

INTRODUCTION OF 19% FLAT TAX IN SLOVAKIA IN 18 MONTHS

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I. INTRODUCTION

Slovakia came into existence in 1993 after a well-known “Velvet Divorce” when Czechoslovakia was split up into two newly independent states, Slovakia and the Czech Republic. It was just three years after so called “Velvet Revolution” of November 1989 that accelerated a collapse of a communist Czechoslovakia.

Back in 1993 there were many uncertainties associated with Slovakia in eyes of international community, especially concerning future performance of its economy. Because of serious macroeconomic imbalances and microeconomic structural weaknesses many analysts predicted a drastic devaluation of the Slovak currency, and early overall collapse of the Slovak economy.

These extremely negative expectations did not materialize. Moreover, Slovakia successfully escaped from risky period of the first years of its independent existence, later learned its painful lessons with bad government policies in mid 1990s, and finally surprised the world with courageous reforms implemented especially in 2002-2006.

In 2003, just one decade after 1993, there was a completely different perception of Slovakia. Slovakia increasingly started to be known as „Detroit of Europe“ as a result of its success in attracting many multinational car-makers, including Volkswagen, Peugeot-Citroen, Kia Motors, and others investing in Slovakia in recent years. In a summer of 2003 Steve Forbes, an American billionaire, after his visit in Slovakia wrote: *“The Slovak Republic is set to become the world’s next Hong Kong or Ireland”*¹

Of course, there are many factors behind this fairy-tale turnover. There is no doubt that a tax reform, an introduction of 19 % flat tax, does represent one of the most fundamental elements of a reform program of the Slovak government in 2002-2006 which can be considered as the most consistent and radical free market program any developed country implemented in the first decade of the 21st century.

An old tax system in Slovakia was the typical tax system of European welfare state country, in addition having a communist heritage. It was distorted by efforts to stimulate economic growth with help of tax policies favouring certain economic activities,

¹ Steve Forbes: “Investor’s Paradise”, Fact and Comment, *The Forbes Magazine*, August 11, 2003.

industry, location, business forms, small and medium sized enterprises etc. It was dominated by special regimes and allowances.

Unavoidable result of these policies was a high tax rates environment with special tax regimes and allowances, rates differentiation, exemptions, relieves, etc. The most serious problems of this system were almost textbook ones: serious distortions of competition, administrative complexity, and unintended consequences of government actions.

Flat tax reform eliminated progressive income taxation (ranging from 10 to 38 %), introduced one universal rate of 19 % for personal income tax, corporate income tax, and value added tax (without having reduced VAT rate). Moreover, it simplified the tax system by abolishing of several types of taxes like inheritance tax, dividend tax, etc.²

This experience of Slovakia can serve as an inspiration for other countries, especially for post-communist countries of a Central and Eastern Europe, including the former Soviet Union republics. Its most inspiring part is the experience of the country once desperately lagging behind others, and later implementing ambitious reform plan putting it far ahead of others. If Slovakia did it, other countries can do it as well.

II. 1996-1998: PRE-HISTORY OF THE TAX REFORM - RAISING AWARENESS STAGE

Favourable conditions for any fundamental reform, including the tax reform, originally rarely exist. It was true also in case of Slovakia in mid 1990s. The most important challenge of that period was therefore to contribute to such changes that would transform unfavourable conditions for the tax reform to the favourable ones.

In mid 1990s Slovakia as a transition country was still struggling to get its fundamentals right, facing difficult challenges of price deregulation, liberalisation, and privatization. Taxation was not among the top priorities of that time. In 1993 Slovakia replaced its old tax system inherited from communism and adopted a standard system of a typical European country with introduction of value added tax, excise duties, real estate taxes, corporate and personal income taxes.

² For more details on major parameters of the reformed tax system in Slovakia see Appendix 1.

As a result almost all experts and government officials did not see any reason for introduction of any significant changes into the tax system that was adopted only several years ago.

Ministry of Finance for a long time refused to speak about necessity of the reform in the area of taxation. The only thing the government officials were ready to discuss was a “fine tuning”, in other words minor changes and adjustments of the tax system.

Almost nobody seemed to understand that Slovakia was not able to afford to have a weak and inefficient economy on one side and the tax system with high tax burden financing extensive welfare state as advanced countries of the Western Europe.

Under these circumstances the most important challenge was to increase public awareness of these issues and persuade both general and expert public that Slovakia needed fundamental tax reform.

There was a crucial role played by small circle of people associated with the F. A. Hayek Foundation established in 1991 as the first free-market think-tank in Slovakia. It was an important historical step not only because the foundation was having a significant impact on a public policy making process in Slovakia during its transition period, especially during its second half (after 1995). The foundation proved to be a very efficient vehicle in introduction of innovative ideas like flat tax into debates on public policy-making process in Slovakia as it was expected from the think-tank. What was equally important, however, it was ability and capability to act also as the "do-tank" - to make sure that these ideas were also implemented

In order to increase public awareness of growing tax burden and need of the fundamental reform of the tax system people from the Hayek foundation decided in 1996 to establish specialised association focused exclusively on taxation called *The Slovak Taxpayers Association*.

Its mission was defined as follows:

- To decrease the total tax and contribution burden
- To ensure better media coverage of issues of public interest
- To assure more efficient advocacy of taxpayers interests

- To protect the interests of taxpayers by supporting initiatives in reducing tax rates, public expenditures and balancing the state budget
- To strengthen the public debate about public finance and tax burden
- To involve citizens in control over the public finances
- To increase knowledge about public finance issues

The Association started to make polls on tax related issues, conducted comparative studies of the tax systems in the Slovak Republic and other countries (OECD, EU), organized the public and expert debates on taxes and public expenditures, and started with publication of annual study called *"Analysis of Public Expenditures and Tax and Contribution Burden in the Slovak Republic"*.

However, by far the most successful project of the Association was the *Tax Freedom Day project*, including annual calculation and publication of the Tax Freedom Day that attracted enormous interest of media, and preparing and submitting for a discussion in the parliament a Law on the Tax Freedom Day. These activities were preparing a fertile soil for more courageous ideas how to change the tax system, including a flat tax idea.

It was also important that The Slovak Taxpayers Association was internationally recognized and became a member of the World Taxpayers Association and The Taxpayers Association of Europe.

III. 1998-2002: THE FLAT TAX IDEA: GOING INTO POLITICS

It was important that The Taxpayers Association's activities encouraged a huge public debate on taxes in mass media, and the ideas of cutting tax burden and the tax reform were much more widely accepted.

However, it was still long way to go. In order to put them into practice still two very important steps needed to be made:

1. to plant the idea of the tax reform into political environment
2. subsequently to do the same with executive power, policy-makers.

The Taxpayers association's publications and analyses of taxes and public expenditures, its legislative proposals discussed in the Slovak Parliament attracted also interest of politicians. The Association's ideas and activities started to have impact on programs of

political parties. One of useful tools proved to be a preparation of a handbook for policy- and decision-makers on taxpayers friendly behavior, and taxpayers audit of political programs. The smaller political parties were first to come up with the flat tax idea, later followed also by larger and more relevant parties becoming in following years members of a government coalition.

In 1998 reform oriented coalition came into power in Slovakia thus reflecting frustrations of voters with bad policies of previous government that brought the Slovak economy into a serious financial crisis. However, despite reform oriented policies of the new government, the executive power, especially the Finance Ministry still resisted to any fundamental changes of the tax system.

In order to accelerate elaboration, implementation, and adoption of much needed changes by executive power some members of the Hayek foundation and The Taxpayers association decided to accept executive positions at responsible ministries, first, in a period of 1999-2002 at a Ministry of Economy, later, in a period after 2002 at a Labor Ministry.

The fight was brought into internal structures of the government. In one of the documents elaborated by the team at a Ministry of Economy and submitted to government for approval there was also the introduction of 20 per cent flat tax of (still back in 2000-2001!) proposed as one of potentially the most powerful measures to make the business environment more favourable for both domestic and foreign businesses. Since at that time the lady minister of finance was a representative of the left wing party, the proposal failed. The first seeds were planted, and this venture brought its fruits several years later when the comprehensive flat tax proposal was implemented as of January 1, 2004.

However, there were also two very positive immediate results of this pioneering activity:

1. under the growing pressure the Finance Ministry finally stopped talking about the “fine tuning“, and was forced to admit that much more ambitious change of the tax system is needed,
2. corporate income tax rate was cut from 40 to 29 per cent as a compromise

between gradualist proposal of the Finance Ministry³ and the “radical” proposal of the Economy Ministry.⁴

In September 2002 there were regular parliamentary elections called and it was a good sign that several political parties were campaigning with the flat tax idea. It was decided that it was good timing for The Slovak Taxpayers Association in co-operation with the WTA and the TAE to organize an international conference on recent trends in taxation policies in Bratislava in order to strengthen the reform message.

IV. 2002-2006: IMPLEMENTATION OF THE REFORM AND THE FIRST RESULTS

Since reform oriented government was re-elected, the prospects for the implementation of the flat tax increased. In November 2002 the new government approved its reform program announcing an ambitious plan to implement a long list of fundamental reforms, including the flat and pension reforms. A wording of the text on the tax reform did not commit the government to implement the flat tax. It was defined more broadly as an intention to reduce income tax rates and consider possibilities of implementation of the flat tax.

The Finance minister in November 2002 set up a task force to come up with a proposal. One of the major underlying principles of the tax reform was its fiscal neutrality. The government took a cautious approach and wanted to calibrate all changes in the tax system with an aim to collect about the same amount of tax revenues after the reform as before its implementation.

Based on this assignment the team in less than 12 months⁵ designed a fiscally neutral proposal, including:

- shifting of the tax burden from direct toward indirect taxes
- introduction low standard tax rates and elimination of all exceptions, exemptions and special regimes

³ Proposing to take cautious approach and cut CIT from 40 to 38 per cent.

⁴ Proposing to bring down rates for both CIT and PIT to 20 per cent.

⁵ Fundamental Reform of The Tax System, Ministry of Finance, November 2003.

- introduction of flat tax rate in personal income tax, replacing the regime with different tax brackets
- elimination of distortive roles of tax policy as instruments for achieving non-fiscal goals
- elimination, as much as possible, of double taxation of income

In the area of direct income taxation, the tax reform proposal was centered on the implementation of the flat-rate tax. In accordance with the principle of **taxing all incomes of individuals and corporations equally**, only **one linear percentage rate of 19%** was proposed as of January 1, 2004. The new legislation eliminated 21 different types of taxation of direct income that were in force in Slovakia, including five different personal income tax brackets (10%, 20%, 28%, 35% and 38%).

While the government officials and expert teams were working on the specific draft laws there was a public debate that started in the end of 2002 and continued throughout of 2003 both domestically and internationally.

Political and ideological opponents of the reform mobilized themselves. In summer of 2003 the debate peaked. In order to counterbalance the growing criticism the Hayek Foundation and The Taxpayers Association invited Steve Forbes, an American billionaire that was running in the US for Presidency with the flat tax idea to visit Slovakia.

It proved to be an excellent idea. He gave annual lecture of the Hayek foundation, attracted interest of all media in Slovakia, he also met the Slovak President and the Finance Minister. His visit was the best promotion of the idea of the flat tax that positively influenced the public debate on the government proposal. And it was also the best promotion for the country because Mr. Forbes wrote an article he published in his Forbes Magazin called Investors' Paradise: *„The Slovak Republic is set to become the world's next Hong Kong or Ireland, i.e., a small place that's an economic powerhouse.“*⁶ And he continued: *„Slovakia is about to enact a 19% flat tax, for both individuals and corporations. The death tax is being consigned to the graveyard and the tax on dividends, abolished. The government plans to chip away at the high payroll tax that*

⁶ Steve Forbes, Fact and Comment, *The Forbes Magazine*, August 11, 2003.

*funds various social programs such as health care. It is also considering ways to fundamentally reform its social security pension system, perhaps privatizing a portion of it.*⁷

However, it was still not the end of the debate. There were two powerful international organizations still waiting for their chance to present their views on the flat tax proposal.

IMF sent its experts on their mission to Slovakia in the second half of 2003 to analyze the flat tax proposal. They produced a thick report basically saying to the Slovak government that the flat tax is a very good idea, but not for Slovakia today in its specific situation, perhaps by gradual adjustments sometimes in future... These conclusions influenced even majority of domestic advisors of the Finance minister. They did not encourage the responsible minister to go ahead with the reform plan after the IMF report has been released. As a result, at the end of the day, it was on a personal decision of the minister and fortunately he courageously decided to go against opinion of the majority of his advisors and against the IMF recommendations and he gave a green light to the reform plan that was approved by the parliament in the autumn 2003 and became effective as of January 1, 2004.

Equally negative role was played by **EU** representing the most immediate environment for Slovakia. Outside pressures on Slovakia from old EU member countries were envisaged even before negotiations on EU accession started. These pressures started to be more intense after the first intentions to introduce 19 per cent flat tax were published. Many political leaders of old EU member countries, including then German Chancellor Schroeder and Swedish Prime Minister Persson, were criticizing Slovakia for its intention to reduce tax rates. In addition, these EU leaders were generating pressure on Slovak politicians at EU level talking repeatedly about a necessity of tax harmonization in Europe.

And the criticism continued also after January 1, 2004. It was one month to go for ten candidate countries to become new EU member countries as of May 1, 2004 when the above mentioned politicians have made their open and critical statements concerning tax policies and lower income tax rates of these countries. They even threatened them by

⁷ Steve Forbes, Fact and Comment, *The Forbes Magazine*, August 11, 2003.

future cuts of EU funds and no toleration in case they will continue in what you call „inadequate taxation“.

In reaction to their declaration about “inadequate taxation practices” in some of the new EU member countries The Slovak Taxpayers Association sent an open letter of the Slovak taxpayers to German Chancellor Mr. Gerhard Schroeder and Swedish Prime Minister Mr. Goran Persson.

“We strongly disagree with your statements. We believe that high taxes are incompatible with high growth rates, accumulation of wealth, and high standards of living. We believe that on a long term countries cannot either maintain or achieve prosperity without low tax environment.

... We feel really sorry that you and your colleagues are not able to identify tax systems destroying incentives for profit making activities, savings, investments and employment, among critical factors preventing EU countries to become the most competitive economy of the world...

We strongly believe of benefits of tax competition. That is why we encourage you that you should try to learn lessons from countries reforming their tax systems instead of trying to teach them the lessons. If your efforts you invested into creating a pressure on these countries will be used to implement necessary reforms in your countries’ tax systems, everybody in Europe will benefit from it. All taxpayers of Europe are expecting it from you.”

Countries like Germany and Sweden criticised Slovakia for using tax dumping.⁸ The results of the reform clearly demonstrated that this criticism was completely unreasonable and off the ground. In autumn 2005 the Slovak Finance Ministry published a report evaluating the first results of the flat tax reform after the first year of its implementation. Even though it is too early to draw bold conclusions, its results are impressive anyway:

- 2004 PIT revenues/GDP increased by 29.7 %
- 2004 CIT revenues/GDP increased by 39.9 %

⁸ In their interpretation, the country is involved in tax dumping by attracting investors from the West by reduced tax rates and at the same time receiving EU subsidies from high tax countries.

The total tax burden/GDP⁹ remained almost unchanged: about 30 %, the third lowest burden in the EU after Lithuania and Latvia, with tax revenues representing about 18 % of GDP.

A strongly positive overall impact of the flat tax reform on a performance of the Slovak economy is expected. The Finance Ministry estimated that GDP growth rate accelerated by 0,5 % in 2004, future growth rates will be accelerated even further.

In June 2006 there were early elections called in Slovakia.¹⁰ Unfortunately, EU played its role here again. It was a slogan of “a return to European welfare state” that was used by leftist political parties their election campaign together with a heavy criticism of right-wing political parties for their efforts to diverge from so called European social model. This strategy helped leftists to win elections and form new government. And one of their election promises was to introduce such changes into the tax system that would effectively mean the end of the flat tax in Slovakia.

Fortunately, it seems that Slovakia will not be the first flat tax country also eliminating it because the new leftist government finally will introduce only minor changes into the flat tax system. It is also a result of a combination of lobbying and public campaign of NGOs and businesses to keep the flat tax system.

V. 2006: 12 LESSONS

A list of countries implementing flat tax reforms has been getting longer and longer. For freedom lovers it is one of the most encouraging trends of today in public policy. As demonstrated in case of Slovakia, it can be introduced relatively consistently even in countries with strong previous egalitarian traditions, and with inherited extensive welfare state. It also demonstrated that EU environment makes this type of reform more difficult both in terms of their implementation and their further defence in case of their successful implementation.

There are many crucial conditions that are necessary for successful implementation of the reform program. In case of the introduction of tax reform in Slovakia there can be at least following 12 lessons listed:

⁹ including social security contributions representing about 12 % of GDP.

¹⁰ Instead of originally scheduled September 2006.

Lesson No. 1: Early start of grass root movement

It is true that dedicated individuals can make a difference. The Slovak Taxpayers Association was founded by such individuals having a very clear vision. By establishing of the civic association they wanted to decrease the total tax and contribution burden, ensure better media coverage of these issues, assure more efficient advocacy of taxpayers interests, protect the interests of taxpayers by supporting initiatives in reducing tax rates, public expenditures and balancing the state budget, strengthen the public debate about public finance and tax burden, involve citizens in control over the public finances, increase knowledge about public finance issues.

Lesson No. 2: Open crisis and a sense of urgency

According to a long-term experience from transition process it is much easier to implement any significant reform change with a widely shared sense of urgency. To persuade politicians, policy-makers, and citizens that there is a real problem that needs to be solved urgently, it is the very first step (and major challenge for any think-tank) before any innovative idea or radical reform can be implemented in any area.

Lesson No. 3: Think-tank – do-tank strategy

The Slovak Taxpayers Association was established by people from the Hayek foundation as a specialized tool to fight against high tax burden, high redistribution rates, and government waste. This project increased enormously public awareness of these issues, especially via its Tax Freedom Day campaign. For this result-oriented think-tank – do-tank approach and successful implementation track record the foundation was awarded by the International Templeton Award in 2004.

Lesson No. 4: Friendly Media

One of crucial conditions for success of any venture is extensive media coverage. In case of the flat tax it was important to offer to media an interesting product. The Tax Freedom Day was definitely the product, at least in Slovakia. However, it is not enough to have such product in order to get reasonable media coverage.

In addition to supply side of the media market there is also important its demand side. Fortunately, in Slovakia there were media and their demands without serious political, ideological, religious or other biases. It would be much more difficult to get the message

through if media, both electronic and printed, would be dominated e.g. by leftist views. Again, in Slovakia even those media that were considered as leftists had unbiased economic sections with open minded economic journalists.

In addition, Slovakia is a small country where it is relatively easy to get access into the most of nation-wide media even for small groups like those supporting activities of the Hayek foundation or the Slovak Taxpayers Association.

Lesson No. 5: Celebrities in Campaign

In order to strengthen the message it is always helpful to have celebrities, preferably coming from abroad, also spreading the message. In case of flat tax it is almost impossible to find someone who would be better than Steve Forbes. He helped to promote the idea of flat tax at a critical time of heated public policy debate about this issue. And he also helped to promote those non-governmental organizations like the Hayek foundation and the Slovak Taxpayers Association fighting for the flat tax in Slovakia.

He did not hesitate to add to his impressions from his visit to Slovakia published in his The Forbes Magazine a personal note called **Tocqueville Would Have Understood:** „I visited Slovakia recently at the invitation of the F.A. Hayek Foundation and one of its offshoots, the Slovak Taxpayers Association. The foundation was founded in 1991 to promote free-market ideas and political principles in a country where such traditions had never existed before. That Slovakia is emerging as a beacon of democratic capitalism is in no small part because of the foundation's work. For example, it persistently and effectively pushed the flat tax idea, which should be-come effective Jan. 1, 2004. All of us, including savvy investors, should be grateful that such civic institutions as the Hayek Foundation are taking root in former Communist countries. They are providing the real push, the impetus for Western-style reforms and ideas.“¹¹

Lesson No. 6: Responsive Politicians

While looking back at election results in Slovakia since early 1990s it can be said that about half of Slovak voters constantly vote for leftist parties, and another half for reform-oriented parties underlying conservative and liberal values.

Tax reform would be impossible without a fundamental shift in a view of policy-makers in power on taxes. Also due to public awareness campaigns of the Slovak Taxpayers

¹¹ Steve Forbes: “Investor’s Paradise”, Fact and Comment, *The Forbes Magazine*, August 11, 2003.

Association taxes increasingly started to be understood by right-wing politicians in Slovakia as a burden that is distorting economic incentives rather than active tool of economic policy.

Once right-wing political parties gained power in Slovakia this shift has led to a new assignment for tax policy: it was expected to minimise distortions of various taxes on economy via new priorities: low tax rates, marginal tax rates reductions, elimination of tax holidays, tax relieves, special tax regimes.

Lesson No. 7: External pressures to keep status quo

The external pressures are especially important factor for small countries like Slovakia. It is not only a long list of domestic political and ideological opponents that makes life difficult for reformers. In addition, there are international institutions playing their role as well.

In case of Slovakia there were two international organizations, International Monetary Fund and European Union, that deserve to be mentioned for their negative impact on the process of introduction of 19 per cent flat tax .

Lesson No. 8: Quick implementation

While facing the above mentioned external pressures, especially from EU, the best strategy was to push the implementation of as many fundamental and far-reaching reforms as possible, including the flat tax, prior to accession of Slovakia to EU. This strategy proved to be successful when the flat tax was implemented as of January 1, 2004, four months prior to May 1, 2004 when Slovakia became a member of the European Union.

However, the quick implementation of the reform proposal is of crucial importance also because of internal factors. Domestic interest groups are usually even more powerful and more dangerous enemies of the reform preferring the bad status quo and preventing much desired changes from being implemented. That is why it is important to avoid any gradualism or incrementalism and implement reform changes as quickly as possible, earlier than the interest groups that are benefiting from the old system wake up and stop the reform efforts. One of explanations of an overall success of the Slovak tax reform is rooted in its quick implementation. It was implemented in 14 months if we take into

account a period between the November 4, 2002 when the new reform oriented government in Slovakia adopted its reform program, and January 1, 2004 when the reformed tax legislation started to be effective. It was implemented in 18 months if we add to this period also four months of pre-election campaign during which the flat tax was one of important issues.

Lesson No.9: Reform package

After 2002 the re-elected right-wing government adopted a very ambitious and comprehensive program of further acceleration of reform processes. In 2002-2006 7 fundamental reforms were adopted: 1. Labour Market Reform, 2. Flat Tax Reform, 3. Pension Reform, 4. School System Reform, 5. Health Care Reform, 6. Fiscal Decentralisation Reform, 7. Business Environment Reform. Thus, an introduction of flat tax was not isolated act. It was an integral part of much broader reform efforts.

Lessons No. 10: Nothing is irreversible

As it was mentioned the flat tax was implemented against views of many of its domestic and foreign critics. It was especially heavily criticised by leftist parties as the policy measure of the right-wing government favouring rich and disadvantaging poor or low income people. It was openly hated as a symbol of policy that was reducing a role of the state, redistribution rate, and dependency of individual citizens on state. The leader of this political camp was repeatedly making public promises to revise the tax reform and abolish the flat tax.

This proves that nothing is irreversible, and even the best reforms and measures can be reversed. If this would happen, Slovakia would have been the first country from “the list of flat tax countries” that would eliminate the flat tax. Fortunately, it seems that even the new leftist government that was formed in July 2006 will keep the flat tax, satisfied only with minor changes in income taxation¹² and in value added tax.¹³ However, it will still require a co-ordinated and concentrated approach to defend it from all those who promoted its implementation in the past.

¹² By keeping 19 per cent flat income tax unchanged, and a maintaining a flat deductible item only for low income taxpayers.

¹³ By introducing the lower VAT rate for drugs.

Lesson No. 11: Expenditures reform

Flat tax type of reforms is focused only on one side of public finances, on its revenue side. A long-term upward trend in the ratio of tax to GDP reflects long-term upward public expenditure trends. The largest part of this increase has taken the form of higher social security contributions.

Fatal consequences of these developments were the textbook ones. High public spending levels forced governments of European countries to take comparatively too much money out of the economy via high taxes. High taxes represent serious distortions of economic behaviour via affecting incentives to work, to invest, to employ, to save, etc. And distorted economic behaviour means a decline of economic efficiency, a lower economic growth, and less tax revenues for public spending. A vicious circle is completed. That is why any tax reform can not be successful from long-term without a reform of expenditure side of public finances.

Lesson No. 12: Thinking beyond possible

While supporting the idea of flat tax as much as possible, it is important to think about next steps extending a reform agenda even further. What should be the next after the flat tax? One of possible strategies in this direction can potentially be “a flat benefit revolution”. Similarly to consistent flat tax reforms, replacing complicated, and unjust system of progressive taxation with various rates by one simple system with one single tax rate, a flat benefit reform would eliminate complex and generous system of tens of various contributions paid to and benefits paid out of the welfare system and replace it by one single contribution and one single benefit. Like in case of flat tax rate, calibration would be of crucial importance. Only if in future reform strategies flat tax (revenue side of public finances) and flat benefit (expenditure side of public finances) reforms will go hand in hand, rates of redistribution can be cut significantly, and Bismarckian welfare state as we know it today in Europe can finally disappear.

Appendix 1
19 % FLAT TAX REFORM IN SLOVAKIA
IMPLEMENTED AS OF JANUARY 1, 2004

TABLE 1
Comparison of old and new tax systems in Slovakia

OLD SYSTEM	NEW SYSTEM
<ul style="list-style-type: none"> • PIT: 10-38%, 5 tax brackets • CIT: 25 %, previously 40 % • VAT: 20 %, also 14 % • Dividend Tax: 25 % • Real estate transfer tax: progressive taxation • Inheritance (Death) Tax, Gift Tax: various rates • Deductible item: SKK 38 760 • Exemptions: many 	<ul style="list-style-type: none"> • PIT: 19 % Flat rate • CIT: 19 % • VAT: 19 % • Dividend Tax: ABOLISHED • Real estate transfer tax: ABOLISHED • Inheritance (Death) Tax, Gift Tax: ABOLISHED • Deductible item: SKK 80 832 • Exemptions: reduced

TABLE 2

Income Tax Rates (in %)		
	OLD SYSTEM	NEW SYSTEM
PIT	2, 2.25, 2.5, 2.75, 10, 20, 28, 35, 38	19
CIT	15, 18, 25	19
Withholding Tax	1, 5, 10, 15, 20, 25	19

TABLE 3

Tax Brackets And Marginal Tax Rates			
OLD SYSTEM		NEW SYSTEM	
Tax Bracket In SKK	Marginal Rate In %	Tax Bracket In SKK	Marginal Rate In %
< 3 230	0	< 6 736	0
3 230 – 10 730	10		
10 730 – 18 230	20		
18 230 – 36 230	28	> 6 736	19
36 230 – 50 230	35		
> 50 230	38		