

# Republic of Slovenia: Selected Issues



# REPUBLIC OF SLOVENIA

## SELECTED ISSUES

February 2019

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# REPUBLIC OF SLOVENIA

## SELECTED ISSUES

January 29, 2019

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**European Department**

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## CONTENTS

<b>GROWTH-ENHANCING TAX REBALANCING</b>	<b>2</b>
A. Introduction	2
B. Overview of the Slovenian Tax System	4
C. The Case for Rebalancing Taxes	6
D. Simulation of the Tax Reform Impact	9
<b>FIGURES</b>	
1. Sustained Higher Growth is Needed for Income Convergence	2
2. Rapid Ageing Poses Fiscal and Growth Challenges	3
3. General Government Revenue Mix	4
4. International Comparison of Property Tax	4
5. Tax Wedge and Employment Rate	5
6. Comparative CIT Revenue	6
7. CIT Rate and Revenues	6
8. Countries with VAT Standard Rates Above 20 percent	8
9. VAT Rate Changes	8
10. Detailed Simulation Results	12
<b>ANNEXES</b>	
I. The GIMF Model	13
II. Taxing SMEs	14
References	16

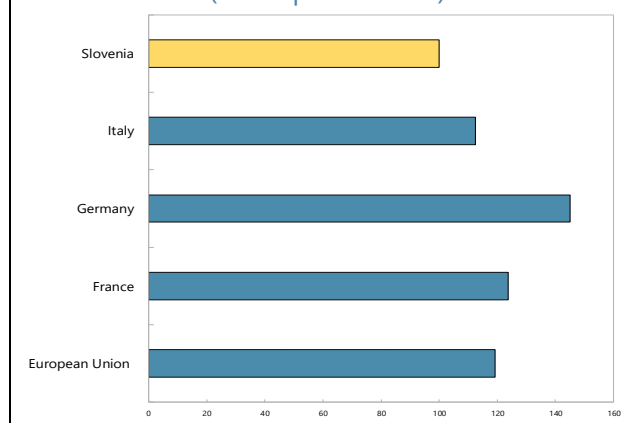
# GROWTH-ENHANCING TAX REBALANCING<sup>1</sup>

*This paper argues that revenue-neutral tax rebalancing would help Slovenia address long-term fiscal and growth challenges. The present tax-benefit system is supportive of distributional fairness in Slovenia, but we argue that tax reform can help bring stronger employment and productivity growth and enhanced resilience to the challenges of population ageing. First, this paper lays out the case for tax reform in view of long-run fiscal and growth challenges; second, it reviews the current tax system and its weaknesses in comparison with international best practices; third, it sets out tax reform options; finally, it uses a model simulation to illustrate the medium- to long-term fiscal and growth impact.*

## A. Introduction

**1. Despite recent achievements, achieving sustained strong growth is critical to address the challenges that Slovenia faces from population ageing and in reaching income convergence to the EU average.** Slovenia has achieved a remarkable recovery since the 2012–13 banking crisis, with growth well above the euro area average. Also, Slovenia's income inequality is low, with a GINI index at 0.24, compared to the Organisation for Economic Co-operation and Development (OECD) average of 0.32. The tax-benefit system has contributed to make the after-tax disposable income more equal than the before-tax market income (OECD 2018a). Yet, income level is still below the EU average, and accelerating income convergence requires sustained strong growth (Figure 1). Meanwhile, Slovenia is facing the challenge of rapid ageing, which not only reduces the size of productive labor force but also productivity growth (Figure 2). For example, Aiyar and others (2016) find that ageing is estimated to reduce productivity growth by about 0.5 percentage points during 2014–35. In addition, recent projections indicate that Slovenia faces one of the highest increases in age-related public spending in the medium- to long-term, adding further pressures for more efficient tax and social security systems to safeguard fiscal sustainability while supporting productivity growth.

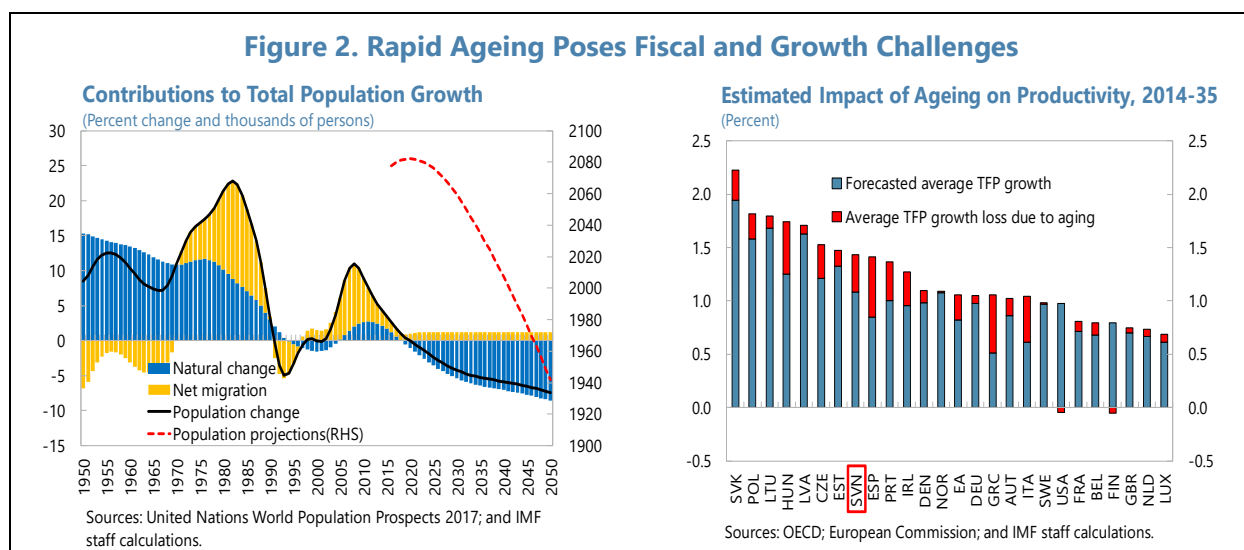
**Figure 1. Sustained Higher Growth is Needed for Income Convergence**  
(Per capita income)



**2. Despite rising spending needs from ageing, revenue levels in Slovenia only match the EU average.** In 2016, Slovenia's tax-to-GDP ratio of 36.6 percent was between the average of OECD and EU countries (34.3 and 38.9 percent respectively). Excluding social security contributions (SSC),

<sup>1</sup> Prepared by Michal Andrle, Larry Qiang Cui, Martin Grote, and Jens Reinke.

Slovenia maintains a tax ratio of 22 percent of gross domestic product (GDP). SSC raise an additional 14.8 percent of GDP, making Slovenia the 6th heaviest SSC-burdened economy in the EU.



**3. Slovenia's tax system is complex, and international comparison indicates that improving the revenue mix could better support growth.** OECD (2018a, b) argues that Slovenia's tax mix is not supportive of economic growth and that restructuring key tax instruments could secure significant efficiency gains while safeguarding the overall progressivity of the tax system. General government revenues are raised by more than 20 different tax instruments and rely heavily on taxes on labor (including SSCs) that are potentially distortive, inhibiting employment growth. Slovenia also depends heavily on broad-based consumption taxes (such as the value-added tax) whose complex exemptions likely result in distortions. In contrast, taxes on residential property, on inheritance, and on excess returns or rents are likely to be least distortive for growth, are of low importance in Slovenia.

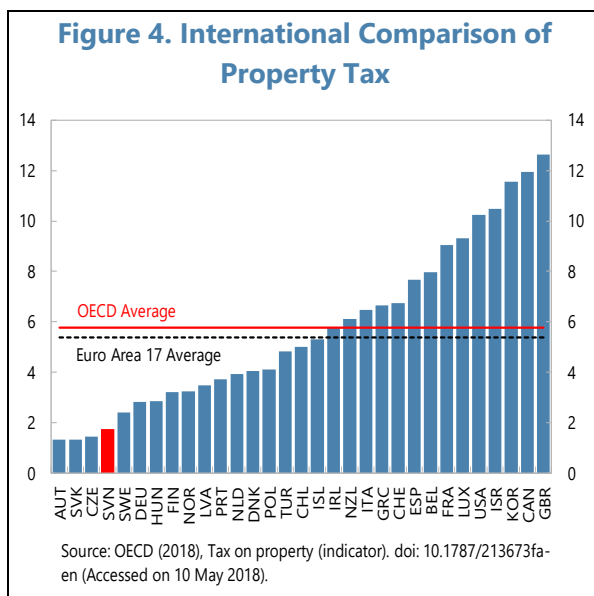
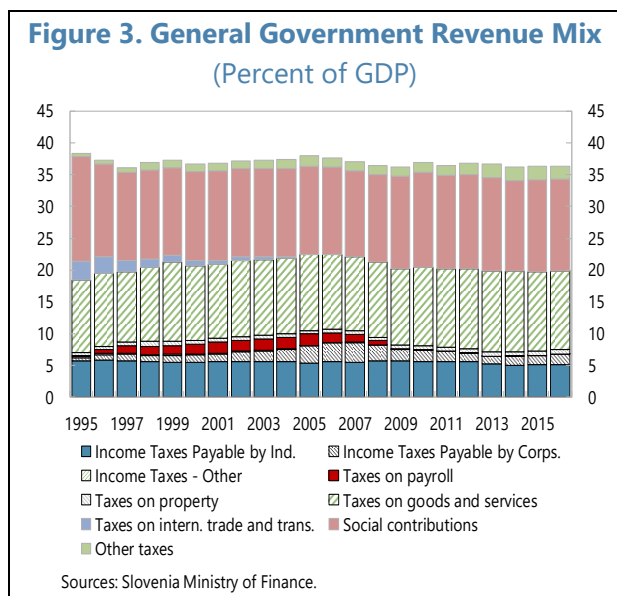
**4. A comparison with international experiences suggest that Slovenia has strong potentials to raise revenue more efficiently while also boosting growth.** International experiences show that reducing the high labor tax burden would increase work incentives. In addition, raising more revenue from the less distortive wealth tax, such as a value-based recurrent property tax, has substantial revenue potential. Although reforming this local tax would also require some rebalancing of revenue and/or spending assignments between central and local governments. Likewise, reducing SSCs will require additional direct support of the Health and Pension funds from the central budget. Furthermore, other options include broadening the base for the value-added tax (VAT) and personal income tax (PIT) or rationalizing tax expenditures, including those in capital gain taxation.

**5. Model simulations confirm substantial growth benefits from revenue-neutral tax rebalancing in Slovenia, supporting the case for growth-enhancing tax reform.** Shifting the tax burden from labor to consumption would increase Slovenia's output level by 0.5 percent in the

medium- to long-term.<sup>2</sup> Lower taxation on labor leads to a permanent increase in private consumption, aggregate labor, and real output. However, future research is required to the potential impact on income distribution.

## B. Overview of the Slovenian Tax System

**6. Slovenia’s tax mix relies heavily on consumption taxes and SSC.** Consumption tax revenues of 14.3 percent of GDP in 2016 and SSC of 14.5 percent of GDP (Figure 3) were above the respective OECD averages of 11 percent and 9,2 percent, and also above the respective EU-28 averages of 11.1 percent and 12 percent of GDP. However, proceeds from taxes on income, profits, and capital gains (both for natural and legal persons) are at 6.8 percent of GDP, well below the OECD average of 11.3 percent of GDP. Immovable property tax revenues have plateaued at 0.6 percent of GDP against the OECD average of 1.9 percent (Figure 4) and France’s and UK’s respective 4.3 and 4.1 percent of GDP. Overall in EU-28 Slovenia is ranked 23 in property tax collections. In contrast, Slovenia is one of the top revenue performers in respect of environmental taxes (excises) among OECD member states. Over time, Slovenia has gradually reduced its reliance on taxes from income, profit and capital gains but maintained the high SSC ratio and increased the reliance on consumption taxes.



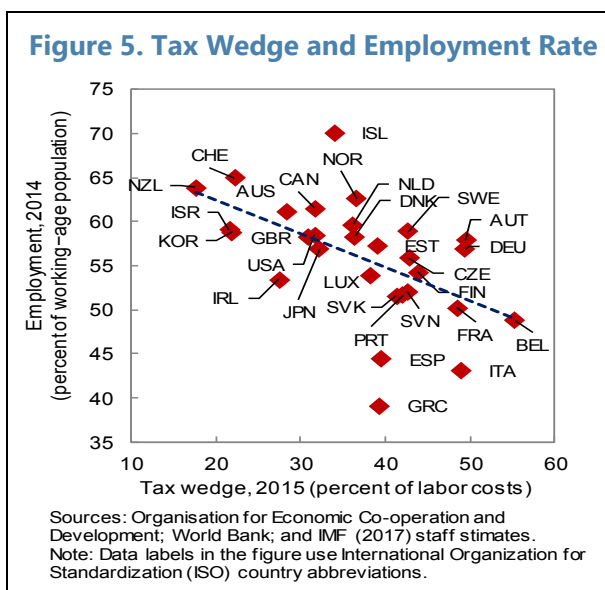
**7. Slovenia’s labor tax system contains distortions and inefficiencies.** Slovenia has a very steep PIT rate structure but raises only 14.1 percent of total tax revenue from PIT, compared to 24.1 percent for the EU-28 (2016, Eurostat). Slovenia’s SSC in 2016 accounted for 14.5 percent of GDP (6<sup>th</sup> highest) whereas for EU-28 it was an average of 12.1 percent of GDP (EU 2018 Taxation Trends). Experience in advanced economies show that a lower labor tax wedge is associated with

<sup>2</sup> The model simulation is based on increased effective tax collections, mainly from base-broadening and administration efficiency.

higher employment rate (Figure 5). Thus, reducing the labor tax wedge can further improve labor market outcomes.

### 8. The PIT system grants generous tax allowances to families with dependents.

The Ministry of Finance (MoF) estimates their total cost at 852 million euros or 2.1 percent of GDP in 2016. These social policy-oriented tax privileges strengthen distributional fairness of the tax system but result in higher tax burdens on single individuals without children. Also, they may not be the most effective way of supporting families in need: tax allowances benefit mostly high-income earners due to their larger tax deductions, whereas tax credits could be more beneficial to low-income households (OECD 2018a).



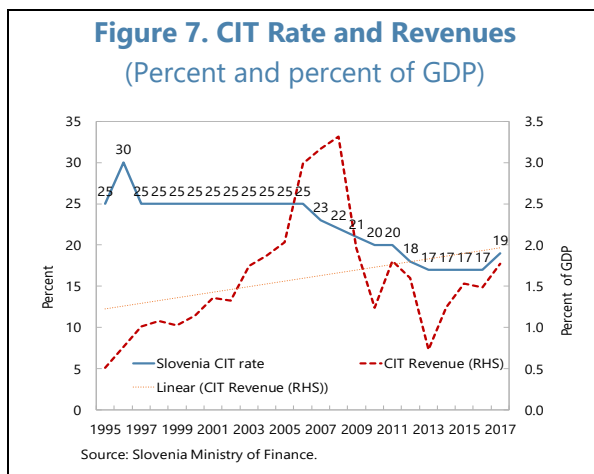
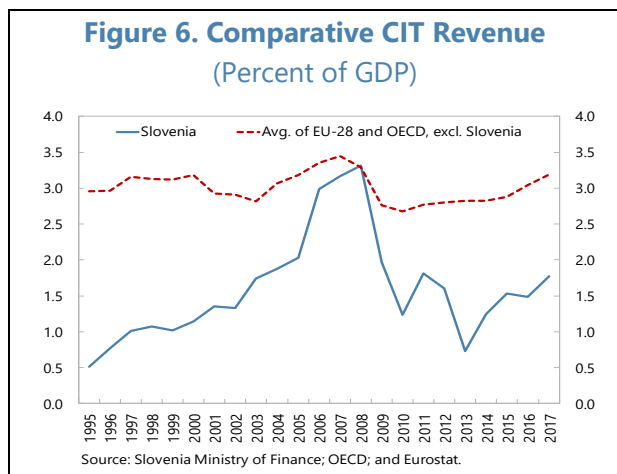
**9. The revenue potential of consumption and income tax is not fully used due to reduced tax bases.** Slovenia has a high headline VAT rate of 22 percent generating 8.2 percent of GDP (2016) against the EU-28 average of 7 percent of GDP. Yet, there are EU-countries with lower VAT rates that are able to raise between 9.2 and 9.4 percent of GDP.<sup>3</sup> In addition, Slovenia raised 1.6 percent of GDP from corporate income tax (CIT) in 2016 (1.8 percent of GDP in 2017)<sup>4</sup> taxed at a rate of 19 percent, compared to the average statutory CIT rate in EU-28 and OECD member states of 22.3 percent, making it the weakest CIT performer in EU-28 (Figures 6 and 7).<sup>5</sup>

**10. Local government finances depend on significant sharing of revenues collected by the central government and lack a solid base in recurrent property taxes.** In 2017, tax revenues constituted 71.8 percent of local governments own revenues (vis-à-vis 58.6 percent in 2000). The most important revenue source for municipalities is their 54 percent PIT share, collected by the central government. In 2017, PIT revenue contributed 55.5 percent to total local government revenues, property taxes raised 13.9 percent of this total, of which 2.1 percentage points relate to the 2 percent property transfer duty (2000: 11.8 percent and 2.6 percent respectively). This is low by international standards: the share of recurrent property taxes in total local taxes is 100 percent in advanced economies such as Australia, Ireland, the United Kingdom and averages at 30.6 percent in 15 other European countries. The third most important tax instrument for local governments are taxes on the use of goods and services (2.5 percent of total revenues in 2017).

<sup>3</sup> For example, Bulgaria collects 9.2 percent of GDP in VAT revenue at 20 percent VAT rate; Estonia, 9.4 percent of GDP at 20 percent rate; and Cyprus, 9.2 percent of GDP at a 19 percent rate.

<sup>4</sup> OECD, Revenue Statistics: Comparative Tables.

<sup>5</sup> IMF FADTP Rates Database.



### C. The Case for Rebalancing Taxes

**11. The Slovenian labor market is adversely impacted by a high tax wedge.** High employee-SSCs of 22.1 percent, high employer-SSCs of 16.1 percent and steeply progressive PIT rates translate into high tax burdens on labor income. The combined tax and SSC regime increases employers' labor cost, discourages the hiring of workers, and leads to early retrenchment of older workers as their generally higher salaries are accompanied by significant SSCs. The combination of high marginal PIT rates and SSC rates reduces the net pay for workers and therefore discourages labor market participation. These factors combined contribute to labor market weaknesses but also undermine the revenue potential of the PIT and SSC systems. Given the rapidly ageing population of Slovenia, increasing the labor market participation by older workers is a priority, necessitating tax and social safety net reforms.

**12. Reducing the tax burden on labor will require compensating revenue sources with strong revenue potential.** Rationalization of tax expenditures is preferable to raising rates on key taxes. Base-broadening would permit downward rate adjustments, which nurtures growth and enhances tax buoyancy. In Slovenia, there are still untapped opportunities for a growth-enhancing tax rebalancing that includes VAT base-broadening. Moreover, there appears to be room in Slovenia to raise more revenues from high-income taxpayers since there is a particularly strong case for introducing a revenue-productive property tax without the generous tax-free threshold and exemptions. Other taxes on wealth, such as a capital gains tax (CGT) without generous taper relief, are expected to offer sizable revenue potential at relatively low efficiency costs.

#### Personal Income Tax

**13. Enhancing the PIT revenue productivity could partially compensate for revenue loss while supporting the social security system.**<sup>6</sup> The tax wedge includes employee-SSC and PIT. The current systems of PIT and SSCs, alongside the loss of out-of-work benefits for the unemployed,

<sup>6</sup> According to the recent joint OECD and Ministry of Finance analysis, a one percentage point reduction of the employee-SSC would lead to a revenue loss of 104 million euros, after adjusting for the PIT revenue gain since SSCs are a deductible expense for PIT purposes.



contributed to unemployment and inactivity traps because those who rejoin the labor market face high effective tax rates.<sup>7</sup> Implementing the recently amended Labor Market Act would help address such traps. In addition, reducing SSCs would increase workers' disposable income, enhance the incentives to work, and broaden the PIT base and thus partially offset the revenue loss. Rationalizing the PIT rate structure and exemptions would also help increase labor participation and broaden the PIT base to increase revenue. Drawing on international experience, OECD (2018a) finds that financing social benefits through general taxation would increase labor market participation and would ensure that the welfare support remains available for a large section of people who may not find themselves in a traditional employer-employee relationship (e.g., independent service contractors). Across the OECD, unemployment insurance and maternity benefits are co-financed through general taxation (OECD 2018a, b).

**14. A system of targeted tax credits should replace the multiplicity of allowances.** The current proliferation of allowances is not aligned with best practices in the OECD, while options are available to achieve progressivity more efficiently. Compensatory revenue-raising measures can thus include restructuring PIT rates and allowances and providing less generous tax treatment of fringe benefits. These can include improving the targeting to ensure that the benefits reach the intended recipients in the most efficient way.

### Corporate Income Tax and Interest Deductibility

**15. Slovenia's CIT regime would benefit from tightening the rules on the deductibility of interest on shareholder loans.** The debt-to-equity rules provide that interest on loans from shareholders, who directly or indirectly at any time during a tax year hold at least 25 percent of capital or voting rights of the taxable person (with the exception of banks and insurance companies as borrowers), is deductible only if it is attributable to the part of the loan that does not exceed a multiple of 4:1 of the value of the share capital owned (debt-to-equity ratio). The current rule, as compared to international practices, is generous. International experience points to a gradual tightening of this ratio down to 1.5 to 1. Slovenia has to implement the interest limitation rule and the earnings stripping rule as stipulated in Article 4 of the EU Anti-Tax Avoidance Directive (ATAD) by January 1, 2024. An earlier tightening of the debt-to-equity ratio would translate into immediate revenue gains.

### SME Tax Treatment

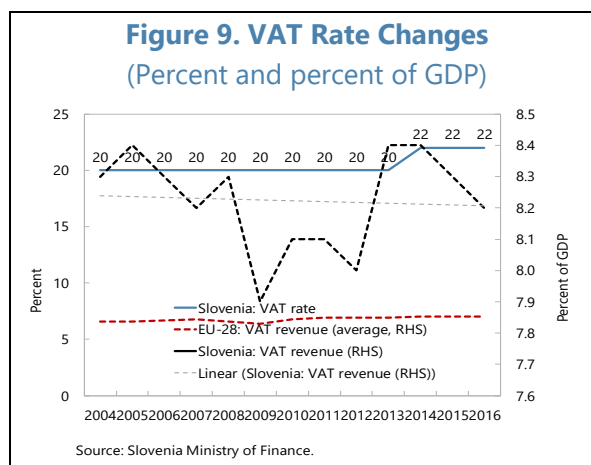
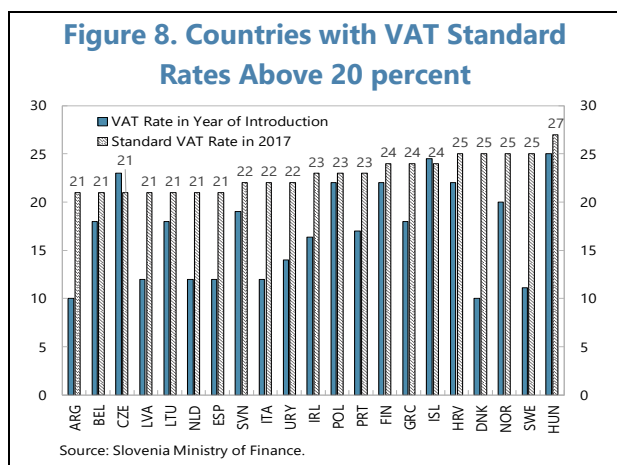
**16. The flat-rate tax regime for SMEs is overly generous, and its applicability should be tightened.** A tax relief measure for small scale entrepreneurs was introduced in 2013 with a turnover up to 100,000 euros who are authorized to deduct a generous lump-sum expense equal to

<sup>7</sup> The structure of Slovenia's total tax wedge (see OECD, *Taxing Wages—2018*) is evident: A single person with no child earning the average wage faces a total tax wedge (2017) equal to 42.9. The personal income tax contributes to this "only" 10 percent vis-à-vis an average 13.5 percent for the OECD. The rest is represented by employee-social security contributions of 19.0 percent, against an average 8.2 percent for the OECD. Employer-SSC are 13.9 percent against the average of 14.2 percent for the OECD. Thus, the pressure on policy changes to lower employee-SSCs as the SSCs have a particularly high weight.

80 percent of the taxable base.<sup>8</sup> The resulting net business income attracts a flat final tax of 19 percent. The flat tax is significantly more favorable for service activities with high margins. This regime, with its effective tax rate of 4 percent, is available to sole traders and companies. Consequently, the flat tax regime has become a popular tax planning tool. The erosion of the PIT and CIT bases is evidenced by growing income splitting of existing companies into smaller companies to qualify for the turnover threshold. Preferably, the flat-tax regime should be applicable only to individuals, be limited to the original turnover level of 50,000 euros, and the demarcation between employment and independent service provider contracts be enforced robustly.<sup>9</sup>

## VAT

**17. The applicability of reduced VAT rates should be narrowed.** Despite its high headline rate, the VAT system is underperforming because reduced rates apply to a wide range of goods: total revenue forgone from Slovenia’s expansive list of 22 reduced VAT rate supplies is 1.85 percent of GDP (2017).<sup>10</sup> In 2016, indirect taxes raised revenues equal to 14.7 percent of GDP, ranking Slovenia at 11th position in the EU-28. VAT contributed 8.2 percent of GDP. Increasing the standard VAT rate above the current 22 percent is unrealistic as globally there are only 11 countries out of 160 VAT-raising jurisdictions with higher VAT rates. Furthermore, raising Slovenia’s statutory VAT rate would entail additional compliance risks, also because Austria’s lower VAT rate of 20 percent makes the avoidance through cross-border shopping attractive (Figures 8 and 9).<sup>11</sup> In lieu of a further VAT standard rate increase, a narrowing-down of the range of 22 reduced-rate (at 9.5 percent) goods and services could create revenue gains.



<sup>8</sup> The Slovenian presumptive system may also be applied by taxpayers whose taxable income in the preceding tax year was higher than 50,000 euros but did not exceed 100,000 euros. This option is only available to taxpayers who employ at least one socially insured person for at least 5 months of the year, which could be the business owner. Sole proprietors under the flat rate regime pay SSC on the minimum basis.

<sup>9</sup> The challenges of taxing SMEs are discussed in Annex II.

<sup>10</sup> Incidentally, an extensive application of the reduced VAT rate is neither good social nor tax policy. Better targeted social support measures could provide the same poverty reduction effect at much lower cost. Also, multiple rates increase risk of non-compliance and tax evasion and may require a higher standard rate.

<sup>11</sup> Note that Slovenia ranks about 10<sup>th</sup> place among EU-28 countries according to VAT gap studies by MoF.

## Property Tax

### 18. A value-based property tax would raise revenue potential, buoyancy and transparency.

The authorities' attempts to introduce a market value-based real estate tax, were held to be unconstitutional in 2014. Currently, property taxes are raised on the reinstated pre-2014 legislation. Revenues show no buoyancy, raising no more than 0.5 percent of GDP, with revenues from the transfer tax on immovable property transactions adding another 0.2 percent of GDP. There are considerable differences in the tax burden between individual municipalities, as well as within individual municipalities for different groups of real estate, indicating that the property tax regime is neither transparent nor equitable. Yet progress has been made in improving land registration systems and valuation methodologies which will support the introduction of the new property tax.

## Capital Gains Tax

19. **Taper relief on capital gains undermine the fairness principle of taxation and should be revised.** Capital gains attract a flat withholding tax at 25 percent on all income from capital. However, this is mitigated by elaborate tapering relief provisions whereby the 25 percent rate is reduced for every completed five-year period of ownership of the capital asset, to 0 percent after 20 years. Primary residences are also CGT exempt. This is a generous approach for adjusting for the illusory gains due to the impact of inflation on asset values over time. The resulting relief is very beneficial to high-income household who hold most assets. Best practice is to treat all short-term capital gains realized within one year of acquisition as ordinary revenue and tax them at the applicable marginal PIT rate or tax them at the flat proportional rate of the DIT. International best practice further suggests accommodating the inflationary gain element by either indexing the asset value for inflation, or by gradually reducing the inclusion of gain by a certain percentage for each year for holding the asset in question.

## D. Simulation of the Tax Reform Impact<sup>12</sup>

20. **The tax rebalancing parameters are based on OECD (2018) with a cut in the rate of social security contribution by about 5 percentage points offset with increased collections from consumption tax.** This tax rebalancing would reduce labor tax by about 1.2 percent of GDP in 2017. To achieve revenue neutrality, the simulation assumes that this is offset by increased effective collections from the consumption tax by about 1 percent of GDP and other lump-sum tax by about 0.2 percent of GDP, such as by reducing tax expenditures and broadening the corresponding tax base. The reform impact is simulated using the IMF's Global Integrated Monetary and Fiscal model (GIMF).<sup>13</sup> GIMF is a dynamic general equilibrium model with a full set of stock-flow-consistent national accounting and budget constraints of households, firms, and the government. Drawing on a

<sup>12</sup> The purpose of the simulation is to illustrate the order of magnitude of economic impact after reflecting the general equilibrium effects. It does not indicate a policy advice on specific tax instruments or the timing and sequencing of reforms. Designing reform parameters would require more detailed analysis, including on the sectoral impact.

<sup>13</sup> Positive long-run effects of lower income tax in Slovenia are also reported in a recent paper by Attinasi et al (2016), who consider financing by lump-sum transfers.

recent GIMF application used to evaluate fiscal and structural reforms in Austria, the model is calibrated using key national account and revenue parameters for Slovenia. The model set up is summarized in the Annex I with additional references that explain GIMF's underlying theoretical structure and applications in more details.

**21. In the simulation scenario, labor taxes were reduced with offsetting increases in consumption taxes in a revenue-neutral manner.** An ex-ante revenue-neutral cut of income taxes by 1.2 percent of GDP is offset by an increase of consumption and lump-sum taxes. It is assumed that seventy percent of the income tax decline is covered by the consumption taxes, the rest is financed by lump-sum taxes approximating the effects of inheritance or property taxes.<sup>14</sup> The scenario is designed as revenue neutral, based on the ex-ante output share of labor income tax and consumption tax revenues for ease of implementation. The revenue neutrality holds on average over a few years even after considering the endogenous response of macroeconomic variables, however. The deficit-to-GDP target is kept unchanged, and small deviations from this target (due to the endogenous response of the economy to the tax changes) average out over time and thus the debt-to-GDP ratio is kept roughly unchanged. The timing of a tax policy change would also need to consider the position in an economic cycle and other related public spending reforms.

**22. Shifting the tax burden from labor to consumption would permanently increase Slovenia's output level by 0.5 percent in the medium- to long-term.** Consistent with economic theory, lower taxation on labor leads to increase in private consumption and aggregate labor, resulting in a permanent increase in real output by roughly 0.5 percent in the medium- to long-run. Results of the simulation are presented in Figure 10. Due to the increase of consumption taxes and drop of the income taxes, households' marginal propensity to consume out of their newly increased wealth is permanently lower. All components of household wealth improve, both human wealth (permanent labor income) and financial wealth. The increase in domestic production is supported by exports, with the real effective exchange rate depreciation inducing foreign demand and discouraging imports. In the medium run, as the private consumption rises on par with output, imports recover, and the positive trade balance unwinds. In the long run, the economy moves to an equilibrium with higher labor input, higher level of the capital stock, and higher net foreign assets position. The change in the tax structure induces households to work and save more, and thus creates a permanent output benefit.

**23. The positive effects of the change in labor tax structure are reached gradually, being largest in the medium- and long-term.** It takes time for firms and households to adjust to the new tax measures and it takes time to accumulate a new target level of the capital stock. Households provide more labor effort, cumulate larger stock of productive capital, and reap the benefits of permanently higher consumption and output in the long run. The simulations indicate that

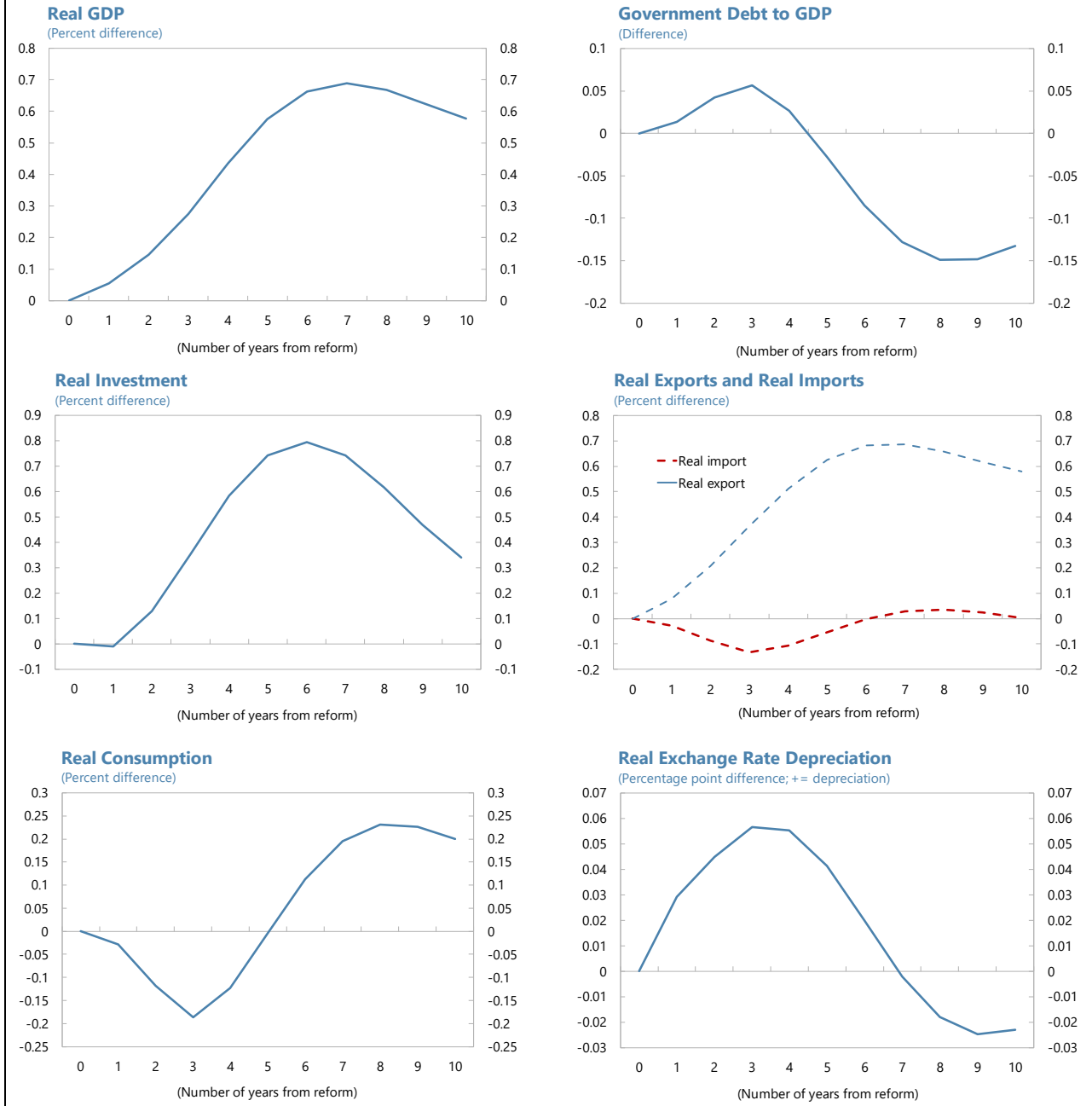
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<sup>14</sup> Consumption taxes are understood in a broad sense here, including excise taxes, other environmental taxes passed on to the consumer, and increases in the reduced VAT rate on certain goods. To the extent the net effect of the tax rebalancing affects low-income consumers adversely, the latter should be supported through the social assistance system. In the GIMF, all households, including the liquidity-constrained households, pay both consumption and labor taxes. The need for compensation would be more relevant for households who do not pay income taxes.

consumption would decline marginally in a couple of years after the reform when consumption tax is increased, but it would then rebound to a higher level in the medium term. The temporary consumption decline would also reduce tax collections and contribute to a marginally higher deficit, with government debt rising by less than 0.1 percentage point. Meanwhile, the reform would support rising investment and higher growth, including from net exports. Fiscal revenue would be higher in the medium- to long-term, with government debt lower by about 0.15 percentage point.

**24. The analysis on the tax rebalancing impact suggests that it can permanently and significantly increase potential output in Slovenia.** The simulations indicate that a revenue-neutral tax rebalancing has positive fiscal and growth benefits over time. Shifting the tax burden from labor to consumption and other taxes in a revenue-neutral way could increase Slovenia's output level by 0.5 percent in the medium- to long-term. However, there could be a small negative fiscal impact in the short term. This suggests that the timing of the tax reform should consider the position in an economic cycle and other complementary reforms to maximize the fiscal and growth benefits. The current economic recovery with a positive output gap presents a good opportunity to consider such a reform. Ultimately, the size of the output effect depends on the scale of the implemented reforms and can be scaled up in response to policy preferences. In addition, the positive impact can be amplified, and short-term adverse impact minimized, when combined with other growth-enhancing structural reforms as discussed in the Staff Report for the 2018 Article IV Consultation. The proposed measures could include structural measures aimed at increasing employment and productivity growth. These include reforming state-owned enterprises, enhancing labor market flexibility for and labor quality of all workers including the younger and elder ones, and improving product and service markets to support investment and firm growth.

**Figure 10. Detailed Simulation Results**  
(percent change from no reform level)



## Annex I. The GIMF Model

**1. The model used to quantify the impacts of fiscal and structural reforms in this paper is the IMF's Global Integrated Monetary and Fiscal model (GIMF).** GIMF is a multi-country structural dynamic general equilibrium model. Kumhof and others (2010) and Anderson and others (2013) provide more detailed documentation and key properties of the model. The model used in this paper features Slovenia, the rest of the euro area, and the rest of the world.

**2. GIMF links the behavior of households, firms, and government sector within and among countries.** The model has a consistent system of national accounting and stock-flow budget constraints for all sectors, including the government. The model belongs to the exogenous-growth family of models, meaning that the long-term (potential) growth of output is exogenous. Hence, fiscal or structural measures may change the structure of the economy, possibly increasing permanently the level of real output per capita, but not the potential output growth rate.

- Household sector consists of forward-looking optimizing households, as well as of liquidity-constrained households who spend all their available income. The forward-looking households are modeled as overlapping generations (OLG) with finite lives, following the Blanchard-Weil-Yaari approach. The presence of OLG households breaks the Ricardian equivalence in GIMF and is important for realistic results of fiscal policy in the long run. Households have utility from consumption and disutility from labor effort, they consume traded and non-traded services, receive labor income, transfers from the government, dividends from corporations, and pay taxes—income, consumption, and lump-sum taxes.
- Firms produce intermediate and final goods using the labor and capital inputs, cumulate capital, and import or export their production. Firms pay taxes from corporate income.
- Slovenia is a member of the euro area. Monetary policy in the euro area and rest of the world regions follows an inflation-forecast targeting rule and set policy interest rates.
- Government collects tax revenues and spends them on government consumption, investment, and transfers. Government target a specific debt-to-GDP (and thus deficit-to-GDP) target and uses a mix of its instruments to achieve it. The government's commitment to sustainable public finance is credible for firms and households, who hold the stock of government bonds.

## Annex II. Taxing SMEs<sup>1</sup>

- 1. SMEs are a diverse group. Commonly, small and micro enterprises constitute between 85–95 percent of the bulk of business taxpayers but their tax revenue contribution is mostly small.** To deal with this group coherently in terms of the overall tax system, it should only include business income taxpayers below the VAT registration threshold. It is a heterogeneous group of street- and produce- market vendors, artisans, subsistence farmers, small individual entrepreneurs, professionals, small shopkeepers, and businesses with few employees.
- 2. SME taxation should be treated as a special case.** The tax treatment and accurate registration of SMEs is important for reasons beyond tax collections. SMEs generate employment; taxing them consistently would increase horizontal and vertical equity; it would enhance economic efficiency; support a country's tax morale by attempting to level the playing field; advance government's accountability and transparency; and negotiating with SMEs their taxes would enhance the accountability and transparency of public institutions.
- 3. The indicator-based patent tax regime—**It is used for micro or sole traders, substituting for income tax and social contributions. Countries adopt a fixed fee across all economic activities as it would keep it simple (differentiation across activities leads to abuse, rent-seeking and corruption). The flat fee is not adjusted for profitability or turnover; as it typically is a small fee to prevent evasion. Since it does not address real profitability of a business it is regressive which should encourage business to formalize. This is good for growing firm size but migrating to the formal sector may be difficult due to tax compliance burdens. In this tax regime no bookkeeping is required.
- 4. Presumptive taxation based on indicators—**Instead of income taxation, physical indicators or financial information are used as proxy income indicators regarding activity or location. It can become very complex such as the French du forfait regime. There is no reliable comparability across sectors since varying definitions of small business (related to turnover or employees) are used. Again, it requires little bookkeeping but could create distortions vs. the general regime.
- 5. Turnover-based SME taxation—**The system is only available to firms under the VAT registration threshold. A flat tax of say 3-5 percent is imposed on gross receipts in lieu of income taxation, providing a link to VAT which is also turnover-based. The effective tax rate varies inversely with profit margins. The turnover tax system requires simple bookkeeping such as recording sales.

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<sup>1</sup> Khwaja, 2013, Small and Micro Enterprise (SME) Taxation—issues and challenge



**6. Cash-flow based presumptive tax**—In lieu of accrual accounting, it requires cash-based single-entry bookkeeping by offsetting against gross receipts total expenditures/costs with immediate expensing of capital expenditure. This makes tax depreciation superfluous. It replaces the income tax and achieves equal effective tax rates across sectors.

**7. Tax design and avoidance challenges**—As amply evidenced globally, presumptive regimes encourage larger businesses in the standard/general tax regime to split income (size) to benefit from the SME-regime's lower effective rates. Hence, one should exercise care in not introducing low turnover rates as existing owners can create new small firms instead of consolidating their expansions. Where the SME regime's tax burden deviates significantly from the wage tax burden, employees in the PIT regime will convert into independent contractors. Significantly lower tax burdens in the presumptive regimes create lucrative tax planning avenues for related parties with big corporations to establish small firms only for tax avoidance purposes—e.g., loans to small SME operations instead of equity injections or delaying payments to reduce cash receipts. The biggest drawback is that because of lower compliance standards in the SME regime, the difficulty in verifying tax facts (total sales, input costs, number of employees) provides ample opportunities to stay in the "shadow."

**8. Tax policy advice for correcting slippage and leakage from the general tax system**—Tax authorities should focus on using a well-considered VAT registration threshold as the cutoff turnover threshold for the SME tax regime. This ensures that medium-sized businesses are subject to the general tax regime. One still needs to clarify the thresholds between micro and small businesses with only turnover being the criteria for differentiation. Firms requiring VAT registration (as turnover exceeds the VAT registration threshold) should attract the general income tax. Any professional service should be excluded from the SME regime, allowing for streamlined and synchronized VAT returns, CIT filing, and tax payment obligations. This reordering will facilitate migration into the general regime.

**9. Tax administration**—Special audit and tax filing support by the tax administration to SMEs will shore up trust and tax morale. Tax audits of presumptive taxpayers should be risk-based addressing abuse by large taxpayers. SME assistance and advisory programs with focus on improving SMEs bookkeeping standards encourages compliance.

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