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PERSONAL INCOME TAX REFORMS IN SLOVENIA AND OTHER EUROPEAN ECONOMIES

Abstract

The paper examines some measures introduced in the tax system reform in Slovenia, as an example of a new EU member state. In the analysis we focus on the personal income tax. We analyze recent data for Slovenia and selected EU member states. In this context, we also discuss the question of flat tax rate suitability. Based on the presented simulation, we can conclude that the tax burden wasn't diminished significantly. We believe that additional reforms are needed.

Key words:

Tax reform, fiscal sustainability, personal income tax.

JEL: H2, H5, J3.

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1. Introduction

The Slovenian tax system is similar to that observed in the other European countries, owing to a stronger emphasis on income redistribution, wider social safety and broader provision of social services. Not surprisingly, reflecting the universal public provision of health care and education services, and high income transfers through the budget, government spending as a share of GDP, and hence the tax burden, is very high. Tax reform process is, therefore, the ongoing process in all European countries [1; 14; 8; 22; 27].

We shell consider trends in public spending as a share of gross domestic product (GDP) in the period since World War One. Tanzi (2004) has traced the growth of public spending in industrialized countries for the period between 1870 and the middle of 1990s. The pace of growth in the majority of countries was particularly pronounced in the period after 1960, when many established what came to be called a welfare state. When the welfare states were created, pushing the level of public spending to high shares of GDP, the industrialized countries were part of a world economy that was not well integrated and had markets that suffered from lots of inefficiencies. In that period (largely the 1950s and first half of the 1960s) economists developed economic concepts – public goods, externalities, cost-benefit analysis, merit goods – that gave governments the justifications for intervention. Now, half a century later, the situation has changed. Markets have become more sophisticated than they were in the 1950s. Goods and services that cannot be provided efficiently by the domestic market can be bought from other countries more easily than in the past. Policymakers have become more sensitized to the fact that high levels of public spending create inefficiencies on the tax side – because they require higher tax rates – and on the expenditure side – because they require large bureaucracies, and because, from the individual citizen's point of view, government services often have a zero (or at least a very low) price thus stimulating greater demand for them. Finally, high public spending may lead to macroeconomic difficulties when it is partly financed by fiscal deficits [21]. Even more, Schuknecht and Tanzi (2005) show that the trend toward lower levels of public spending may actually be happening. They also show that over the past two decades several countries were able to reduce public spending from its highest level by remarkable amounts. Furthermore, these countries did not seem to have suffered from these large reductions either in a macroeconomic sense, or in terms of lower values for socio-economic indicators.

However, reducing public spending and taxes seems very challenging for governments since they need to provide sound public finance. Sound public finances are a prerequisite for price and macroeconomic stability and strengthen the conditions for sustainable growth, where soundness covers the health of public finances in the short run (fiscal stability) and in the long run (fiscal sustainability) [11]. There is another issue of the optimal point-in-cycle for a tax reform. This is closely connected with the pro- or counter-cyclical fiscal policies of the government. In spite of the unanimous view among economists and policymakers that pro-cyclical fiscal policies should be avoided, counter-cyclical fiscal policies are far from being the norm in most European countries. What is most surprising is that the available evidence seems to indicate that in most advanced countries pro-cyclicality is an issue that mostly arises in good times, when the economic activity is above potential or when growth is above trend [8]. In such public finance policy there seem to be no optimal point for fundamental tax reforms at all. In the last two decades several developed countries have experienced significant budget deficits, while the ability of government to cope with fiscal deficits has been receiving increasing attention [1; 4; 26].

Almost all the tax reforms of the last two decades involving the income tax can be characterized as rate reducing and base broadening reforms, following the lead given by the United Kingdom in 1984. In the mid-1980s, most OECD countries had top marginal income tax rates in excess of 65 percent. Today, most OECD countries have top rates below, and in some cases substantially below, 50 percent. Most reforms have also tried to shift the balance in the tax structure from taxes on income and profits towards taxes on consumption [15].

In this paper we examine the case of Slovenia. When Slovenia was about to enter the EU in 2004 it had to review and reform the tax system to be compliant with EU legislation. But that wasn't enough. Changes were small and did not bring much to improve competitiveness. In the years 2005 and 2006 new tax reforms were heavily discussed. Heavily discussed was the flat tax rate proposal. Impact on the Slovenian economy was discussed by several economists and institutions (see Cajner, Grobovsek and Kozamernik 2006, Ovin and Jagric 2006, Caprirolo 2006, Rabushka 2006, Bole and Volcjak 2006, and many others). Finally, the government introduced a tax reform in 2006 with few changes of the existing tax system [12]. Impacts on the economy are expected to be small, government tax revenues are expected to diminish slightly what could cause fiscal deficit to raise unless the government won't raise consumption taxes in the next period.

The paper starts by describing the tax reform process in the European countries. There has been a lot of changes introduced to the tax systems in the last years, whereas the reasons behind are quite similar to those which indicated the need of a reform in Slovenia. In section 3 we show features of the personal income taxation in Slovenia and some early reforms on it. Section 4 presents the process of reforming the tax system in Slovenia as it took place in recent years. In this section we also analyze results of our simulation on different scenarios of personal income taxation in Slovenia. Finally, in the concluding section, we examine the results of introduced reforms and present our critical view.

2. Reforming tax systems in the European countries

In this section we shall consider developments in the share of public spending into GDP and the process of tax reforms in the European countries. We shall observe two groups of countries with similar developments and later on observe to which Slovenia is more similar. We shell argue that these developments contain lessons that are to be considered more closely, also by Slovenia.

In the first group of countries we observe western European countries which typically have high tax burden and sizable welfare payouts for the citizens. High GDP per capita in last decades has led the public to be used to live in an extremely welfare society. Not only that people are used to receive high payouts of the social security system but also they are used to live in a country where the infrastructure is high developed. Here we do not mean only the quantity on public infrastructure, but also the quality level of the public educational system, health care system and also of the legal system. Sweden, Denmark, Finland, Norway and Belgium have the highest total tax revenue as a per cent of GDP. The share varies from 51 in Sweden to 43 in Norway [17]. An important fact is that the share lowered in the last decade; however, it still remains on a very high level. We shell additionally analyze the data in Table 1 for the year 2005. Government revenue in the first group countries is still very high, ranging from 43.40% GDP in Germany to 59.40% GDP in Sweden. On average in selected countries the level of public spending is lower than revenues. It ranges from 42.60% GDP in Norway to 56.60% GDP in Sweden.

Even more interesting for our analysis is data on labour tax burden. In Table 1 we present the OECD data on tax burden as implicit tax rates on labour in %. We can observe that the tax burden on labour costs has diminished in all selected countries except in Austria and Norway, where the change is not very significant. To a large extent, changes in tax wedges reflect changes in income tax. However, often changes in income taxes are offset by changes in social security contributions like, for example, in Austria, Finland or Denmark. In France and Sweden, the main drivers of the changes in the tax wedge were jointly changes in income tax and changes in employer's social security contributions [15]. We can also observe that the highest marginal tax rate of personal income tax is very high in the first group of countries. On average it is almost 50%.

High tax revenue enables any government to finance extensive level of public goods, as already mentioned before. For example in Norway, the government has the chance to fulfill some special national interests, such as: keeping remote areas populated, which is possible only if the government aims to keep employment in those areas high. On the other hand, the Norwegian government wants to keep the provision of public services up to the high national standards. This requires a substantial re-allocation of public funds across regions. Norway's tax system already in the early 1990s went through a sweeping base-broadening and rate-cutting reform [27].

Table 1

Public finance data overview for first group of countries

Group 1	Total general government revenue (in % of GDP for 2005)	Total general government expenditure (in % of GDP for 2005)	Implicit tax rates on labour (in %)		Personal income tax marginal tax rate for highest income bracket (in % for 2006 income)	Tax wedges for a single example worker at 2/3 of average earnings (in %) for 2005
			2005	Diff. 2000–2005		
Austria	48.20	49.90	40.90	0.70	50.00	42.50
Belgium	50.10	50.10	42.80	–1.10	50.00	49.10
Denmark	57.10	53.20	37.30	–3.60	59.00	39.30
Finland	53.10	50.70	42.00	–2.10	32.50	39.50
Germany	43.40	46.70	38.70	–2.00	45.00	46.70
Norway	58.80	42.60	39.40	1.20	51.30	34.30
Sweden	59.40	56.60	46.40	–2.80	60.00	46.50
Average	**52.87**	**49.97**	**41.07**	**–1.39**	**49.69**	**42.56**

Source: OECD 2007 and EC 2007.

In Denmark, for example compared to other European countries, there is a classical system with progressive taxation of labour income by relatively high marginal tax rates at relatively low-income brackets and almost no social security contributions as a means of financing public expenditures in place. There was a debate about introducing a flat tax rate in Denmark, but calculations have shown, this would require gross tax revenue cuts. Especially this would bring savings to middle- and top-income citizens [14]. Currently, Danish income tax consists of state tax, country tax and local tax. The state tax amounts to 5.5% of the taxable income regardless of the size of the income. An additional 6% is paid on taxable income exceeding DKK 259500, and an additional 15% on income exceeding DKK 311500. Local and country taxes vary. In 2004 the average is 33.3% on the taxable income. On average the voluntary church tax is 0.7%. A tax ceiling ensures that the total income tax paid as state tax, country tax and local tax does not exceed 59% of one's income. Church tax, labour market contributions and the special pension scheme savings are not included under the tax ceiling. Due to the special tax rules of the 25% tax scheme, foreign researchers and high salaried key employees have an opportunity to pay a gross tax of 25% on their salary instead of paying the ordinary income tax. They will however still have to pay 9% of social security contributions (Danish Ministry of Science 2007).

Demographic changes in the last decades are only one of the reasons why all countries selected in the first group have constantly to reform their public finance systems, not only the personal income tax. In Germany, Austria and France the tax reform has been heavily discussed in the past years. Currently we can observe a falling trend in the personal income tax as a share of total tax revenue. This still varies from 53.10% in Denmark to 31.40% and 31.30% in Belgium and Sweden. In the recent years there has been a shift from personal income tax to consumption taxes as one of the tax reforming process figures in selected European countries [18].

Schuknecht and Tanzi (2005) have analyzed the period from 1982 to 2002 to identify trends in reforming the public finance process in selected countries. For many countries, public spending kept rising after 1982 and reached a peak after 1982 but before 2002. This peak was in most countries reached by 1996. While in Belgium expenditures reductions are taking place ever since 1983, in some other countries the same trend begins later. The same is true for Finland and Sweden, where the peak in public spending was achieved in 1993 or like in Norway and Austria, where the peak was reached in 1994 and 1995 respectively.

In the second group of countries we observe eastern European countries: Czech Republic, Estonia, Hungary, Latvia, Poland and Slovak Republic. They are all transitional economies and therefore differ from the first group of countries. We will examine their tax reform process and public finance conditions. We present some relevant data in Table 2.

Government revenue in the second group of countries is lower than in the first group, on average by 13.19% GDP. Also public spending is lower than in the first group, however not that much lower, on average by 7.89% GDP. As we could expect from the data, also tax wedge on labour costs is lower. And even more, the data indicate that tax reductions have been even bigger in recent years in the first group than in second group. Reforms in income taxation began in the transitional economies already in the mid-1990s just after most of those countries have become independent. The most popular concept seemed to be the flat tax rate, which might have had some positive effects on attracting foreign investment into the countries. However, the effects of the flat tax rate extremely depend on the current tax system of the country; therefore, for the countries with high tax revenue the flat rate may, for example, negatively affect welfare payouts to the citizens. Estonia was the first to adopt a 26 percent flat rate in 1994. Before that, the tax legislation was drafted on ad hoc basis without a clear tax policy, and it was a rather transitional system from the Soviet tax rules to Estonia's own system. The Basic World Tax Code prepared by Harvard University was used as an example to prepare the new law. There were several reasons presented for introducing the flat rate: an easy system with a broad tax base and low tax rates is much easier to administrate, high inflation in the beginning of

1990s in Estonia, it is easier to administer if the same tax rate applies both to individuals and legal persons, the system with a broader tax base and one tax rate provides more transparency [28].

Table 2

Public finance data overview for second group of countries and Slovenia

Group 2	Total general government revenue (in % of GDP 2005)	Total general government expenditure (in % of GDP 2005)	Implicit tax rates on labour (in %)		Personal income tax marginal tax rate for highest income bracket (in % for 2006 income)	Tax wedges for a single example worker at 2/3 of average earnings (in % for 2005)
			2005	Diff. 2000–2005		
Czech Rep	41.40	44.40	41.30	0.60	32.00	42.10
Estonia	37.50	35.90	33.10	–4.70	23.00	39.80
Hungary	44.50	50.60	40.50	–1.60	36.00	42.90
Latvia	36.40	36.20	35.90	–5.30	27.00	43.20
Poland	40.90	44.80	35.50	–0.60	40.00	42.40
Slovak Rep	37.40	40.60	33.70	–5.00	19.00	35.30
Average	**39.68**	**42.08**	**36.67**	**–2.77**	**29.50**	**40.95**
Slovenia	***45.50***	***47.30***	***38.50***	***0.70***	***50.00***	***36.40***

Source: OECD 2007 and EC 2007.

Latvia and Lithuania followed Estonia with 25 percent and 33 percent rates, respectively. Serbia was next; in 2003 it went with a 14 percent rate. In 2004, it was Slovakia (19 percent) and Ukraine (13 percent) [22]. In 2005 it was Georgia, which boasts the lowest rate of 12 percent, and Romania (16 percent). The flat tax rate reform in Romania was expected to bring fiscal expansion. So far, it has been noticed that the reform led to a simplification and more efficient computation system of global income taxation, to a significant reduction of bureaucracy and to an increase of transparency in tax collection and administration. The expected impact was mainly in the change in economic behaviour of business environment by increasing the tax base through extending hidden economy into formal economy, increasing the voluntary compliance in paying budgetary obligations and increasing the arrears recovery [10]. Since it's not long ago since the reform was introduced, the quantitative evaluation of results will give a meaningful result in about few years.

In the next years even more reforms on personal income tax are expected in the region. For Estonia, the rate is expected to drop to 20 percent. The downward trend in tax rates is ongoing: in ten EU countries rate cuts were introduced in 2006 or 2007 (Bulgaria, the Czech Republic, Estonia, Greece, Spain, France, Luxembourg, the Netherlands, Portugal, Slovenia). None of them were from the first group, but two countries from the second group and Slovenia which we shall examine in more detail in the next section.

We shouldn't however take cutting rates on personal income as an overall tax-diminishing process. The European Commission and Eurostat (2007) report on a slight increase of the overall tax ratio. In 2005, as compared to the previous year, the overall tax ratio increased by half a percentage point in the arithmetic average. This increase is the first significant one since 1999; in most countries, that year marked a turning point from the continuous increase of the second half of the 1990s. The upturn of 2005 is not strong enough to push the ratio back to its historical peak; the level of taxation is, however, now practically back at its 1995 level. Efforts to reduce taxes permanently after 2000 petered out gradually; reductions in tax ratios, fairly aggressive in 2001, lost importance in subsequent years and mostly stopped altogether in 2005; furthermore, in several of the new Member States most reductions in tax ratios took place in the 1990s; the following decade even saw increasing overall tax ratios in some of them.

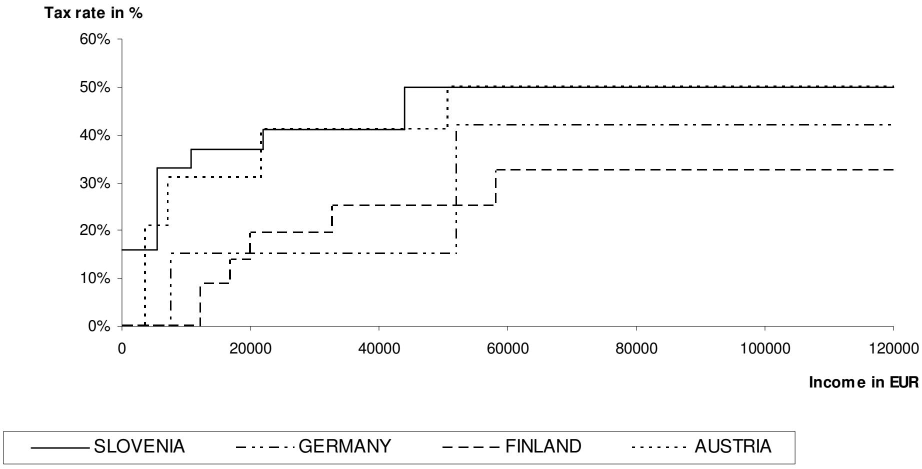
3. Personal income tax in Slovenia

One fundamental trade-off in the design of tax policy is between efficiency and vertical equity, interpreted as the relationship between tax liability and a family's level of well-being. Loosely speaking, placing the tax burden more on high-income families requires higher marginal tax rates, which causes more welfare loss due to disincentives to work, save, and invest [25]. Slovenia is just in the same situation as all other European countries presented above, having a great need in reforming the tax system and facing the trade-off presented.

In Slovenia, the proposed tax reform has the same origins as in any other developed economy (countries from the first group or from the second group): losing competitive advantages of the economy. Already from Table 2 we saw that Slovenia does not share much of public finance features with the second group of countries, which are also transitional economies. According to the data, it is more similar to the first group of countries and the need of reforming the system is even greater than in the second group.

Figure 1.

Personal income tax brackets in Slovenia in 2006 and in first group of countries

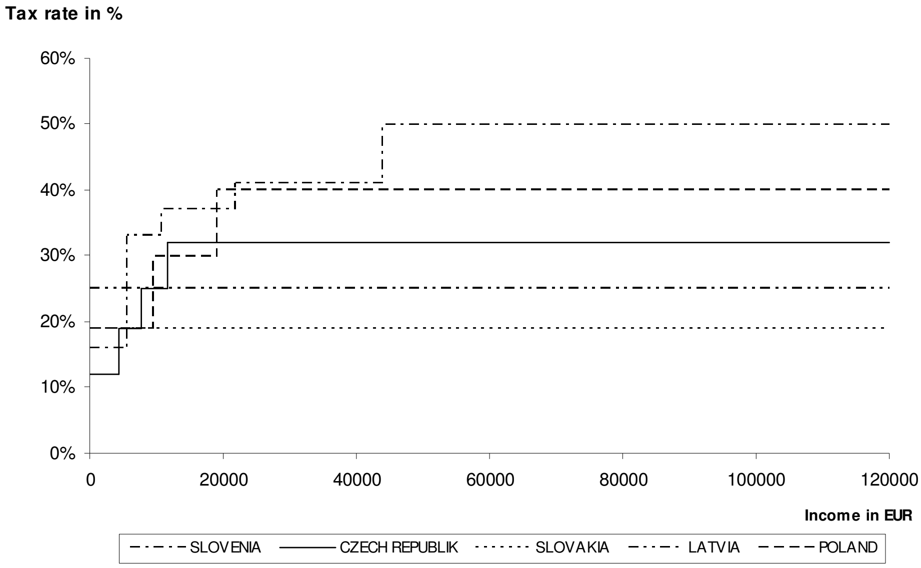


Source: Own calculations upon national legislations.

In Figure 1 we compare the marginal tax rate in Slovenia and some countries from the first group in 2006. In the countries not presented in the figure personal income tax have dual tax systems like Norway, for example. We can see that Slovenia has in the lower income brackets the highest marginal tax rates, but it is closely followed by Austria. In higher income brackets both countries have the highest marginal tax rate among selected countries. From the Figure 1 there are also seen high marginal tax rates in Germany. At the end we can see Finland with very low marginal rates, which are only in the middle-class income bracket lower in Germany. There was a trend in falling personal income tax rates in all observed countries. Whether this is likely to continue is another question. However, we wouldn't expect the first group of countries to cut rates significantly just to come to the level of eastern European countries. We should consider that tax rates and tax systems are not the only determinant of whether a country will achieve competitiveness around the globe. There are countries with very high tax rates (such as Denmark or Sweden), but they are still among the most competitive economies in the world. There must be some other determinants on competitiveness than tax rates.

Figure 2.

Personal income tax brackets in Slovenia in 2006 and in second group of countries



Source: Own calculations upon national legislations.

Also in Figure 2 we can see that Slovenia has the highest individual marginal tax rates among the compared countries. All compared countries have relatively high tax rates for low-income citizens but relatively low rates for high-income citizens. Among the compared countries Slovenia is followed by Poland, Czech Republic, Latvia, and finally Slovakia in the highest tax bracket. Again, we should consider competitive advantages broader, in the sense that lower tax rates might help a company to improve competitiveness, but this is not enough. New EU member states try to improve competitiveness in several ways: not only by lower tax rates, but also by introducing a tax system with features like efficiency, transparency and easily accessible information.

In Slovenia, there has been a reform process going on. Taxation of personal income as one tax for different income sources was introduced at the beginning of the 1990s as Slovenia became an independent country. The new personal income tax legislation was valid from 1.1.1991. There were five income brackets, with marginal tax rates ranging from 18% to 45%. Changes in the tax rates – and not only for personal income tax – may be seen as the first tax reform in this period. In general, the Slovenian government tried to achieve unification or similarity of the Slovenian tax system with those of the other European countries.

A new review of personal income tax took place in the year 1993, with new tax legislation valid from 1.1.1994. There were changes in the definition of tax base, tax payer and marginal tax rates. The main purpose was to relieve taxpayers in the lower income brackets and to load higher tax burden on high income taxpayers. The tax base was given a broader definition. Another change was introduced in the year 2000, which extremely relieved low-income taxpayers. For those, whose income was less than or equal to 40% of yearly gross average wage in Slovenia, the tax burden was lowered by 100%. Similarly, for those whose income was 42% or less than the yearly gross average wage in Slovenia, the income tax was lowered by 70%, and for those taxpayers, whose income was lower than or equal to 45% of yearly gross average wage, the income tax was lowered by 40%.

Only few years later, in 2004, Slovenia had to review its tax regulations again. There were several reasons for the need for a tax reform. One of it was Slovenia's entrance into European Union. But this wasn't the only reason. There was a general need for revision, since the income sources of citizens had changed. Tax burden was considered to be too high as well. On the other hand, there was major difference in how different types of income were treated. Tax reform in the year 2004 implemented a new view on types of income. In the legislation before the reform, the law explicitly defined all types of income subject to tax. This reform brought the taxation of all possible income types, and the law listed only exceptions.

The tax reform of 2004 did not bring enough changes. Therefore, just a year after the reform, a discussion on a possible new tax reform took place. The public brought up arguments on the crucial need for a new reform, which should include all taxes, not only personal income tax. For the first time it was very clearly discussed in the public about the impact of tax system on the competitiveness of the economy. High marginal tax rates were considered to be far too high. If Slovenian economy wishes to grow and develop on knowledge-based industries, it needs an especially highly qualified labour force. It is very clear that such a labour force earns high salaries, and its income is therefore taxed by high marginal tax rates in the higher tax brackets. Since the tax burden on high income is very big, highly qualified workers will leave the country and work elsewhere. The Slovenian economy would thereby lose the crucial factor of its future development, with long-run consequences and already in the short run lose its tax revenue.

4. Analysis of recent reforms in personal income tax in Slovenia

The aim of our analysis is to find out what the newest income tax reform will bring to the tax payers in Slovenia. We have seen that tax rates on income are declining in both the first and the second group of countries. The same is happening in Slovenia. But what is the effect? For whom is it going to be better and for whom worse?

Table 3.

Income tax brackets in 2006 in Slovenia (in EUR) and tax rates

Income bracket	Income		Tax rates
	from	to	
1	0.00	5538.72	16%
2	5538.72	10821.82	33%
3	10821.82	21899.27	37%
4	21899.27	44011.56	41%
5	44011.56		50%

Source: The Official Gazette of RS, No. 21/2006 ZDoh-1-UPB3.

Slovenia's personal income tax after the last reform described in the previous section had 5 tax brackets and was valid since 1.1.2006 (see Table 3). We have seen in Figures 1 and 2 that marginal income tax rates are very high in Slovenia in comparison to other European countries. However, besides the tax brackets we should consider also tax reliefs and allowances available to tax payers in 2006.

In Slovenia, there has been a general allowance in amount of 2521.81 EUR available to all tax payers. Further reliefs were available to special social groups: disabled, retirees and students. There have also been benefits for the people self-employed in culture or journalism. Their income tax is being lowered by 15% if their total income does not exceed 25037.56 EUR. There has been a tax relief of 2% for diverse purposes (medicine or tuition for example). Another tax relief of 4% has been available for taxpayers who have bought a house or a flat. There has also been another tax relief aimed at encouraging people to pension savings. Savings in certified pension funds counted as tax relief, but only in the maximum amount of 2340.75 EUR [24].

If the government wishes to lower the tax burden and at the same time improve the competitiveness of the Slovenian economy, there should be one way to do that: by lowering the taxes (lower marginal tax rates, greater tax withdrawals) and, at the same time, by reducing public sector expenditures. Without lower public sector expenses, the reform will not be sustainable. It is very hard to do so for any government which faces the same demographic trends as those in Slovenia. Slovenia is facing the problem of ageing population. Like in most of the EU countries, Slovenia's population will be older in 2050, with a much smaller population of working age (if we refer to the EC 2006 simulation of age-related expenditures in EU countries). On the whole, the projections of EC (2006) show that Europe faces a significant budgetary challenge posed by ageing populations. Most of the projected increase in public spending will be on pensions, healthcare and long-term care, becoming apparent starting from 2010 and with the largest increases in spending projected to occur between 2020 and 2030. We show projections of age-related expenditures for Slovenia in Table 4. The government will have to cover these additional expenditures somehow, whether with higher tax revenues or with shifts from direct to indirect taxes. We shall consider that a reform with lowering tax revenues but without lowering government expenditures cannot be sustainable in the long run. If none of this is done in the short run and the government stops at cut rates on personal income taxes, a new reform will be needed after a short period of time. We would expect the Slovenian government to raise value added tax, since we can notice a shift to higher consumption taxes in all observed countries.

Table 4.

Projected changes in age-related public expenditure between 2004 and 2050 (% of GDP)

	Pensions		Health care		Long-term care		Unemployment benefits		Education		Total	
	Level 2004	Change 2004–2050	Level 2004	Change 2004–2050	Level 2004	Change 2004–2050	Level 2004	Change 2004–2050	Level 2004	Change 2004–2050	Level 2004	Change 2004–2050
Slovenia	11,0	7,3	6,4	1,6	0,9	1,2	0,5	–0,1	5,3	–0,4	24,2	9,7
EU-25	10,6	2,2	6,4	1,6	0,9	0,6	0,9	–0,3	4,6	–0,6	23,4	3,4
EU-15	10,6	2,3	6,4	1,6	0,9	0,7	0,9	–0,2	4,6	–0,6	23,5	3,7

Source: European Commission (2006).

In its 2006 development strategy, the Slovenian government had several goals for its tax reform, such as sustainable social cohesion, lower labour costs, creating a competitive tax environment with more simple tax regulations for companies, lower cost of tax administration for companies and more transparent tax obligations for all citizens [13]. To meet these goals, the concrete tax reform proposals had to be created. The first tax-reform proposals package included flat tax rate in Slovenia for personal income tax, value added tax and profit tax. Tax rate for personal income tax was set at 20%, and the general allowance was proposed to be 2578 EUR which is a little bit higher than the general allowance valid in 2006 at 2521.81 EUR. The system did not contain any other tax relieves.

Public reaction on the flat tax rate system proposal wasn't positive at all. Labour unions went on streets, protesting against flat tax rate. Their main concern was that flat tax rate would bring higher taxes to low-income part of the population. Savings would be made by wealthy people only. The government came across with another proposal, a less radical one. Their proposal was based upon the existent tax system. Main change was in the number of income brackets, which was lowered down to three, tax rates were proposed to be lower, but also tax relieves and allowances were to be lowered or withdrawn at all. The general allowance was increased to 2.800 EUR. On the other hand, there are no longer allowances for diverse purposes or real estate investment. Both child and pension fund savings allowances would still be available to tax payers. The government succeeded with the proposal, and the new tax reform was set effective in Slovenia from 1.1.2007. In Table 5 we present income tax brackets and tax rates valid from 1.1.2007.

Table 5.

Income tax brackets (in EUR) and tax rates valid from 1.1.2007

Income bracket	Income		Rate range
	from	to	
1		6800.00	16%
2	6800.00	13600.00	27%
3	13600.00		41%

Source: The Official Gazette RS 21/2006 ZDoh-1-UPB3.

We performed a tax simulation, which has shown what would happen with income tax obligations for an average tax payer. We present our results in Table 6. The simulation is based on the assumption that the tax payer earns wage income only. For comparison, this thesis is plausible, since in Slovenia, both before as after the reform, a dual system of income from capital gains and interest receiving is in place. For the observed taxpayer, also the following assumptions were taken: he has 1 child, meets conditions for the allowance for diverse purposes and has just bought a real estate as his first home.

Table 6.

Income tax simulations in EUR

Income	Tax system for 2006 income Total tax	Flat tax rate (proposal)		Tax reform, valid from 1.1.2007	
		Total tax	Change to 2006 (in %)	Total tax	Change to 2006 (in %)
1 x AVG	1133,28	1728,25	+ 52,50	1034,46	– 8,72
2 x AVG	4892,86	3973,98	– 18,78	4644,30	– 5,08
5 x AVG	18234,71	10711,74	– 41,26	18581,66	+1,9

Source: own calculations upon legislation (The Official Gazette of RS: ZDoh-1-UPB3 and ZDoh-2 and Government RS 2006a and 2006b).

Note: AVG means average of monthly gross value wages in 2006 in Slovenia less paid social security contributions.

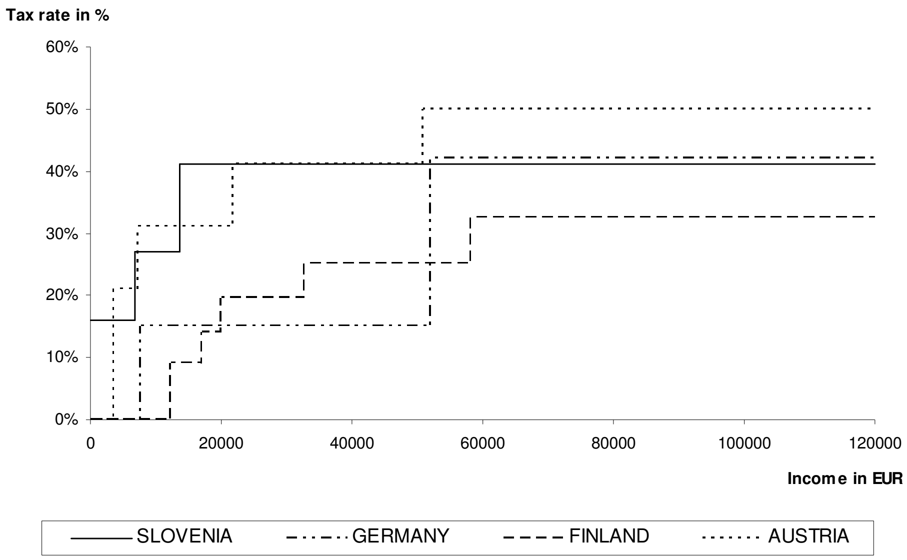
As income basis we took the monthly average gross value for earnings in Slovenia and calculated the average value for the year 2006. The tax base is in Slovenia calculated as income less paid social security contributions less allowances. In all three calculations we could include the general allowance since it is included in all three tax systems. We calculated three scenarios. The first is for the tax payer with 100% average earnings; the second was at 200% and the third one was at 500% average earnings.

The results of simulations suggest that the tax reform valid from 1.1.2007 suggests a system which isn't very different from what was valid in Slovenia before. On the other hand, the flat tax rate system would bring benefits to high-income tax payers, while the tax burden for low-income tax payers would increase significantly. Considering unchanged gross wages, high income labour costs would fall under flat tax rate system (for over 41% in the highest bracket). For tax payers with two-times average income tax burden, it would fall by about 19%. From the perspective of highly qualified labour force, the impact on competitiveness might be positive. On the other hand, social cohesion might be under question.

On the other hand, the simulation has shown that tax burden with the new tax system valid from 1.1.2007 will not fall dramatically; however, it will fall for most of the tax payers. For the tax payer at 100% average earnings the total tax would fall by 8.7% under the taken assumptions. For a tax payer with income at the 200% average earnings level, the tax burden would fall by 5%. For a tax payer with income at 500% average earnings, the tax burden would raise by 1.9%. This raise is the consequence of fewer allowances. In our simulation we took the assumption that the tax payer had the allowance for diverse purposes and real estate. As they were quite high in the old system, there will be a difference for tax payers with high income and which did put to use allowances in the old system.

Figure 3.

Personal income tax brackets in Slovenia after the reform and in second group of countries



Source: Own calculations upon national legislations

On Figure 3 we compare Slovenia's marginal income tax rates to those in the selected countries of the first group of countries. We can see that there are no significant changes. Similarly, marginal tax rates are still very high compared to countries in the second group. If we take into account that some tax allowances have been withdrawn from the tax system, it becomes clear that the present tax reform will not bring significantly higher net wages (for some tax payers not even at all) at the same level of gross wages or the same net wages at the lower level of gross wages. We believe that the government tries to improve the competitiveness of the whole Slovenian economy; however, the magnitude might be far from what in Slovenia is really needed.

5. Conclusions

There are many factors influencing the competitiveness of national economy. One of them might be tax policy. We have examined if the government in Slovenia helped companies to lower the costs of highly qualified labour force and improve their competitiveness on domestic and foreign markets. For any company gross wages are important at the cost side of their business outcome analysis. However, highly qualified specialists will choose to work for the employer if the net wage will be near to what they expect. The Slovenian government tried to reduce costs for the companies in the way that net wages would stay at least at the same level but gross wages could decrease.

In this paper we have shown that the process of tax reform is taking place all around Europe. Reforms are needed also in Slovenia, although we consider that reforms throughout the last decade in Slovenia haven't been sufficiently revolutionary and fundamental. On the other hand, we should include the stage of public finance in all developed countries where health care costs and pensions are booming. From this point of view, we can not expect that the government would try to reduce tax burden significantly. High tax rates became a fact for most of the developed economies, which face similar demographic movements as does Slovenia. But there are not only demographic changes which force the Slovenian government to reformulate public finances. Also globalization and EU enlargement process have important impacts on the Slovenian tax system in sense of becoming more competitive and efficient.

We would expect the government to reduce public sector costs at least where this would be possible (administration, military expenditures). Even though the political interest of helping companies to reduce wage costs has been great in the recent years in Slovenia, we can see from our simulation that in the end the tax burden hasn't diminished significantly. We compared the flat tax rate system as it was proposed in Slovenia and the recent personal income tax reform to the personal income taxation in 2006. We have shown that the flat tax rate would let lower income tax payers pay more and create benefits for higher income tax payers. We have also shown that the recent tax reform doesn't change much in the total tax amount, which will decrease only slightly. Tax revenues will consequently decrease and cause the government to look for another reform in the near future, most probably shifting the tax burden to consumption taxes.

Yet, we see another possibility of how the government could help improving competitiveness of the Slovenian economy without diminishing tax revenues, which seems to become more of a wish than a reality because of the booming age-related public expenses. The government could put more effort in supporting research and development projects directly undertaken in companies, as well as in the academic field. The companies which produce goods and services with high added value typically incorporate in their products the results of research, either internal projects or academic ones. This would improve competitiveness of the Slovenian economy and at the same time raise tax revenues since the tax base would rise. In the future we would expect the government to find an optimal combination of reducing public sector costs, reducing taxes where it is possible, and support research activities extensively. Another simple tax reform won't bring any important results. Most probably, future tax deficit could be covered with higher tax rates on value added tax in Slovenia.

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