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PUBLIC FINANCE[1]

INTRODUCTION

Public finance developments in 2002 and the first half of 2003 confirmed that in Slovakia, this area is affected more visibly than others by election cycles.[2] This remains true of the current administration inaugurated at the end of 2002, in which three of its four parties were also represented in the previous government. That government (1998-2002) pledged in its program manifesto to reduce the public finance deficit[3] and the general rate of redistribution, but failed to deliver on either objective.

In 2002, the general government was even less thrifty in 'administering' taxpayers' money than in previous years, as we see from the fact that in 2002, the public finance deficit excluding financial transactions (i.e. not including loans drawn or privatization-generated revenues) was 6.4% of the country's GDP, while a year before, for instance, it was 'only' 5.5% of GDP. When the methodology used by the European Union (EU) is applied to the deficit, the government's performance in public finances looks even worse; according to this methodology, Slovakia's public finance deficit soared to 7.2% of GDP in 2002, far above the 3% of GDP ceiling stipulated by the Maastricht convergence criteria for accession to the economic and monetary union (EMU). The rate of redistribution through public spending was also extremely high in the final year of the previous administration's tenure, reaching almost 45% of GDP, matched only by the rate recorded in 2000 (see Graph 1).

Understandably, the current administration's program manifesto defined reform of public finances as one of its top priorities. Still, it was surprising that a government which is much more homogeneous and – at least on paper – more market-oriented than any of its predecessors did not pledge to reduce the excessive role of public finances in the national economy.

In 2003, the new administration managed to reduce state budget spending (i.e. current and capital expenditures) somewhat, which is common in the first year of the election cycle. The government had pledged to contain the public finance deficit within 4.9% of GDP in 2003. It eventually reached this goal despite a substantial shortfall in tax revenues, especially value-added tax (VAT), due to a change in the VAT payment system and an erroneous tax revenue estimate by the finance ministry. The government cushioned the tax revenue shortfall with a non-standard increase in excise duties in 2003.

In 2003, the government approved its final tax reform concept and passed new legislation. Since the new tax system was expected to take effect on January 1, 2004, the effects of these changes will appear gradually in 2004, 2005 and even later (for details see *General Public Finance Developments to the End of 2003 and in 2004*). These years will be greatly influenced by Slovakia's accession to the EU. With that in mind, the government in its draft budget for 2004 pledged to reduce the public finance deficit to 3.9% of GDP.

This chapter will also analyze public finances in Slovakia as administered by various general government institutions; according to international standards, these include the following:[4]

a) organizations and items defined by the state budget, i.e. the general cash administration and national debt budget sections;
b) state funds that have not been eradicated, namely the State Fund for Housing Development and the State Fund for Decommissioning Nuclear Power Facilities and Handling Spent Nuclear Fuel;
c) privatization funds, namely the National Property Fund (FNM) and the Slovak Land Fund (SPF);
d) institutions specializing in handling "hidden liabilities", namely the Slovenská konsolidačná, a. s. hospital bank (SKo) and Veriteľ, a. s. (since the latter institution was established in 2003, this chapter does not examine its performance);
e) social security funds, namely the Social Insurance Company (SP), the National Labor Bureau (NÚP) and health insurance companies;
f) local and municipal elected governments;
g) regional elected governments;
h) public universities.

With a few exceptions, this chapter does not attempt a detailed analysis of the public finance performance of individual constituents of the general government, but instead focuses on general public finance developments and their impact on the national economy.

THE CURRENT PUBLIC FINANCE SITUATION

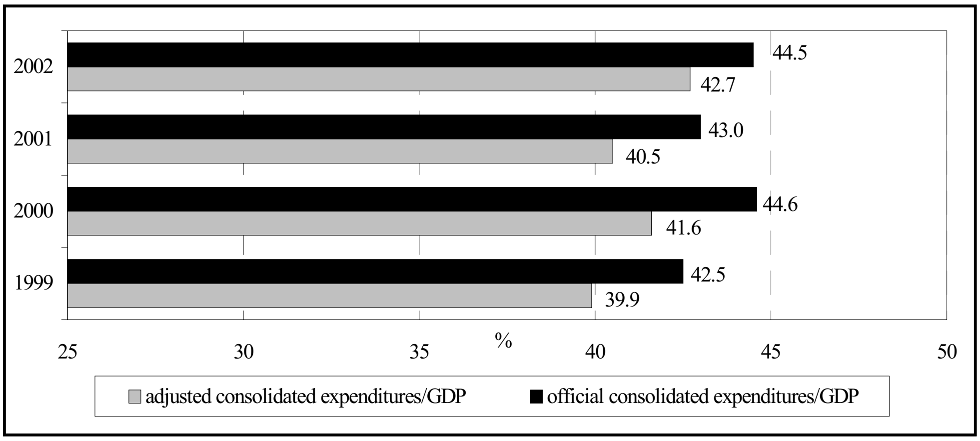
GENERAL GOVERNMENT EXPENDITURES

In the final year of the previous administration's term in office, increased pressure for greater redistribution of 'public' funds caused a substantial increase in general government expenditures. According to data provided by the finance ministry, consolidated[5] public expenditures without financial transactions in 2002 recorded a year-on-year increase of 12.2% in nominal terms. In money terms, public expenditures reached 458.7 billion Sk in 2002, or almost 43% of the product created by all economic players in Slovakia (see Graph 1).

The following data, adjusted by the author,[6] are more appropriate for analysis and are closer to reality and updated international methodologies, including the revised methodology used by the International Monetary Fund (IMF). According to the adjusted data, consolidated general government expenditures reached 477.7 billion Sk in 2002, or 44.5% of GDP. Since the year-on-year increase in public expenditures in 2002 was greater than year-on-year GDP growth, the ratio of the two in 2002 along with that in 2000 was the highest since 1998 (see Graph 1). This trend is extremely unwelcome in the light of the country's improving economic performance, as seen in the 2002 increase in economic growth.

Given the considerable gap between Slovakia's general economic performance and that of economically developed countries, along with the significant public finance deficit, it is a 'luxury' to redistribute almost 45% of the limited resources produced every year by the country's economy. In the long term, such

Graph 1
Ratio of consolidated general government expenditures to GDP (%)



Note: Consolidated general government expenditures are presented as expenditures without financial transactions (which the finance ministry registers as expenditures under the item *Total loans minus repayments*). However, adjusted consolidated expenditures also include expenditures that may have been statistically registered under the item *Total loans minus repayments* but which better meet the criteria of non-financial transactions (i.e. standard public expenditures). A good example of this is government guarantees for loans. In keeping with the consolidation principles set by revised IMF methodology, total consolidated general government expenditures include insurance payments for government employees.
Source: Finance ministry, author's calculations

public spending severely hinders greater productivity and the performance of Slovak economic players.

To obtain an objective view of the public finance situation, we must look not only at the overall volume of public spending but also at its destination (targets, aims). Table 1 gives an economic breakdown of general government consolidated expenditures in 2002 and the first half of 2003.

The calculations of consolidated general government expenditures featured in Table 1 confirm that the previous government engaged in expansive public spending toward the end of its tenure (i.e. in 2002), and that the virtually identical administration practiced greater austerity at the beginning of its new electoral term (i.e. the first half of 2003). The finance ministry itself admitted that public spending toward the end of 2002 had been more expansive than envisaged (see also *Návrh štátneho záverečného*..., 2003).

The year 2002 was also characterized by relentless pressure for further public spending on welfare benefits, road maintenance and paying down school sector debt. The finance ministry managed to compensate for the extra spending somewhat by capping other types of spending, especially in the national debt and government office budget sections (such as on completing the GOVNET network). Nevertheless, public expenditures increased considerably in 2002, and the government did not manage to slow growth in consolidated expenditures until the first half of 2003.

The fastest-growing form of public spending in 2002 was current expenditures, which rose 13.0% in nominal terms from the previous year. This increase came on the heels of a hefty spike (18.3% year-on-year) in transfers

Table 1
Consolidated general government expenditures in 2002 and 1H 2003

	2002			1H 2003
	Total (Sk bn)	% of GDP	Annual change (%)	Annual change (%)
Total expenditures without financial transactions	477.7	44.5	10.0	3.9
1. Current expenditures, of which figure:	420.3	39.1	13.0	4.9
• **consumption (wages, goods and services)** [a]	135.9	12.7	6.5	3.2
• **interest** [b]	39.3	3.7	24.1	-25.4
• **subsidies to the corporate sector (direct and indirect)** [c]	17.8	1.7	-36.8	37.5
• **transfers to non-business subjects, of which figure:**	227.3	21.2	18.0	11.4
• **transfers to inhabitants**	226.9	21.1	18.3	11.5
2. Capital expenditures, of which figure:	57.4	5.3	5.7	-7.8
• **capital transfers to the corporate sector**	17.5	1.6	-22.2	-7.7
Memorandum item: • **official expenditures excluding the item *Loans minus repayments***	458.7	42.7	12.2	41.4

Note:
a) Expenditures allocated to consumption (i.e. current and total expenditures) include insurance payments for government employees.
b) The substantial year-on-year drop in expenditures on covering interest costs in the first half of 2003 was due to the massive interest costs related to bank restructuring in the first half of 2002 (including the interest paid on restructuring bonds for 2001).
c) Besides standard (i.e. "direct") subsidies, the item *Subsidies to the corporate sector* included "indirect" subsidies as well, such as government guarantees for loans that are unlikely to be repaid (e.g. guarantees for the interest and principal related to bank restructuring).
Source: Finance ministry, Slovak statistical office, author's calculations

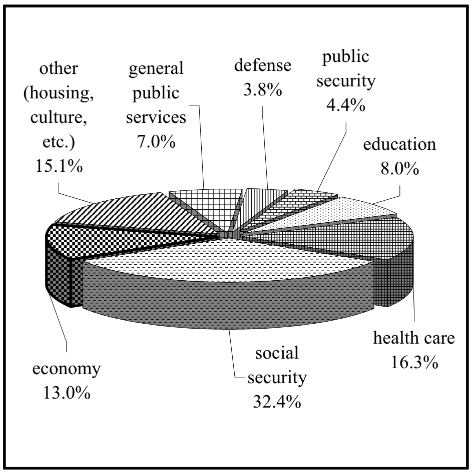
to inhabitants. The increase was driven by amendments to social policy laws, especially the Law on Child Allowance (for details see the *Social Policy* chapter in this *Global Report*). This significant (although reduced) year-on-year growth in public spending on social transfers continued well into 2003 (see Table 1).

Expenditures to cover the consumption of institutions administering public finances developed far more favorably. Although the already excessive public spending on wages and purchases of goods and services increased by a further 6.5% in 2002, general government institutions managed to stifle growth in their consumption spending in the first half of 2003 (see Table 1). That this type of public spending must be drastically reduced is borne out by the fact that general government consumption accounted for almost one-third (32.3%) of total public expenditures in 2002.

Transfers to the corporate sector are another form of public expenditure that the government is expected to slash. Following the excessive rise in current and capital transfers in 2001, the government leashed this type of public spending in 2002. Total capital transfers to corporates continued to fall in the first half of 2003; on the other hand, the volume of current transfers to the corporate sector rose steadily in the first half of 2003, despite reduced subsidies to agricultural enterprises. The catalyst in the growth was a massive current transfer to the state-run Slovak Railways of 3.3 billion Sk.

The distorted structure of public spending, which is due to the government's role in the economy, is better illustrated by a breakdown of public expenditures by their purpose. In spite of the cut in transfers to the corporate sector in 2002, the weight of public spending on economic activities is still excessive, and is to the detriment of spending on

Graph 2
Structure of general government consolidated expenditures in 2002 – breakdown by purpose



Note: The total shares of the various types of expenditures according to purpose are based on 2002 data and comply with COFOG and revised IMF methodology (GFSM 2001).
Source: Finance ministry, author's calculations

defense, policing or education. In 2002, the government's spending on the economy represented about 13.0% of general government consolidated expenditures; on the other hand, spending on public security and external defense each made up only 4% of general government consolidated expenditures.

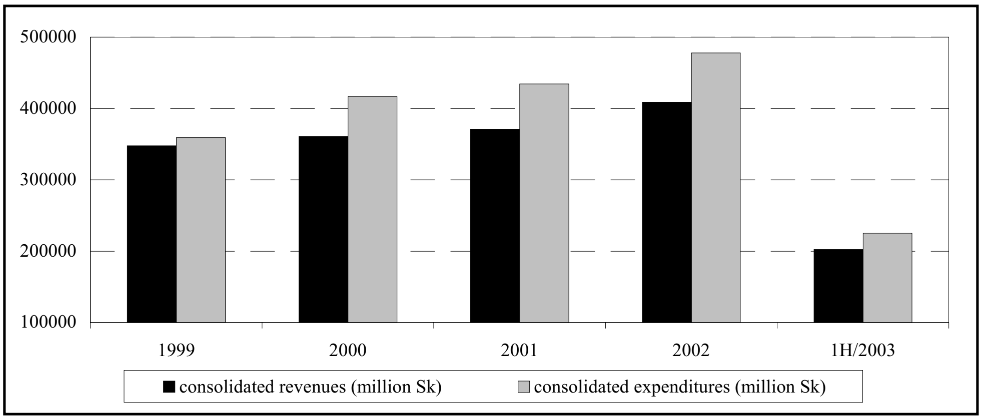
The excessive public spending on market activities (especially on subsidies to agriculture and transport), which is higher than public spending on basic government functions (i.e. public security and external defense combined), shows that the government is meddling excessively with the market. At the same time, it suggests that the government does not pay the necessary attention to the administration of public possessions.[7] In other words, the government does not have enough money to perform its basic functions adequately (for details see *Conclusion*).

In general, the most pressing problem that remains is the inefficiency in the allocation of public funds; a related problem is reducing overall public spending from non-credit and non-privatization resources.

GENERAL GOVERNMENT REVENUES

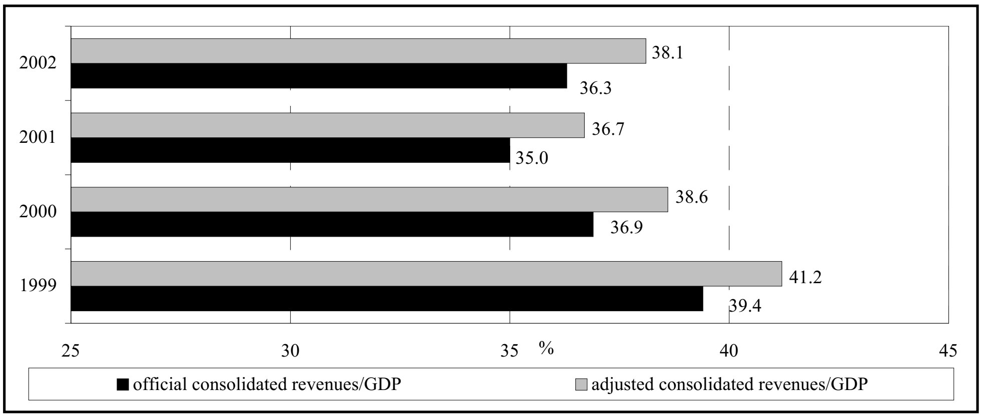
Public spending in each calendar year should be covered principally (ideally fully) by the general government's overall revenues, espe-

Graph 3
Comparison of the volume of consolidated general government revenues and expenditures (without financial transactions)



Source: Finance ministry; calculations and graph by the author cially its tax and contribution revenues. In Slovakia, the year-on-year increase in general government consolidated revenues has in recent years been outstripped by the annual growth in public spending. This remains true despite the fact that in 2002 and the first half of 2003, the tables began to turn and the difference in year-on-year growth rates was reduced to a minimum. In 2002, the growth in general government consolidated revenues

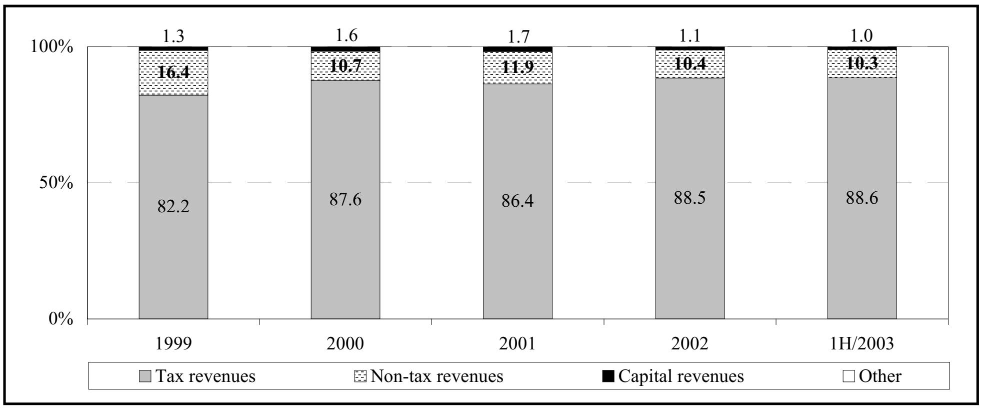
Graph 4
Ratio of consolidated general government revenues to GDP (%)



Note: Official consolidated general government revenues correspond to data presented by the finance ministry and obey current IMF methodology. Compared to official revenues, adjusted consolidated revenues (in compliance with revised IMF methodology under GFSM 2001) are higher by the total social and medical insurance dues paid by the general government for its employees.

Source: Finance ministry, Slovak statistical office, author's calculations

Graph 5
Structure of general government consolidated revenues in 2002



Note:
1. Tax revenues are understood in a broader context, which means they include revenues from contributions to social and medical insurance.
2. Since revenues generated by grants and transfers represented only 0.1% of overall revenues in 2002, they are not graphically illustrated.

Source: Finance ministry, author's calculations

was even slightly higher than the growth in public spending; nevertheless, the gap between absolute revenues and absolute expenditures remains significant (see Graph 3).

In 2002, the consolidated revenues of the general government increased by 10.4% to 390.2 billion Sk. Following the trend recorded in the preceding years, 2002 again showed an increase in the ratio of public revenues to GDP. After making the same adjustment we made on the expenditure side (i.e. after incorporating the social and medical insurance dues the government paid for its employees), total consolidated general government revenues come to 408.9 billion Sk, or 38.1% of the country's GDP (see Graph 4).

The overall growth in consolidated general government revenues was catalyzed by the growth in tax and contribution revenues. Their inflationary impact on overall revenues was due not only to their significant year-on-year growth but also to their decisive share (88.5%) in total revenues (see Graph 5).

Tax revenues of the general government

According to data from the finance ministry, the revenues generated by taxes and social security contributions increased by 13.1% in 2002, a hefty jump compared to the 1.1% growth recorded the year before. When insurance payments for government employees are taken into account, this year-on-year increase was 12.8% to reach 363.8 billion Sk (see Table 2). Naturally, the solid rise in official and adjusted tax revenues, combined with a growing economy, increased the ratio of tax and contribution revenues to GDP from 32.0% in 2001 to 33.9% a year later.

On the back of this growth, the 'Tax Quote II' (i.e. the ratio of revenues generated by taxes and social security contributions to GDP) saw a hefty increase in 2002. Although this is one way of calculating the overall tax burden on economic players in the country, it is not considered decisive for analytical purposes.[8] On top of taxes and social security contributions, citizens must pay a number of charges that fall outside public finance, such as various fines, fees, compulsory insurance, and other charges. To incorporate these charges we would have to guess the overall amount citizens have to spend from their available income.[9]

The substantial increase in tax and contribution revenues in 2002 was brought about by

Table 2
Consolidated tax and contribution revenues of the general government in 2002 and 1H of 2003

	2002			1H 2003
	Total (Sk bn)	% of GDP	Annual change (%)	Annual change (%)
Consolidated tax and contribution revenues	363.8	33.9	12.8	2.3
1. Income tax, profit tax and capital gains tax, of which figure:	76.2	7.1	15.7	-4.1
• individual income tax	37.1	3.5	7.2	8.0
• corporate income tax	29.8	2.8	37.0	-13.2
2. Social security contributions	158.1	14.7	11.3	8.4
3. Property taxes	5.9	0.6	11.1	23.4
4. Domestic taxes on goods and services, of which figure:	119.6	11.1	13.5	-2.5
• VAT	82.2	7.7	11.8	-10.9
• excise duties	32.0	3.0	12.7	15.3
5. Taxes from international trade and transactions	4.0	0.4	1.9	4.0

Note: The data on consolidated tax and contribution revenues comply with revised IMF methodology (GFSM 2001). Therefore, they also include payments of social security contributions for government employees.
Source: Finance ministry, author's calculations

an improvement in the collection of almost all types of taxes, especially the following:

- indirect taxes (i.e. VAT and excise duties), due mostly to rising household consumption (up 5.4% in real terms) and purchasing power;
- direct taxes, especially corporate income tax, due to the reduced tax rate and the relatively good economic results of major non-financial corporations in Slovakia during the examined period;
- social security contributions, caused by the increase in the total volume of wages in the national economy, which came on the heels of a significant growth in real wages (by 5.8% from the previous year).

However, the ensuing period did not confirm this improvement in the collection of tax revenues, but on the contrary, the first half of 2003 saw a year-on-year decline in revenues generated by the most important taxes. The VAT yield fell by 10.9% while the corporate income tax yield dropped by 13.2% compared to the same period in 2002. This resulted from the following factors:

- declining real incomes and household consumption, due especially to the austerity measures taken by the government after the 2002 elections; some of these measures had been postponed by the previous administration, e.g. adjustments in regulated prices;
- legislative changes to the VAT system, which concerned not only VAT rates but especially the new possibility for taxpayers to apply in 2003 for VAT refunds for previous periods; this forced the government to refund VAT for several years at once, which reduced VAT revenues.

In 2003 it turned out that the finance ministry had made a mistake in its projections of VAT revenues and, consequently, overall tax revenues for 2003. Halfway through the year, the deficit in collected VAT was 13.7 billion Sk. This prompted the government to adopt a very unpopular measure and raise excise duty rates in the course of the year. The excise duty on mineral fuels even exceeded the minimum required by EU regulations. As of the end of 2002, the weight of excise duties increased to 9% of total tax revenues.

The adjustments in the excise duties increased the tax burden on economic entities in Slovakia. In spite of the positive steps to reduce income tax rates, the overall tax and contribution burden on Slovak citizens remains excessive. The overall tax burden on the average employee is higher than the actual tax rate, and for citizens thus paints a more realistic picture. According to the most recent calculations (see Suďa, 2003), overall tax and contribution costs per employee have increased to 52.7% of employer wage costs, meaning that employees' net income has declined to 47.3% of their gross salaries.

GENERAL GOVERNMENT'S ECONOMIC PERFORMANCE AND DEBT

In 2002, the institutions that administer public finances spent 68.5 billion Sk more than they managed to collect in revenues. This deficit in the general government's economic management, equal to 6.4% of GDP, expresses the difference between cash payments on the revenue and expenditure side. We deliberately excluded financial transactions (especially loans and privatization-generated revenues), which the finance ministry registered under the item *Total loans minus repayments*. Although the ministry's method of accounting complies with current IMF methodology (GFS from 1986), it is not helpful to this analysis. For instance, data provided by the finance ministry in 2002 showed a 109.2 billion Sk surplus in the general government's economic management (check www.finance.gov.sk), due to 161.3 billion Sk in privatization-generated revenues.

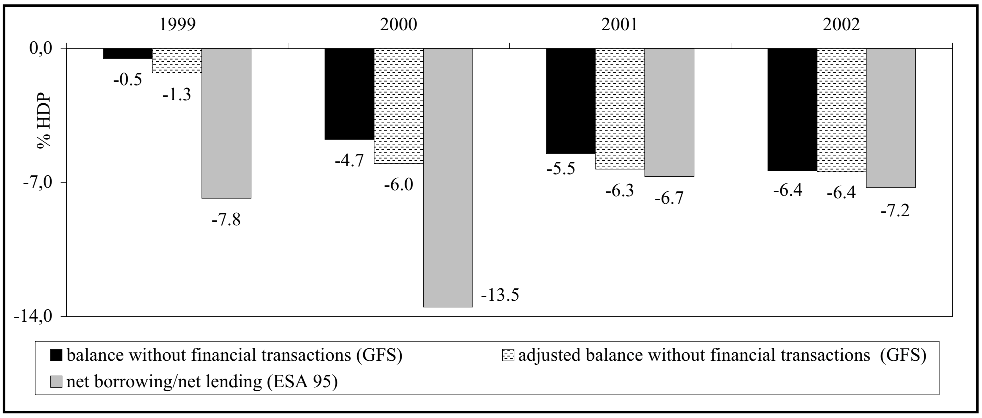
One gets a far more accurate picture of the general government's economic performance when one looks at the difference between revenues and expenditures, excluding financial transactions but including loans provided (especially loan guarantees) that are unlikely to be repaid. While in previous years the public finance deficit, as adjusted by the author of this chapter, was considerably higher than the officially presented deficit, in 2002 this was not the case (see Graph 7).

Both methods of evaluating the general government's economic performance are built on the cash basis, which largely complies with the GFS methodology used by the IMF, especially the current version from 1986. However, the updated GFSM 2001 methodology requires that governments present the results on an accrual basis (i.e. recording transactions at the time they occur, rather than the time of payment).

In order to evaluate the compliance of various countries with the Maastricht convergence criteria for public finance, Eurostat uses the analogical ESA 95 methodology. When we use this methodology, the preliminary data provided by the finance ministry suggest that the net borrowing of the general government[10] was 77.8 billion Sk, or 7.2% of GDP, in 2002 (see *Návrh štátneho záverečného…*, 2003).

All three methods of assessing public finance administration confirm the same trend, how-

Graph 6
Results of the general government's overall economic management with respect to GDP (%)



Note:
1. The official balance without financial transactions corresponds to data presented by the finance ministry in compliance with the GFS 86 methodology, without financial operations registered under the item *Total loans minus repayments* (which includes extended loans and their repayments as well as the sale and purchase of stocks).
2. The adjusted balance without financial transactions includes the total volume of provided loans, as well as related guarantees issued, that are not truly expected to be repaid, and which therefore are not considered financial transactions.
3. Data on the net borrowing/net lending of the general government comply with the accrual basis of ESA 95 methodology used by Eurostat (i.e. the Maastricht convergence criterion of the deficit not exceeding 3% of GDP). The slump recorded in 2000 and also partly in 1999 was largely due to the loss produced by the depreciation of most claims related to bad and doubtful loans cut out of restructured banks.

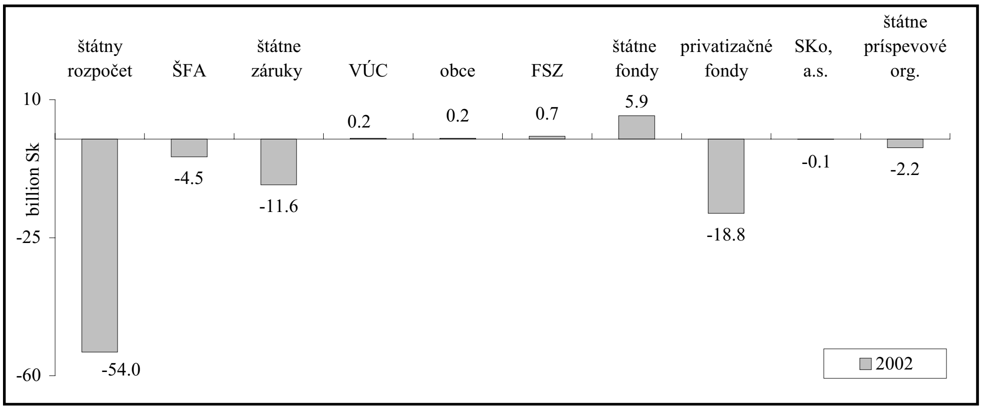
Source: Finance ministry, author's calculations

ever: since the first Dzurinda administration's austere approach in 1999, the general government's economic performance has gradually deteriorated. The only exception to this trend came in 2000, when the economic result of the general government according to the ESA 95 methodology worsened considerably due to the costs of bank restructuring (see Note 3 to Graph 6).

As for individual general government constituents, net borrowing (i.e. the "deficit" according to ESA 95) was brought about mostly by the poor economic results of the state budget and of the privatization funds, especially the National Property Fund (see Graph 7).

The huge public finance deficit in 2002 was not reflected in increasing public debt. The

Graph 7
Economic management of individual constituents of the general government in 2002 (according to the ESA 95 methodology)



Note: Besides standard constituents of the general government, the graph specifically illustrates the impact of government guarantees and financial possessions on its overall net borrowing/net lending. These figures should subsequently be added up to the state budget to which they are related.
ŠFA – government financial possessions;
VÚC – higher territorial unit;
FSZ – social security funds;
SKo – Slovenská konsolidačná, a. s.
Source: Finance ministry, graph by the author

Table 3
Development of the general government consolidated debt (Sk billion)

	1999	2000		2001		2002		1H 2003
			% change		% change		% change	
Consolidated public debt [a] (1)	344.9	410.1	18.9	431.8	5.3	410.1	-5.0	425.1
Risky government guarantees [b] (2)	62.9	74.1	17.8	78.0	5.3	65.4	-16.2	62.8
Consolidated public debt according to ESA 95 [a] (1+2)	407.8	484.2	18.7	509.7	5.3	475.5	-6.7	487.9
Memorandum item **Consolidated public debt according to ESA 95/GDP**	48.3%	51.8%	na	50.5%	na	44.3%	na	na

Note:
a) Consolidated public debt is the overall volume of unpaid loans, issued securities, returnable financial assistance and guarantees the government provided to subjects outside the general government.
b) Government guarantees classified as risky by the finance ministry.
ESA 95 – European System of Accounts introduced in 1995
Source: Finance ministry, author

main reason was the repayment of a sizeable chunk of the public debt (59.1 billion Sk of the national debt and almost 15 billion Sk in FNM liabilities) from privatization-generated funds. For the first time in Slovakia's modern history, the government managed to reduce the public debt in absolute terms (see Table 3).

The consolidated public debt was reduced from 431.8 billion Sk at the end of 2001 to 410.1 billion Sk (38.2% of GDP) a year later; however, by the end of June 2003 it was almost back to the level of 2001 (see Table 3).

When the government guarantees the finance ministry labeled as risky are factored in (i.e. 65.4 billion Sk of the total 137.8 billion Sk in government guarantees), the consolidated public debt at the end of 2002 reached 475.5 billion Sk, falling from almost 50% of GDP in 2001 to 44.3% of GDP in 2002 according to the ESA 95 methodology.

Following repeated reminders by independent economists, including the author of this chapter (see Gonda, 2001 and Gonda, 2002), the government for the first time ever presented a share of government guarantees as part of the public debt. In doing so, the government transformed parts of the hidden debt into official public debt, a prerequisite for getting to grips with the problem in the future.

The largest among the risky government guarantees are guarantees provided for loans drawn by state-run enterprises, especially Slovak Railways (ŽSR) and Slovenské elektrárne.

For many years, ŽSR has swallowed tax revenues but has failed either to cut its astronomical costs (e.g. by addressing its massive over-employment) or to attract investments. In the first half of 2003, the government continued its policy of benevolence to ŽSR in handing the corporation a further 21 billion Sk in debt relief. The basic problem in financing railway corporations in general and ŽSR in particular is that, in the public interest, the government has regularly ignored its liabilities stemming from these corporations' woeful performance. Instead of paying directly for the company's losses, the government has provided guarantees for the loans it has drawn.

Besides paying off the debt of railway corporations, the government has also begun to tackle the debt of medical establishments through Veriteľ, a joint stock company established by the health ministry. Here too there are other forms of indirect or hidden debt, especially the 'implicit' debt of the pension system, which is several times greater than the official consolidated public debt.

GENERAL PUBLIC FINANCE DEVELOPMENTS UP TO THE END OF 2003 AND IN 2004

The State Budget Law for 2003 outlined the chief public finance objectives of the finance ministry and the government, which were to keep the state budget deficit within 4.8% of GDP and the public finance deficit within 4.9% of GDP.

During the first half of 2003, as mentioned above, the government ran an increasingly serious shortfall in the collection of tax revenues, especially VAT. The government reacted by raising excise duties effective August 2003, in other words before its tax reform was launched on January 1, 2004. In the summer of 2003, the cabinet also decided to levy VAT on advance payment invoices, which especially affected construction and leasing companies.

Despite the measures adopted, the tax revenues collected by the government remained inadequate well into the second half of 2003, not only compared to the previous year but also with respect to the plan outlined in the state budget. The revenue-side risks continued to be fuelled by lingering deficits in revenues from VAT, corporate income tax, capital gains tax and individual income tax.

Having approved its basic tax reform concept, the government in the second half of 2003 set out to make the related legislative changes. Table 4 shows the most important changes envisaged in the main taxes (i.e. income tax and VAT) under the framework of tax reform.

The planned reform introduces certain rational elements to Slovakia's tax system, such as a flat tax. Combined with the general drive to make the system simpler and more transparent (e.g. several measures featured in Table 4), the planned changes may be a beacon for a number of Western countries, particularly EU member states. It is hoped that

Table 4
Changes in select taxes introduced by the most recent tax reform

	Before January 1, 2004	After January 1, 2004
1. Individual income tax		
1.1 Rates	10, 20, 28, 35, 38%[a.]	19%
1.2 Non-taxable amount of tax assessment base:		
• per taxpayer	38,760 Sk	19.2–multiple of subsistence level [e]
• per spouse	12,000 Sk [b]	19.2-multiple of subsistence level [f]
• per child	16,800 Sk [c]	tax bonus [g]
• if taxpayer receives disability pension	8,400, 16,800 Sk [d.]	0
1.3 Tax deductible items – gifts:	10% of tax base	0
1.4 Lump sum costs [h]		
• agriculture [i]	60%	25%
• using intellectual ownership rights	35%	
• trade, from tenancy	25%	exception for artisan trades: 60%
1.5 Special tax rates		
• lump sum tax [j]	2 – 2.75%	abolished [l]
• other	5, 10, 15, 20, 25% [k]	abolished [m]
2. Corporate income tax		
2.1 Rates	25%	19%
2.2 Tax deductible items – gifts	2% of tax base	0
2.3 Special tax rate		
• agriculture	15%	abolished
3. Value added tax		
• rates	14; 20%	19%
• other	taxation of pre-payment invoices	

Note:
a) in accordance with the taxpayer's income (the tax bracket system);
b) as long as the spouse's income was less than 38,760 Sk;
c) doubled if the child suffered from a serious handicap;
d) i.e. either partial or full disability pension;
e) for 2004, the non-taxable amount was 80,832 Sk;
f) as long as the spouse does not earn an income. If the spouse earns an income that does not exceed the stipulated amount, then the non-taxable part of the tax base is 80,832 Sk minus the spouse's income;
g) for each child without means, the taxpayer's final income tax is reduced by 4,800 Sk;
h) applies if the taxpayer fails to demonstrate actual costs;
i) applies to individuals doing business in agriculture, forestry and water management;
j) applies to specific trades people whose annual turnover is less than 2 million Sk;
k) applied to various types of income;
l) replaced by an increased limit for tax-deductible lump sum costs applicable to the artisan trades;
m) for some types of income, taxation by deduction has been retained; however, the tax rate is the same at 19%.
Source: Finance ministry, author

Box 1
General evaluation of the state budget draft for 2004 as approved by the cabinet in October 2003

Compared to previous years, the cabinet's draft state budget for 2004 is more transparent and complex; however, it is no thriftier than in the past, and suggests that the government's approach to public finance has not changed.

In the document, the cabinet presents a model of future public finance administration that is more realistic and open to the public. For the first time ever, the government views public finance as a complex and organic whole; it also analyzes individual public finance constituents using the ESA 95 methodology. A management strategy for the public finance budget in the midterm (next several years) forms an integral part of the state budget for 2004. The budget also features a program and purpose breakdown.

The projected impact of Slovakia's accession to the EU on the planned administration of the state budget and public finance is a complete novelty compared to previous years. The country's contributions to the Union's budget make up part of budgetary expenditures; a substantial proportion of envisaged (potential) resources received from EU funds show up on the budget's revenue side, while their allocation shows up on its expenditure side. In the draft, the government takes into account the need to participate in financing individual projects, and seems aware of the need to reform some types of public expenditures.

In the document, the cabinet pledges to reduce the public finance deficit to 3.9% of GDP in 2004, which would be a vast improvement from the 7.2% in 2002 and the estimated 5% in 2003. Given the envisaged brisk pace of economic growth, the planned deficit is not over ambitious; nevertheless, if the government manages to deliver on this pledge, it will be seen as a positive thing.

The unchanged structure of expenditures was an unpleasant surprise in the cabinet's state budget draft, especially the continued excessive subsidies to the corporate sector. This type of expenditure leaves room for enormous and legitimate savings in the future, as it permits the government to meddle in areas that should be totally outside government influence in a free society.

A classic example is the several billion crowns in subsidies to Slovak Railways (ŽSR) and Slovak agriculture companies. ŽSR received further funding even though it failed to cut costs and continues to employ too many people. On the pretext of the country's joining the EU, Slovak agricultural businesses extorted an increase in subsidies of about 6 billion Sk over 2003, despite limited budget funds and far more important tasks, such as law enforcement. Moreover, Slovak agriculture entities won the increase despite their substantially lower wage and price costs compared to their competitors in EU member states. When purchasing power is taken into account, direct payments to agriculture firms in Slovakia before the increase were over 120% of the EU average, and were higher than in any other Visegrad Four country (see Kotian, 2003). The IMF also regards the proposed subsidies to the country's agricultural sector in 2004 as excessive.

Nor did the cabinet's state budget draft for 2004 envisage cuts in yet another expenditure item that cried out for it – expenditures on state administration consumption. Compared to the previous year, the government's spending on wages, goods and services should grow by 6%, representing almost one-quarter of all state budget expenditures.

The collection of tax revenues in 2004 will be affected by the tax reform, as well as by Slovakia's accession to the EU. The government envisages a substantial increase in tax revenues on the back of the tax reform and higher excise duties. On the other hand, with respect to the country's EU accession it expects several one-time factors that should significantly reduce tax revenues. One such factor is the envisaged transfer of the power to collect VAT and excise duties on EU imports from customs offices to tax offices, and the consequent two-month delay in collecting these revenues. The finance ministry expects this change to cut VAT revenues by 15.4 billion Sk (see *Návrh štátneho rozpočtu…*, 2003).

In spite of this setback, the finance ministry expects VAT-generated revenues to increase by 16.6% compared to the total estimated amount at the end of 2003 (see *Návrh štátneho rozpočtu…*, 2003). Given the recent experience with VAT revenue estimations by this body, this optimism is surprising and foreshadows a repeat of last year's fiasco in 2004 as well.

In conclusion, the 2004 state budget draft shows that the basic philosophy of the government's approach to public finance has not changed, as seen from its plans to redistribute an excessive chunk of available public funds in order to continue meddling with the market.

the changes in Slovakia's tax system will catalyze a reduction in business costs, stimulate enterprise and, consequently, improve resource allocation and job creation, which will reduce unemployment.

On the other hand, the most negative aspect of the reform is the fact it increases the overall tax burden, something most people are very sensitive to. In particular, the substantial increase in the lower VAT rate from 14% to 19%, the significant rise in excise duties, and the taxation of real estate according to "price maps" are likely to outweigh the positive effects of the reduction of income tax rates.

Many independent economists and NGOs calculate that the 'reform' will have a negative impact on most taxpayers.[11] The overall fiscal impact of the tax reform (especially the envisaged growth in tax revenues) indirectly corroborates this conclusion.

KEY PROBLEMS AND RISKS OF PUBLIC FINANCE

The cabinet's 2004 state budget draft and its tax reform are classic instances of wasted, never-to-be-repeated opportunities to make thorough reforms in the first stages of the election cycle (and in the last months before EU accession!) to achieve an across-the-board and substantial reduction in the overall tax burden. Increasingly strong political barriers, such as the influence of various interest groups including trade unions, are likely to hamper similar attempts in the future. Slovakia's public finance administration will also likely be further limited by the European Union.

On the one hand, reform efforts are inhibited by domestic (especially political) opposition to thorough pension, health care and other reforms (including financially demanding ones), which cite the country's interest in complying with the Maastricht criterion for the public finance deficit in order to join the economic and monetary union (EMU) as soon as possible. On the other hand, reform may be hindered by long-term EU restrictions on Slovakia's attempts to implement essential economic and social reforms, including tax reform.

Using the argument that "the higher priority is Slovakia's early accession to the EMU," a line used especially by the central bank, the domestic political opposition has already crippled the original pension reform concept. The recently introduced pension system is far more timid than experts had expected (for details see the *Social Policy* chapter in this *Global Report*).

The long-term limitations to be expected from the EU can be seen in the Union's negative view of Ireland's radical tax reform.[12] The risk that future attempts to make essential public finance reforms in Slovakia will be hampered is heightened by the Union's current move towards greater regulation and harmonization (i.e. adopting more rules that interfere with the market and the business sector) and its tendency to transfer decision-making powers from the national to the central, supranational level.

The Union's desire to harmonize taxes and member states' fiscal policies is seen not only in its current floor for excise duties and VAT (15%) but also in its drive for a unified dividend tax, capital gains tax (including dividends) and interest tax at 35%, and its recent initiative to abolish the veto held by member states over tax issues.

These and other risks may perpetuate long-term problems in Slovakia's public finances, especially the following:[13]

- the excessive rate of redistribution through public expenditures, and the general government's excessive meddling in the market;
- the excessive tax and contribution burden on citizens and businesses;
- the inefficient administration of public finances.

During the first Dzurinda administration, the rate of redistribution through public spending increased every year; according to my calculations, it reached 44.5% of GDP by the end of 2002 (see Graph 1). The structure of public spending remains distorted, with excessive transfers to the corporate sector at the expense of adequate administration of public possessions. The state budget draft for 2004, approved by the cabinet in October 2003, does not envisage any fundamental changes to the existing public finance model.

Recently, the overall tax and contribution burden on citizens has stagnated or moderately increased. According to the Association of Slovak Taxpayers, the ratio of overall tax and contribution costs per employee to employer wage costs in 2003 increased slightly from the previous year, reaching 53.3%.

In the coming period, the country will anxiously await the effects of the tax reform; unfortunately, the reform will likely increase the tax burden on a substantial proportion of taxpayers. For most of them, the government increased the tax burden in advance by raising excise duties in 2003, ahead of the reform designed to reduce the tax burden.

Given the general government's limited ability to boost revenues, a natural consequence of the increase in public expenditures was a deficit in public finances. In 2002, the deficit in the economic management of general government institutions reached 6.4 – 7.2% of GDP, depending on the methodology used; a slight improvement is expected for 2003. In terms of public finances, the best news for the national economy was the repayment of a sizeable chunk of the public debt from privatization revenues. For the first time in the country's modern history, the general government debt declined in absolute terms, which may have favorable effects on the real economy, including interest rates.

CONCLUSION

In the course of 2003, the government took certain measures to tackle the most urgent problems in Slovakia's public finances; however, apart from minor exceptions, it failed to make significant progress in eliminating them. It is increasingly obvious that public finance problems that have accumulated over a long time cannot be fixed quickly.

The principal objective of public finance reform in future should be a substantial reduction in the government's role in the economy and in the redistribution rate of public funds, while rationalizing and decentralizing general government as a whole.

In this context, we should define the concrete functions the government should perform and the extent of (enforced) social solidarity it should guarantee. The author believes that the government should gradually reduce the scope of the functions it performs to core ones; on the other hand, it should perform them far more efficiently than it does today.

The author believes that the government must remain involved in the following spheres:

- legislation and the judicial sector (emphasizing guarantees of ownership rights);
- foreign affairs;
- external defense of the country;
- public security;
- basic living standard of inhabitants;
- education of children;
- other spheres where market rules do not apply and the private sector is not interested in getting involved (however, this function should be performed exclusively through a grant system).

In the longer term, this clear concept of government roles should enable it to determine what forms and volumes of public spending it should keep, and what it should eliminate. Types of public spending that do not fit this concept of government functions and which should be gradually eliminated are corporate sector subsidies (especially to agriculture and railways) as well as any types of across-the-board financial support for families (e.g. child allowance).

The principal aim of this concept is to enable society to return to universal rules and values, i.e. personal responsibility, individual freedom, undistorted competition, a properly functioning market, and respect for ownership rights. In the long term, the key to accomplishing such a systemic change is to transform the indirect 'responsibility' borne by the general government into the direct responsibility of each citizen for his life, including his financial security.

Naturally, such a reduced scope of public spending would demand far lower taxes and contributions. Although it sounds quite bold at the moment, a 10% tax burden on taxpayers would suffice to achieve the balanced (i.e. non-deficit) administration of public finances.

If any Slovak government in the future gathers the courage to make such changes, it had better be prepared for serious resistance, not only from most voters but also trade unions and the European Union. However, if Slovakia wants to ensure long-term and dynamic economic development, attract more investment and create new and productive jobs, it must emphatically reject the attempts of some EU member states (especially Germany and France) to abolish the existing right of veto in the field of taxation and social security, as well as their attempt to harmonize public finances within the Union.

ENDNOTES

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2. Naturally, the impact of political decisions on public finances is significant throughout the entire electoral cycle, not only at its end.
3. In this chapter, we shall discuss only realistic objectives. In its program manifesto from 1998, the first Dzurinda administration also pledged to "… achieve balanced budgetary management by the end of the electoral term" and "… adjust its expenditure policy to the goal of balanced public finances". Immediately after formulating these otherwise praiseworthy objectives in 1998, there were serious doubts about the government's ability to accomplish them. The main reason for the doubts was not only the expected unwieldiness of the broad-spectrum ruling coalition (which were later fully borne out by that coalition's performance) but also the significant debts, including loan guarantees, that the new government was required to repay.
4. The delimitation of 'general government' was part of the *Public Finance* chapter in the *Global Report* from 2001 (see Gonda, 2001). Naturally, the definition from 2001 does not include institutions that emerged later on (e.g. regional governments).
5. Consolidation means the elimination of transfers between individual constituents of the general government in order to present the overall economic results of the general government as such (i.e. excluding internal cashflows), with respect to other players in the national economy.
6. The author adjusted official data on consolidated general government expenditures without financial transactions by incorporating insurance payments for government employees and those loans (especially government guarantees for them) that are classified as irretrievable. Both adjustments correspond to the recently updated methodology used by the IMF (GFS 2001) as well as to that used by the EU (ESA 95), which is used in calculating the country's compliance with the Maastricht convergence criteria for public finances. Regardless of the adjustments, however, the figures presented are still calculated on a cash basis, as opposed to the accrual basis that both mentioned methodologies use.
7. First and foremost, each government should take care of public possessions, i.e. possessions that benefit the majority or even all inhabitants. The hallmark of these possessions is that all individuals are equally entitled to benefit from them, that there is no rivalry in consuming them (e.g. defense and security) and that their market value cannot be defined.
8. For a number of reasons, the ratio of consolidated tax revenues to GDP is not interchangeable with the concept of the tax burden on economic subjects. For instance, the ratio of overall tax revenues to GDP does not reflect the relationship of particular types of taxes to their respective tax assessment bases (e.g. corporate income tax to profits, value-added tax to household consumption, etc.). Besides, the pace of GDP growth in transition economies is usually higher and more frequently revised.
9. Potentially, it could fall within the Tax Quote III, but that is not the focus of this chapter.
10. The basic methodology used by Eurostat for presenting figures in the system of national accounts is ESA 95 (European System of Accounts from 1995). Based on its ESA 95 Manual, Eurostat issued the ESA 95 Manual on Government Deficit and Debt, a specialized public finance manual. Both methodologies, along with the European Commission Directive on Excessive Deficit Procedure (EDP), are used to calculate various countries' compliance with the Maastricht convergence criteria for public finances. Using the correct methodology in presenting public finance data is one of the basic requirements for joining the EU, and complying with these criteria is the basic precondition for joining the economic and monetary union (EMU).
11. For instance, the Institute for a Free Society calculated that taxpayers with a gross monthly income below 21,000 Sk would pay more taxes than before the tax reform. Similarly, the Institute for Economic and Social Reforms in co-operation with the Slovak Entrepreneurs' Alliance calculated that the tax burden on a family with two children and a gross monthly income of between 32,900 and 42,450 Sk would increase through the tax reform by almost 2% (see www.ineko.sk).
12. The most recent example was EU finance ministers censuring Ireland for cutting national taxes too radically in 2001.
13. Since these problems have been thoroughly described and analyzed in several other texts

by this author (see Gonda, 2002), this chapter mentions only the most common.

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