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Labour market spur tax revenues

Tax Forecast for 2016 to 2020 (comparison with previous forecast from November 2016)

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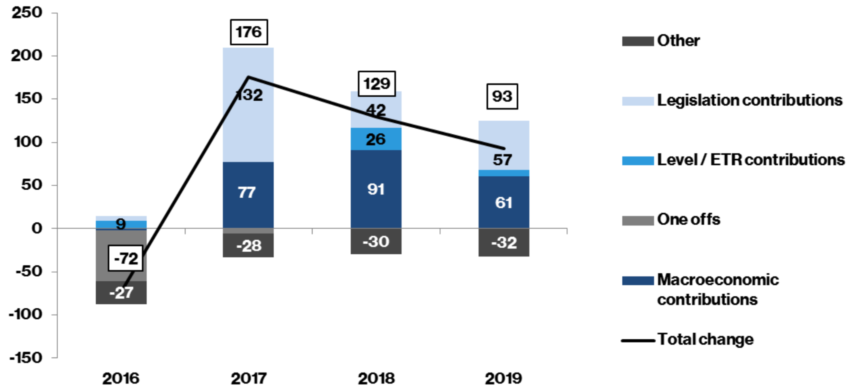
Tax revenue forecast for 2017 to 2019 is higher by EUR 93 million to EUR 176 million. (0.1 % to 0.2 % GDP) compared to previous forecast from November 2016. Ongoing growth of labour market and new legislative measures are main contributors to revised forecast. The revision has increased tax revenues by EUR 176 million for 2017 (0.2 % GDP), EUR 129 million for 2018 (0.1 % GDP) and EUR 93 million for 2019 (0.1 % GDP) compared to November. Lower CIT collection and higher amount of finished audits on excess credit in VAT drag down forecasted tax revenues in 2016 by EUR 72 million (0.1% GDP). Improvement in VAT effective tax rate[1] overcomes its own pre-crisis maximum in the third quarter of 2016 (Figure 7).

Higher tax revenues forecasted over the medium-term

Based on actual collection of tax revenues we **increase expected general government revenues by EUR 93 to 176 million for 2017 to 2019 compared to previous forecast**. Macroeconomic fundaments, mainly ongoing improvement of labour market, contribute significantly to the higher accrued revenues. Abolition of maximum assessment base of health insurance contributions (HIC) offsets negative fiscal effect from abolition of minimum CIT in 2018 (Table 2). Final, lower than expected, 2016 CIT outcome (EUR 128 million) was partially offset by higher revenues from PIT (EUR 31 million) and HIC (EUR 20 million). Hence, overall 2016 tax revenues is lower by EUR 72 million (Figure 1).

Figure 1: Change of GG tax revenue forecast compared to November 2016[2] (EUR million)



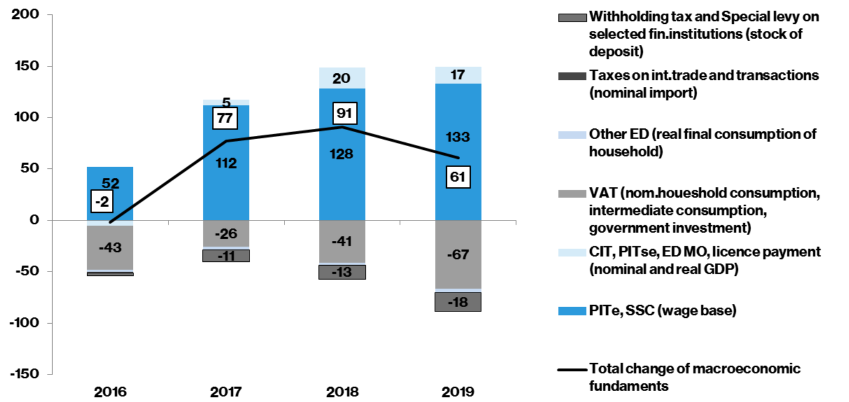
Source: IFP, UloziskoIFP

Labour market continues to spur tax revenues

The revised macroeconomic forecast[3] increases tax revenues in years 2017 - 2019 especially thanks to labour market growth (Figure 2). Lower government investments from slower drawing down of euro funds drags down VAT revenues. Lower interest rate from deposits negatively affects withholding tax.

[1] Effective Tax Rate "simplified measure" of effectiveness of tax collection. It is calculated as share of adjusted revenues from tax returns to corresponding modified macro tax base. VAT revenues are adjusted for one-offs, or legislative changes. Modified macro tax base consist of final consumption liable to VAT, intermediate consumption and gross fixed capital formation of general government subject to VAT. Calculated on quarterly basis, seasonally adjusted.
[2] The joint methodology for assessment of specific contributions to forecast update based on approved assessment methodology by Tax Committee (manual available only in Slovak).
[3] The updated (February 2017) macroeconomic policy brief is published at IFP website.

Figure 2: Macroeconomic impact on update of tax revenues forecast[4] (EUR million)



Source: IFP, UloziskoIFP

Table 1: Update of main macro indicators, February 2017 vs. November 2016

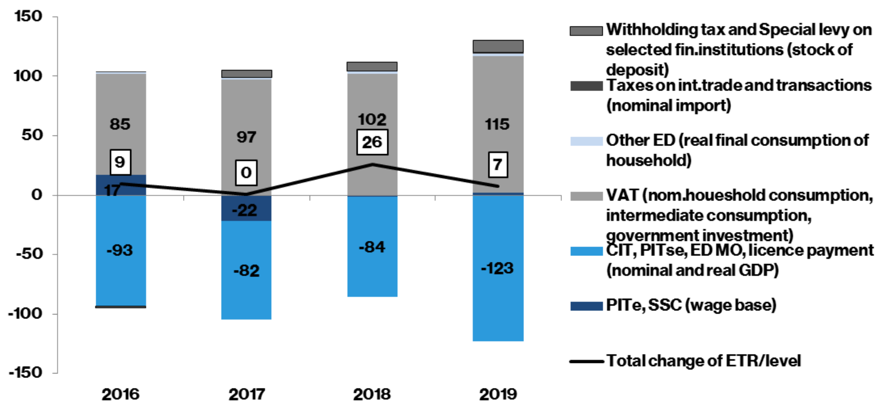
	growth in %					change compared to November (in pp)			
	2016	2017	2018	2019	2019	2016	2017	2018	2019
GDP, real	3.3	3.3	4.0	4.4	3.8	-0.2	-0.2	0.1	0.0
Real household consumption	2.7	2.5	2.7	2.9	2.9	-0.2	0.0	0.0	-0.1
Nominal household consumption,	2.3	3.6	4.4	4.8	5.1	-0.1	0.2	0.0	-0.1
Adjusted base for VAT	-0.7	3.4	3.5	4.4	4.7	-0.4	0.3	-0.2	-0.4
Wage base	5.5	5.4	5.5	5.7	6.1	0.5	0.4	0.2	0.0
Stock of deposit	7.8	6.6	5.9	6.6	6.1	0.6	0.6	2.1	1.3

Source: IFP, UloziskoIFP

Ongoing growth of VAT tax collection

We observed small impact of overall tax collection efficiency on revenues compared with previous forecast from November. For years 2016 to 2020 we expect improved VAT tax collection offsets lower CIT effective tax rate (ETR) resulting of weaker expected profitability growth of companies, which is not macro base for CIT[5]. Changes in macro base should be captured within macroeconomic contribution of updated tax revenue (Figure 2). However, changes in profitability of companies are not, but following joint methodology approved by Tax Committee they have an impact on ETR (Figure 3).

Figure 3: Impact of ETR on update of the tax revenue forecast (EUR million)



Source: IFP, UloziskoIFP

[4] 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

[5] As a proxy macro base for CIT, GDP adjusted for labour compensation is used

Legislative changes

Update of fiscal impact of previously approved legislative measures and forecasted impact of new legislative measures have been included within current revision. The measures involved are shown in Table 2.

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

Measure	ESA 2010				
	2016	2017	2018	2019	2020
1. Revision of previously approved legislation	**6**	**25**	**32**	**39**	**-**
VAT – interest on excess credit	0	4	4	4	-
Excise duty on tobacco[6]	-1	-2	-2	-2	-
Revision of HIC allowance	7	23	30	37	-
2. New legislation – approved by government	**0**	**107**	**10**	**18**	**28**
Abolition of tax license (minimum CIT)		0	-83	-80	-77
Property taxes		16	17	17	17
Abolition of maximum assessment base of HIC		90	76	81	88
TOTAL	**6**	**132**	**42**	**57**	**28**
TOTAL (in % GDP)	**0.01**	**0.16**	**0.05**	**0.06**	**0.03**

*Source: IFP, **UloziskoIFP***

Slowdown of CIT collection

In third quarter of 2016 we observed slower growth of profitability for the first time since February 2014 which results in lower estimate of CIT revenues. Compared to November forecast accrued CIT revenues for 2015 were negatively affected by EUR 46 million due to worse than expected final settlements for 2015. Correspondingly we updated CIT revenues in 2016, which are expected to drop by EUR 128 million. The revision is attributable to lower profitability growth and higher than usual portion of one-off profit nature in final 2015 CIT liability, confirmed through higher levels of adjusted advance payments in 2016.[7] Since 2018 abolition of tax licence will drag down accrued CIT revenues (BOX 1).

BOX 1: Abolition of minimum CIT

Former static estimate of minimum CIT abolition was EUR -72 million on accrued revenues. During last year Council for Budget Responsibility (CBR) pointed out that dynamic effects of its abolition could pose higher negative impact up to EUR 112 million.

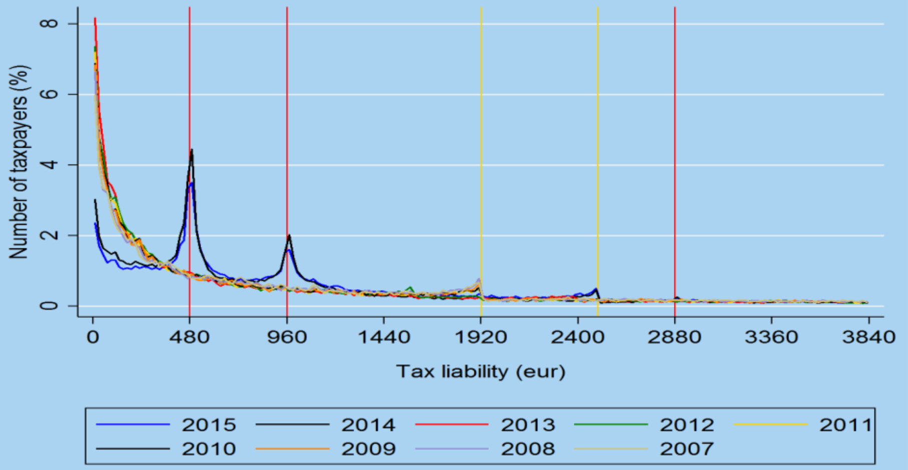
Therefore IFP analysed companies' individual tax returns for 2014 and 2015 tax period. Revised impact based on the current, updated IFP analysis increased negative effect of its abolition to EUR -83 million.

Analysis shows that introduction of minimum corporate tax caused clustering of declared corporate tax liability close to three levels of minimum tax in years 2014 – 2015 which was not observable before (Figure 4). Accrued fiscal effect of clustering is expected at EUR 30 million, however possibility to carry-forward of previously paid minimum tax partly offsets it (for 2015 counts for EUR 12 million).

[6] Revision of legislative measure about different amount of cigarettes in one pack

[7] The amount of advance payments depend on preceding tax liability, however companies may ask to pay adjusted (lower) advances in case that one-off transactions influenced their profitability in preceding year. Such transactions have any impact on current operating results, thus company may ask to reduce advance payments calculated based on the preceding tax liability. This leads to lower potential tax base and also lower advance payments in current year.

Figure 4: Distribution of tax liability (EUR, 2007 to 2015, exclusion of taxpayers with zero tax liability)

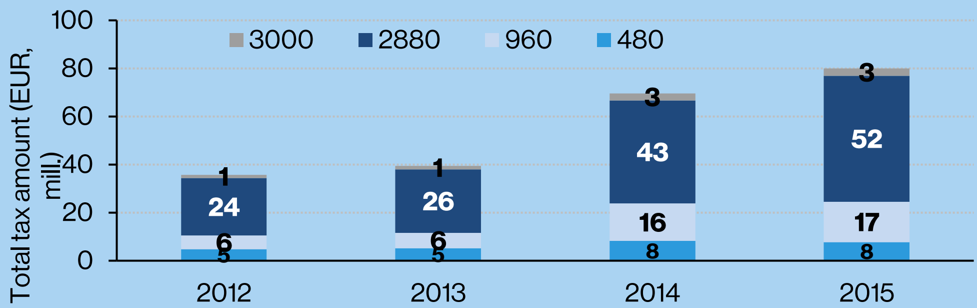


Source: individual data from tax returns FR SR, IFP,

Observed clustering of declared tax liability represents the change of taxpayers' behaviour. These agents used to pay very low tax or declared zero tax liability. However, after introduction of minimum CIT, motivation of agents to optimize the tax base up to zero significantly diminished. In particular, taxpayers declared higher profit corresponding to the level of minimum CIT or close to that level. From the fiscal revenue point of view, such a dynamic effect should be taken into account when assessing the impact of minimum CIT abolition in 2018.

However, IFP argues that a part of clustering behaviour is related to economic growth. The total tax liability volume of corporations that paid tax EUR 3 000 or lower was growing before, as well as after the introduction of minimum CIT (Figure 5). In particular, the year-on-year increment in 2015 represents the positive economic conditions. Moreover, the economic growth is observed at the level of tax liability reduced for amount of tax liability up to EUR 3 000. The year-on-year growth was 18 % and 23 % in 2014 and 2015 respectively.

Figure 5: Total amount of paid CIT for companies with CIT lower than EUR 3 000



Source:: IFP, UloziskoIFP

The second important driver deriving the final revenue effect of minimum CIT abolition is the tax allowance effect.[8] According to 2015 individual tax returns data, the tax allowance volume reached the 20 % of total paid minimum CIT. Furthermore, according to our expectations, the taxpayers attempted to declare maximum available tax allowance from tax period 2014 directly in 2015[9]. Further details are given in projection of minimum CIT abolition (Table 3).

[8] Positive difference between tax licence and tax licence allowance (reduction of tax liability in next 3 tax periods).
[9] Legally, taxpayer may employ the tax allowance for three consecutive years.

Table 3: Abolishment of minimum CIT - decomposition (accrued revenues, EUR mil.)

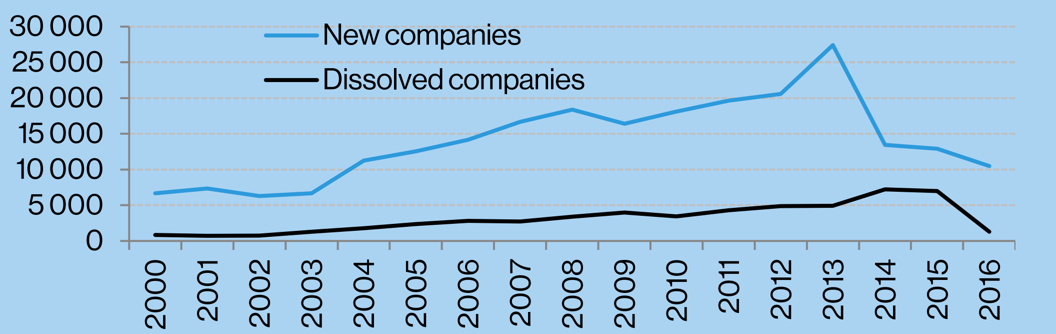
	2014	2015	2016F	2017F	2018F
Accrued revenues from minimum CIT*	-82,5	-74,6	-70,8	-66,9	-62,9
Clustering effect** (r800: EUR 0 - 3.000)	-26,2	-28,8	-30,3	-31,8	-33,4
Minimum CIT allowance***	-	+12,1	+15,3	+14,4	+13,5
Total effect of abolition of minimum CIT	**-108,7**	**-91,3**	**-85,8**	**-84,3**	**-82,8**

* y-o-y growth decreased by 50 % in the next period
** cumulative sum of y-o-y growth (r800 - (r800: 0-3 000), years 2014-2015 growth 10%; years 2016-2018 growth 5%
*** Maximal possible amount of tax allowance in year t is 20 % of minimum CIT in year t, tax allowance in year t is divided between t+1 (74 %) and t+2 (26 %) – this ratio is accumulated through the time.

Minimum CIT and dormant companies

One of the goal of minimum CIT introduction was removal of dormant companies from Business Register (BR). However, various public discussions stressed that even active corporations might ceased to exist due to increased business costs. Detailed analysis of BR data shows that especially inactive corporations ceased to exist (80 % of total corporations in 2014 declared no taxable income). Furthermore, the introduction of minimum CIT resulted in reduction of new business establishments. We believe, that minimum CIT limits motivation of agents to establish business to avoid the tax system.

Figure 6: Number of new and dissolved companies (2000 to 2016)

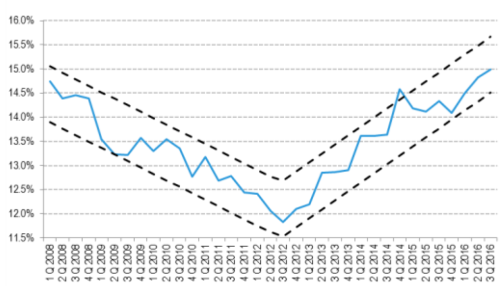


Source: IFP, UloziskoIFP

ETR for VAT reached its post crisis peak

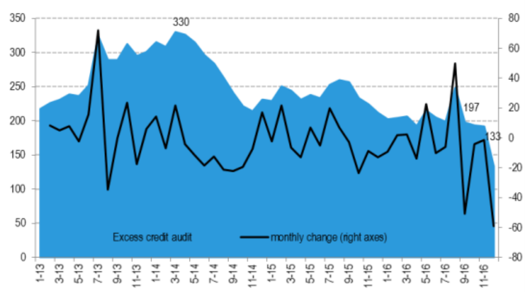
VAT collection is rising further (Figure 7). Higher than expected amount of finished excess credit audit by Financial Directorate of SR had a negative impact on accrued revenues in 2016 (Figure 8). Lower volume of audited excess credits (total sum) in addition to improved compliance is a positive step toward improving business environment. For years 2017 – 2019 we expect stable ETR development.[10]

Figure 7: VAT Effective Tax Rate (in %)



Source: IFP, UloziskoIFP

Figure 8: Amount of excess credit audit (EUR mil.)[11]



Source: IFP, UloziskoIFP

[10] Defined as an average ETR of the last two quarters.
[11] Financial Administration, responsible for VAT collection can begin investigation into excess credit of suspicious tax payers. Blue area represents total amount of money in excess credit which are under investigation.

Positive effect of labour market on SSC

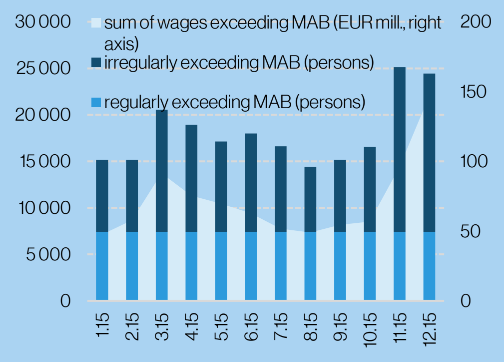
The greater than one elasticity of SSC to wage base is not further observable[12] as of last quarter of 2016. Current development of SSC yield is fully consistent with our assumptions from November forecast. For budgeted horizont we expect equal growth of SIC and the wage base. Final settlement of HIC for 2015 slightly raised HIC revenues in 2016. Solid performance of labour market, abolition of HIC maximum assessment base (BOX 2) and updated impact of HIC allowance[13] increase forecast of HIC for 2017 - 2020.

BOX 2: Abolition of maximum assessment base (MAB) for HIC

Since 1st january 2017 ceiling for HIC payment has been abolished. In 2016 MAB was equal to EUR 4 290 monthly (EUR 51 480 annualy). All incomes which exceeded this ceiling were not subject to HIC. Abolition of MAB increases progressivity of the tax system by increasing tax burden for employees earning more than 7 times of the average wage.

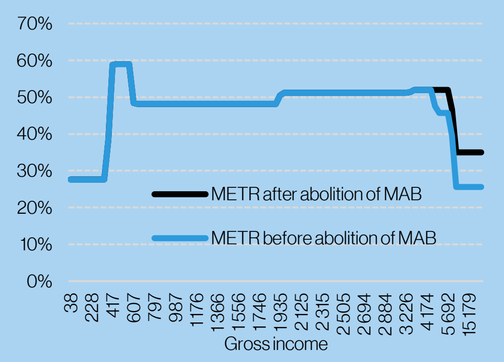
In 2015 income of 7 400 employees exceeded maximum ceiling every month on average (72 thousands of employess exceeded MAB at least once a year). The total number of individuals with income exceeding annual ceiling is eual to 16 thousands of employess. Fiscal effect of ceiling abolition is aproximatelly EUR 100 million annualy.

Figure 9: Employees with incomes exceeding MAB in 2015



Source: IFP, UloziskoIFP

Figure 10: Marginal effective tax rate of gross income



Source: IFP, UloziskoIFP

Improved ETR for mineral oils

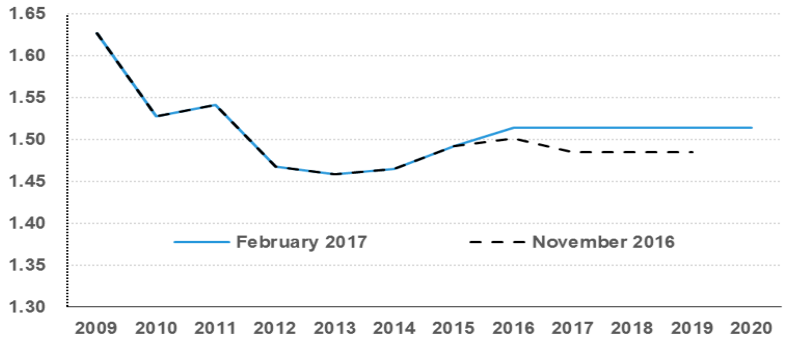
Improved tax collection of mineral oils in 2016 was partly offset by slower economic growth. Accrued revenues for 2016 were higher by EUR 7.3 million (0.01% GDP). Based on the ETR growth during 2014-2016 we revised our expectation about further development of ETR. Currently we forecast preserved level of tax compliance at the level of 2016 on the whole budgeted horizon (Figure 11).

Taxes as a % of GDP

Tax revenues account for almost one-third of GDP in 2016 (29.6 %). The share of tax to GDP is expected to slightly increase in 2017 and will start to decline as from 2018. Abolition of tax licence will decrease CIT revenues and consequently its proportion to GDP. Stronger labour market will boost the share of SSC and PIT for 2017. Between 2018 - 2020 we expect stable share of direct taxes to GDP due to positive impulse of labour market, which is partially offset by CIT development. The share of indirect taxes to GDP is slightly declining due to non-indexation of specific tax rates in case of some excise duties.

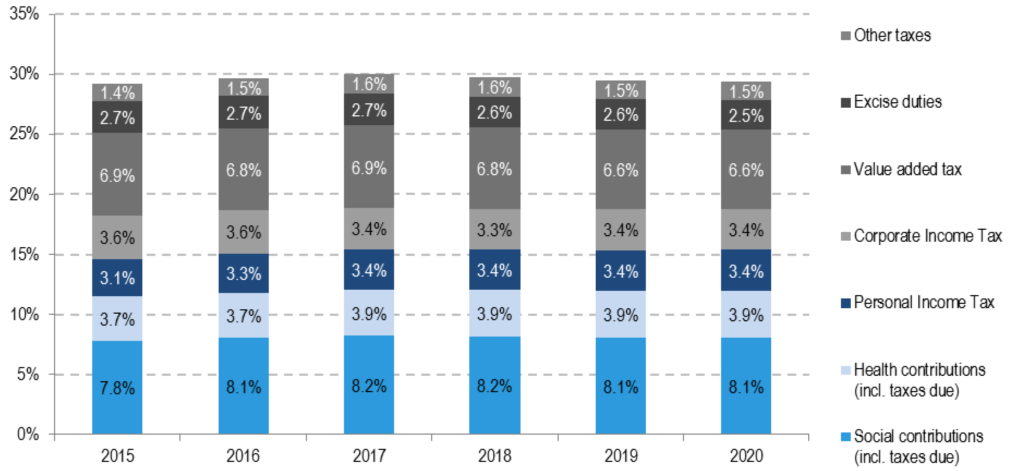
[12] In 2015 and 2016 we observed greater than one elasticity of SSC to wage base.
[13] Based on the figures from state Health Insurance Agency we revised down the impact of HIC allowance by EUR 26.1 million to EUR 41.9 million for years 2017 to 2019.

Figure 11: Excise Duty on Mineral Oils, ETR development (in %)



Source: IFP, UloziskoIFP

Figure 12: 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 9th February2017. The forecast was evaluated as realistic by every member of the Committee (KRRZ, NBS, Infostat, ČSOB, SLSP, Tatrabanka a UniCreditBank)[14].**

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 data to each figure and table in this policy brief can be found on UloziskoIFP

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