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Booming labour market boosts tax revenues

Tax revenue forecast for 2016 to 2020 (comparison with the previous forecast from June 2017 and General Government budget for 2017 – 2019)

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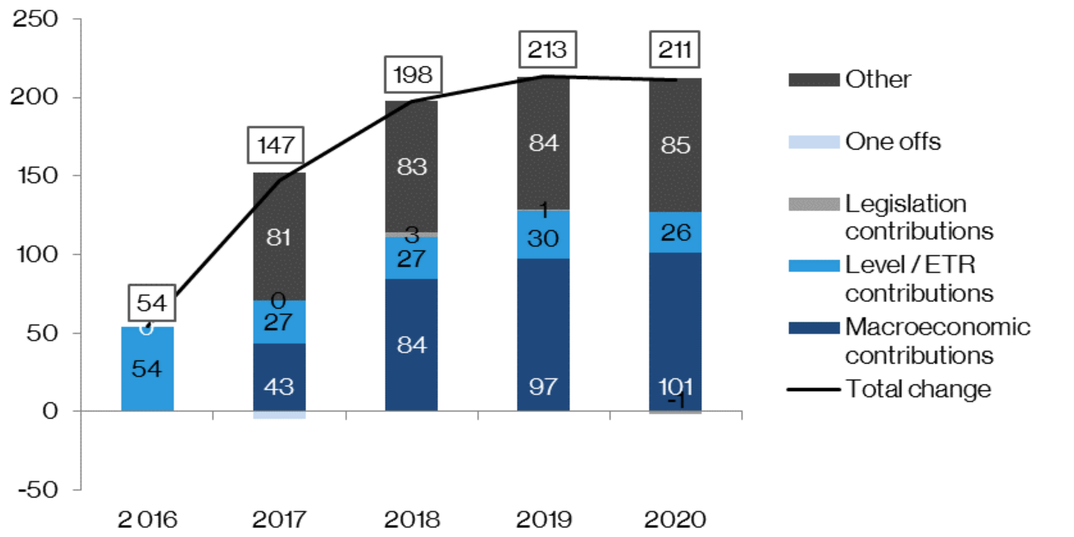
The continued expansion in the labour market along with the growth in social and health contribution revenues constitute the main factors of revisions vis-à-vis the last tax revenue forecast. Compared to the June 2017 projections round, the tax revenues have been revised up by EUR 147 to 211 million (0.1 to 0.2 per cent of GDP) between 2017 and 2020, respectively. Compared to the General Government budget for 2017 to 2019, however, the revision is marginal (EUR 8 to 25 million respectively). The 2016 upturn in the tax revenue forecast is fully attributable to corporate income tax, reflecting better-than-expected tax settlements by the largest corporations. In the meantime, the effective value-added tax rate increased above 15 per cent during the second quarter of 2017.

Higher tax revenues in 2017 - 2020

Based on the updated tax collection information and latest macroeconomic projections, the estimated **General Government (GG) revenues[1] for 2017 – 2020 have been revised up by EUR 147 to 211 million** respectively (Figure 1), as compared with the June tax revenue estimates. In particular, the ongoing favourable developments in the labour market have significantly lifted the projections of personal income tax (PIT), as well as that of social and health security contributions. Additionally, value-added tax (VAT) and excise duties revenue estimates were also revised up. The 2016 corporate income tax (CIT) is set to benefit from higher-than-expected tax settlements[2] of the largest corporations, though the recently observed drop in corporate sector profitability is projected to counteract the increase over the forecast horizon.

Figure 1: Change of GG tax revenues forecast compared to June 2017 (EUR million)



Source: IFP, UloziskoIFP

[1] Tax, social and health contributions revenues
[2] The higher-than-expected tax settlements of the largest corporations in amount EUR 62 million at corporate income tax is moderately compensated by lower tax settlements at special levy in regulated sectors. Therefore, accrued revenue in 2016 is updated by EUR 54 million in comparison to our June forecast.

Table 1: New legislation incorporated in tax revenue forecast (EUR million)

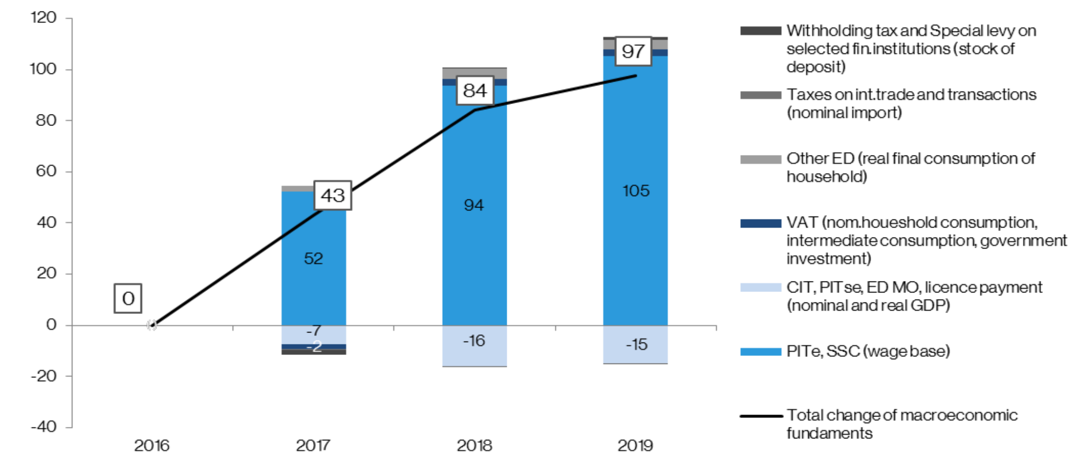
Legislative measures	ESA 2010		
	2018	**2019**	**2020**
Income Tax Act No. 595/2003 Coll. as later amended	**-11**	**-14**	**-16**
PIT	**-2**	**-2**	**-2**
Introduction of mortgage tax credit	0	0	0
Introduction of spa basic allowances	-2	-2	-2
CIT	**-9**	**-12**	**-14**
Introduction of separate depreciation for technical improvement increasing the value of spa buildings	0	-1	-1
Increase of deduction for R&D costs	-9	-11	-13
Act No. 98/2004 Coll. On the Excise Duty on Mineral Oil	**-1**	**0**	**0**
Update of statutory tax rate	-1	0	0
Act No. 222/2004 Coll. On Value Added Tax	**0**	**0**	**0**
Humanitarian aid exemption	0	0	0
Act No. 576/2004 Coll. On Health Care	**15**	**15**	**15**
Health insurance contributions allowances – update of legislation	15	15	15
Total	**3**	**1**	**-1**

Source: IFP, UloziskoIFP

Labour market continues to be a major driver of tax revenues

Tax revenues have been revised up over the forecast horizon 2018 – 2020 owing mainly to **favourable macroeconomic developments, especially the intensified activity in the labour markets** (Figure 2). Household consumption is set to reach its peak since 2008 positively affecting the VAT, which is in turn offset by lower projected government consumption and public investment. In addition, the assumption of growing interest rate at the end of the budget forecast horizon underpins the revision of withholding tax revenues.

Figure 2: Tax revenues update based on current macroeconomic forecast (EUR million)



Source: IFP, UloziskoIFP

Table 2 : Update of main macro indicators, September 2017 vs. June 2017

Indicator	growth in %					change compared to June (in pp)				
	2016	**2017**	**2018**	**2019**	**2020**	**2016**	**2017**	**2018**	**2019**	**2020**
GDP, real	3.3	3.3	4.2	4.4	3.9	0.0	0.0	0.0	0.0	0.0
GDP, nominal	2.9	4.5	5.8	6.4	6.0	0.0	0.0	0.0	0.0	0.0
Final household consumption, real	2.9	3.4	2.9	2.9	2.9	0.0	0.2	0.2	0.0	0.0
Final household consumption, nominal	2.5	4.8	4.6	4.8	5.0	0.0	0.3	0.2	0.0	0.0
Adjusted base for VAT	-1.0	4.1	4.2	4.7	4.7	0.0	0.0	0.1	0.0	0.0
Wage base	5.8	5.9	6.1	5.9	6.2	0.0	0.4	0.3	0.1	0.0
Stock of deposit	7.6	5.2	5.9	6.3	6.1	0.0	0.3	0.0	0.3	0.0

Source: IFP, UloziskoIFP

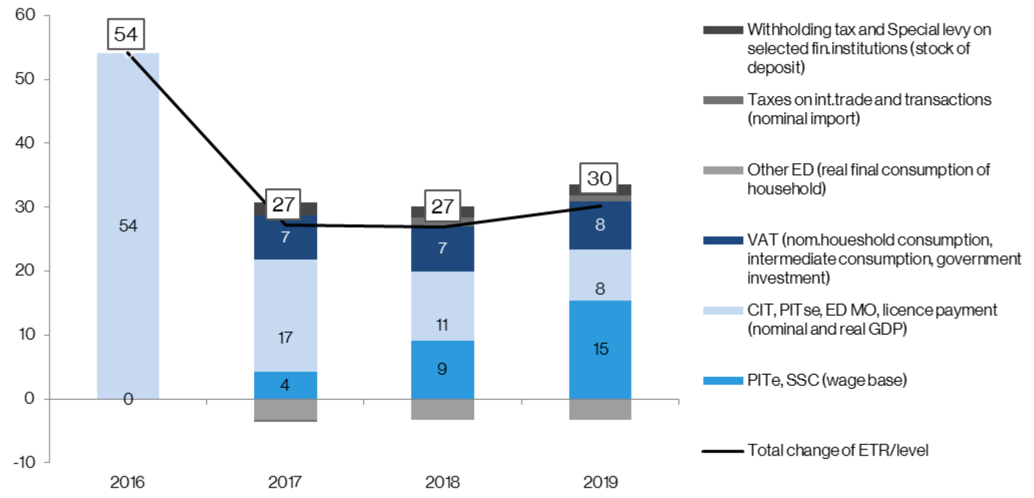
Positive surprise at corporate income tax

Effective tax rate (ETR) favourably underscores the current tax revenue forecast (Figure 3). The full level of ETR in 2016 is attributable to CIT, driven by better-than-expected tax settlements of the largest corporations, which postponed tax return submissions to September 2017. In the following years, the ETR attributed to CIT is counteracted by a decline in corporate profitability. In the meantime, the growing tax collection efficiency increases VAT and excise duty ETR. PIT, as well as social and health contribution revenues outpaced the wage base growth over the course of the first half of 2017, which has furthermore contributed to an upward revision in the ETR[3].

Better than expected tax settlements

In our June tax revenue forecast, the CIT has been revised down by EUR 285 million for 2016. **The June revision has been softened in the current forecast by EUR 58 million**, owing to the better-than-expected tax settlements of the largest corporations, which postponed tax return submissions for 2016 to September 2017[4]. Importantly, however, higher CIT revenues projected for 2016 are not transferred to the following years due to a year-on-year drop in corporate sector profitability already observed in 2017[5]. Moreover, the lower macroeconomic base[6] growth, coupled with the legislative increase in R&D allowances are set to jointly decrease corporate revenues from 2018 onwards.

Figure 3: Tax revenues update based on ETR (EUR million)



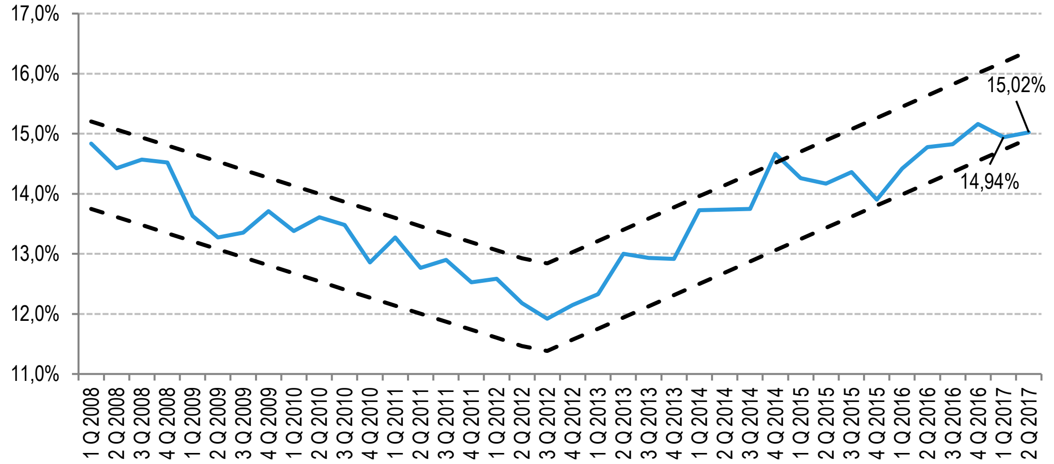
Source: IFP, UloziskoIFP

Resumed growth at VAT collection efficiency

VAT collection efficiency resumed growth after a temporary drop in the first quarter of the year. The former along with a strong household consumption growth are offset by lower investment and weaker government consumption in the second half of 2017. The current tax revenue forecast assumes tax collection efficiency at an average level of the two most recent quarters over the forecast horizon[7] (Figure 4).

[3] Faster growth of PIT in comparison to wage base is attributed to fiscal drag which represents higher growth of nominal wages than indexed value of basic allowances.
[4] Higher tax settlements were estimated from financial statements for fiscal year 2016 because these corporations postponed submission of tax returns for 2016 to September 2017.
[5] Statistical office of the Slovak republic reports a year-on-year drop (-11.7%) in profitability for the first half of 2017. Estimated and seasonally adjusted profitability for 2017 is expected to reach -9.4 %.
[6] Gross domestic product adjusted for compensation of employees
[7] The projection of VAT ETR employs average of two last known quarters when ETR is growing. In case that ETR is decreasing, the last known EDS level is employed.

Figure 4: Effective tax rate of VAT (%)



*Source: IFP, **UloziskoIFP***

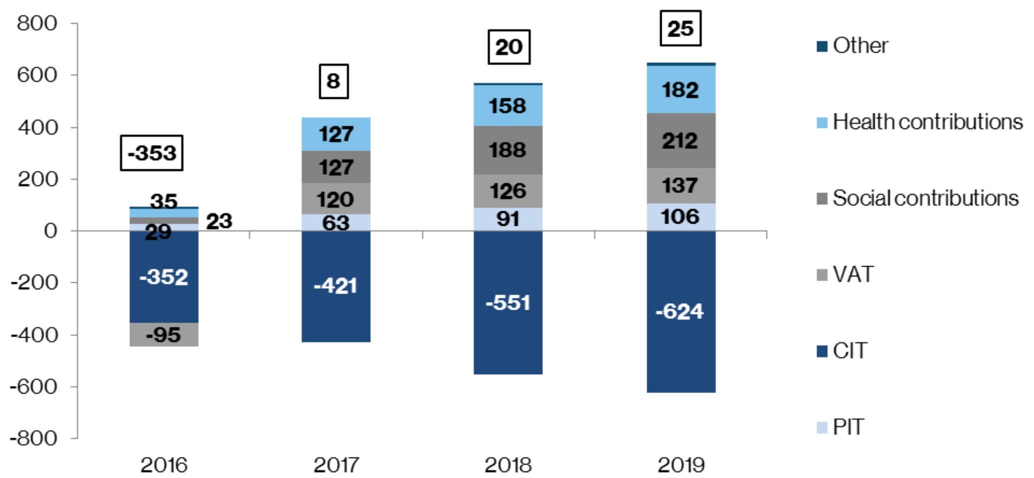
Social and health contributions are growing faster than expected

Turning to **social and health contributions, both outpaced the wage base in the second quarter of 2017**[8]. Economic literature[9] assumes proportional relationship (i.e. elasticity close to one) between wage base and social and health contributions revenue growth. However, incorporation of such assumption would lead to an underestimation of the tax revenue forecast in 2017, hence elasticity higher than one is assumed for this year, and the standard unity elasticity is incorporated from 2018 onwards. At the same time, elasticity higher than one is considered an upside risk to the baseline forecast in line with the past experience.

Marginal revision of tax revenues compared to GG revenues

The current tax revenue forecast delivers only a marginal revision of tax revenues for the projection horizon 2018 – 2020 (EUR 8 to 25 million respectively) as compared to the agreed GG revenues. The main difference stems from the individual tax revenue revision structure vis-à-vis the GG (Figure 5). The CIT drop in 2016 constitutes the main negative revelation, as the remaining tax revenue components, especially social and health contributions grow in line with the favourable labour market developments.

Figure 5: Change of tax revenues forecast in comparison to GG revenues (EUR million)



*Source: IFP, **UloziskoIFP***

[8] PIT, social and health contributions employ wage base as a macroeconomic base. Wage base is derived as a product of registered employees and their wage.
[9] For more information please see Box 1 in our policy **brief**.

The Ministry of Finance regularly prepares and publishes tax revenue forecast in accordance with the constitutional Fiscal Responsibility Act. The current tax revenue forecast was discussed at the Tax Revenue Forecast Committee on September 21, 2017. **The forecast was evaluated as realistic by all Committee Members (NBS, KRRZ, Infostat, ČSOB, SLSP, Tatrabanka and UnicreditBank).**[10]

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

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

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