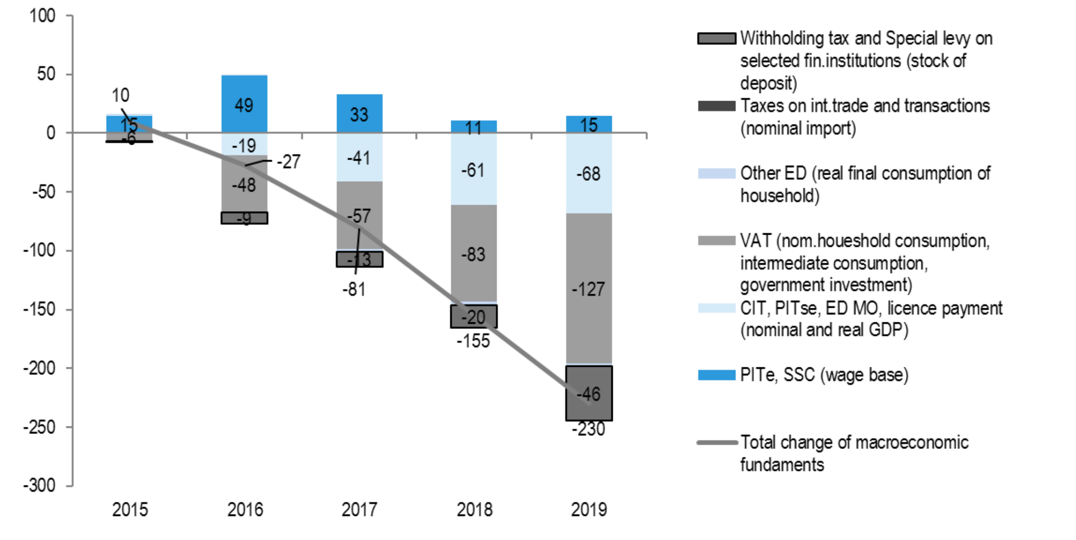
[2] PIT and SSC are growing significantly above wage base for five quarters. A more detailed explanation of this issue can be found in Box 1. Higher growth of these revenues is not a result of improved collection. We suspect that wage base is seriously underestimated. In Figure 1 we consider this discrepancy as „Other".

[3] The updated (June 2016) macroeconomic policy brief is published at IFP website.

[4] The methodology for calculation of contributions can be found in forecast evaluation methodology manual (only in Slovak)

by weak price development. Ongoing strengthening of labour market results in higher expected PIT and SSC revenues. The growth of these revenues is even higher than growth of their corresponding macro fundaments (Box 1). However, positive development of labour market only partially affects household consumption. Weaker consumption and revision of general government intermediate consumption and investments influence expected VAT revenues. Revision of nominal GDP due to lower inflation rate results in a slower growth of excise duties revenues. Historically the lowest expected interest rate drag down revenues from withholding tax. On the other hand, confirmed higher than expected growth of profitability in 2015 (9.2 % vs. 7.9 %) drag CIT revenues.

Figure 2: Macroeconomic impact on tax revenues forecast[5] (EUR mill.)



*Source: IFP, **UloziskoIFP***

BOX 1: Source of PIT and SSC revenues underestimation

Since the beginning of 2015, annual growth of SSC and PIT is significantly higher than its corresponding fundament (wage base), which is regularly published by Statistical office of the Slovak republic (SO SR). This implies improved effectiveness of SSC collection with tax elasticity higher than one.

If a response of SSC revenues is almost identical to a change to employee's wages, elasticity of SSC is equal to one[6]. This means that one p.p. growth of wage base results in one p.p. growth of SSC revenues. SSC are levied as a percentage on a gross wage. Consequently, an increase of wage or employment lead to higher SSC revenues. Maximal assessment base and various type of allowances decrease elasticity slightly below one (ceteris paribus)[7]. It is, therefore, surprising that SSC revenues grows faster than the wage base.

Ex post analysis of data from Social Insurance Agency (SIA) revealed, that real growth of wage base in 2015 was significantly higher than official data published by SO SR (Figure 3). Annual growth of wage base calculated from SIA figures[8] highly correlates with growth of SIC and it is above the growth of wage base by SO SR. Taking this into account, we expect that higher SIC revenues can be partially assigned to

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[5] PIT is divided as follows : PITse = PIT business activity, PITe = PIT dependent activity

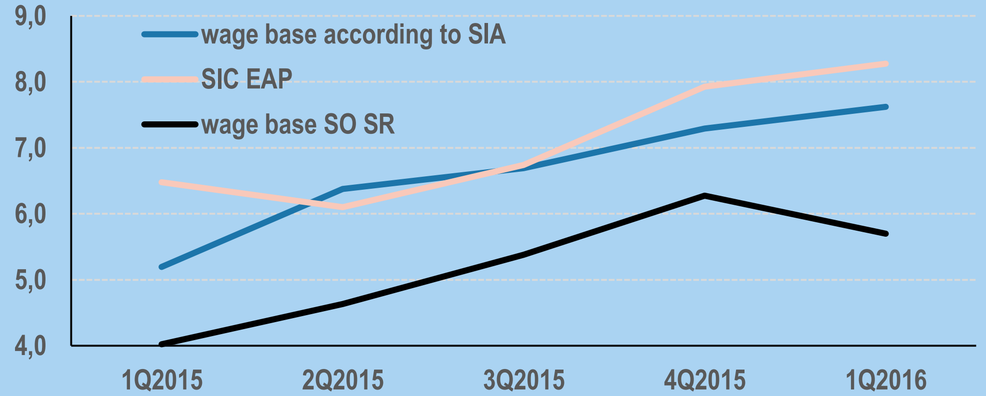
[6] Economic literatures as well as latest study by **OECD** acknowledge elasticity of SSC lower than one.

[7] Total amount of SSC revenues are affected by minimal level of SSC and exemptions, but these have limited impact on elasticity of SSC., In case of Slovak republic this impact is marginal.

[8] Sum of retirement contributions from employees, temporary job workers and self - employed

underestimated official wage base rather than to improved SIC collection. As a result of using underestimated official wage base, SIC and PIT revenues forecast is conservative for the whole forecast period.

Figure 3: Annual growth of base wage and SIC



Source: IFP, UloziskoIFP
EAP = economically active population

Table 1: Update of main macro fundaments, June 2016 vs. February 2016

	growth in %					change compared to February (in pp)				
	2015	**2016**	**2017**	**2018**	**2019**	**2015**	**2016**	**2017**	**2018**	**2019**
GDP, real	3.6	3.2	3.7	4.1	4.6	0.0	0.0	0.1	0.0	0.0
GDP, nominal	3.3	3.0	4.9	5.9	6.8	0.1	-0.3	-0.4	-0.4	-0.1
Final household consumption, real	2.4	3.1	2.4	2.7	2.9	0.1	-0.1	-0.2	0.0	0.0
Final household consumption, nominal	2.2	2.7	3.7	4.5	5.0	0.1	-0.6	-0.6	-0.3	-0.1
Adjusted base for VAT	4.8	0.2	3.3	3.9	5.0	-0.1	-0.8	-0.1	-0.4	-0.7
Wage base	5.1	5.0	5.3	5.7	6.1	0.1	0.3	-0.2	-0.2	0.0
Stock of deposit	7.2	7.2	5.5	5.2	5.6	0.3	0.4	0.5	-0.4	0.4

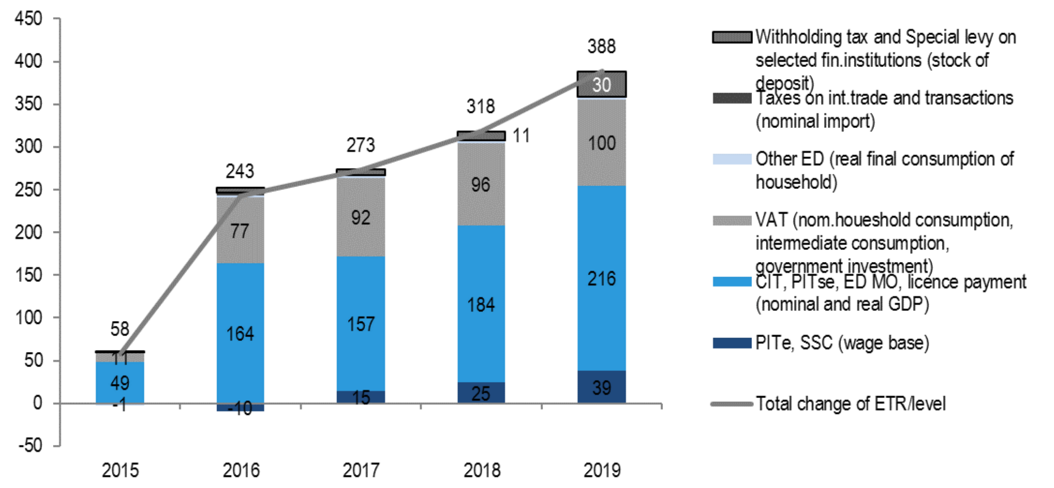
Source IFP, UloziskoIFP

Improved tax collection thanks to CIT and Excise duties

Further improvement in tax collection increases expected tax revenues by EUR 243 mil. (0.3 % GDP) in 2016. We expect this positive trend to continue in 2017-2019 (Figure 4). Better tax collection more than fully offsets negative impact of macroeconomic development. Current update of revenues is based on higher than expected tax collection in first quarter of 2016 and new information about CIT returns and its deferrals. Improved tax collection[9] is expected mainly in CIT, VAT and ED on mineral oils.

[9] The effectiveness of tax collection is measured by effective tax rate („ETR“)

Figure 4: Impact of ETR on the tax revenue forecast (EUR mill)



Source: IFP, UloziskoIFP

New legislative changes

Three new legislative measures has been included within current revision. Their impact on tax revenues is shown in Table 2.

Table 2: Major changes in legislation (ESA 2010, EUR mil)

	ESA 2010			Cash		
Measure	**2017**	**2018**	**2019**	**2017**	**2018**	**2019**
Reduction of corporate income tax rate from 22% to 21% (from 1.1.2017)	-132	-141	-153	-122	-141	-152
Minimum CIT abolishment (from 1.1.2018)	0	-72	-69	0	0	-72
Extension of the Special levy in regulated industries	77	80	83	90	80	83
- from which: CIT	-21	-21	-22	0	-21	-21
- from with : SC	98	101	105	90	101	104
Total CIT	**-153**	**-162**	**-175**	**-122**	**-162**	**-173**
TOTAL	**-55**	**-133**	**-139**	**-32**	**-61**	**-141**

Source IFP, UloziskoIFP

Ongoing positive growth in CIT

For CIT we are experiencing ongoing positive growth since February 2014. Based on higher than expected settlement and profitability growth accrued CIT revenues for 2015 are higher by EUR 50 mil. The profits of Slovak companies increased by 9.2 % in 2015 (recorded by SO SR) which is higher than originally expected 7.9 %. Stable profitability of non-financial corporations and ongoing growth of profits in first quarter of 2016 further drag CIT revenues in actual year. Improved CIT collection is partially offset by new legislation changes and macroeconomic development in 2017-2019.

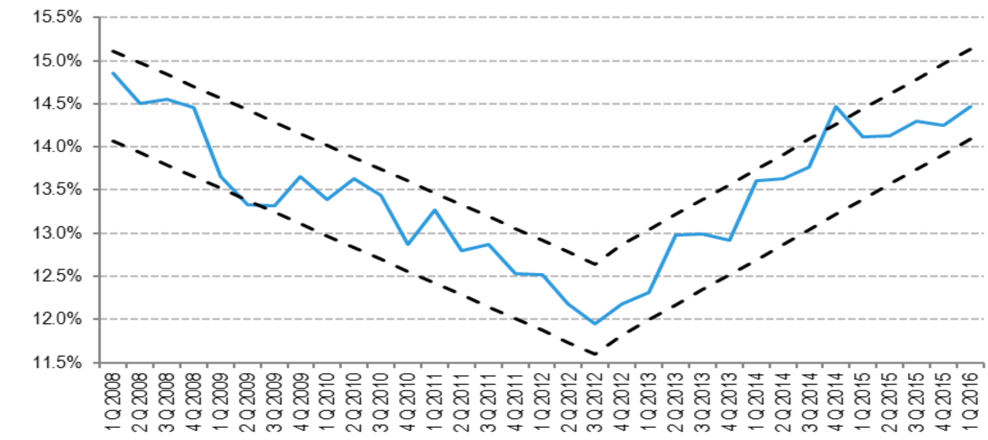
VAT revenues in line with February forecast

VAT revenues in first quarter of 2016 are in line with our expectation from February despite weaker growth of macroeconomic fundaments. Improved tax collection overcomes weaker macroeconomic development and results in prediction of similar VAT revenues as those in February. The VAT effective tax rate (ETR) reached its the pre-crisis level. For years 2017 – 2019 period we expect stable ETR development.[10] Slower growth of

[10] Defined as average ETR of the last two quarters

household consumption and decreased government investment slightly decrease expected VAT revenues on the whole forecast period.

Figure 5: VAT Effective Tax Rate (in %)



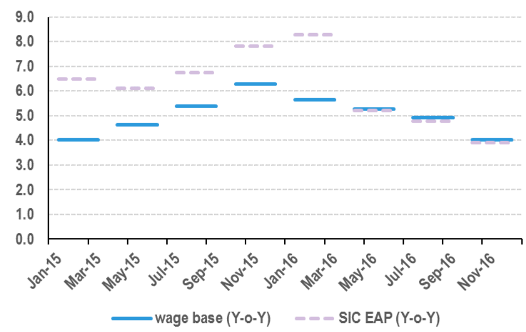
Source: IFP, UloziskoIFP

Strong labour market increases expected revenues

For SSC we are experiencing onging positive growth of revenues since 2015. Annual growth of SSC is significantly higher than annual growth of wage base (Figure 6). This difference cannot be fully explained by higher tax elasticity. Ex post analysis of data from SIA revealed that real growth of wage base was significantly underestimated by SO SR in 2015 and in the first quarter of 2016. For 2017 – 2019 we expect the growth of SSC revenues to be in line with growth of wage base published by SO SR. Discrepancy between growth of official wage base and SSC revenues is identified as a source of positive risk for next years.

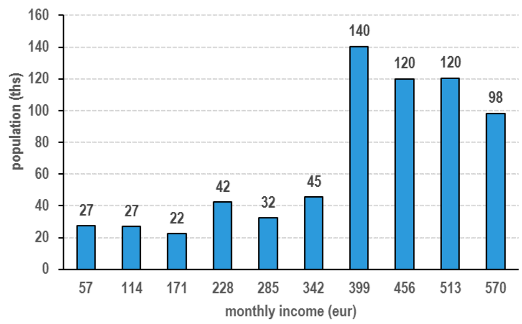
Based on the figures from SIA we slightly updated the impact of health insurance contribution allowance (HIC). The overall effect of HIC allowance (which is linked with wages paid in 2015) on HIC revenues is expected around EUR 187 mil., close to our initial expectations.[11] Almost one-third of the impact (EUR 56 mil.) has been claimed in 2015 and the rest is going to be required in annual tax clearing[12]. Number of eligible person for HIC allowance in 2015 is in line with our initial expectation (678 thousands of employees).

Figure 6: Annual growth of SIC[13] and wage base (%, 2 – 4Q 2016 estimate)



Source: IFP, UloziskoIFP

Figure 7: Number of persons eligible for health insurance contribution allowance to their monthly income (person ths.)



Source: IFP, UloziskoIFP

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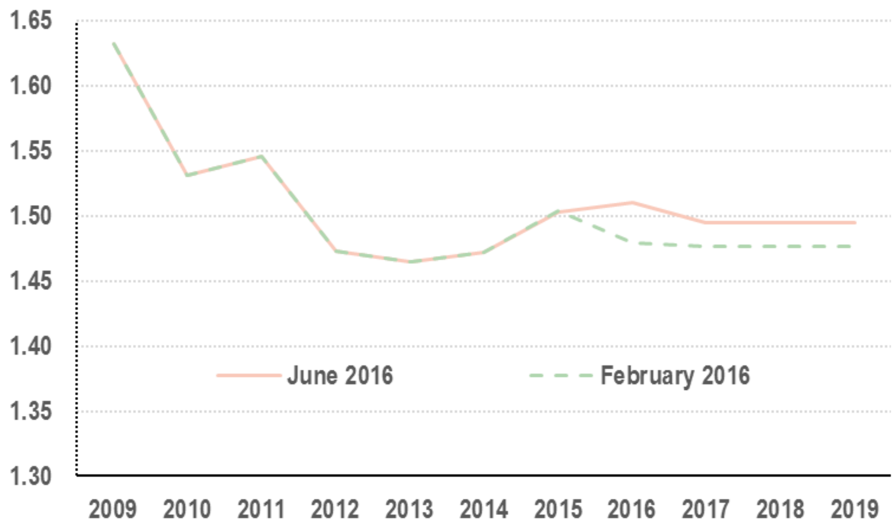
[11] More information about impact of health insurance contribution allowance can be found in IFP' **policy brief.**
[12] Latest possible day for annual tax clearing - 31st October 2016
[13] SIC without revenues of privately-managed fully funded second pillar

We increase PIT revenues by EUR 43 mil. (0.1 % GDP) for 2016 compared to previous forecast. Difference between an annual growth of the corresponding macro fundament and PIT revenues was 8.3 p.p. in the first quarter of 2016. This gap can be almost fully explained by both positive annual tax clearing and underestimation of wage base. For 2016 revenue forecast we take into account the real growth of PIT revenues in the first quarter and for the rest of the year we predict revenues slightly over wage base. Faster growth of PIT revenues than growth of wage base is a result of the elasticity of PIT higher than one caused by fiscal drag[14]. There is only a minor change in forecast for PIT from self-employment activity. The highest amount of deferred tax returns is identified as positive risk.

Ongoing positive surprise by ED from mineral oils

As a result of improved tax collection in first quarter of 2016, revenues from mineral oils for actual year are higher by EUR 12 mil. than was expected d in February. Based on slight increase of ETR development during 2012 - 2015 and ongoing growth in first quarter of 2016 (Figure 8) we revised our expectation of mineral oils revenues. Forecasted growth of other excise duties is in line with the latest forecast.

Figure 8: Excise Duty from Mineral Oils, ETR development (in %)



*Source: IFP, **UloziskoIFP***

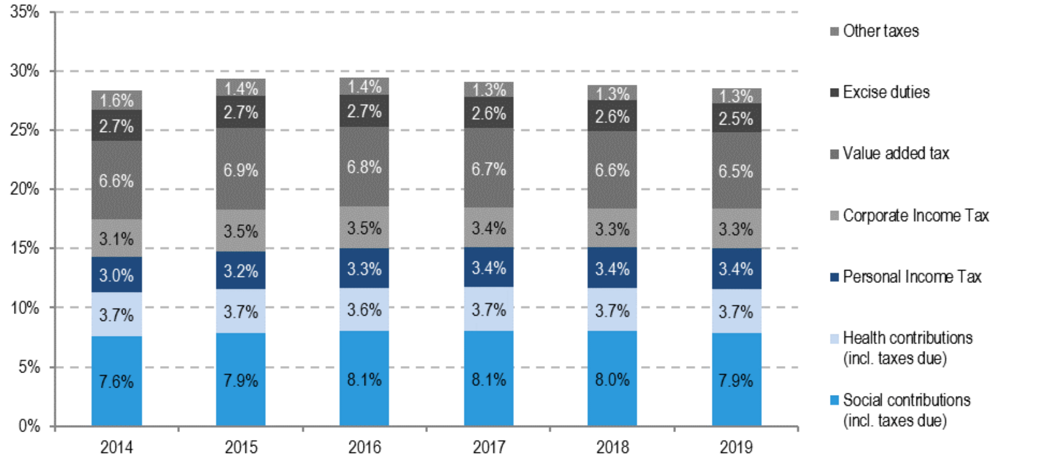
Taxes as % of GDP

Tax revenues account for almost one/third of GDP in 2016 (29.4 %). There are minor changes in tax-to-GDP ratio compared to previous forecast. Share of tax to GDP is expected to slightly decline since 2017.

Major direct taxes from labour and capital are expected to grow faster than other taxes in 2016. Ongoing improvement in labour market rise both SSC and PIT revenues. Improved tax collection offsets slower macroeconomic growth in case of VAT. Higher than expected companies' profitability materializes in higher CIT revenues. For 2017 - 2019 we expect stable share of direct taxes to GDP. Indirect taxes are slightly declining due to weaker consumption relative to GDP and non-indexation of specific tax rates in case of some excise duties which automatically lead to deterioration of this revenues over corresponding macro fundaments.

[14] Fiscal drag is a situation when earnings growth is higher than indexation of PIT allowances pushing more taxpayers into higher tax bracket or higher taxation.

Figure 9: Ratio of taxes to GDP



Source: IFP, UloziskoIFP

The Ministry of Finance (MoF) prepares and publishes forecasts of tax and social contribution revenues in accordance with the constitutional Fiscal Responsibility Act. The forecast of tax and social contributions revenues was discussed at the meeting of **The Tax Revenue Forecast Committee on 23th June 2016. The forecast was evaluated as realistic by every member of the Committee (KRRZ, NBS, Infostat, ČSOB, SLSP, Tatrabanka a UniCreditBank)[15].**

More about tax forecast, including materials and relevant documents can be found on the IFP website in the section "Economic forecasts ⇨ tax forecast".

This documents presents the views of its authors and of the Institute for Financial Policy which do not necessarily reflects the official views of the Ministry of Finance of the Slovak republic. The analyses prepared by Institute for Financial Policy (IFP) are published to stimulate and enhance professional and general discussion on various economic topics. Therefore, any quotations of this text should refer to the IFP (and not the MFSR) as to the authors of these views.

Detailed information about tax forecast, decomposition of contributions and source of data to each figure and table in this policy brief can be found on the UloziskoIFP

[15] NBS=National Bank of Slovakia, KRRZ=Council for Budget Responsibility and Infostat are public organizations. SlSP, Tatrabanka, UnicreditBank and ČSOB are private banks.