OECD Tax Policy Reviews

Slovenia 2018

OECD

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Please cite this publication as:
OECD (2018), *OECD Tax Policy Reviews: Slovenia 2018*, OECD Publishing, Paris.
https://doi.org/10.1787/9789264303898-en

ISBN 978-92-64-30388-1 (print)
ISBN 978-92-64-30389-8 (PDF)

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Foreword

This report provides a comprehensive tax policy assessment of the taxes paid by individuals in Slovenia and makes recommendations for tax reform. The report is divided into six chapters, starting with a general chapter which sets the scene for tax reform in Slovenia (Chapter 1) followed by a chapter on the labour market, social policy and tax policy related challenges (Chapter 2). The next chapters assess the financing of the social security system (Chapter 3) and identify strategies to strengthen the design of the personal income tax (Chapter 4), indirect taxes (Chapter 5), and the taxation of capital income at the individual level (Chapter 6). The main findings of the report are summarised in the executive summary and the main findings chapter; more detailed recommendations are included at the end of chapters 3 to 6.

This report is included in the OECD Tax Policy Reviews. OECD Tax Policy Reviews are intended to provide independent, comprehensive and comparative assessments of OECD member and non-member countries' tax systems as well as concrete recommendations for tax policy reform. By identifying tailored tax policy reform options, the objective of the Reviews is to enhance the design of existing tax policies and to support the adoption of new reforms.

This report was written by Bert Brys, Céline Colin and Seán Kennedy and the project was led by Bert Brys. The analysis is primarily based on desk research, OECD statistics and tax modelling including an analysis based on microdata from individual taxpayers provided by the Ministry of Finance of Slovenia. The analysis of the microdata was carried out by Seán Kennedy. The value-added tax microsimulation analysis included in Chapter 5 was carried out by Alastair Thomas. The analysis benefited from a fact-finding mission which took place in Ljubljana in February 2018. During this mission, the OECD team spoke with a wide range of stakeholders and their valuable input is kindly acknowledged. The authors of the report would like to thank the Ministry of Finance of Slovenia for the assistance in organising the mission and for follow-up support in the drafting stage of the review.

The authors wish to thank Mateja Vraničar Erman, Minister of Finance of Slovenia, Tilen Božič, State Secretary and Irena Popovič, Director General of the Directorate for the System of Tax, Customs and Other Public Finance Revenues from the Ministry of Finance of Slovenia, as well as their teams who have provided valuable input and guidance. Thank you in particular to Meta Šinkovec from the Ministry of Finance and Avgustin Staric from the Financial Administration. Thank you also to Irena Sodin, Ambassador, Permanent Representative to the OECD. The authors wish to thank Sarah Perret, Dominique Paturot, Pierce O'Reilly, Alastair Thomas, David Bradbury and Pascal Saint-Amans from the OECD Centre for Tax Policy and Administration for their helpful suggestions and input. The authors are also thankful to Jens Hoj from the Slovenia desk in the Economics Department of the OECD and to Francesca Colombo, Head of the Health Division in the OECD Directorate of Employment, Labour and Social Affairs. Thank you also to Carrie Tyler for her guidance on communications.

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Executive summary

Slovenia needs a comprehensive tax reform that rebalances the tax mix away from employee social security contributions (SSCs) towards personal income tax (PIT) and less distortive taxes such as value-added tax (VAT) and recurrent taxes on immovable property. The tax reform will have to prepare Slovenia for the ageing of its population. The reform should incentivise older workers to stay in the labour market longer and younger workers to enter the labour market sooner and should reduce unemployment, in particular of the low-skilled. In order to put the funding of the welfare system on a solid footing, without reducing entitlements to social benefits, the reform should partly shift the funding of the pension and health system from SSCs towards general taxation. The tax reform should be complemented with a broader set of reforms, including the pension and health care systems.

A comprehensive tax reform should be (at least) budget neutral and aligned with the country's fiscal rule. Over the past two decades, Slovenia has undertaken a number of extensive reforms. Some of these reforms were not fully funded, resulting in significant budget deficits as high as one quarter of the current public debt of Slovenia. In recent years, the government has narrowed the budget deficit. The level of public debt has been falling since 2016, while the country's highly redistributive tax and benefit system has been maintained. A comprehensive tax reform should therefore ensure that public debt can be further reduced.

The population in Slovenia is ageing rapidly with over 30% of people projected to be older than 65 by 2050, which will be one of the highest proportions in the OECD. The increase in age-related expenditure, especially on health and public pensions, will put pressure on the budget and require accompanying fiscal measures. In addition, population ageing will reduce PIT and SSC revenues, thereby exacerbating the challenges associated with financing the costs of ageing.

Older workers leave the labour market in Slovenia too early. While Slovenia is the top performer in the OECD with respect to the employment rate of workers in the prime age category of 25-54, for both men and women, it is one of the weakest performers with respect to the labour market participation of its workers who are older than 54. The 2013 pension reform increased the legal retirement age to 65 for both men and women, which has increased the number of workers in employment aged 55 and above. Nevertheless, tax return data for the year 2016 reveals that a significant gap remains between the official and the effective ages of retirement. Such a low rate of participation of older workers in the labour market is unsustainable in the context of Slovenia's ageing population. Further efforts to continue increasing the effective retirement age are needed.

A well-designed PIT is the cornerstone of a tax system that can effectively produce inclusive economic growth. While the PIT raises 25% of total tax revenues on average in the OECD, it raises only 14% in Slovenia. In contrast, SSCs raise 26% of total tax revenues on average in the OECD, while they raise almost 40% of tax revenues in Slovenia.

By broadening the PIT base, Slovenia has an opportunity to rebalance the tax mix away from employee SSCs towards PIT. The combination of high employee and employer SSCs and progressive PIT rates results in very high and distortive tax burdens on labour income. These high tax rates also reduce incentives for employers to hire workers and for individuals to participate in the labour market and to increase work efforts. The narrow PIT base presents a challenge for reshaping the role of the PIT in Slovenia, and the PIT base could therefore be broadened.

Opportunities also exist to rebalance the tax mix towards taxes on capital income at the individual level. The recent move towards the automatic exchange of financial account information (AEOI) between tax administrations creates an opportunity for countries to reassess the way they tax personal capital income under the PIT system.

In addition to broadening the PIT base, there is scope to finance a cut in SSCs by **broadening the VAT base** and by **strengthening the role of the recurrent tax on immovable property** in the financing mix of municipalities away from revenues from PIT.

Reshaping the personal income tax in Slovenia

A stronger role for PIT in Slovenia would allow a significant reduction in employee SSCs in the order of 5 percentage points. Such a reform would encourage greater workforce participation among workers who are not currently active in the labour market, including low-income, low-skilled and older workers.

A cut in employee SSCs would require redesigning the PIT rate schedule in order to balance the budget. First, the top PIT bracket could be abolished. The current top PIT rate of 50% is too high, in particular in combination with the high employee SSCs. The combined employee SSC and top PIT rate in Slovenia is 61%, which is the highest in the OECD. Few taxpayers pay the top PIT rate as it is introduced at a high income level; abolishing the 50% top PIT rate bracket would, therefore, only have a small impact on PIT revenues.

Second, the tax rates in the second, third and fourth tax bracket (respectively 27%, 34% and 39%) could be increased to help finance the cut in employee SSCs. The increase in the PIT rates would depend on the size of the reduction in employee SSCs. The PIT rate in the bottom bracket (16%) could be kept unchanged in order to maximise the impact of the cut in employee SSCs on low-income workers. The PIT rates in the third and fourth bracket could be increased more than the rate in the second bracket. However, the PIT rate in the fourth bracket (i.e. the new top PIT rate) should not be higher than 45%.

To compensate for the high tax burden on labour income, Slovenia has generous tax provisions that lower the tax burden particularly for families with children as they benefit from both child tax allowances and child cash benefits. The design and interaction of these provisions is complex and could be reformed.

Scope exists to broaden the PIT base. The PIT base is narrow as a result of exemptions and special tax provisions. First, tax provisions in Slovenia take the form of tax allowances, which give a larger tax reduction to higher incomes. This is not aligned with best practice in the OECD, where tax credits are more widely used as they provide the same benefit to all taxpayers irrespective of their income and marginal tax rates. Second, broadening the tax base could be achieved by abolishing the tax exemption for the reimbursement of home-to-work travel expenses, meals during work and by taxing performance bonuses and annual bonuses as regular income under the PIT.

The SSC base could be broadened by limiting the number of different contribution rates and bases, and aligning the treatment of different types of incomes. A cut in employee SSCs would also imply that self-employed SSCs, which are high by international standards, are reduced.

High tax burdens on labour income and high tax compliance costs reduce the incentives for entrepreneurship. In response, Slovenia has introduced an alternative "flat-rate" tax regime for self-employed entrepreneurs. However, the design of this regime induces entrepreneurs to conceal their income and discourages businesses from growing. The flat-rate regime is very generous in that it allows a deduction of "presumptive costs" equal to 80% of income, which is significantly higher than the actual costs incurred by most businesses. This approach not only results in low PIT liability but also reduces the SSC base. The flat-rate regime needs to be reformed or abolished.

Self-employed who do not opt for the generous flat-rate regime have a tax-induced incentive to incorporate in order to transform highly taxed labour income into low-taxed capital income. The tax burden on labour and capital income needs to be more closely aligned by lowering the tax burden on labour income and increasing the tax burden on capital income.

The financing of the health system needs to be strengthened. A wide range of measures are available. An in-depth evaluation of the efficiency of the health and welfare systems should be undertaken. Such an evaluation would be welcome along-side the introduction of measures that would allow the Health Insurance Institute of Slovenia (HIIS) to focus on its core activities and to put its financing on a more sustainable footing in light of the challenges linked to the ageing of society.

Main findings

Setting the scene for comprehensive revenue-neutral tax reform

A well-designed personal income tax (PIT) is the cornerstone of a tax system that can effectively produce inclusive economic growth. Slovenia needs a comprehensive tax reform that shifts the tax mix from employee social security contributions (SSCs) to PIT, value-added tax (VAT) and recurrent taxes on immovable property. The tax reform must prepare Slovenia for the ageing of its population. The reform should incentivise older workers to stay in the labour market longer and younger workers to enter the labour market sooner. It should also reduce unemployment, in particular among the low-skilled. In order to put the funding of the welfare system on a solid footing without reducing entitlements to social benefits, the reform will need to shift part of the funding of the pension and health system from SSCs towards general taxation. The tax reform should be complemented with a broader set of reforms, including the pension and health care systems.

A comprehensive tax reform will have to be (at least) revenue neutral and be aligned with the country's fiscal rule and budgetary obligations as a member state of the European Union. The level of public debt has increased sharply: from 22% of GDP in 2008 to more than 82.6% of GDP in 2015. Over the past two decades, Slovenia has undertaken a number of extensive reforms. Some of these reforms were not fully funded, resulting in significant budget deficits as high as one quarter of the current public debt of Slovenia. Since 2014, the government has narrowed the budget deficit. The level of public debt has been falling since 2016. Also, privatisation has reduced contingent liabilities somewhat, although state-ownership remains at an internationally high level. A comprehensive tax reform should therefore ensure that public debt can be reduced further.

The population in Slovenia is ageing rapidly with over 30% of the population projected to be older than 65 by 2050, which will place the country as one of the oldest populations in the OECD. The increase in age-related expenditure on health and public pensions will put pressure on the budget and require accompanying fiscal measures. In addition, population ageing will reduce tax revenues. Currently, labour taxes (i.e. PIT and SSCs) account for a large share of Slovenia's tax revenues. The reduction in the share of people who are active in the labour market arising from ageing will significantly lower these tax revenues, exacerbating the challenges associated with financing the costs of an ageing population.

Older workers leave the labour market in Slovenia too early. While Slovenia is the top performer in the OECD with respect to the employment rate of workers in the prime age category of 25-54, for both men and women, it is one of the weakest performers with respect to the labour market participation of its workers who are older than 54. The 2013 pension reform increased the legal retirement age to 65 for both men and women, which is having positive effects on the number of workers in employment aged 55 and above. Nevertheless, analysis of tax return data for the tax year 2016 reveals that there is still a significant gap between the official and effective ages of retirement. Such a low

participation rate among older workers in the labour market is unsustainable, particularly in the context of Slovenia's ageing population. Further efforts to continue increasing the effective retirement age are needed.

Low youth labour market participation due to long study periods and high long-term unemployment among the low-skilled present additional labour market challenges for Slovenia. In addition, there are inequities in the tax treatment of different types of workers.

Low PIT revenues are not the result of low PIT rates or a lack of tax progressivity – in fact, the top PIT rate in Slovenia is comparatively high – but the consequence of a narrow PIT base due to many generous tax provisions and tax exemptions. PIT accounts for a comparatively small share of revenues in Slovenia. While the PIT raises 25% of total tax revenues on average in the OECD, it raises only 14% in Slovenia.

SSCs raise a large share of revenues in Slovenia. SSCs are usually levied at flat rates and revenues are typically earmarked for social welfare spending. On average in the OECD, SSCs account for 26% of total tax revenues, while they account for close to 40% of tax revenues in Slovenia. Nevertheless, a wide range of special SSC regimes narrow the SSC base. Despite the narrow SSC base, high SSC revenues reflect high SSC rates in Slovenia.

By broadening the PIT base, Slovenia could rebalance its tax mix away by shifting from employee SSCs towards PIT. The combination of high employee and employer SSCs along with progressive PIT rates result in high and distortive tax burdens on labour income. These distortions reduce incentives for employers to hire and for individuals to participate and work hard in the labour market. The narrow PIT base presents a challenge for reshaping the role of the PIT in Slovenia, and the PIT base could therefore be broadened.

Opportunities also exist to rebalance the tax mix by shifting more towards taxes on capital income at the individual level. The recent move towards the automatic exchange of financial account information (AEOI) between tax administrations creates an opportunity for countries to reassess the way they tax personal capital income under the PIT system.

There is scope to finance a cut in SSCs by broadening the VAT base. A wide range of goods and services are taxed at a reduced VAT rate and provide the largest gain to richer households.

There is also scope to strengthen the role of the recurrent tax on immovable property in the financing mix of municipalities by shifting away from revenues from PIT towards a greater reliance on taxes on immovable property.

In order to better prepare Slovenia for the future, tax reform will need to be complemented by a broader set of reforms, including a pension reform and a reform of the health care system.

This report provides an assessment of the taxes paid by individuals in Slovenia and outlines recommendations for tax reform. It does not include an assessment of the taxes paid by corporations such as the corporate income tax (CIT) or the international tax rules in Slovenia, which is beyond the scope of this analysis.

Key elements of a comprehensive tax reform in Slovenia

A comprehensive tax reform should be considered in the context of a tax-to-GDP level that is above the OECD average and high in view of the income level in Slovenia, in addition to a tax mix that relies heavily on distortive taxes on labour. Slovenia has a

sophisticated social welfare system that is successful in reducing income inequality. The system is financed largely though SSCs which are levied at very high rates, in particular for employees. However, there are discrepancies between the tax and SSC treatments of different types of workers, reducing transparency and increasing inequality.

The combination of high employee and employer SSCs and progressive PIT rates results in very high tax burdens on labour income. In general, it reduces incentives for employers to hire workers and for individuals to participate in the labour market and to increase work efforts, which is likely to be a particularly significant issue for workers with a weaker attachment to the labour market such as low-skilled workers and older workers.

Employers have to pay higher effective SSC rates for low income workers due to the imposition of a minimum SSC base for workers under a certain income threshold. This makes it expensive for employers to hire low-skilled and low-income workers and reduces the labour market opportunities for these types of workers.

Slovenia has high implicit tax rates on return to work for the unemployed. This arises due to a combination of high taxes on labour income and the loss of out-of-work benefits for the unemployed who re-enter the labour market – also known as unemployment and inactivity traps. Young people enter the labour market later in part due to extensions of their study periods, which is linked to the generous tax treatment of income from student work. Recent reforms have reduced the tax privileges for students but their income continues to benefit from preferential tax treatment. Moreover, almost all workers leave the labour market when they reach the age of 59, which is reflected in the sharp income declines at and after this age. The 2013 pension reform is having positive effects on the labour market participation of older workers but further reform efforts are necessary in order to significantly raise the effective retirement age of workers in Slovenia.

To compensate for the high tax burden on labour income, Slovenia has generous tax provisions that lower the tax burden in particular for families with children. While tax base narrowing measures can strengthen the fairness of the tax system by providing support to some taxpayers, they result in higher tax rates on all other taxpayers. Families with children benefit from both child tax allowances and child cash benefits. The design and interaction of these provisions is complex and needs to be reformed. Secondary earners, usually women, face very high marginal tax rates, partly as a result of the decline in child benefits at higher income levels

A stronger role for the PIT in Slovenia would allow reductions in employee SSCs, possibly by phasing in the reduction over time. Such a reform would encourage greater workforce participation among workers who are not currently active in the labour market, including low-income, low-skilled and older workers. Lower employer SSCs would stimulate labour demand, which would expand the tax base.

A cut in employee SSCs would require re-designing the PIT rate schedule in order to balance the budget. First, the top PIT bracket could be abolished. The current top PIT rate of 50% is too high, in particular in combination with the high employee SSCs. The top marginal "all-in" rate, which takes into account employee SSCs and the top PIT rate in Slovenia is 61.1% which is the highest all-in rate that is levied in the OECD. Such a high combined tax rate strongly discourages taxpayers from increasing work efforts and may encourage tax avoidance, such as business incorporation particularly as the top rates on labour and capital income are not aligned. Very few taxpayers pay the top PIT rate as it is levied on very high income levels. Simulations based on tax return data show that reducing the top PIT rate would come at a low tax revenue cost. Even if the top PIT rate was lowered

to 45%, the marginal "all-in" rate would continue to be above the rates that can be found in countries such as Austria, Italy, and Germany.

The tax rates in the second, third and fourth tax brackets (which are 27%, 34% and 39% respectively) could be increased to help finance the cut in employee SSCs. The increase in the PIT rates needed to compensate for the cut in employee SSCs would depend on the size of the reduction in employee SSCs. The PIT rate in the bottom bracket (16%) could be left unchanged in order to maximise the impact of the cut in employee SSCs on low-income workers. The PIT rates in the third and fourth bracket could be increased more than the rate in the second bracket. However, the PIT rate in the fourth bracket (i.e. the new top PIT rate) should not be higher than 45%.

People on lower incomes face a lower tax burden due to generous basic allowances. However, low-income workers face disincentives to move up the income scale as, in addition to the general tax allowance, there is an additional basic allowance which is reduced at higher income levels and therefore increases marginal effective tax rates. One possible option could include replacing both tax allowances by a single tax credit which would not vary with income, but to compensate for the tax revenue cost by increasing the bottom PIT rate.

There is scope to broaden the PIT base, which would limit the extent to which PIT rates would have to be increased. The PIT base is relatively narrow as a result of exemptions and special tax provisions. First, tax provisions in Slovenia take the form of tax allowances, which give a larger tax reduction to people earning higher incomes. This is not aligned with best practice in the OECD, where tax credits are more widely used. Tax credits provide the same benefit to all taxpayers irrespective of their income and marginal tax rates. Among the tax provisions that could be abolished to broaden the PIT base are the tax exemption for the reimbursement of home-work travel expenses and meals during work. Across the OECD, the expenses that workers incur to earn taxable personal income, including home-work travel costs, are typically included in the basic allowance and therefore exempt from PIT through the basic allowance. Exempting the reimbursement for those expenses from tax, as is the case in Slovenia, results in a double tax exemption. In addition, the performance bonuses and annual bonuses, which are currently tax exempt up to the average wage, could be taxed as regular income under the PIT.

The SSC base could be broadened by limiting the number of different contribution rates and bases, and aligning the tax treatment of different types of incomes. A cut in employee SSCs would also imply that the SSCs that the self-employed have to pay, which are high by international standards, would be reduced. Slovenia could further align the SSC treatment of employees and the self-employed. However, this would not only imply a convergence in SSCs, but also a convergence in benefit entitlements for the different types of workers. As part of such a reform, Slovenia could consider introducing a SSC ceiling for employees or abolishing the ceiling for the self-employed; the latter reform would require an accompanying increase in the maximum pension for the self-employed in order to ensure that the link between contributions made and benefits received remains intact. Such a reform would also require that, instead of exempting 25% of the income from tax, the income earned by the self-employed would be split in a return for work and a return for the capital invested; both returns could then be taxed separately.

Generous tax provisions have long-run costs for the taxpayers who benefit from them. The remuneration which workers receive for home-work travel and meals during work are exempt from PIT and SSC, which narrows the base and reduces their effective tax burden. However, as taxpayers do not pay SSCs on tax-exempt income, they also do not build up

rights to future benefit entitlements (e.g. a pension). While a narrow base might have advantages in the short run for some taxpayers, it also comes at a cost in the longer run for individuals and society more generally.

The financing of the welfare system, including the health system, needs to be strengthened. An in-depth evaluation of the efficiency of the welfare system, and in particular of the health fund, would be welcome along-side the introduction of measures that would allow the Health Insurance Institute of Slovenia (HIIS) to focus on its core activities and to put its financing on a more sustainable footing in light of the challenges linked to the ageing of society.

While the link between SSCs and benefits could be strengthened, the link at low income levels could be relaxed to prevent labour market distortions. Wages and pensions in Slovenia are relatively low by OECD standards, although not necessarily in comparison with some other East European countries. Tax return data shows that the wage structure is compressed principally at the low end of the wage distribution. This implies that financing the welfare state primarily through SSCs, as is the case in Slovenia, is challenging as raising sufficient revenues would require levying high SSC rates. Typically strengthening the link between the SSCs that workers pay and the benefits that they will receive constitutes good tax policy. However, in the presence of low wages and a condensed wage distribution it may be challenging to implement. In order to ensure that low income workers will be entitled to a minimum pension that prevents them from falling into poverty when they retire, very high SSCs are levied, which might price these workers out of the labour market. In such a setting, a more balanced financing mix of the welfare state beyond SSCs would be optimal and would prevent a drop in pension and other benefits. Indeed, the minimum SSC base for workers under a certain income threshold, which is planned to increase further, will be too high leading to very large effective employer SSC rates; this threshold should be abolished for both employees and self-employed or, if that would not be feasible in the short run, lowered to the minimum wage.

The flat-rate regime for self-employed workers needs reform. High tax burdens on labour income and high tax compliance costs reduce the incentives for entrepreneurship. In response, Slovenia has introduced an alternative "flat-rate" tax regime for self-employed entrepreneurs. However, the design of this regime encourages entrepreneurs to conceal their income and discourages businesses from growing. The flat-rate regime is very generous in that it allows a deduction of "presumptive costs" equal to 80% of income, which is significantly higher than the actual cost incurred by many businesses. This approach not only results in low PIT liability but also reduces the SSC base. A large share of the self-employed under the flat-rate regime therefore pay SSCs on the minimum SSC base. Abolishing the flat-rate regime and the minimum SSC base therefore needs to go hand in hand.

The self-employed who do not opt for the generous flat-rate regime have a tax-induced incentive to incorporate in order to turn highly taxed labour income into low-taxed capital income. The tax burden on labour and capital income needs to be more closely aligned by lowering the tax burden on labour income and increasing the tax burden on capital income.

Strengthening the design of consumption taxes could help finance a cut in SSCs. The standard VAT rate is high and the reduced VAT rate, which is relatively low, applies to a large number of goods and services. As the VAT rate in neighbouring countries is somewhat lower than in Slovenia, the standard VAT rate should be maintained at its current level. However, there is scope to address regressive distributional effects of the reduced VAT rate in Slovenia. Some of the products and services that are taxed at the reduced VAT

rate benefit the rich more than the poor both in relative and absolute amounts. This is the case for cultural activities, hotels, restaurants, and air transport.

The recent move towards the automatic exchange of financial account information between tax administrations creates opportunities for Slovenia to revisit the way it taxes personal capital income. Tax rates on capital income at the individual level in Slovenia are not particularly high and effective tax rates on household savings vary widely across assets. Some assets, such as owner-occupied and rental immovable property and private pension savings are taxed particularly lightly. The capital income tax system also lacks progressivity, which is typical under dual income tax systems. Slovenia could consider increasing the progressivity of its capital income tax system.

Finally, improving the design of the tax system will also require property tax reform and changes to the way municipalities are financed. The introduction of the new real estate tax is much-awaited as it creates opportunities to rebalance the tax mix and to reform the financing mix of local governments. Municipalities currently receive a significant share of PIT from central government which facilitates underuse of the recurrent tax on immovable property. For instance, the formula that assigns additional tax revenues to municipalities could be adjusted to take into account the extent to which the municipality faces the opportunity to collect revenues from recurrent taxes on immovable property. Analysis presented in this report indicate that central government could lower the PIT revenue sharing ratio from 54% to 36% once the recurrent tax on immovable property is in place and then continue to lower the ratio gradually over time to a ratio between 30% and 18%.

Table 1 presents the key tax reform recommendations. More detailed recommendations are included at the end of each chapter in this report.

Table 1. Key tax reform recommendations

Strengthen the design of the PIT	Abolish the top PIT rate Increase the PIT rates in the second, third and fourth tax bracket Broaden the PIT base, including by abolishing the exemption for the reimbursement of home-work travel expenses and meals during work and taxing performance and annual bonuses as regular income Redesign the provisions that provide support for children Reduce tax disparities between different businesses legal forms Abolish or reduce the generosity of the flat-rate regime for self-employed workers Publish an annual tax expenditure report and improve transparency
Reform social security financing	Reduce employee SSCs Lower the minimum SSC income base Broaden the SSC base Evaluate the link between SSCs paid and benefits received Increase and diversify the sources of financing dedicated to health care
Improve the design of indirect taxes	Maintain the 22% standard VAT rate Broaden the VAT base by reducing the use of lower VAT rates
Improve the taxation of capital income at the individual level	Raise more revenues from taxing capital income at the individual level Revise the tax treatment of immovable property
Reform the financing of municipalities	Partly shift the financing mix of municipalities

A revenue neutral reform package

The main tax reform recommendations presented in this report have been costed through microsimulation analysis using information on income data from individual taxpayers for the fiscal year 2016. The tax revenue potential of the recurrent tax on immovable property have been calculated on the basis of OECD Revenue Statistics data. VAT base broadening measures are based on microsimulation analysis of Household Budget Survey information.

According to the simulation analysis, a 5.24 percentage points reduction in employee SSCs (from 22.1% to 16.86%) is associated with a reduction in tax revenues of EUR 519 million. The reduction in employee SSCs of 5.24 percentage points reflects a general reduction in employee SSCs of 5 percentage points augmented by the reduction in employee SSCs if the rates for unemployment insurance (at 0.14 percentage points) and maternity leave (at 0.10 percentage points) are put to 0. A reduction in employee SSCs of 5 percentage points has been chosen as it reflects a significant cut, but other assumptions could have been made. There is a reduction in SSC revenues of approximately EUR 700 million through lower employee SSCs but EUR 180 million (about one-quarter) is recovered through the PIT. This is the result of a direct and indirect PIT recovery channels. A reduction in employee SSCs broadens the PIT base which increases PIT revenues directly and also indirectly as some taxpayers might be pushed into higher PIT rate brackets. The PIT recovery could exceed SSC losses in the top PIT brackets. The analysis assumes no behavioural changes.

Abolishing the top PIT rate bracket comes at a small revenue cost of EUR 13 million; and lowering the top PIT rate from 50% to 45% would cost EUR 6 million. The analysis shows that a 2 percentage points increase in the PIT rate of the second, third and fourth brackets, for instance, is estimated to raise EUR 61 million of extra revenues when employee SSCs remain at 22.1% and EUR 71 million if employee SSCs were reduced to 16.86%. Overall the estimations show that a narrow base comes at a significant revenue cost. Broadening the tax base by, for instance, 10% would raise additional revenue of EUR 120 million, which would be close to the cost of a 1 percentage point reduction in employee SSCs. The analysis also indicates that broadening the PIT base will require smaller PIT rate increases in order to finance a significant employee SSC cut. Finally, the SSC loss associated with introducing a cap at 350% of the average wage for employees is EUR 61 million and EUR 45 million for employee and employer SSCs respectively.

Significant tax revenues could be raised through VAT base broadening. Abolishing the reduced VAT rate on hotel accommodation and restaurant food, for instance, would collect an extra EUR 68 million. Higher statutory tax rates on capital income at the individual level would increase tax revenues only modestly. These simulations, however, do not take into account the additional information that the tax administration might receive through the AEOI between tax administrations of capital income earned by tax residents in Slovenia on assets held offshore but which have not yet been declared to the tax administration in Slovenia. However, an important amount of additional tax revenue could be raised by using the potential of the recurrent tax on immovable property. If Slovenia would raise revenues from the recurrent tax on immovable property equal to an amount which other OECD countries collect on average, it would collect an extra EUR 280 million. Increasing the revenues from recurrent taxes on immovable property to the level of the best performers in the OECD would allow Slovenia to raise EUR 670 million of additional tax revenues, which would correspond to a reduction in employee SSCs by 6.8 percentage points.

Table 2. Costing of main recommendations

Main objective	Recommendation	Scenario		Change in revenues (EUR millions)
Strengthen the design of the PIT	**Abolish the top PIT rate**	Abolish the top PIT rate (50%) and bracket		-13
		Lower the top PIT rate to 45% (but maintain bracket)		-6
	Increase the PIT rates in the second, third and fourth tax bracket (note: estimates based on 2018 PIT schedule applied retrospectively to 2016 tax data; estimates presented are cumulative).	PIT rate increases for an employee SSC rate at 22.1%	Second bracket PIT rate: + 1, 2, 3, 4pp	22, 45, 67, 90
			Third bracket PIT rate: + 1, 2, 3, 4pp	7, 14, 21, 28
			Fourth bracket PIT rate: + 1, 2, 3, 4, 5, 6pp	1, 2, 4, 5, 6, 7
		PIT rate increases for an employee SSC rate cut to 16.86%	Second bracket PIT rate: + 1, 2, 3, 4pp	26, 51, 77, 103
			Third bracket PIT rate: + 1, 2, 3, 4pp	8, 17, 25, 34
			Fourth bracket PIT rate: + 1, 2, 3, 4, 5, 6pp	1, 3, 4, 6, 7, 9
	Broaden the PIT base	Reduce tax allowances	By 5%	58
			By 10%	120
			By 15%	184
			By 20%	251
			By 25%	319
Reform social security financing	**Reduce employee SSC rates**	Reduce employee SSCs	From 22.1% to 16.86%	-519
	Align the SSCs for regular employees and the self-employed	Apply SSC ceiling to employees at 350% of average wage	Employee SSC only	-61
			Employer SSC only	-45
			Both	-106
Broaden the VAT base by reducing the use of lower VAT rates	**Tax goods and services at the standard rate instead of a reduced VAT rate**	All goods (including food) and services		689
		Books, newspapers, periodicals, cinema, theatre, concerts		27
		Hotel accommodation and restaurant food		68
		Passenger transport (excluding international air transport)		17
Improve the taxation of capital income at the individual level	**Raise more revenues from taxing capital income at the individual level**	Increase in statutory tax rate on capital income	By 5 pp	18
			By 10 pp	37
			By 15 pp	55
	Revise the tax treatment of immovable property	Increased use of recurrent taxes on immovable property to	Average across OECD countries (1.1% of GDP)*	280
			Good OECD performers (2% of GDP)*	670
			Best OECD performers (2.5% of GDP)*	890

Note: Estimates are purely informative and provide an indication of the impact of each specific tax reform on total tax revenues holding all other tax characteristics unchanged (i.e. ceteris paribus). As a result, the different estimates cannot be simply added as the revenue impact of certain measures will depend on, and interact with, the impact of other measures. For instance, a reduction in employee SSCs and a corresponding PIT rate increase will interact with the revenue implications of PIT base broadening measures. Hence, the simultaneous introduction of various measures included in the table may have a different tax revenue impact than would be obtained by adding the presented revenue estimates of each measure in isolation. In addition the tax reform measures may lead to a reduction in the funding of different public funds (government budget, health fund, pension fund, local budgets); this will need to be taken into consideration when drafting the changes in a tax law. Furthermore, the reduction in employee SSC rates is presented as a net effect as it combines the reduction in SSC revenues with the increase in PIT revenues as a result of the base broadening effect of a reduction in employee SSCs (for more information: see chapter 4). The effects in Table 2 are calculated using 2016 data and take into account tax allowances and PIT rate schedule valid in 2016. Some tax parameters have changed since then. However, the increases in the PIT rates have been based on the 2018 PIT rate schedule which has been applied retrospectively to the 2016 tax data.* Calculations are based on the GDP figure from the Statistical Office of Slovenia (EUR 43 278 billion in 2017, current prices). Methodological information on the microdata is available in the annex.

Source: Authors' calculations based on Ministry of Finance of Slovenia tax records microdata.

Slovenia needs a labour market reform that goes beyond taxation

Tackling the challenge of low labour participation of young and in particular older workers and population ageing in Slovenia requires reforms that go beyond tax policy. The retirement age has been increasing since the 2013 pension reform. Nevertheless, the gap between the official and the effective retirement ages remains large as a result of pre-retirement schedules, for example the use of sickness leave as a bridge between work and retirement. The abuse of these mechanisms should be prevented in order to increase the effective retirement age in Slovenia. In addition to measures that discourage early retirement, measures that make working longer financially more attractive could be implemented. Slovenia may also further develop systems that allow for a smooth transition between work and retirement such as, for instance, part-time work and part-time retirement schemes. The government should also consider increasing the official retirement age from 65 to 67, as recommended in the OECD Economics Surveys: Slovenia 2017 (OECD, 2017). Such a measure could form part of a longer term proposal to lift the retirement age on a prospective basis.

Wages in Slovenia increase automatically with the worker's age irrespective of the worker's labour market productivity, which has negative implications for the work opportunities, particularly for older low-skilled workers, especially when considered in the context of high SSCs. Ideally, such an automatic increase in wages with age is replaced with an alternative system of remuneration.

Chapter 1. Setting the scene for tax reform in Slovenia

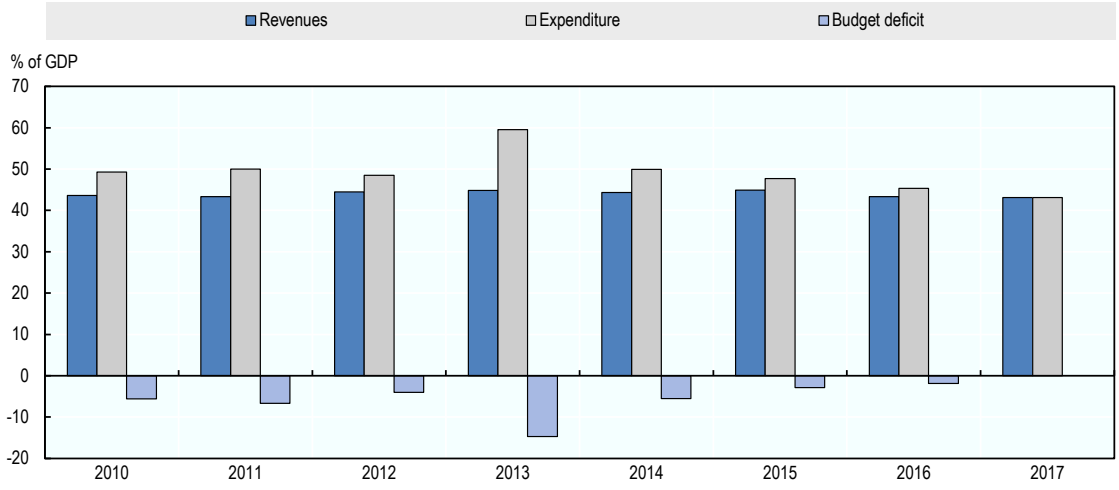
Slovenia enters the fifth year of economic recovery. The government has closed the budget deficit and reduced public debt. Slovenia continues to face major challenges: public debt is high, the population is ageing, labour market participation rates are low for old and young workers, long-term unemployment is high, and labour productivity is low. Without reform, the government will have to raise more tax revenues to face the rising costs of ageing, and to maintain the generous transfers system. Population ageing will not only increase public spending but, in the absence of reform, will also put tax revenues under pressure. Reforms should be considered in the context of a tax level which is above the OECD average and a tax mix which relies heavily on distortive taxes on labour. Improving the design of the tax system will also need to reform the financing of local municipalities.

1.1. After a double dip crisis Slovenia's economy is recovering but the country continues to face major economic challenges

The international financial crisis (2008-09) followed by the Slovenian banking crisis (2013) weakened the economy but growth has now recovered. In 2018 Slovenia enters the fifth consecutive year of steady economic recovery. The growth rate was 3.1% in 2016 and 5% in 2017 (Eurostat) which contrasts with the negative growth in 2012 (-2.7%) and 2013 (-1.1%). Initially, the recovery was led by exports, but it is increasingly being supported by stronger private domestic demand underpinned by real income growth, stronger employment and rising consumer confidence (OECD, 2017[1]).

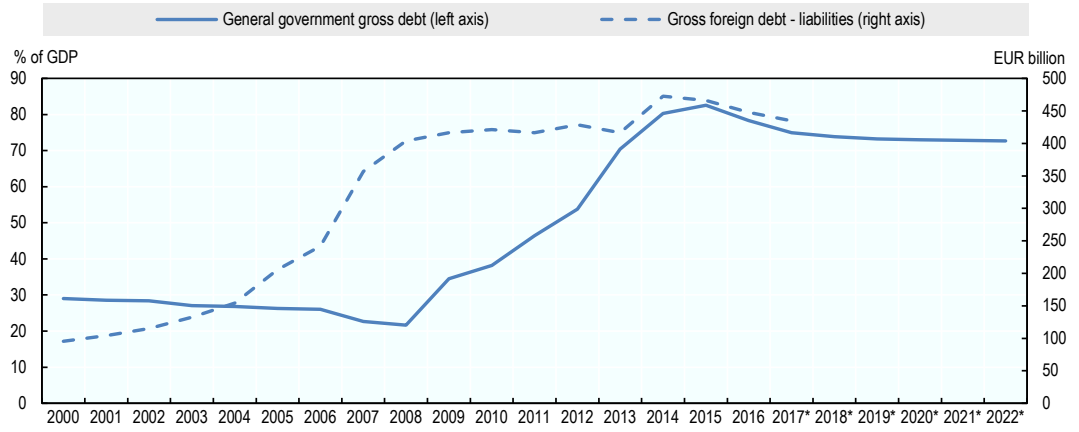
The budget deficit and the debt-to-GDP ratio have decreased since 2014. In 2017 the general government budget registered a small surplus (Ministry of Finance, 2018[2]), and Slovenia exited the European Commission's excessive deficit procedure (Figure 1.1). A budget surplus is also expected in 2018. The debt-to-GDP ratio has quadrupled from 22% in 2008 to more than 82% of GDP in 2015, in part as a result of the banking sector bail-out in 2013, and the 2006-07 tax reform, which was not revenue neutral (Figure 1.2). More recently, the government has managed to narrow the budget deficit and the level of public debt has been falling since 2016. Privatisation has also reduced contingent liabilities[1] somewhat, although state-ownership remains at an internationally high level (Ministry of Finance). The debt-to-GDP ratio had decreased by 9 percentage points from 2015 to 2017 (to 73.6% of GDP). According to the International Monetary Fund projections, public debt is expected to reach 77% of GDP in 2018 (IMF, 2017[3]). The government's objectives for 2020 are to eliminate the structural budget deficit and to have a debt-to-GDP ratio close to 60%.

Figure 1.1. The budget deficit is closing



Source: Statistical office of Slovenia.

Figure 1.2. Public debt has stabilised but remains high

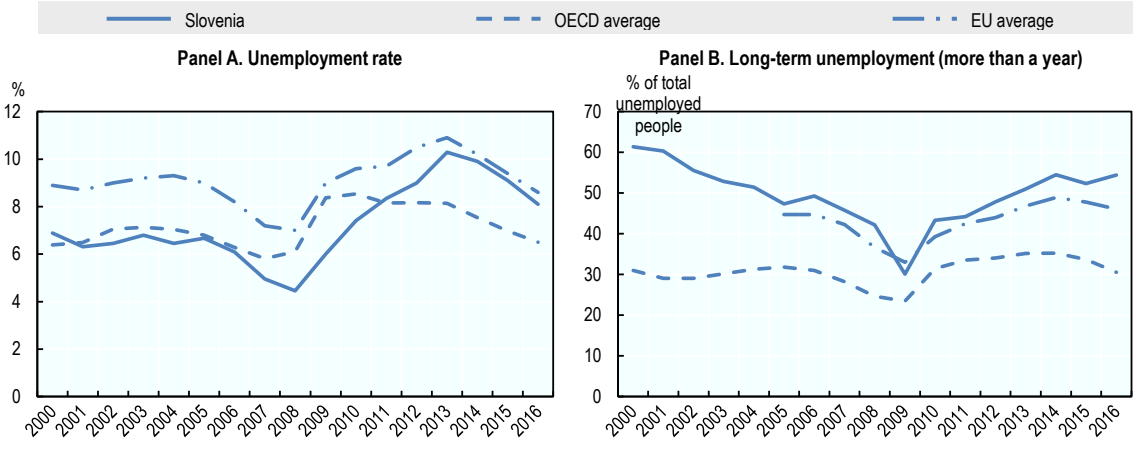


Note: * are estimates.
Source: IMF (2017); Ministry of Finance of Slovenia.

The ageing population will put more pressure on public spending. Since independence, the share of elderly people has increased and could represent a third of the population by 2060[2] (IMAD, 2016[4]). In 2015 the dependency ratio of older people is 27.8% of the working-age population. According to the main scenario of the EUROPOP2013, the proportion of elderly people could exceed the size of the working age population by 2060 (IMAD, 2016[4]).

The unemployment rate (6.4% in 2017) has dropped since 2013 but remains above the pre-crisis level (Figure 1.3 Panel A). Unemployment rates are relatively high for both young (13% in 2016) and old workers (6.5% in 2016). Slovenia's unemployment trends are lower or similar to the European Union (EU) average but above OECD average. Long-term unemployment remains an issue (Figure 1.3 Panel B). Half of all jobless workers have been unemployed for more than a year (OECD, 2017[1]) and more than 40% of long-term unemployed are older than 50.

Figure 1.3. Unemployment, in particular long-term unemployment, is a challenge



Source: OECD Labour Force Statistics database.

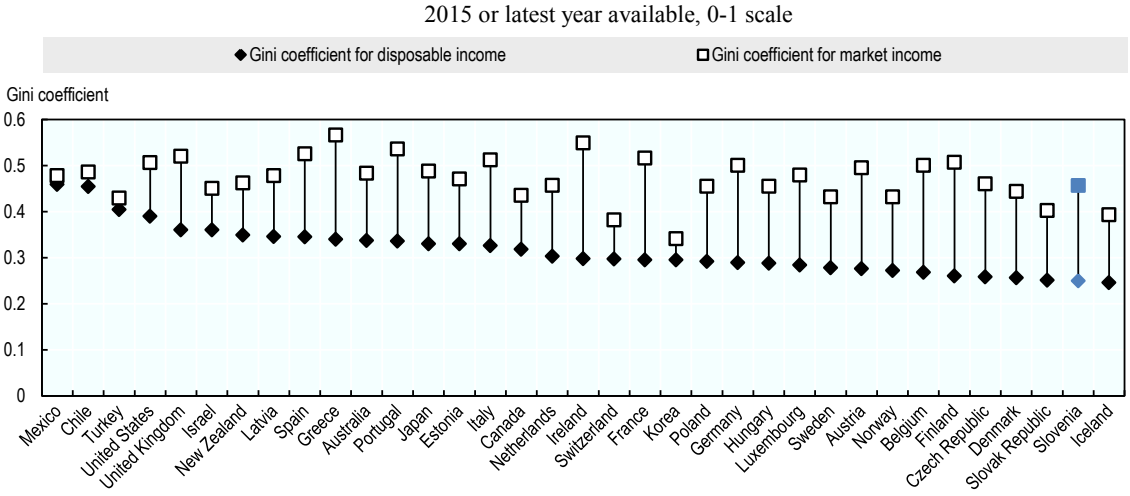
Slovenia lags behind more developed economies in terms of productivity. Before the global financial crisis, Slovenia experienced very strong labour productivity growth and per capita GDP growth. However, per capita GDP levels remained flat in the years after the downturn, as productivity growth slowed and labour use declined (OECD, 2017[5]). In 2015 productivity was around one fifth lower than the EU average (IMAD, 2017[6]). This reflects the impact of the crisis and the collapse of domestic demand, depressed capital investment, production factors misallocation in addition to significant regulatory and competition barriers.

1.2. Disposable income inequality is low

Market income inequality has increased in Slovenia, following international trends. The Gini coefficient for market income (before taxes and transfers) increased to 0.46 in 2015, up from 0.42 in 2008. Market income inequality in Slovenia is higher than in Poland, Hungary or the Slovak Republic, but lower than in Austria, Germany, and Italy (Figure 1.4).

Generous tax provisions and benefits lower inequality considerably. Benefits and tax reliefs for dependent children, students and low income households lower inequality. The Gini coefficient for disposable income (i.e. after taxes and transfers) fluctuates around 0.25 which places Slovenia among the most equal countries in the OECD. This reflects both the design of the tax system and the orientation of public policy towards generous transfers which support the purchasing power of low income households.

Figure 1.4. The Slovenian tax and transfer system significantly reduces inequality



Source: OECD Income Distribution and Poverty database.

Analysis of tax record data for 2016 reveal that over 740 000 employees earn EUR 14.6 billion in gross income and pay EUR 6.8 billion in personal income tax (PIT) and social security contributions (SSCs) (Table 1.1). Employees in the bottom decile earn 2.4% of all income and pay 0.1% of all PIT and 2.0% of all PIT and SSCs combined. Those in the top decile earn 27% of all gross income in 2016 (approximately the same percentage as in deciles 1 to 5 combined), and contribute to 44% of PIT and 30% of all PIT and SSCs combined. Employees in the top 1% earn 6.5% of all income and contribute to 13% of all PIT and 7% of all PIT and SSCs.

Concentration measures suggest a relatively equal income distribution in Slovenia. The gross income earned by the top 20% of employees is 5.7 times greater than the gross income earned by the bottom 20%, as shown by the S80/S20 quintile share in Table 1.1. Similarly, the S90/S10 inter-decile range shows that gross incomes earned by the top 10% are 11.3 times greater than those earned by the bottom 10%. For disposable incomes, the two ratios are smaller at 4.6 and 8.8 respectively.

The distribution of disposable income in Slovenia is more equal than in many other European countries. According to the results of the OECD Income Distribution and Poverty database, which is based on survey data in contrast to the tax return data which is at the core of the analysis in this report[3], the S80/20 ratio of disposable incomes in Slovenia is 3.7, which is similar to the Slovak Republic and the Czech Republic. However, S80/20 ratios are higher in Austria, Germany, Hungary, Italy and Poland.

Table 1.1. Distribution of income earned by employees and the PIT and SSCs they pay in Slovenia

Employee shares of income, PIT and SSCs, by decile, 2016

	Taxpayers (number)	Gross income	Disposable income	PIT	PIT & employee SSCs	PIT & total SSCs
Total (EUR millions)	**741 670**	**14 629**	**9 992**	**1 685**	**4 637**	**6 775**
Bottom decile	74 167	2.4%	2.8%	0.1%	1.6%	2.0%
2	74 167	5.0%	5.7%	0.7%	3.5%	4.1%
3	74 167	5.8%	6.3%	2.4%	4.6%	5.0%
4	74 167	6.6%	7.1%	3.9%	5.7%	6.0%
5	74 167	7.6%	8.0%	5.2%	6.8%	7.1%
6	74 167	8.8%	9.0%	6.8%	8.2%	8.4%
7	74 167	10.1%	10.3%	8.8%	9.8%	9.9%
8	74 167	12.0%	12.0%	11.7%	12.1%	12.1%
9	74 167	14.7%	14.4%	16.3%	15.5%	15.3%
Top decile	74 167	26.9%	24.5%	44.1%	32.3%	30.0%
Top 1%	7 416	6.5%	5.8%	13.0%	8.1%	7.2%
S80/S20 quintile share		5.7	4.6	83.1	9.5	7.5
S90/S10 inter-decile		11.3	8.8	703.0	20.7	15.3

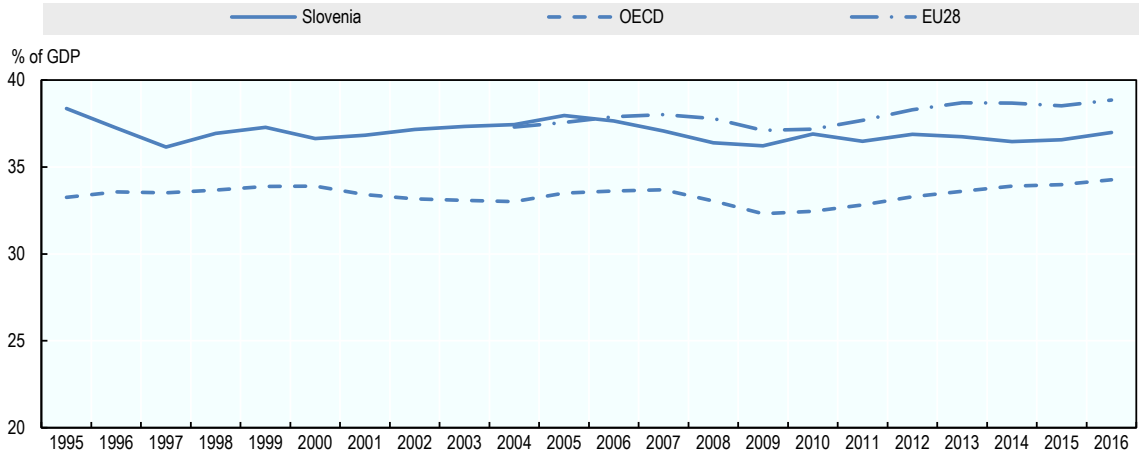
Note: For the purpose of this analysis, disposable income is calculated as gross income less PIT and employee SSCs. These measures are calculated on an unequivalised basis at the individual taxpayer level rather than on an equivalised basis at the household level, which is commonly used in household surveys. Methodological information on the microdata is available in the annex.
Source: Authors' calculations based on Ministry of Finance of Slovenia tax records microdata.

Transfers reduce poverty but the share of the population with a risk of falling into poverty remains high. 24.3% of the population is at-risk-of-poverty before transfers in 2016 in Slovenia, similarly to the EU average (25.9%) (Eurostat). The share of population at-risk-of-poverty after transfers is reduced to 13.9% (17.3% for the EU average). However the elderly remain the most vulnerable population: the at-risk-of-poverty rate for people over 65 years old is above the EU average before and after social transfers (including pensions). Almost 14% of them are at a persistent risk of poverty, which is among the highest in the EU.

1.3. The tax-to-GDP ratio is relatively high and the tax mix is unbalanced

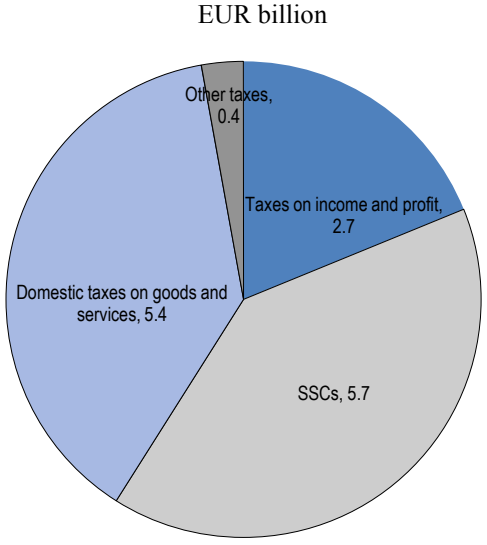
The tax-to-GDP ratio reached 37.0% in 2016, higher than the OECD average (at 34.3% of GDP) but lower than the EU average (at 40% of GDP) (Figure 1.5). Without SSCs, taxes represent 22.1% of GDP (Ministry of Finance, 2018[7]), which is lower than the OECD (25.1% in 2014) and the EU averages (26.9% in 2015) (OECD, 2016[8]) (European Union, 2017[9]). After a slight decrease in the years following independence, the tax-to-GDP ratio has remained relatively constant over time. In 2016, EUR 14.2 billion were levied in tax (35.2% of GDP) (Figure 1.6).

Figure 1.5. The tax-to-GDP ratio in Slovenia is relatively high



Source: OECD Revenues Statistics database.

Figure 1.6. In 2016, Slovenia collected EUR 14.2 billion in tax revenues



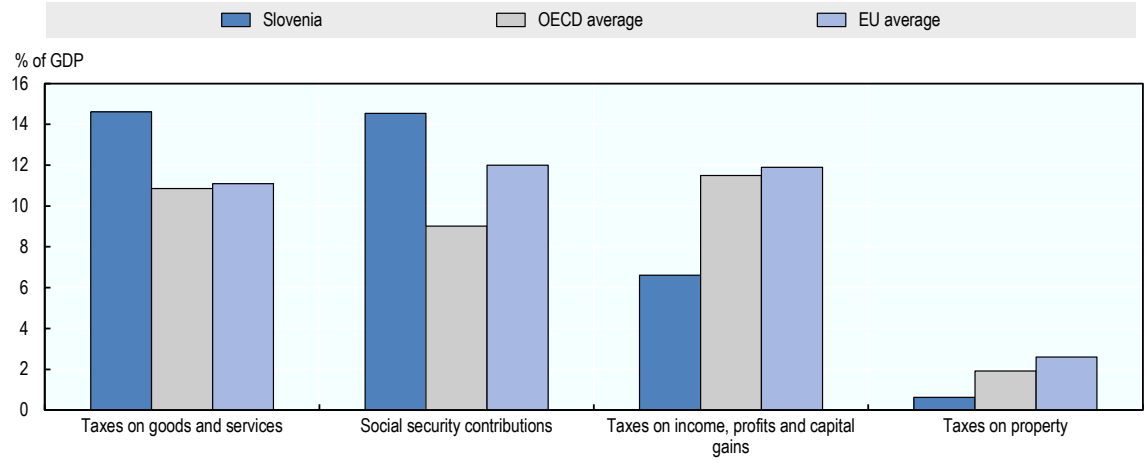
Source: Ministry of Finance (2018[7]).

Slovenia's tax mix diverges from the OECD average (Figure 1.7). Slovenia's tax structure is tilted towards consumption taxes (14.6% of GDP in 2015) and SSCs (14.5% of

GDP) above OECD averages (10.9% and 9% respectively) and EU averages (11.1% and 12%). Taxes on income, profits and capital gains (both of individuals and corporates) represent 6.6% of GDP (below the OECD average of 11.5%). Immovable property taxation stands at 0.6% of GDP in 2016 (1.9% for OECD countries on average). Slovenia levies high environmentally-related tax revenues (4% of GDP in 2016 compared to 1.6% in OECD countries on average in 2014). Over time Slovenia started relying progressively more on taxing goods and services, and less on taxing income, profit and capital gains. This contrasts with OECD countries that experienced an increase in income, profit and capital gains taxation since 2008.

Slovenia's tax mix may be harmful for economic growth. Taxes can be grouped based on their potentially distortive effects on growth (OECD, 2010[10]). Less distortive taxes include consumption taxes (which are high in Slovenia), recurrent taxes on immovable property and inheritance taxes (which are low), while the corporate income tax (CIT), PIT, SSCs, and taxes on financial and capital transactions tend to be more harmful for economic growth. In Slovenia, the sum of the more distortive taxes accounts for 60% of total tax revenues in 2016.

Figure 1.7. The tax mix in Slovenia is titled towards consumption taxes and SSCs



Note: 2015 data.
Source: OECD Revenues Statistics database; European Union (2017[9]).

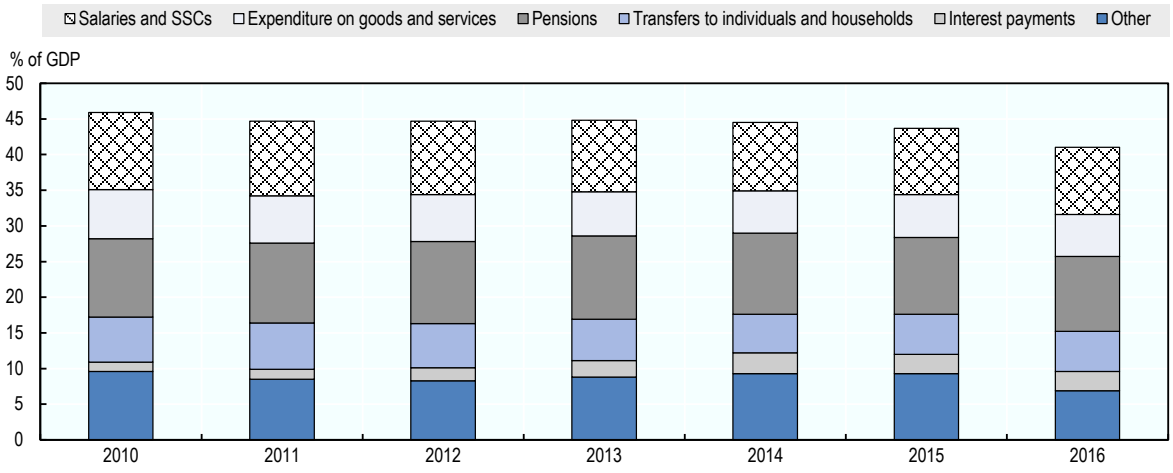
1.4. Government expenditure have declined but ageing-related costs might reverse this trend

Since 2010 public spending has been progressively reduced as a share of GDP. In 2010, public expenditure accounted for 46% of GDP (Figure 1.8). Public spending has been reduced to 41% of GDP in 2016 as a result of consolidation efforts, lower interest payments on public debt and less public investment (OECD, 2017[1]).

Pensions constitute the main item of government spending. Pensions amounted to 26% of total public spending in 2016 (24% in 2010), followed by salaries and social security contributions (23%), and expenditures on goods and services (14%) (Ministry of Finance, 2018[2]).

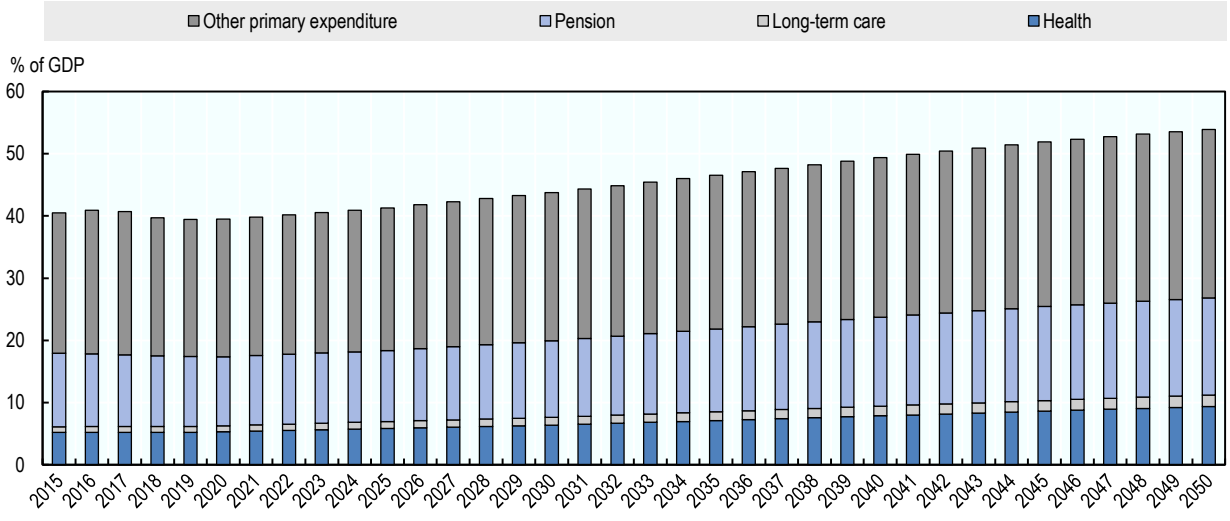
Public expenditure is expected to rise to 9% of GDP by 2050 due to the ageing population (Figure 1.9). The share of people aged 65 years and above will reach 33% by 2050 (Figure 1.11). Pensions could increase by up to 15.6% of GDP by 2050 (11.8% in 2015). Health public expenditures are forecast to reach 9.4% of GDP (5.2% in 2015) while long-term care is expected to reach 1.9% of GDP (0.9% in 2015). The ageing of the population will not only increase public spending but it will also put tax revenues under pressure, as described in Box 1.1.

Figure 1.8. Public expenditure as a share of GDP has decreased strongly



Note: Other: payments to the EU budget, capital transfers, capital expenditures, other current transfers and subsidies.
Source: Ministry of Finance (2018[2]).

Figure 1.9. Public expenditure is set to increase



Source: Forthcoming work on Slovenia; De la Maisonneuve and Oliveira-Martins (2013) (for health and long-term care); OECD (2017 [11]) (for pensions).

Box 1.1. Impact of ageing on the PIT and SSCs revenues in Slovenia

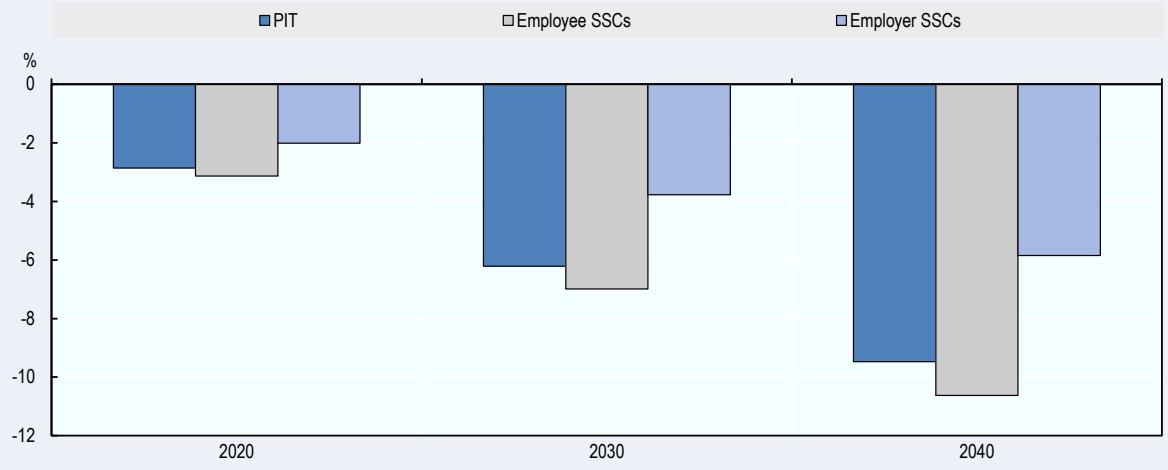
The working age population currently pays the vast majority of PIT and SSCs in Slovenia. Therefore, the projected decline in this cohort, alongside a rise in older workers will have significant negative consequences for the revenues raised from PIT and SSCs in the coming decades.

The Slovenian old-age dependency ratio is set to rise sharply from 18.7% in 2016 to 25.2% in 2030 and 28.3% in 2040 (European Commission, 2017[9]). Over the same period, there is an expected decline in the working age population from 66.4% in 2016 to 61.0% in 2030 and 58.2% in 2040. Among the taxpaying population, those of working age pay 97% of all PIT, 99% of all employee SSCs and 90% of all employer SSCs (the small amounts of PIT and SSC remaining are paid by those aged over 65).

By applying the projected population changes by age group (in percentage points) to the number of taxpayers in the same age groups in the taxpayer population it is possible to estimate the PIT and SSC loss associated with ageing over the period. This assumes that population changes will correspond to the taxpaying population, that average PIT and SSCs by age group remain constant over the period and stable population growth to 2030. According to the analysis, the PIT could fall by over 9% and employer and employee SSCs by over 6% and 11% respectively by 2040 (Figure 1.10). These Exchequer declines represent 1.6% of GDP.

Figure 1.10. The impact of ageing could be significant on PIT and SSCs revenues in Slovenia

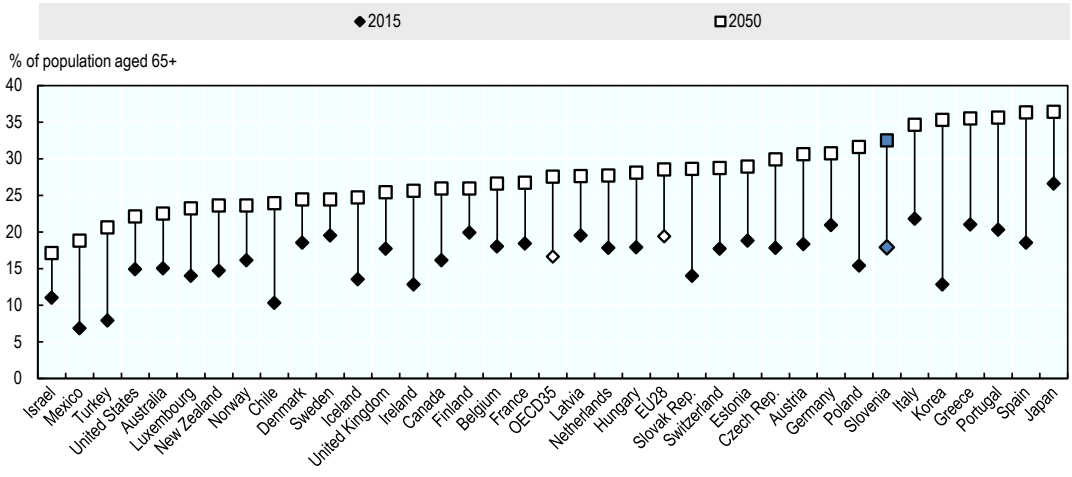
% change



Note: The European Commission 2018 Ageing Report projects that those aged 0 – 14, 15 – 64 and 65 and over will change (in percentage points) between 2016 and 2040 by -1.3%, -8.2% and 9.6%. Note that total PIT and SSCs in microdata do not match exactly to PIT and SSCs reported by the Ministry of Finance of Slovenia. Methodological information on the microdata is available in the annex.
Source: Authors' calculations based on Ministry of Finance of Slovenia tax records microdata; European Commission (2017[12]).

Figure 1.11. In Slovenia, the population is ageing rapidly

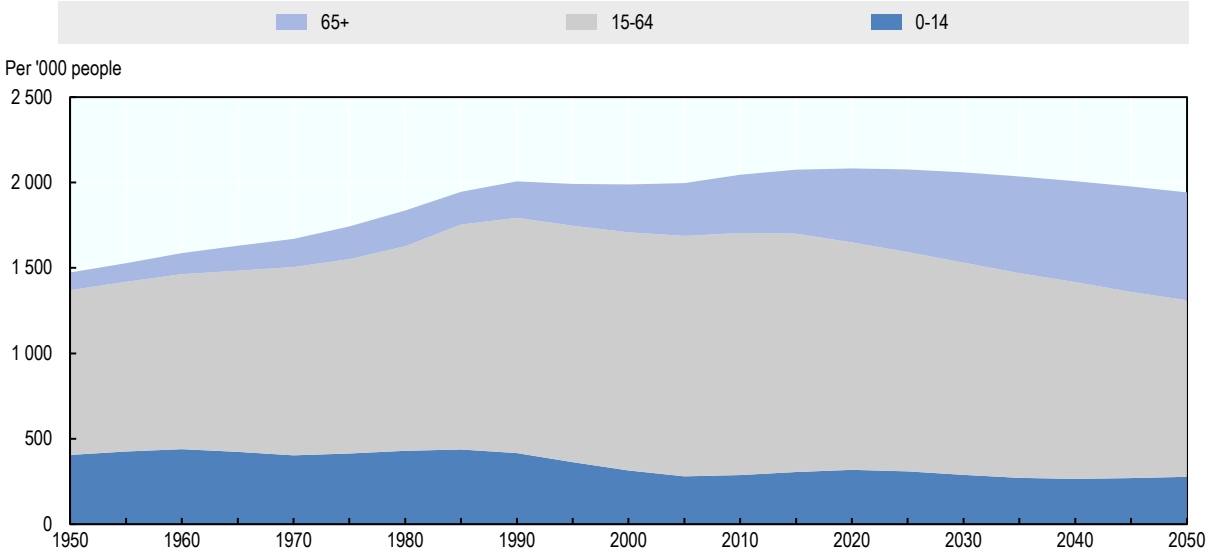
Share of the population aged over 65 years



Source: OECD (2017[13]); Eurostat.

Figure 1.12. Around 630 000 people will be older than 65 in Slovenia by 2050

Population projections in thousands of people



Note: Figures for 2020-2050 are projections based on the medium-fertility assumption (total fertility in all countries is assumed to converge eventually toward a level of 1.85 children per woman).
Source: United Nations database (World Population Prospects: The 2017 Revision).

1.5. Local governments rely on revenues from the personal income tax and property taxes

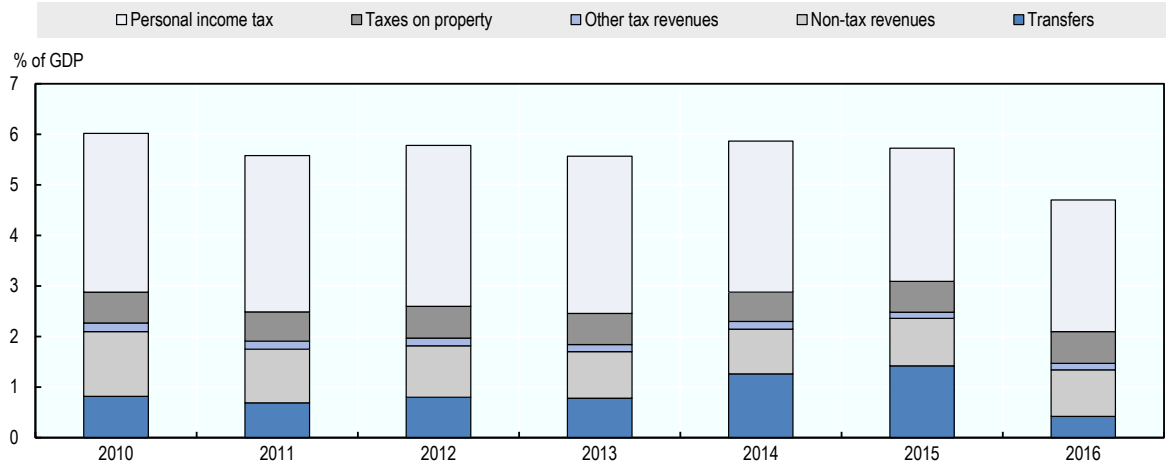
Municipalities rely heavily on tax revenues for financing. Tax revenues constitute 71% of the total revenues for local governments. Revenues from the central government's PIT are shared with local governments. The Financing of Municipalities Act stipulates that 54%

of PIT revenues collected by central government are shared with municipalities. Property tax revenues constitute 13.5% of total local revenues (Figure 1.13), which is low in international comparison. Other local tax revenues include revenues from certain taxes on goods and services and from the inheritance and gifts tax, a tax on real estate trading, the local tourist tax and a gambling tax (Ministry of Finance, 2018[2]). Non-tax revenues including local contributions, fees, fines, concession fees, revenues from assets and grants constitute 20% of local tax revenues.

Equalisation transfers to local government amount to 8.9% of total local revenues in 2016 (Ministry of Finance, 2018[2]). Municipal financing is based upon the principles of "adequate spending" and "adequate funding" (OECD, 2011[14]). The level of "adequate spending" is estimated every year through a formula which takes into account the functions devolved to municipalities and a number of demographic, geographic and development criteria, which vary across municipalities. The "adequate funding" principle aims at matching the financial resources of municipalities with the level of "adequate spending". Each year, the Ministry of Finance determines the exact amount of PIT revenues that will be shared with each municipality, where the total amount that is shared equals 54% of total PIT revenues. If revenues from the share of PIT and own taxes are not sufficient to cover a municipality's spending needs, the municipality can request additional funds from the central government in the form of equalisation transfers.

Revenues from local governments have dropped significantly from 6% of GDP in 2010 to 4.7% in 2016. There are two main explanations for this. First, the significant reduction in PIT revenues for municipalities in 2016 is a result of the drop in central government PIT revenues after the economic crisis; there is a two year gap between the collection of PIT revenues by central government and the sharing of those revenues with the municipalities. As a result, the impact of the crisis on municipalities has been delayed. Second, there has been a reduction in the transfers received from the European Cohesion Fund (Ministry of Finance).

Figure 1.13. Local governments rely strongly on revenues from the PIT and a lot less on revenues from property taxes



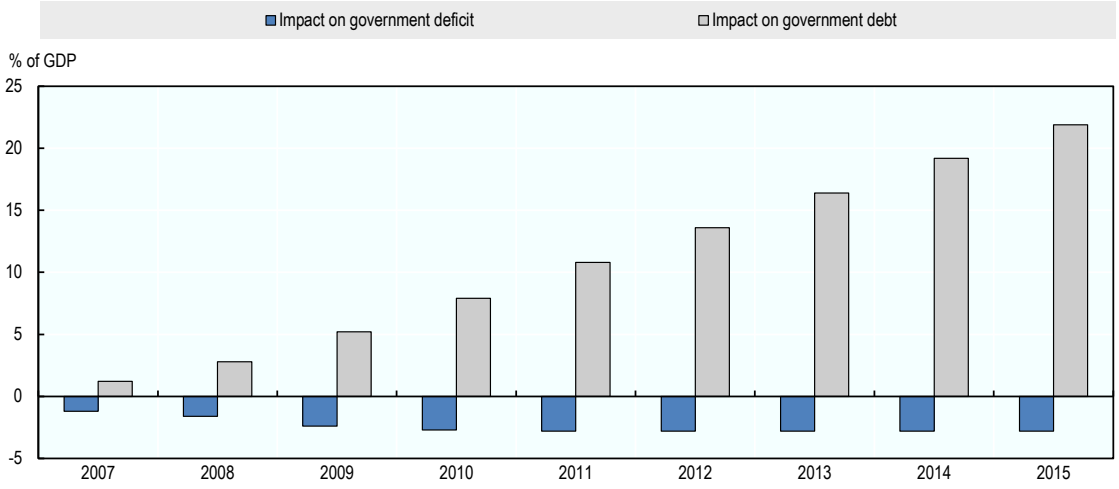
Source: Ministry of Finance (2018[2]).

1.6. Slovenia faces a window of opportunity for a comprehensive tax reform

There is momentum for a fundamental tax reform in Slovenia. The business cycle was impacted by the 2008 and 2013 crisis, with the output gap[4] falling to -5.5% of potential GDP in 2013 (OECD, 2017[1]) (IMF, 2017[3]). Slovenia is currently closing the output gap (Ministry of Finance). With the annual growth rate expected to gradually converge to 1¾–2%, Slovenia could take advantage of this period of favourable economic growth to undertake tax reform.

A comprehensive tax reform will have to be (at least) revenue neutral and be aligned with the country's fiscal rule. Over the past two decades, Slovenia has undertaken a number of extensive reforms. Box 1.2 describes the most recent tax reforms in more details. Some of these reforms – in particular the comprehensive reform in 2006-07 – were not fully funded, creating significant budget deficits. The 2006-07 tax reform reduced the number of PIT brackets from 5 to 3, reduced the top PIT rate and increased the general tax allowance. The payroll tax was gradually abolished and the CIT rate was gradually reduced. The 2006-07 tax reform lowered tax revenues, resulting in an increased budget deficit and government debt (Figure 1.14).

Figure 1.14. The 2006-07 tax reform in Slovenia significantly lowered tax revenues and increased government debt with over 20%



Source: Ministry of Finance of Slovenia.

The upswing in economic activity and growth should be used to lower public debt. Compliance with both the national fiscal rule (balanced government budget in the medium-term, without long-term borrowing), and the medium-term objective of the EU fiscal framework (surplus of 0.25% of GDP[5]) should remain as priorities. The European Commission has recently noted that Slovenia's medium-term objective is not planned to be achieved by 2021, which indicates that Slovenia might have to increase its tax revenues (European Commission, 2018[15]).

Box 1.2. Summary of the tax reforms in Slovenia since 2005

2005

- After debate, decision not to implement a flat personal income tax at a rate of 20% on taxable income net of a basic tax allowance
- Adoption of a dual income tax system with the introduction of schedular taxation of interest, dividends and capital gains at a single rate of 20% (with effect as of 1st January 2006)
- Replacement of the grossing up mechanism used to calculate the PIT on pensions by a special pensioner allowance (tax credit)
- Progressive tax schedule with 5 tax brackets with marginal tax rates ranging from 16% to 50%
- Gradual abolition of the payroll tax (with effect as of 1st January 2006, and a phase out on 31st December 2008)

2007

- Gradual reduction of the CIT rate (from 25% in 2006 to 23% in year 2007, 22% in year 2008, 21% in year 2009 and 20% in year 2010 and beyond)
- Changes in the tax schedule for non-capital income: from 5 to 3 tax brackets (16%; 27%; 41%) with a decrease in the highest marginal tax rate from 50% to 41%
- Increase of the general tax allowance
- Introduction of the additional general tax allowance depending on individual income (2008)
- Increase in the general tax allowance for taxpayers with the lowest income (2010)

2012

- Reintroduction of the 50% PIT rate (as a temporary measure with effect as of 1st January 2013)
- Reduction of the student personal allowance from EUR 3 228 to EUR 2 477 (with effect as of 1st January 2013)
- Increase in the tax rate on interest; dividends and capital gains from 20% to 25% (with effect as of 1st January 2013)
- Introduction of the schedular taxation for rental income with the rate 25% after 10% standardised cost (with effect as of 1st January 2013)
- Introduction of the flat-tax scheme for self-employed and unincorporated business with revenues of up to EUR 50 000 with effect as of 1st January 2013 (extended in 2014 with effect as of 1st January 2015); the same regime was also introduced for micro businesses
- Gradual decrease of the statutory CIT rate: from 20% to 18% in 2012, 17% in 2013, 16% in 2014 and 15% in 2015. However the CIT rate remained 17% from 2013 to 2016)
- Increase of the standard VAT rate by 2 percentage points (to 22%), and the reduced VAT rate by 1 percentage point (to 9.5%) (on 1st of July 2013)

2014 (taking effect as of 1st January 2015)

- Increase of the taxes on insurance premiums and financial services by 2 percentage points (to 8.5%)
- Introduction of SSCs for students (2015): both employee and employer SSCs for pension and disability insurance (8.85% and 15.5%), employer SSCs for health (6.36%) and employer SSCs for injury at work (0.53%).

2016 (taking effect as of 1st January 2017)

- Increase in the CIT rate from 17% to 19%
- PIT schedule
  - Introduction of an additional tax bracket (34%) for income between EUR 20 400 and EUR 48 000;
  - Lowering of the second highest tax rate (from 41% to 39%) for income between EUR 48 000 to EUR 70 907;
  - Reinstatement of the 50% PIT rate as a permanent measure.
- Increase in the additional general allowance threshold for low wage earners just above the minimum wage (from EUR 10 866 to EUR 11 166)
- Reduction of the taxation on performance bonuses (13th salary): up to 70% of the average wage is exempt from the income tax (up to 100% in 2017) with effect as of 1st of January 2018)
- Introduction of the Act on fiscal validation of receipts

2017 (taking effect as of 1st January 2018)

- Additional general allowance: introduction of a linearly determined additional general tax relief for incomes between EUR 11 166.67 and EUR 13 316.83
- Introduction of a special tax scheme for income from employment of posted employees abroad
- Introduction of anti-avoidance provisions in the flat-tax scheme for the self-employed and micro business (absolute limits to expenses, rule that prevents companies from splitting-up to stay under the flat rate threshold, etc.)
- Increase in the special personal tax allowance for the income from students' work from 70% to 100% of the general allowance.

Notes

[1]Fiscal obligations contingent on the occurrence of particular events. These obligations are not budgeted and accounted for, nor are they considered in conventional fiscal analysis.

[2]According to the main scenario of the EUROPOP2013 (projection made by Eurostat in collaboration with national statistical offices).

[3]Important differences between survey and tax return data exist; for example, survey data is less representative at the top of the income distribution in part due to under-reporting of income, while tax return data is typically less representative at the bottom of the income distribution as it does not fully capture taxpayers who receive benefits, inter-alia.

[4]The output gap refers to the difference between actual and potential gross domestic product as a percentage of potential GDP.

[5]The medium-term objective corresponds to a balanced budget to be achieved in 2020, within the stability programme horizon.

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Chapter 2. Labour market, social policy and tax policy related challenges in Slovenia

High employee SSCs, employer SSCs and progressive PIT rates result in very high tax burdens on labour income in Slovenia. This lowers incentives for employers to hire workers and net-take home pay for workers, thereby reducing incentives to participate in the labour market and increase work efforts. High unemployment and inactivity traps exist. Young individuals enter the labour market late and older workers leave early. To compensate for the high tax burden on labour income, Slovenia has put in place many tax exemptions, especially aimed at low-income taxpayers, families and pensioners. High taxes on labour exacerbate existing labour market weaknesses, and result in low labour market participation rates of younger and older workers. The pension and health funds, which rely predominantly on SSCs, face budgetary difficulties. In light of the ageing population, increasing the labour market participation of older workers is a priority.

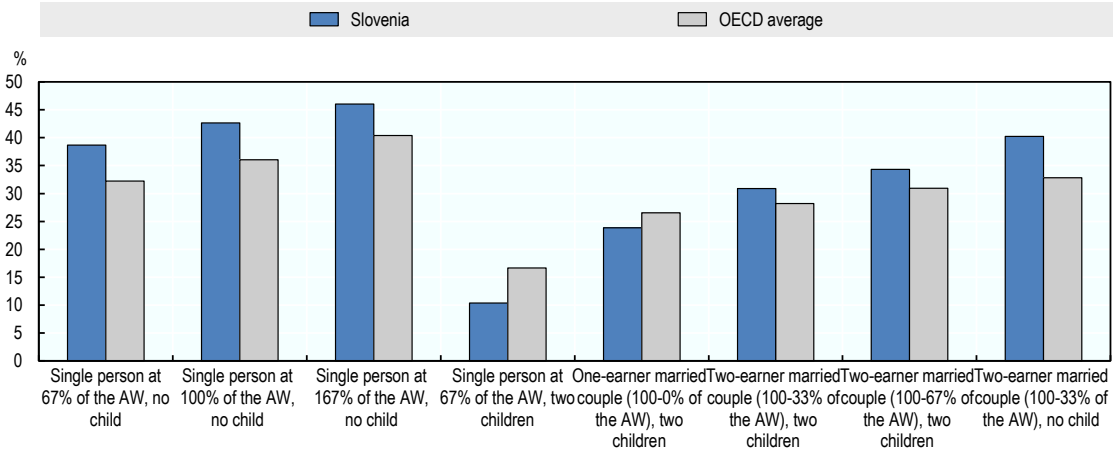
2.1. The labour tax burden is high but the personal income tax base is narrow

2.1.1. The combined personal income tax (PIT) and social security contributions (SSCs) burden is high in Slovenia

The tax burden on labour income in Slovenia is high because of the combined effect of high employee and employer SSCs and a progressive PIT rate schedule. Employee SSCs are levied at a rate of 22.1% which is the highest of all OECD countries; on average across the OECD, employee SSC rates are 9.8%[1]. Employer SSCs are levied at a rate of 16.1% in Slovenia compared to a rate of 17.5% on average in the OECD[2]. In addition, the top statutory PIT rate of 50% is high. Slovenia is among the 10 OECD countries where workers earning an average wage (AW) – i.e. the gross wage that a worker can earn yearly on average in the private sector – are taxed the most. The average tax wedge[3] for single workers without children earning an AW was 43% in 2017 compared to 36% on average in the OECD (Figure 2.1). For married couples, the average tax wedge is lower than for single taxpayers but it is still above the OECD average. The tax wedge in Slovenia is below the average tax burden in the OECD only for single taxpayers and one-earner married couples who have two children.

Figure 2.1. The tax burden on labour income in Slovenia is high

Average labour income tax wedge across different types of workers



Source: OECD (2018[1]).

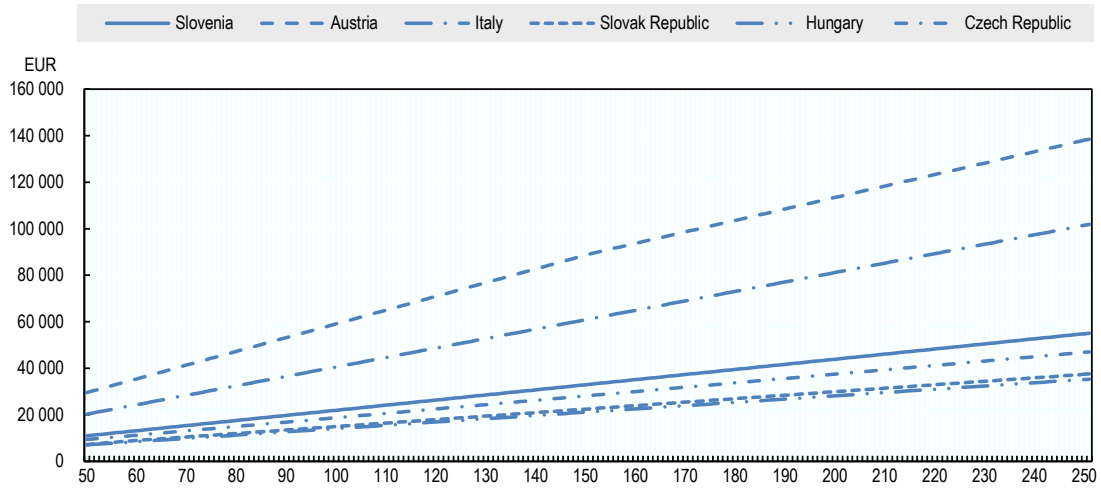
High taxes on labour income increase labour costs for firms (Figure 2.2). Total labour costs are higher in Slovenia than in the Czech Republic, Hungary, or the Slovak Republic because of higher wage levels and employer SSCs. However, total labour costs in Slovenia remain below the levels in Austria and Italy.

A combination of high employee SSCs and PITs reduce worker take-home pay. The net personal average tax rate[4], which measures the effective employee SSC and PIT burden as a percentage of gross wage earnings, is particularly high for single workers without children. For this category of workers, Slovenia is in the top five of OECD countries with the highest personal average tax rate (33.7%), after Belgium, Germany, and Denmark. The tax burden is higher in Slovenia than selected East European countries (the Czech Republic, the Slovak Republic) at all income levels (Figure 2.3). Despite this higher tax burden, Slovenian workers have higher take-home pay because of a higher AW (Figure 2.4).

However the net-take home pay in Slovenia is significantly lower than in Austria reflecting higher wages and a less burdensome tax system.

Figure 2.2. Total labour costs are higher in Slovenia than in other East European countries

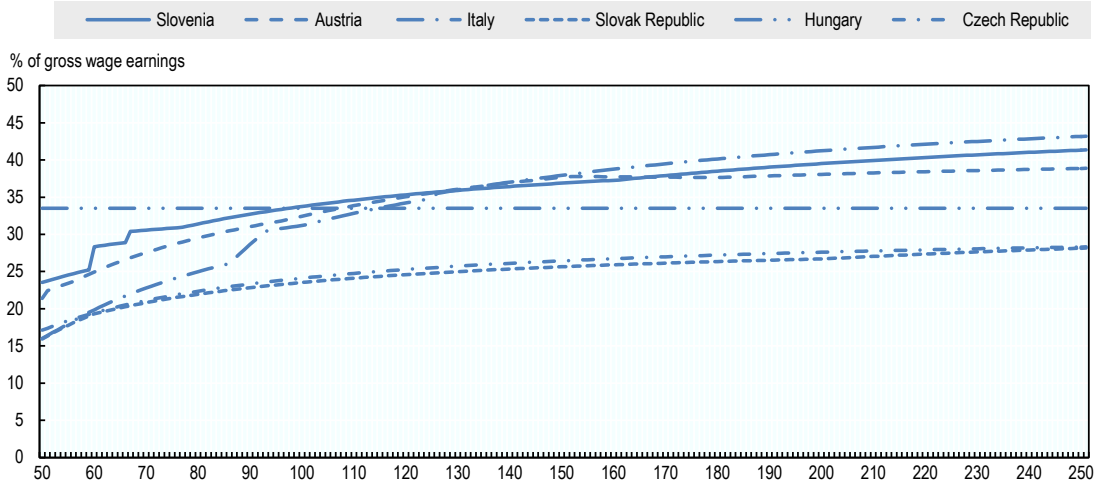
Total labour costs (in EUR) of employing single workers without children at different income levels, as a % of the AW



Source: OECD (2018[1]).

Figure 2.3. The net personal average tax rate in Slovenia is high

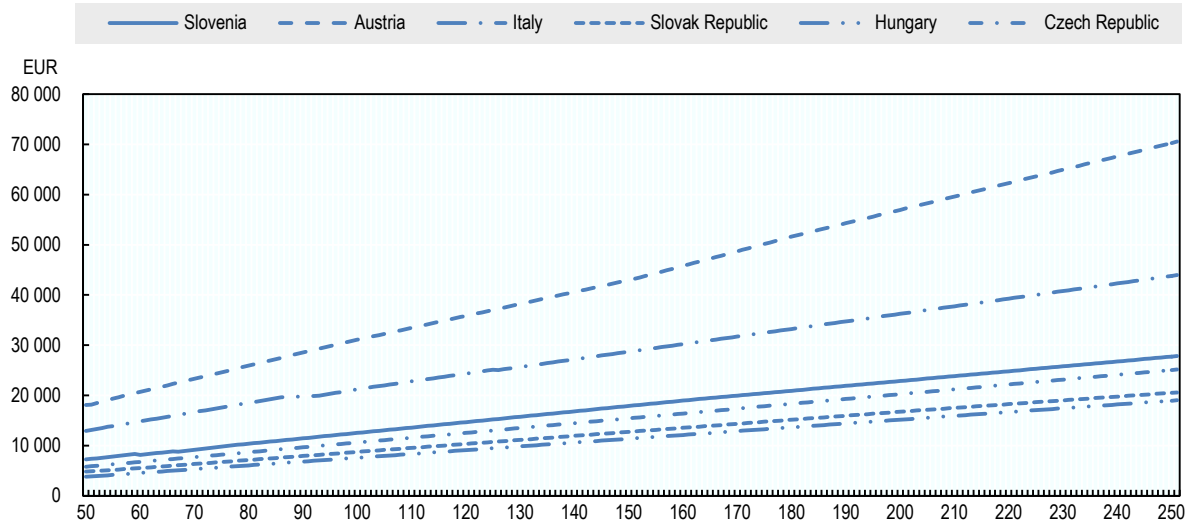
Single worker without children, as a % of the AW



Source: OECD (2018[1]).

Figure 2.4. Workers in Slovenia take home more pay than in other East European countries

Net take-home pay, single taxpayer, no child, as a % of the AW



Source: OECD (2018[1]).

The combined effect of employee SSCs and PITs in Slovenia remains progressive. Despite of the large share of employee SSCs which are levied at flat rates, the overall average effective tax rate (AETR) (which is the joint employee SSCs and the PIT) for single taxpayers is significantly increasing with income; i.e. statutory PIT and SSC progressivity remains relatively high[5]. Over the 50-250% of the AW income range, the AETR increases by 0.085 percentage point for each percentage point increase in the income level. This is above Austria (0.079 pp), the OECD average (0.074 pp), the Slovak Republic (0.047 pp), the Czech Republic (0.045 pp) and Hungary (0 pp), but lower than in Italy (1.04 pp). However, the progressivity of the tax system in Slovenia is below the progressivity on average in the OECD and comparative countries for families with children despite of the generous child tax provisions.

2.1.2. Generous tax provisions narrow the PIT base considerably

Tax allowances significantly narrow the PIT base and come at a high cost in tax revenues foregone. Slovenia implements a wide range of tax allowances, including a general allowance, personal allowances, allowances for dependent family members, and other income-specific allowances. Pensioners benefit from a PIT credit. Overall, the PIT allowances and credits come at a cost in tax revenues foregone of 4.75% of GDP in 2016 (Table 2.1).

Table 2.1. Tax allowances in Slovenia in 2016

	% of taxpayers claiming	Amount (EUR millions)	Amount (% of GDP)
General allowance	95.3	1 038.29	2.61
Additional general tax relief for low income*	54.5	282.55	0.71
Personal allowance			
For disabled person	0.3	1.92	0.0
For student	6.3	20.49	0.02
For dependents	26.2	304.14	0.76
Other			
Special deduction for voluntary additional pension insurance payments	3.6	7.25	0.02
Credit for pensioner (% of pension)	24.6	235.33	0.59
Total		**1 889.96**	**4.75**

Note: *The additional general tax relief for low income have changed on January 1, 2018.
Source: Ministry of Finance of Slovenia.

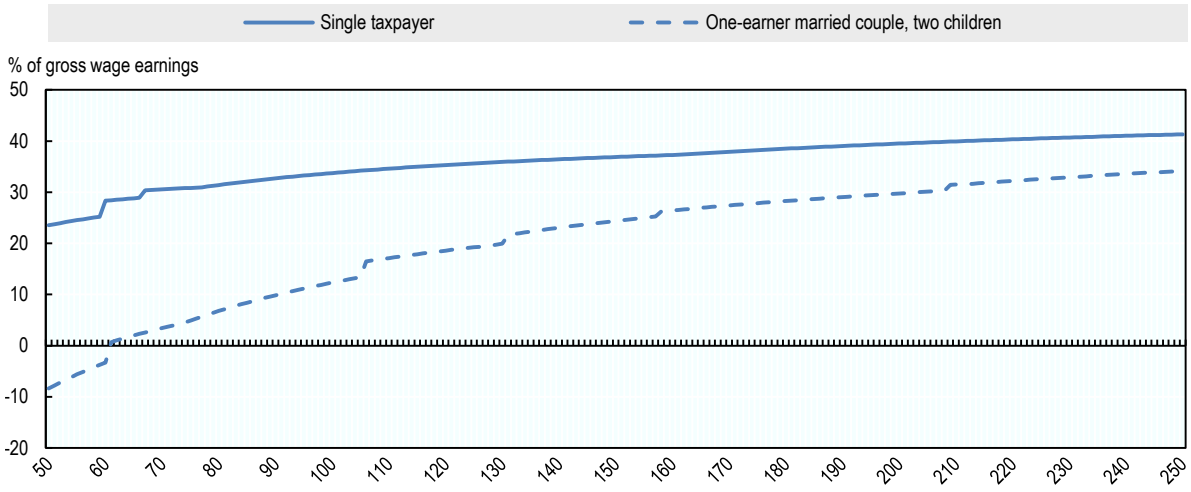
Generous tax allowances offset the impact of the high statutory labour income tax burden in Slovenia. Slovenia is among the OECD countries where labour income tax rates are high but tax bases are narrow. While generous tax allowances could be justified to prevent the distortive effects of high tax rates, their impact is selective in that they target certain taxpayers who benefit over others.

For instance, families with children benefit from very generous tax allowances which reduce their tax burden significantly. In 2017, the average tax wedge in Slovenia for one-earner married couples with two children at the average wage is 24.5%, significantly lower than the corresponding tax burden for single taxpayers (Figure 2.5). This results in large differences in disposable income across family types. Among OECD countries, Slovenia has the third highest difference between disposable income for families with or without children.

Until 2018, the allowance system had no taper rate but thresholds. Figure 2.6 shows the number of taxpayers at gross income levels going up in thousands alongside the general allowance thresholds for taxpayers with low incomes for both 2015 and 2016. Incomes below EUR 10 866 are entitled to a tax allowance of EUR 6 520. As a taxpayer's income increases from EUR 10 866 to EUR 12 571 the allowance is reduced by 32% to EUR 4 419. For incomes beyond this point, the allowance is reduced by a further 25% to EUR 3 303. This allowance structure may produce an economic incentive for taxpayers, and potentially employers, to report incomes below these thresholds before the allowance is reduced. According to an analysis using the tax record data, in both 2015 and 2016, the highest number of taxpayers in any thousand euro band is EUR 10 000 and EUR 11 000, which is just before the most significant loss in the tax allowance. The number of taxpayers continues to fall as the allowance is further reduced in steps. The introduction in 2018 of a linearly determined general tax relief for incomes between EUR 11 166.67 and EUR 13 316.83 might reduce the taxpayers bunching below allowance thresholds in Figure 2.6. The analysis provides suggestive evidence that Slovenian employees and employers may be responding to the allowances schedule. Further multivariate analysis of the microdata is needed to uncover a causal interpretation of such behaviour.

Figure 2.5. Single taxpayers face a much higher net personal average tax rate than families with children

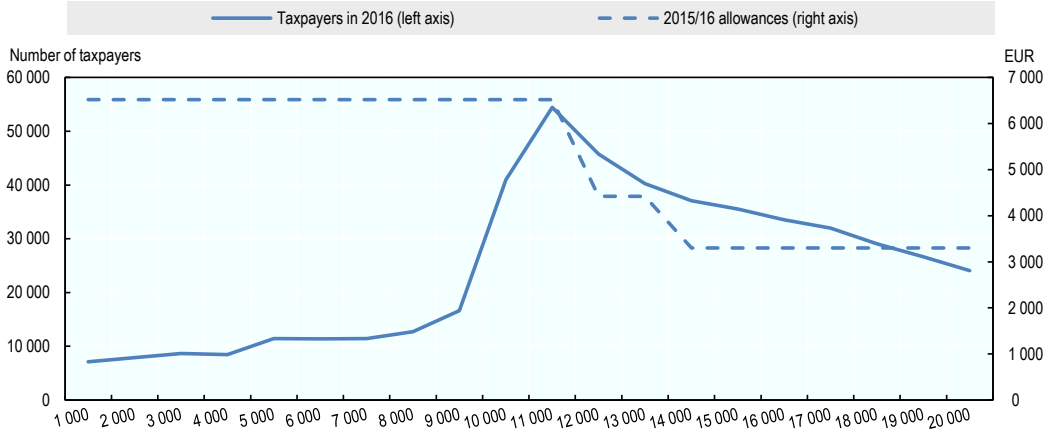
Net personal average tax rate, as a % of the AW



Source: OECD (2018[1]).

Figure 2.6. The former allowance system had thresholds resulting in bunching of taxpayers

Number of taxpayers at gross income levels and allowance thresholds, by income in thousand EUR bands, 2016



Note: Methodological information on the microdata is available in the annex.
Source: Authors' calculations based on Ministry of Finance of Slovenia tax records microdata.

2.2. Too few young and older people are active in the labour market

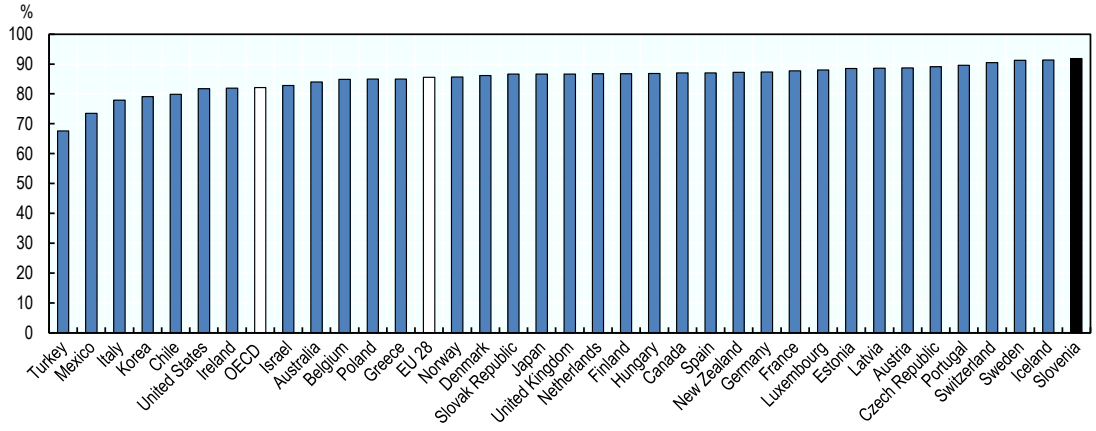
2.2.1. Labour market participation of both men and women in the prime age category of 25-54 is very high

Slovenia's labour market participation rate[6] among workers in the prime age category of 25-54 is 91.9% in 2017, which makes Slovenia the top performer in the OECD (Figure 2.7). The employment rate[7] is also among the highest (86.1% in 2017), above the OECD (77.8%) and the European Union (EU) (79.7%) averages. No major

differences are observed between the participation of both men and women, which suggests that Slovenia does not face a significant gender gap in the labour market. In addition, part-time work is not widespread. In 2015, only 3% of employed men were in part-time employment (5.3% on average in the OECD). The share is higher for women (8.2%) but still significantly lower than on average in the OECD (22.3%).

Figure 2.7. The participation rate of male and female workers in the prime age category of 25-54 is the highest of the OECD

Labour force participation rate, people aged 25-54, 2017



Source: OECD Labour market statistics.

2.2.2. Labour market participation of young workers is low

Labour market participation for younger workers (aged 15-24) drops to 33.7%, far below the participation rate in other OECD countries (47.2% on average) and the EU (42.3%). The weak participation on the labour market is worsened by emigration flows of young skilled workers (see section 2.3). The employment rate shows a similar trend (34.8% for Slovenia, against 41.3% in the OECD on average).

Young workers enter the labour market later. The duration of study for Slovenian students is relatively long (OECD, 2016[2]) which may partly be explained by the fact that students work instead of finalising their degrees. Options are available to students to work (mainly under temporary work contracts which reduce their future benefit entitlements) and study at the same while benefiting from generous conditions (state-funded tuition fee waivers, subsidies for living expenses such as meals, accommodation, transportation and cultural activities, state scholarships) (OECD, 2016[2]).

As a result, current younger cohorts have relatively shorter insurance periods than their counterparts in the past. For example, in 2002, workers aged 30-34 had been insured already for 11 years on average, while in 2015 workers in this age group had been insured for only 8 years on average (OECD, 2016[2]). Shorter insurance periods will result in lower benefit entitlements for workers in the future (e.g. lower pensions) and reduces revenues for government to finance the welfare spending of the current generation.

2.2.3. Labour market participation of older workers is very low

The labour market participation of older workers is very low. Only 41.2% of the workers in the age category 54-65 are still active in the labour market. In only two other OECD countries (Luxembourg and Turkey) older workers participate as little as in Slovenia. Similar trends can be observed with the employment rate of older workers. In 2017, only 42.8% of older workers are employed, whereas it is 57% on average in the EU and 60.4% in the OECD. Among older workers, low skilled (in particular below upper secondary schooling) leave the labour market earlier than skilled workers.

Older workers retire early. According to the tax record data, the gap between the official and the effective retirement age is more than 4 years on average. Slovenia has recently increased the official retirement age to 65 for both men and women by 2020 (from 63 for men and 61 for women)[8]. However if the 4-year gap persists, the effective retirement age would still be significantly below the official retirement age (around 61), which is extremely low compared to other countries.

Several factors explain the early retirement of older workers. First, the unemployment insurance system allows older workers to retire earlier (OECD, 2016[2]). 30% of pensioners used the unemployment system as a bridge to retirement, where unemployment benefits are often higher than the pension the worker will receive (Ministry of Labour, Family, 2016[3]). Seniority bonuses for older workers can make the hiring of an older worker 15% more expensive than a younger worker (OECD, 2017[4]), which could induce employers to end existing contracts of their older workers. Sickness leave is also used by older workers as a vehicle to retire early. In addition, before the 2013 pension reform, older workers faced no financial incentives to continue working as an additional year of working was associated with a 4% decrease in net pension wealth (OECD, 2016[2]).

The 2013 pension reform introduced measures to increase the labour market participation of older workers. First, the reform ensured that workers will increase their pension entitlements if they work longer. Moreover, workers eligible for retirement can choose to continue working under several different arrangements, including: i) working part-time and receiving a proportional pension which is increased by 5% if they are less than 65 years of age; ii) continuing to work full-time and receiving 20% of their pension while they work; iii) receiving a full pension and working via a so-called temporary and occasional work contract, which is subject to social security contributions and an additional 25% duty payable by the employer. Slovenia should evaluate whether the 2013 pension reform is effective in closing the gap between the statutory and effective retirement age, and whether future reforms are needed.

In addition, Slovenia should consider increasing the legal retirement age from 65 to 67, as recommended in the OECD Economics Surveys: Slovenia 2017. Such a measure could form part of a longer term proposal to lift the retirement age on a prospective basis. Following the direction taken by the 2013 pension reform, Slovenia could consider additional (tax and non-tax) reforms which help smooth the transition from work to retirement, such as part-time work and part-time retirement.

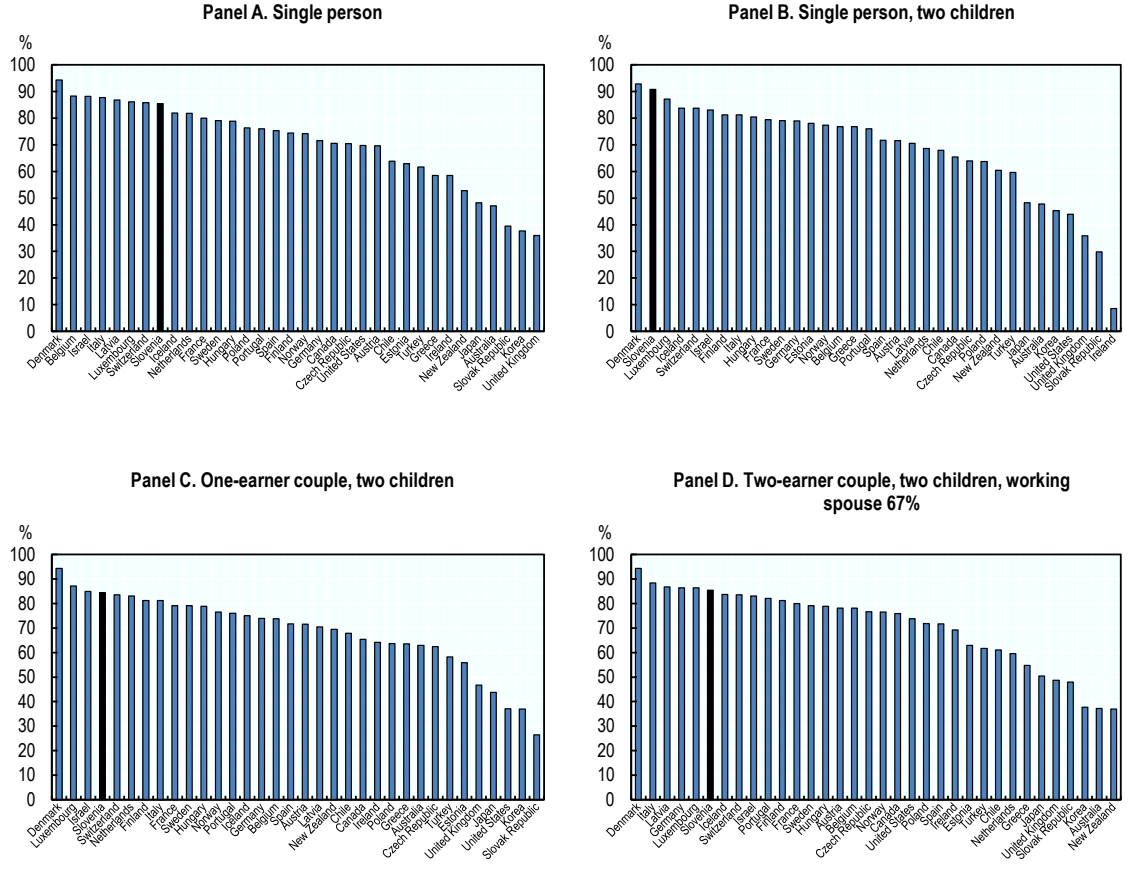
2.2.4. Significant unemployment and inactivity traps exist

Participation tax rates (PTRs) are high in Slovenia. PTRs[9] measure how much of the increase in gross earnings is taxed away when individuals enter the labour market from short-term unemployment into full-time work (Figure 2.8). Therefore high participation tax

rates reflect that the tax and benefit system does not encourage unemployed workers to join the labour market.

Figure 2.8. Slovenia faces high unemployment traps

Participation tax rates (into work at 50% of the AW from short-term unemployment), 2015



Source: OECD Tax-Benefit Model.

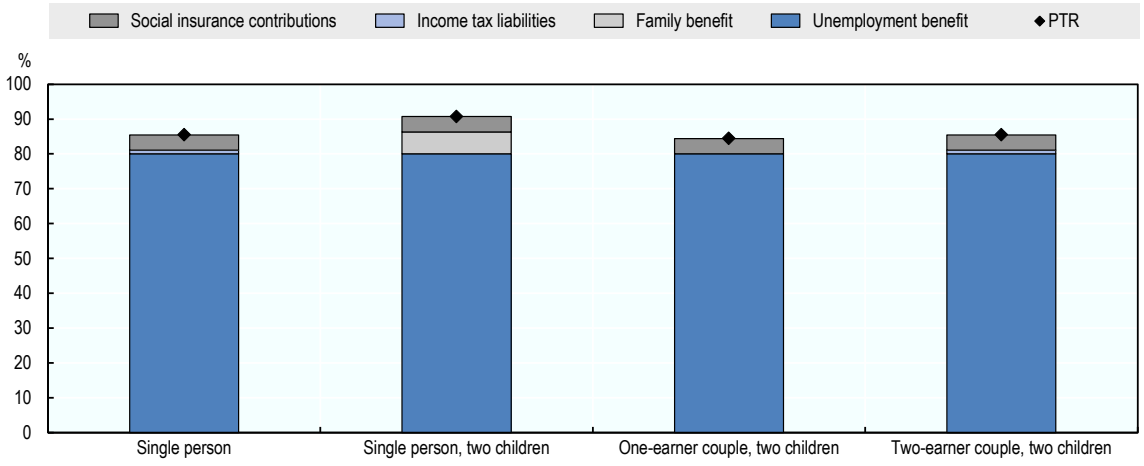
High PTRs are explained by the loss in unemployment benefits when workers enter the labour market and because of the high SSC burden levied on their wage earnings (Figure 2.9). The latter does not appear in the chart as unemployment benefits are also taxed with employee SSCs. PTRs from long-term unemployment into full-time work (inactivity trap) are also high, especially for lone parents and one-earner married couples with children. The loss of social assistance and the payment of SSCs are the main drivers of inactivity traps.

Reducing both unemployment and inactivity traps is particularly important given the ageing of the population in Slovenia. Higher degrees of labour market participation will prevent people from falling into poverty and will increase the revenues from social security contributions, which can help address rising age-related public expenditure. Different options are available to encourage unemployed or inactive workers to re-enter the labour market, including a reduction in employee SSCs and the use of targeted into-work benefits.

For instance, individuals who re-enter the labour market after a period of inactivity could receive, for a pre-set period of time, an additional into-work benefit equal to a fixed percentage of their previous unemployment or social assistance benefit. However, an in-depth discussion of the design of these into-work benefits goes beyond the scope of this report.

Figure 2.9. The loss of unemployment benefits drives the unemployment traps

Decomposition of the unemployment trap, 2016



Note: For a first earner at 50% of the AW. The second earner is at 67% of the AW.
Source: OECD Tax-Benefit Model.

2.3. Low levels of skills have a negative impact on productivity

Adults skills levels are low (OECD, 2017[4])**.** Almost one-third of the working-age population (around 400 000 adults) in Slovenia, and in particular older workers, have low levels of literacy and/or numeracy proficiency. Slovenia has achieved a great improvement in skills across age cohorts: around 94% of 25-34 year-olds have completed at least upper secondary education, a figure which is higher than almost all other OECD countries. The percentage of young adults in Slovenia with tertiary education rose from 25% in 2005 to 41% in 2015, exceeding the EU 2020 target of 40%. However, average literacy scores for 25-34 year-olds (including tertiary graduates) are lower than for their counterparts in other countries in the Survey of Adult Skills (PIAAC).

Slovenia's lack of skills is exacerbated by the increasing share of highly skilled people that emigrate, although evidence suggests that Slovenia is not experiencing a so-called 'brain drain' (OECD, 2017[4]). Of the 15 500 adults who emigrated from Slovenia in 2016, 22% were adults with tertiary education. However, this figure has almost doubled between 2011 and 2016, possibly reflecting the impact of the economic crisis. In addition, the share of young (aged 20-29) highly skilled emigrants has increased (from 18% in 2011 to 35% in 2015) perhaps driven, among other things, by better socio-economic opportunities including higher wages and lower taxes abroad. This reduces the availability of highly skilled workers for the Slovene labour market and reduces the return on public investment in education for the country (OECD, 2017[4]). The skills challenge is reinforced by the daily work-home commute to neighbouring countries (Italy, Austria) and the low attraction of foreign highly-skilled workers (16% of immigrants in 2016).

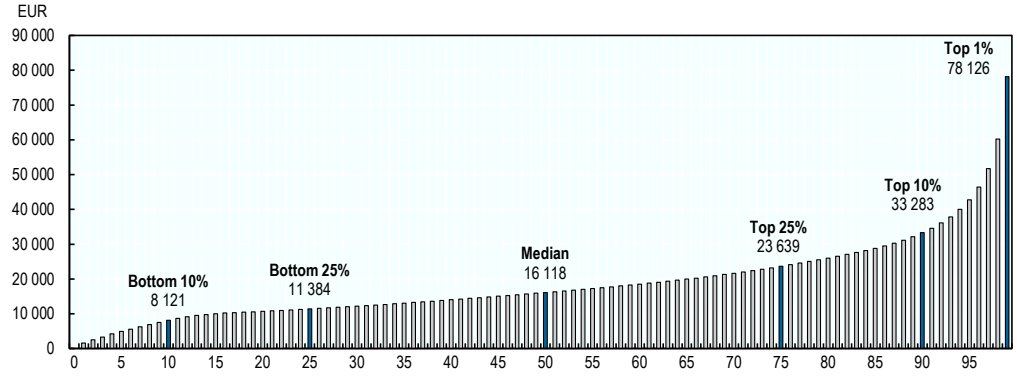
The low skill level lowers productivity and growth. Skills are central to a country's economic prosperity (OECD, 2017[4]). Making more effective use of people's skills in workplaces can boost labour productivity: after accounting for differences in skills proficiency, the use of reading skills explains a considerable share (26%) of the variation in labour productivity across countries (OECD, 2016[5]).

2.4. Wages are relatively low and the income distribution is narrow

Wage levels are relatively low. In 2016, tax record data show that mean and median incomes are EUR 19 725 and EUR 16 118 respectively (Figure 2.10). The top 10% and 1% income thresholds are EUR 33 284 and EUR 78 126. Low wages have implications for the amount of PIT and SSCs that can be raised. The gap is significant when compared to neighbouring countries such as Italy (EUR 30 642), Germany (EUR 47 809) or Austria (EUR 44 409). However, compared to Central and East European members of the OECD, Slovenia has become a relatively high-wage economy (OECD, 2017[6]). In 2016 the average annual wage was EUR 18 292 which is higher than in Hungary, Poland, the Czech Republic or the Slovak Republic.

Figure 2.10. Wages are relatively low across the entire wage distribution

Employee gross income distribution, by income percentile, 2016



Note: Employees are defined as taxpayers with salary income plus some small self-employment income. Methodological information on the microdata is available in the annex.
Source: Authors' calculations based on Ministry of Finance of Slovenia tax records microdata.

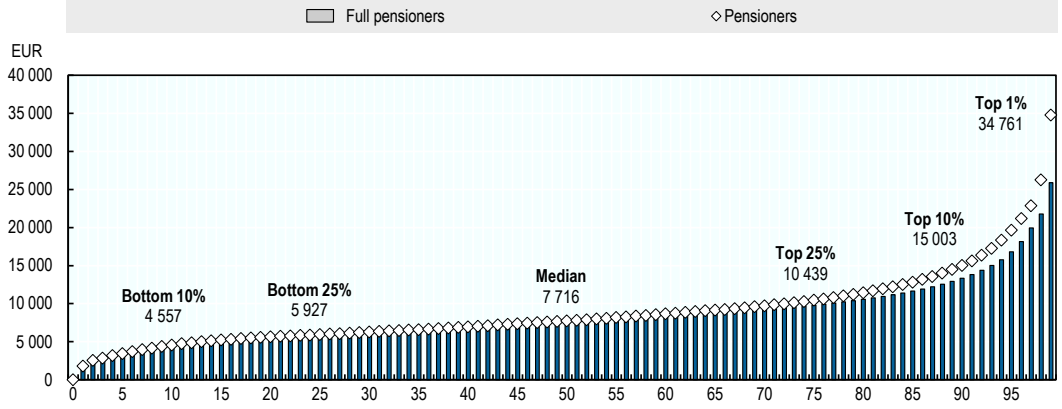
Slovenia has a compressed wage structure at the low end of the wage distribution (OECD, 2017[6]). Mean and median wages are similar across income deciles distribution. In Slovenia in 2016, the top employee decile earns 26.9% of all gross income and 24.5% of all disposable income, while the lower employee decile earns 2.4% and 2.8% respectively (Table 1.1). Almost half (45%) of taxpayers earn the minimum wage and 65% of people in paid employment earn below average gross earnings (Statistical Office).

Pensions are very low in Slovenia. Figure 2.11 presents the distribution of income for pensioners – defined as taxpayers who receive pension income and, possibly, other types of income – and "full" pensioners, which are defined as pensioners who, besides their pension income, do not have any other source of wage or business income. For most of the distribution, the two groups have similar earnings: the median income for pensioners and full pensioners equals EUR 7 716 and EUR 7 479, respectively. Pensioners who have another source of income (7% of pensioners) increase their earnings. This applies in

particular to the higher end of the income distribution; after the 75th percentile pensioners start to become significantly better-off due to their additional income sources from employment and self-employment. For the top 10%, full pensioners earn EUR 13 351 which is well below the gross earnings of EUR 15 003 for all pensioners together (so including pensioners who have another source of income). For the top 1%, full pensioners earn EUR 25 905 compared to EUR 34 761 for all pensioners.

Figure 2.11. Pensions are very low in Slovenia

Pensioners gross income distribution, by income percentile, 2016



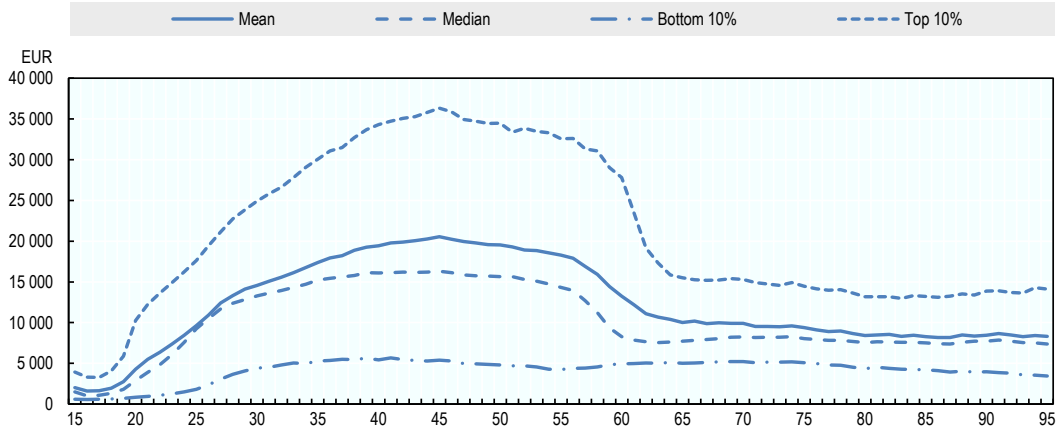
Note: Pensioners are taxpayers with any pension income. Full pensioners are those with only pension income. Methodological information on the microdata is available in the annex.
Source: Authors' calculations based on Ministry of Finance of Slovenia tax records microdata.

Older workers have low, stable and equal incomes. Figure 2.12 shows the gross income distribution of taxpayers aged 15 to 95 in 2016:

- **For young workers**, incomes rise sharply between 20 and 30 years of age in part driven by students, a group more likely to undertake part-time work, moving from study to employment. For example, at 23 years of age, median incomes are EUR 6 106 and by 30 they have more than doubled to EUR 13 292. Thereafter, median income increases are more gradual reaching EUR 15 220 by age 35. The similarity of mean and median incomes across all ages reflects Slovenia's condensed income distribution.
- **For middle-aged workers**, approximately between 35 and 55, median incomes are stable, varying on average (median) between EUR 15 000 and EUR 16 000. The highest incomes are for those aged between 40 and 50. Mean incomes also rise faster than median incomes between these ages indicating a greater level of income inequality, which may partly by attributable to differences in worker productivity.
- **For older workers**, incomes are significantly smaller and income inequality becomes significantly lower, reflected in the closing of the gap between mean and median income after 65 years of age. An extraordinary feature for high earners is the exceptionally steep income cliff as they transition to old age. For example, at age 58, the top 10% of earners have gross incomes of EUR 31 063 but by 64, only a 6 year difference, income among the top 10% have declined dramatically by almost halved. This feature is also unusual internationally compared to Ireland and the US (Kennedy, 2018[7]) (Auten, Gee and Turner, 2013[8]).

Figure 2.12. Gross income inequality is higher for workers than for pensioners

Gross income distribution by age, 2016

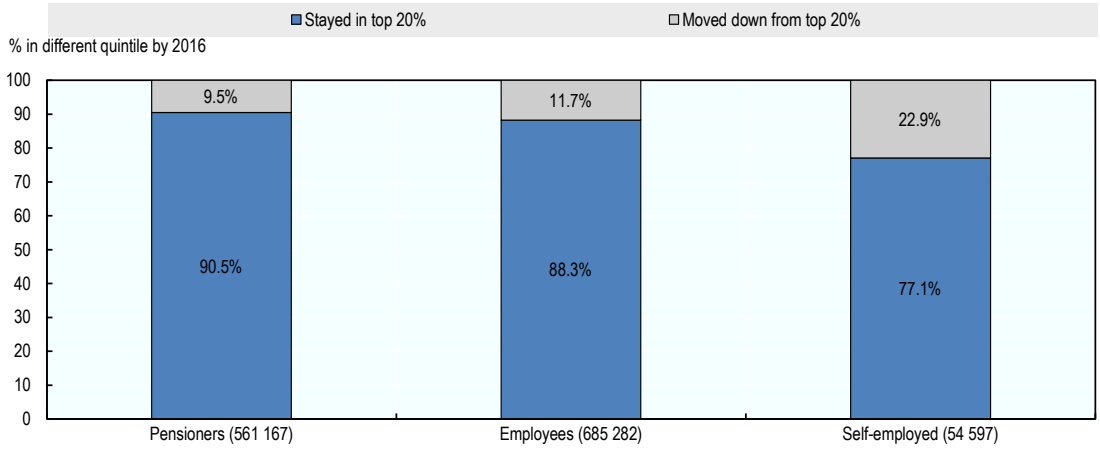


Note: Age data truncated between 15 and 95 for reasons of sample size. Methodological information on the microdata is available in the annex.
Source: Authors' calculations based on Ministry of Finance of Slovenia tax records microdata.

Pensioners in Slovenia have low levels of income mobility. Figure 2.13 examines income mobility in Slovenia by measuring the positional change of different taxpayer groups between 2015 and 2016. The methodology is as follows. A group of taxpayers is identified (for example, employees) and only those observed in both comparison years are retained. In each year, the employee has an origin and destination position in the income distribution. Next, two distinct gross income quintile are calculated in each year. Finally, a transition matrix is calculated across the two years. Figure 2.13 shows the transition probabilities for employees, pensioners and self-employed taxpayers remaining in the top quintile between 2015 and 2016. According to the analysis, of those employees in the top quintile (the top 20%) in 2015, almost 9 in 10 (88%) stayed in that quintile a year later. Of self-employed taxpayers in the top quintile in 2015, 77% stayed in that quintile a year later and 23% moved downwards. Among pensioners, over 90% stayed in the top quintile. Consequently, the highest downward mobility is observed among the self-employed followed by employees and then pensioners. While this analysis is suggestive of mobility trends more conclusive analysis would require producing these transitions over a longer time horizon.

Figure 2.13. Pensioners in the top of the income distribution are more likely to remain there over time

Income mobility by taxpayer type, by quintile, 2015 - 2016



Note: There are important caveats to consider when interpreting transition matrices. For example, they show relative and not absolute changes in income. They do not capture those who leave the workforce (for example, due to emigration, unemployment or death). In addition, the time horizon is important – this one year transition while illustrative is much more limited and will show less mobility than a transition over a longer time period. Methodological information on the microdata is available in the annex.
Source: Authors' calculations based on Ministry of Finance of Slovenia tax records microdata.

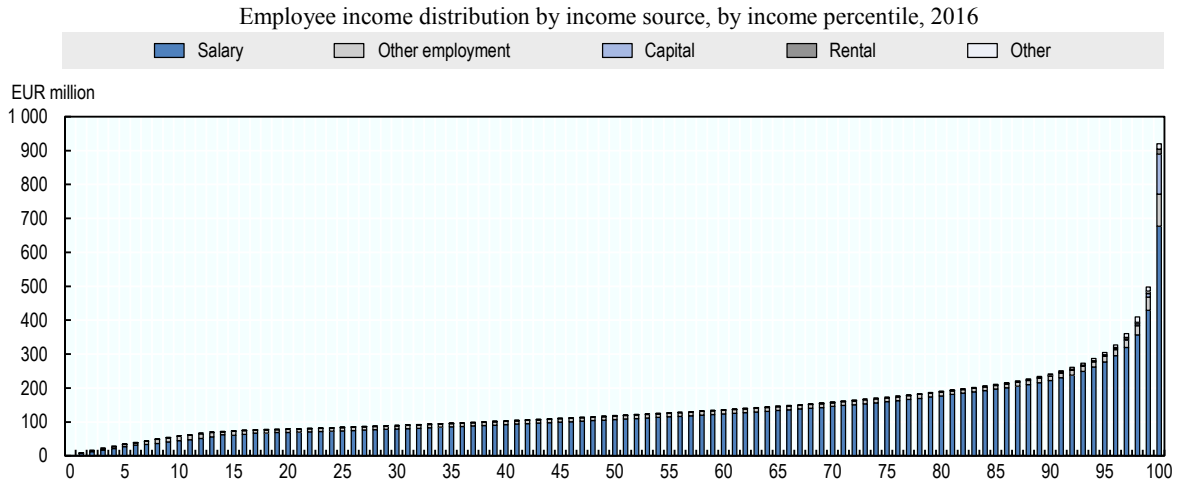
Because wages are low, many taxpayers cumulate jobs. Taxpayers who have different sources of income are considerably better off.

- For employees, with the exception of the very bottom and top of the income distribution, the analysis shows that salary income comprises the vast majority of gross income (around 90% at most income percentiles). In the bottom decile, salary incomes approximately represent a lower 80% of gross income and this is due to relatively high levels of other employment income, which includes income from holiday bonuses, contractual relationships and student incomes (Figure 2.14). At the top end, and in particular in the top 1% of employee earners, salary represents only 70%. This is due to a high concentration of capital, other employment and rental incomes which comprise 12%, 10% and 2% respectively of total gross income in this top percentile.
- For pensioners, for the first two-thirds of the gross income distribution, pensions comprise the vast majority of all income (above 95%) (Figure 2.15). As pensioners become better-off between the 65th and 85th percentiles, they begin to supplement their income to a greater extent with salary income, other employment income and a small proportion of rental property income, causing the pension proportion of all income to fall to about 80%. Among the top decile of pensioners, salary income increases from a proportion of 15% at the 90th percentile to 39% for the top 1%. Capital income rises more slowly – it comprises 2% at the 98th percentile, 3% at the 99th percentile but 15% in the top 1%. Indeed, the top percentile comprises only 18% of gross income from pensions, the majority comes from salary income while capital, other employment and property comprise 15%, 14% and 9% respectively.
- Figure 2.16 shows the self-employed and the full self-employed[10] (taxpayer that derive 100% of their income from self-employment) income distribution thresholds

by percentile for 2016. In the lower half of the income distribution, the more broadly defined self-employed earn approximately 10 – 15% more on average than the full self-employed. At the median, the self-employed and full self-employed earn EUR 6 732 and EUR 6 732 respectively. After this point however, incomes are significantly higher for the self-employed due to their additional employment income. For example, among the top 10% and 1%, the self-employed earn EUR 23 613 and EUR 64 998 compared to the full self-employed who earn EUR 16 377 and EUR 54 703.

- While self-employment incomes are far lower than employment incomes on average, both income sources follow a broadly similar distributional pattern by age – most income is earned by those aged 35 to 60 (Figure 2.17). Unlike salary income however, self-employment income does not decline as sharply after age 60, suggesting that older taxpayers are more likely to supplement their income with self-employment or the self-employed remain active in the labour market after reaching the age of 60.

Figure 2.14. Employees with higher incomes have a more diversified source of income



Note: Employees are defined as taxpayers with salary income plus some small self-employment income. For the purpose of this analysis, other includes all business, agricultural and other miscellaneous income. Methodological information on the microdata is available in the annex.
Source: Authors' calculations based on Ministry of Finance of Slovenia tax records microdata.

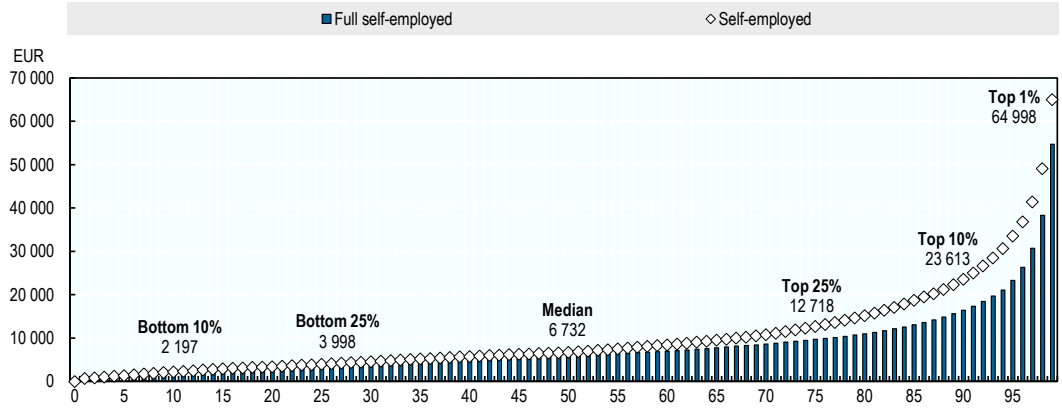
Figure 2.15. Towards the end of the pensioners distribution, the income source diversifies

Pension income distribution by income source, by income percentile, 2016

Note: Pensioners are defined as taxpayers with other income sources. Methodological information on the microdata is available in the annex.
Source: Authors' calculations based on Ministry of Finance of Slovenia tax records microdata.

Figure 2.16. Many self-employed have other sources of revenues

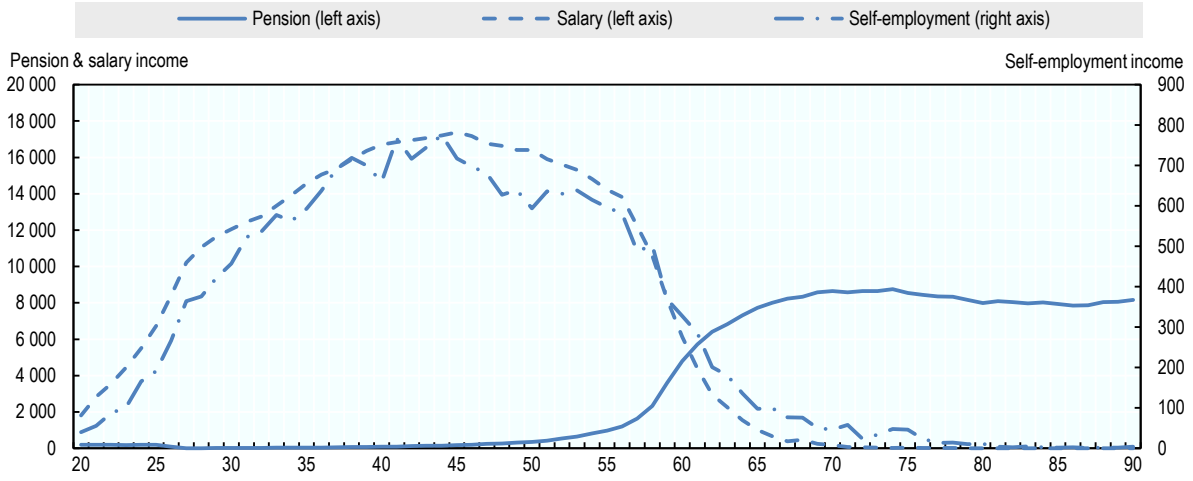
Self-employed gross income distribution, by income percentile, 2016



Note: A full self-employed is a taxpayer that derives 100% of its income from self-employment. Methodological information on the microdata is available in the annex.
Source: Authors' calculations based on Ministry of Finance of Slovenia tax records microdata.

Figure 2.17. Unlike salary income, self-employment income does not decline as sharply after age 60

Mean salary, pension and self-employment income by age, in EUR, 2016

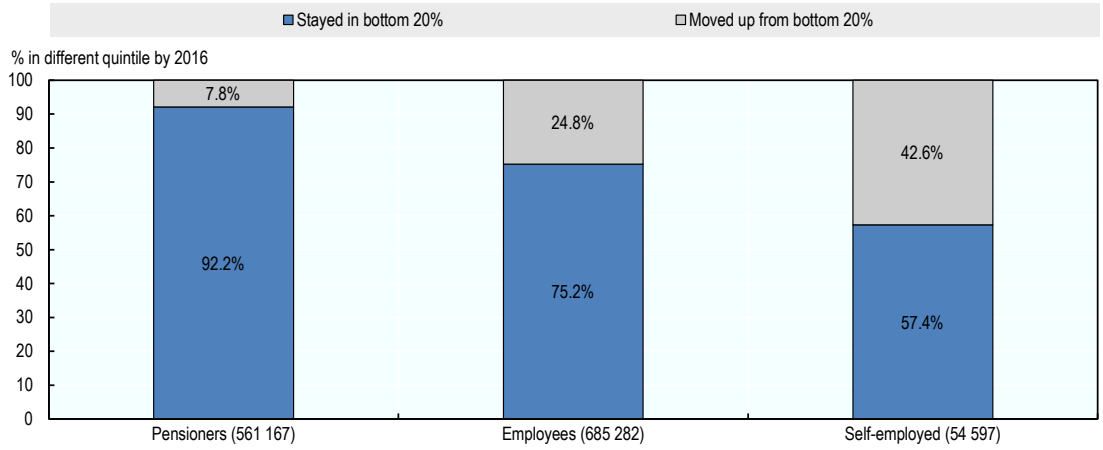


Note: Mean averages calculated based on all salary, pension and self-employment income including incomes reported as nil. An analysis done on a median basis shows a broadly similar distribution for salaries and pensions. Methodological information on the microdata is available in the annex.
Source: Authors' calculations based on Ministry of Finance of Slovenia tax records microdata.

The self-employed are the most mobile population cohort in Slovenia. At the bottom of the distribution, there is greater upward mobility among self-employed, employees and then pensioners (Figure 2.18). For example, 43% of the self-employed moved upwards out of the bottom quintile compared to only 8% for pensioners. Higher mobility among the self-employed is expected and partly reflects the greater risk and returns to business and entrepreneurship. Similarly, pensioners are much more likely to have stable incomes with little income shocks over time compared to employees and the self-employed.

Figure 2.18. The self-employed have the highest upward income mobility from the bottom 20%

Income mobility by taxpayer type, by quintile, 2015 - 2016



Note: There are important caveats to consider when interpreting transition matrices. For example, they show relative and not absolute changes in income. They do not capture those who leave the workforce (for example, due to emigration, unemployment or death). In addition, the time horizon is important – this one year transition while illustrative is much more limited and will show less mobility than a transition over a longer time period. Methodological information on the microdata is available in the annex.
Source: Authors' calculations based on Ministry of Finance of Slovenia tax records microdata.

2.5. The welfare system faces financing challenges

2.5.1. The costs of the pension system are rising

Pension contributions are not covering pension fund expenditures. The pension system in Slovenia is a pay-as-you-go system. In 2016 SSCs amounted to 72% of its total revenues (Ministry of Finance, 2018[9]). The budget balance was achieved with transfers from the general government (27% from the State budget, social security funds and extra budgetary funds) and non-tax revenues.

Several factors are adding pressure on the financing of the pension fund. Old-age pension transfers to individuals represented 51% of the total pension fund expenditures in 2000 (other expenditures included disability pension, family pension, other types of pensions, current expenditure, salary compensation, transfers to non-profit organisation, etc.) (Ministry of Finance, 2018[9]). This share has increased to 65% in 2016 reflecting the ageing of the population. Public expenditures on pension are projected to reach 15.6% of GDP in 2050 (11.8% of GDP over the period 2013-15) (OECD, 2017[10]). Pressure is exacerbated by the relatively low labour market participation on the one hand, and by the low development of the private pension system on the other hand. In its "White book", government explored different options to secure the financing of adequate pensions in the future.

Despite having a minimum pension, pensions in Slovenia remain relatively low increasing the risks that pensioners might fall into poverty (Figure 2.11). In Slovenia low-income pensioners (20th percentile of the income distribution) are below the poverty threshold (OECD, 2017[11]). In addition to the general basic allowance, pensioners with low income can benefit from an additional tax credit equal to 13.5% of the pension received.

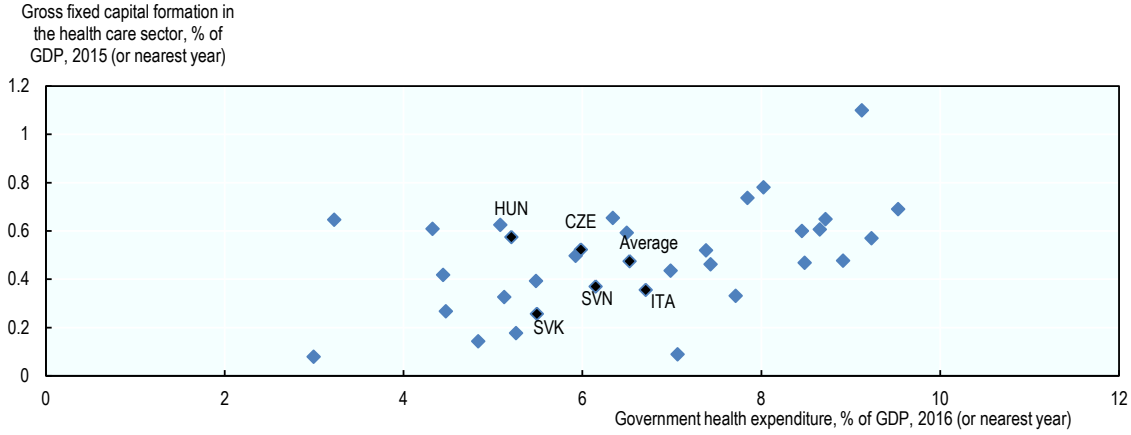
The cost of this tax credit amounts to EUR 221 million in 2016 (OECD analysis of administrative tax records).

2.5.2. The reform of the public health system is even more urgent

In 2016, health expenditures reached 8.6% of GDP in Slovenia compared to 9.9% of GDP on average in the EU and 9% in the OECD countries. The health care system is primarily financed by the Health Insurance Institute of Slovenia (HIIS). This is complemented by co-payments spending and voluntary health insurance from three private insurance companies. In 2016, 72% of the health financing was from public sources, and 28% from voluntary schemes and households out-of-pocket payments.

Investment in physical capital in the health sector (0.37% of GDP) is low as a share of total government health expenditure, and is below the OECD average (Figure 2.19). For example, the Czech Republic has a similar amount of government health expenditure but higher investment in physical capital in the health sector (0.52% of GDP). However, these figures should be interpreted with care and much depends on the types of physical investment that is carried out. For instance, changing demographics and disease patterns imply that there will be less need for "bricks and mortar" investment (especially hospitals) and more need for investment in information infrastructure and human capital. The latter type of investment will strengthen the transfer of information among actors, decentralisation and well-coordinated care (including home care) and prevention and self-care. An in-depth evaluation of these issues goes beyond the scope of this report and could be included in an in-depth evaluation of the functioning of the health care system in Slovenia.

Figure 2.19. Slovenia has relatively low capital investment in the health sector



Note: Only government health expenditure has been considered in the figure and voluntary/out-of-pocket health expenditure has been excluded.
Source: OECD (2017[12]).

The financing of the health care system relies heavily on social security contributions. In 2016 the HIIS revenues were EUR 2.5 billion with 80% coming from SSCs. However, because of the low labour market participation of old and young workers and because of the ageing of the population, the funding of health care in Slovenia is under increasing pressure.

The proposal for health reform aims at addressing some of the challenges. The proposal aims at increasing revenues for the HIIS through a wide variety of measures, including making the voluntary insurance co-payments compulsory while introducing lower and upper caps. While this reform would increase the financing of the health fund, it would result in even higher SSCs. A new institution would be created to advise the Ministry of Health, and a list of indicators would be compiled on a regular basis to guide health related policy decisions.

Notes

[1] This figure is the average employee SSC rate for a single person, at the average wage, without children.

[2] See previous note.

[3] The tax wedge is the difference between labour costs to the employer and the corresponding net take-home pay of the employee as a percentage of total labour costs. It takes into account personal income taxes, employee and employer SSCs, payroll taxes (if any) net of cash benefits. Total labour costs are the sum of gross wage earnings, employer SSCs and payroll taxes (if any).

[4] The net personal average tax rate is defined as the sum of personal income taxes and employee social security contributions net of cash benefits expressed as a percentage of gross wage earnings.

[5] Similar results are observed when taking into account the PIT only.

[6] Labour market participation rate is defined as labour force divided by the total working-age population, with labour force defined as all persons who fulfil the requirements for inclusion among the employed or the unemployed.

[7] Employment rate is defined as employed population divided by the total working-age population, with employed population defined as those aged 15 or over who report that they have worked in gainful employment for at least one hour in the previous week or who had a job but were absent from work during the reference week.

[8] However, early retirement will still be possible for those with more than 40 years of pension contributions.

[9] PTRs are used to investigate the financial disincentive to move into work. They show how much of the gross income earned from moving into work from either unemployment or inactivity is "taxed" away in the form of lost out-of-work benefits, reduced income-tested benefits, and taxation of in-work income.

[10]This distributional analysis includes taxpayers in both the flat-rate and actual cost regimes. An analysis examining these regimes separately is presented in Chapter 3.

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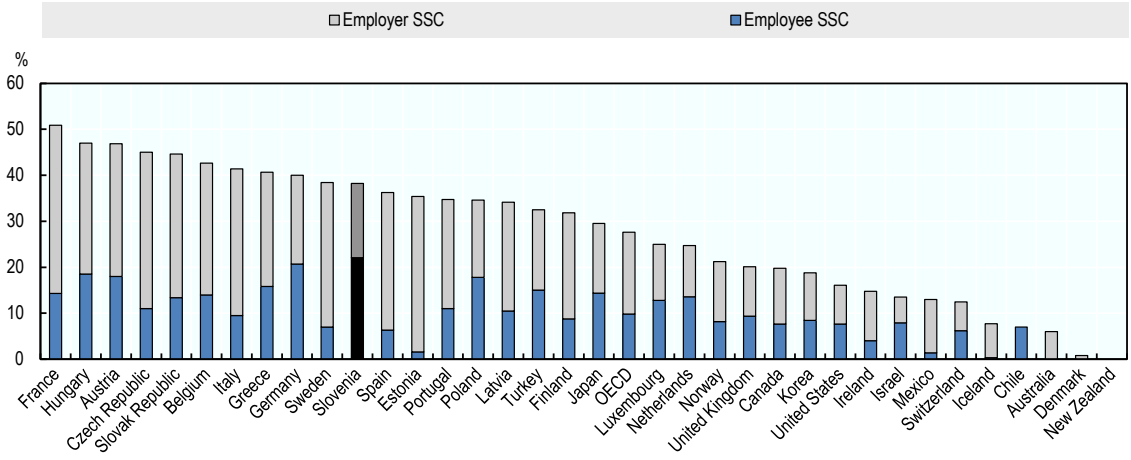
Chapter 3. Tackling the challenges to finance the social security system

Slovenia has a well-developed social welfare system which is successful in reducing inequality. However, it is financed primarily through social security contributions levied at high rates, in particular for employees. This is a challenge given the context of an ageing population. A comprehensive reform of the SSC system is needed and would entail a cut in employee SSCs across all income levels to increase labour market participation. The minimum SSC base is too high and leads to large effective statutory employer SSC rates. The SSC system for employees and self-employed could be further aligned, and the link between SSCs paid and benefits received should be strengthened. Slovenia should consider broadening the SSC base, and aligning the treatment of different types of incomes. To put the funding of the welfare system on a solid footing without reducing entitlements, it will need to partly shifted from SSCs towards general taxation.

3.1. High social security contributions distort the functioning of the labour market

The tax mix in Slovenia relies heavily on taxes on labour income and, in particular, on social security contributions (SSCs). The combined rate of employee and employer SSCs is significantly above the average combined rate in the OECD, although it remains lower than the combined rate that is levied in Austria, Italy, the Czech Republic and the Slovak Republic. Slovenia is one of the few OECD countries where the employee SSC rate (22.1%) exceeds the employer SSC rate (16.1%). While the employee SSC rate is the highest of all OECD countries, the employer SSC rate is below the average rate in the OECD (17.75%). It is also much lower than in other East European countries (the Czech Republic, the Slovak Republic, and Hungary), and Italy and Austria (Figure 3.1).

Figure 3.1. Slovenia levies high employee but relatively low employer SSCs



Note: For a single person at the average wage (AW) without child.
Source: OECD (2017[1]).

Analysis of tax return data confirm that significant revenues are raised from SSCs. Table 3.1 shows total allowances, credits, SSCs and personal income tax (PIT) as a share of gross income in 2016. For employees, employer and employee SSCs represent 15% and 20% respectively while PIT represents 12%. The vast majority of SSCs and PIT is paid by workers between 25 and 60, with the highest payments concentrated among workers aged 35 to 50 (Figure 3.2). Full employees, self-employed and pensioners refer to taxpayers who derive all of their income from salaries, self-employment and pensions respectively.

Table 3.1. Tax return data confirm high SSC revenues while the PIT base is narrowed through generous tax allowances

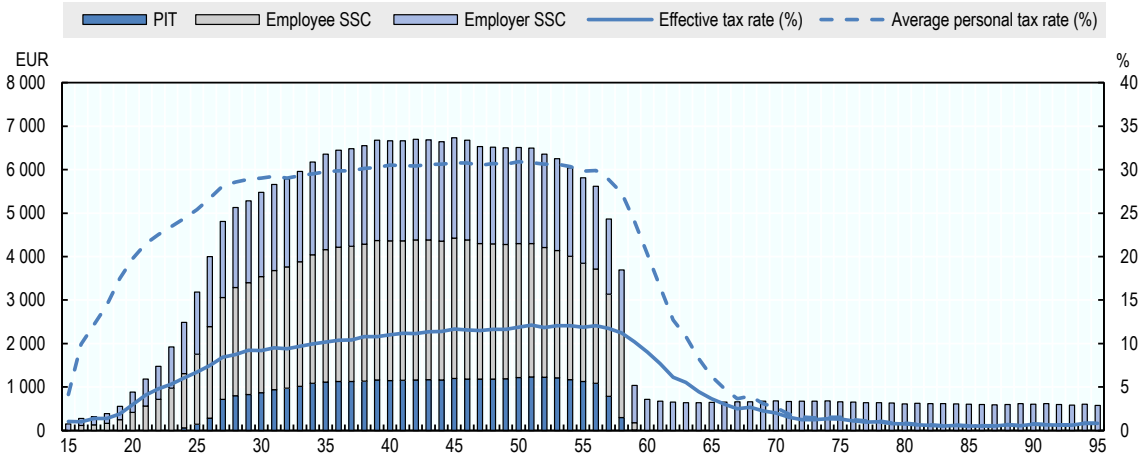
PIT and SSCs contributions by taxpayer group, 2016

	Employees	Full employees	Self-employed	Full self-employed	Pensioners	Full pensioners
			EUR millions			
Labour costs	16 767	16 260	803	501	5 919	4 981
Gross income	14 629	14 184	772	495	5 452	4 611
Allowances	4 221	4 127	429	343	3 557	3 312
Credits	0	0	0	0	235	221
Employer SSC	2 138	2 076	31	6	467*	370*
Employee SSC	2 952	2 867	41	7	135	12
PIT	1 685	1 625	69	44	134	44
			% of gross income			
Allowances	28.9%	29.1%	55.5%	69.3%	65.2%	71.8%
Credits	0.0%	0.0%	0.0%	0.0%	4.3%	4.8%
Employer SSC	14.6%	14.6%	4.1%	1.2%	8.6%*	8.0%*
Employee SSC	20.2%	20.2%	5.4%	1.4%	2.5%	0.3%
PIT	11.5%	11.5%	9.0%	8.9%	2.5%	0.9%

Note: *As pensioners do not have an employer, employer SSCs for pensioners refer to health SSCs, which are payments made for medical care and sickness leave on behalf of pensioners by the employer Pension Fund to the Health Insurance Institute of Slovenia. Methodological information on the microdata is available in the annex.
Source: Authors' calculations based on Ministry of Finance of Slovenia tax records microdata.

Figure 3.2. The vast majority of SSCs and PIT is paid by workers between 25 and 58

Median PIT and SSCs by age, 2016



Note: Age data truncated between 15 and 95 for reasons of sample size. The percentage effective tax rate is calculated as the total sum of the PIT divided by the sum of gross income for each age. The percentage average personal tax rate is calculated as the sum of the PIT and employee SSC divided by gross income for each age. Methodological information on the microdata is available in the annex.
Source: Authors' calculations based on Ministry of Finance of Slovenia tax records microdata.

Slovenia has four social security insurance schemes (Table 3.2). Slovenia levies high SSCs for pensions (including disability) and health insurance, while the contributions for

unemployment insurance and maternity leave are low. Among the selected comparison countries, only the Czech Republic and Hungary levy higher pension SSCs. Only France, the Czech Republic and the Slovak Republic levy higher health SSCs (Table 3.3).

Table 3.2. Social security contributions rates

	Employee (%)	Employer (%)
Pension and disability insurance	15.50	8.85
Health insurance	6.36	7.09
Unemployment	0.14	0.06
Maternity leave	0.10	0.10
Total	**22.10**	**16.10**

Source: Ministry of Finance (2018[2]).

Table 3.3. Slovenia levies high pension and health insurance contributions

Sum of employee and employer SSCs (%)

	Austria	Belgium	Czech republic	Finland	France	Hungary	Poland	Slovak Republic	Slovenia
Pension insurance	22.8	16.36	31.5	24.1	15.45	32	19.52	18	24.35
Health insurance	7.65	7.35	13.5	2.66	13.64[a]	7	2.45[b]	14	13.45
Unemployment insurance	3	4.03		4.01	6.4	1.5		2	0.2
Maternity leave									0.2
Disability insurance							8	6	
Sick leave insurance		1.15						2.8	
General risk	1.3			0.8	2.32			0.8	
Other employer SSCs	0.85[c]	16.37		0.07	5.32[d]	1.5[e]	3.81[f]	0.25[g]; 4.75[h]	
Other employee SSCs	yes				yes				

Note: a: illness, pregnancy, disability, death. b: maternity and sickness. c: including housing fund. d: family allowance, and other. e: training. f: accident insurance, etc. g: guaranteed fund. h: reserve fund
Source: OECD (2018[3]).

High SSCs distort the functioning of the labour market. SSCs are typically levied at flat rates on all labour earnings, in contrast to the PIT which is often levied at progressive rates and exempts a certain amount of income from tax.

- **High employer SSCs increase labour costs for the employer and therefore reduce labour demand**. High employer SSCs are particularly distortive in firms or sectors where skills and labour productivity are low. They are particularly distortive for older workers in Slovenia whose wages are increasing with age. By increasing the labour cost of employing older workers, high employer SSCs strengthen the labour market distortions that arise because of the automatic increase of wages with age irrespective of labour productivity.
- **High employee SSCs reduce labour supply and work incentives**, in particular for individuals with a weaker attachment to the labour market such as low incomes, older workers and second earners (World Bank, 2007[4]). High employee SSCs significantly lower disposable income of low-income earners, thereby reducing

their incentive to participate in the labour market (see Chapter 2). High employee SSCs will also result in lower PIT revenues as employee SSCs are deductible from the PIT base.

In order to put the funding of the social welfare system on a solid footing for the future, Slovenia needs to ensure that as many workers as possible do participate in the labour market and, hence, contribute through taxes and SSCs to the funding of the welfare system. This may require different types of reforms that aim at maintaining strong labour market participation of the prime age population and work effort for all income levels, as well as more targeted reforms that focus on particular groups, such as youth, low-skilled and older workers.

Slovenia needs to tackle at source the underlying causes of the low labour market participation of young and older worker through a comprehensive labour market reform package. Different factors may contribute to the low level of labour market participation of young and older workers. Important factors are the low levels of skills of certain groups of workers, relatively generous benefits for people out of work (in particular compared to the low income that can be earned on the labour market for those workers), generous provisions for students who are active in the labour market, a weak link between social contributions made and benefits received, and the fact that the unemployment system can be misused as a temporary means to bridge to retirement.

A cut in employee SSCs will also be a major part of such a labour market reform. However, the reduction in employee SSCs will reduce the funds received by the social funds and their funding will need to be assured through other revenue sources. In order to put the funding of the welfare system on a solid footing without reducing entitlements to social benefits, the reform will need to shift the funding of the pension and health system partly from SSCs towards general taxation. Moreover, the tax reform will need to go hand in hand with a broader set of reforms, including the reform of the pension and health care systems. The remainder of this chapter discusses a number of reform options, including a shift from employee SSCs towards general taxation or a shift from employee to employer SSCs (sections 3.2 and 3.3). Other reforms include SSC base broadening, unifying the different SSC systems (sections 3.4 and 3.5), and increased spending efficiency (section 3.6).

3.2. Stimulate labour market activity through a cut in the employee SSC rate

The reduction in employee SSCs will need to stimulate labour market participation, work efforts and incentives to work more productively at the lowest possible tax revenue cost. Different reform options exist. The reduction in employee SSCs could apply to all workers irrespective of their income level or it can be targeted at specific income levels and/or types of workers. In order to maximise the impact on labour market participation, the design of a reduction in employee SSCs will need to be tailored to the specific characteristics of the labour market in Slovenia. The choice for a reduction that applies to all incomes or is more targeted at low incomes or particular groups of workers will also have an impact on the tax revenue cost of the reform.

3.2.1. A cut in employee SSCs is the preferred option over targeted cuts

Given the narrow wage distribution in Slovenia, an employee SSC reduction targeted at low incomes would stimulate labour market participation considerably but would also negatively affect work incentives. For a tax reduction to be targeted at low incomes,

the reduction would need to be tapered out (i.e. reduced) at a specific taper rate over a well-defined income range. The taper rate then augments the marginal tax rates and wedges, which are already high in Slovenia, thereby further increasing the labour market distortions. In order to limit the tax revenue cost, the reduction would have to be tapered out at relatively low income levels. The corresponding increase in marginal tax rates would negatively affect the work incentives of a large share of the working population. Alternatively, the reduction could be reduced at a higher income level thereby lowering the tax burden for more taxpayers and, as a result, stimulate labour market participation. This would imply a larger tax revenue cost but would be less distortive as the increased marginal tax rates would affect fewer taxpayers.

A reduction in employee SSCs targeted at all income levels would not only benefit low-income workers but also middle and higher-income workers. High employee and employer SSCs do not only affect low-income workers. Also middle and higher income workers face a high tax burden on labour income, which negatively affects work efforts, incentives to strengthen skills and work more productively and incentives to continue working when approaching the retirement age.

Because of the narrow wage distribution and the high labour income tax burdens across the entire income distribution, a reduction in employee SSCs for all income levels (and all economic sectors) would be preferred over targeted cuts. In order to prevent work disincentives for a large share of the population, a targeted cut in employee SSCs would have to be tapered out at relatively high income levels. However, that would imply that extending the cut to all income levels would come at a relatively small additional tax revenue cost. While such a general reduction would increase the overall tax revenue cost, it would prevent further increases in marginal effective tax rates, which are already very high (Figure 4.8). Because employee SSCs are very high and work incentives need to be increased for all (in particular young and older) workers irrespective of their income level, there is a strong policy rationale to apply a reduction in employee SSCs to all income levels.

3.2.2. To distribute the gains of the reform more equally, a cut in employee SSCs has to be accompanied by a reform of the PIT

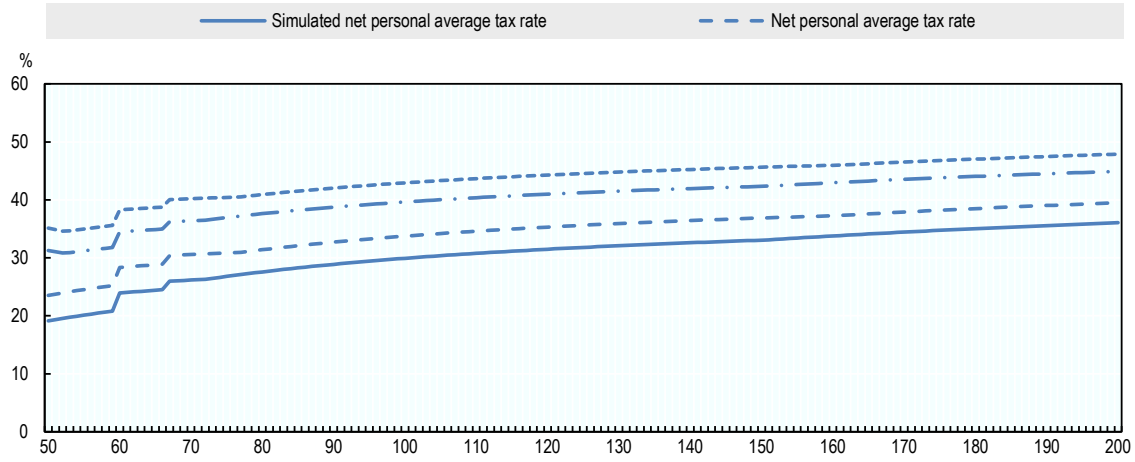
Lower employee SSCs will increase disposable income but would benefit higher incomes more. Figure 3.3 presents results for average tax burdens across the 50-200% of the AW income range for a 5.24 percentage points reduction in employee SSCs. For instance, the net personal average tax rate at the average wage drops from 22.1% to 16.9%. At the average wage, the average tax wedge decreases with 3.3 percentage points. Table 3.4 presents results for different reductions in employee SSCs. Overall a cut in employee SSCs increases disposable income. Disposable income increases more for higher incomes, although lower incomes gain more in relative terms. The PIT offsets part of the decrease in employee SSCs because of the increase in taxable income which is taxed under the PIT. Because of the progressivity of the PIT system, the PIT offsets the impact of the cut in employee SSCs relatively more for higher incomes. Nevertheless, higher incomes would still benefit more in absolute amounts from a general cut in employee SSCs. Figure 3.4 focuses on mean disposable income from employment by income decile before and after a five percentage points employee SSC cut, and shows similar results.

The analysis implies that a general cut in employee SSCs could be accompanied by PIT reform to more equally distribute the gains of the reform. Table 3.4 presents the impact on disposable income for a cut in employee SSC accompanied by a change in the

PIT rate schedule. Results show that a redesign of the PIT rate schedule which leaves the bottom rate unchanged and increases the other rates and installs a top PIT rate of 45% would share the gains in disposable income more equally compared to a baseline scenario where employee SSCs are cut but the PIT rates are kept unchanged.

Figure 3.3. A cut of 5.24 percentage points in the employee SSC significantly reduces the net personal average tax rate and the average tax wedge

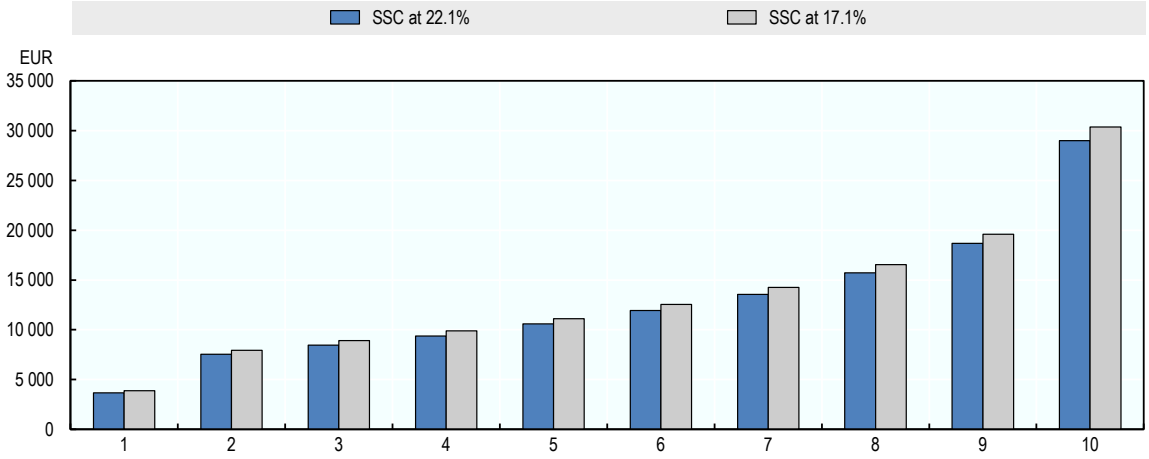
Single worker without children, as a % of the AW



Note: The simulated values represent a cut in employee SSC of 5.24 percentage points (from 22.10% to 16.86%).
Source: OECD (2018[3]).

Figure 3.4. An employee SSC rate cut would increase disposable income across all deciles with greater relative (but not absolute) increases among the lowest deciles

Mean disposable income from employment before and after a 5 percentage points SSC cut, by disposable income decile



Note: The analysis assumes no behavioural change and linearity from the employee SSC rate reductions. Total PIT and SSC in the microdata differ from figures reported by Ministry of Finance. Employment disposable income is estimated as income from employment less employee SSCs less PIT. Methodological information on the microdata is available in the annex.
Source: Authors' calculations based on Ministry of Finance of Slovenia tax records microdata.

Table 3.4. A reduction in the employee SSCs rate significantly increases disposable income across income levels

Single worker without children at different earning levels

	Change in employee SSC rate	Change in PIT brackets*	Average tax wedge (%)	Personal average tax rate (%)	Disposable (after-tax) income (EUR)	Additional income (EUR)	Change in disposable income (% of disposable income)
50% of the AW (EUR: 9 452)	No change: 22.1%	No change	35.1%	23.5%	7 228		
		Change	35.1%	23.5%	7 228	0	0.00%
	3 pp cut: 19.1%	No change	32.9%	21.0%	7 466	238	3.30%
		Change	32.9%	21.0%	7 466	238	3.30%
	5 pp cut: 17.1%	No change	31.4%	19.3%	7 625	397	5.49%
		Change	31.4%	19.3%	7 625	397	5.49%
67% of the AW (EUR: 12 666)	No change: 22.1%	No change	40.0%	30.4%	8 817		
		Change	40.0%	30.4%	8 817	0	0.00%
	3 pp cut: 19.1%	No change	37.9%	27.9%	9 136	319	3.62%
		Change	37.9%	27.9%	9 136	319	3.62%
	5 pp cut: 17.1%	No change	36.4%	26.2%	9 349	532	6.03%
		Change	36.4%	26.2%	9 349	532	6.03%
100% of the AW (EUR: 18 904)	No change: 22.1%	No change	42.9%	33.7%	12 524		
		Change	43.1%	33.9%	12 490	-34	-0.27%
	3 pp cut: 19.1%	No change	41.0%	31.6%	12 938	414	3.31%
		Change	41.2%	31.8%	12 899	374	2.99%
	5 pp cut: 17.1%	No change	39.8%	30.1%	13 214	690	5.51%
		Change	40.0%	30.3%	13 171	647	5.16%
167% of the AW (EUR: 31 569)	No change: 22.1%	No change	46.3%	37.7%	19 664		
		Change	46.7%	38.2%	19 523	-142	-0.72%
	3 pp cut: 19.1%	No change	44.7%	35.8%	20 269	605	3.07%
		Change	45.1%	36.2%	20 129	465	2.36%
	5 pp cut: 17.1%	No change	43.5%	34.4%	20 706	1042	5.30%
		Change	44.0%	35.0%	20 533	869	4.42%
250% of the AW (EUR: 47 259)	No change: 22.1%	No change	49.5%	41.3%	27 731		
		Change	50.2%	42.1%	27 345	-386	-1.39%
	3 pp cut: 19.1%	No change	47.8%	39.3%	28 667	936	3.37%
		Change	48.5%	40.2%	28 252	521	1.88%
	5 pp cut: 17.1%	No change	46.6%	38.0%	29 291	1560	5.62%
		Change	47.4%	38.9%	28 857	1126	4.06%

Note: *The new PIT brackets are as follows: first bracket: 16% (no change); second bracket: 28% (+1 percentage point compared to the current rate of 27%); third bracket: 36% (+2 percentage points compared to the current 34% rate); fourth bracket: 45% (+6 percentage points compared to the current 39% rate); abolishing the top bracket and its 50% rate.
Source: OECD (2018[3]).

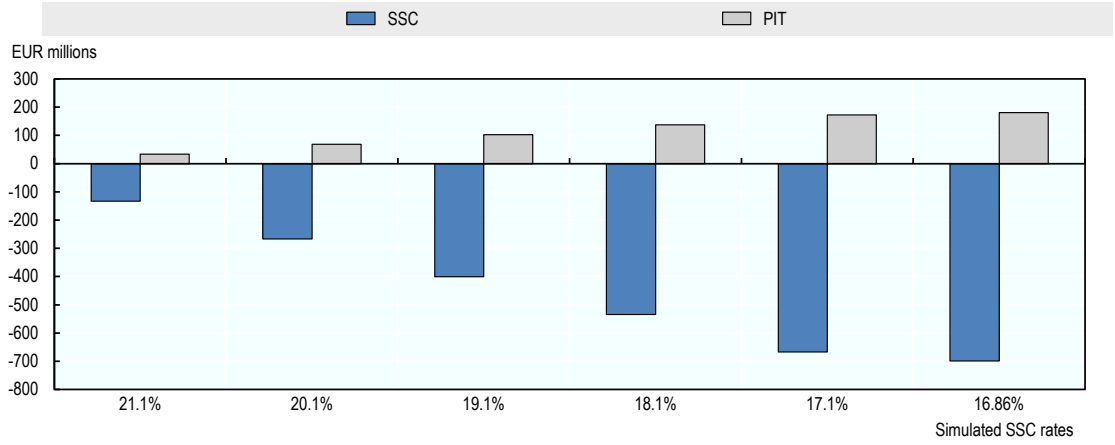
3.2.3. A cut in employee SSC leads to a significant loss in revenues the effect of which is partly offset through the broader PIT base

A one percentage point cut in employee SSC is associated with a total loss of EUR 100 million (loss of EUR 134 million in SSC and an offsetting recovery of EUR 34 million in PIT). Figure 3.5 shows the employee SSC loss and the extent recovered through PIT associated with reducing the employee SSC rate by consecutive one percentage point from 22.1% through to 16.86%. The employee SSC reduction of 5.24 percentage points (to 16.86%) is associated with a total loss of EUR 519 million.

Loosely, just over one-quarter (26%) is recovered through the PIT system. According to the analysis, the SSC and PIT revenue losses in the first bracket are EUR 20 million and EUR 293 million respectively (Figure 3.6). The majority of SSC losses are focused in the first two brackets. In the top three brackets, PIT recovery exceeds SSC losses.

Figure 3.5. The SSC loss associated with an employee SSC rate cut will be partly recovered through the PIT system

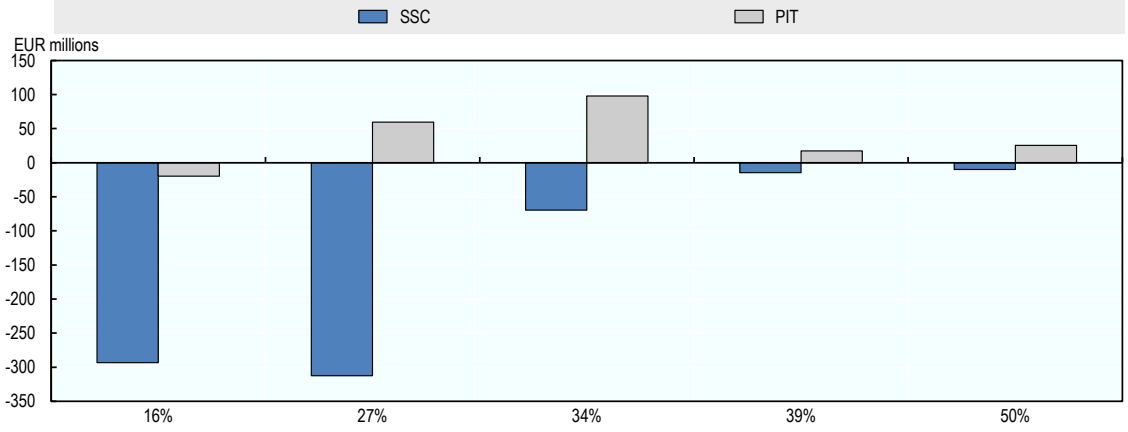
SSC loss and PIT gain from reducing the employee SSC rate from 22.1% to 16.86%



Note: The analysis assumes no behavioural change and linearity from the employee SSC rate reductions. Total PIT and SSC in the microdata differ from figures reported by Ministry of Finance. Methodological information on the microdata is available in the annex.
Source: Authors' calculations based on Ministry of Finance of Slovenia tax records microdata.

Figure 3.6. PIT recovery could exceed SSC losses in the top three PIT brackets

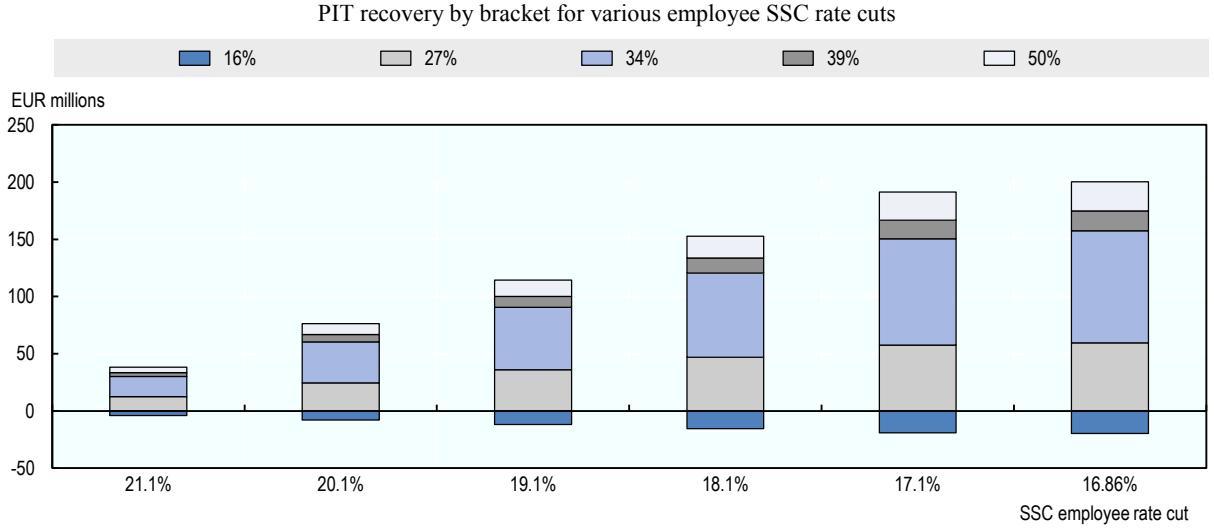
SSC loss and PIT gain by PIT bracket from reducing the employee SSC rate by 5.24 percentage points to 16.86%, in EUR million



Note: The analysis assumes no behavioural change and linearity from the employee SSC rate reductions. Total PIT and SSC in the microdata differ from figures reported by Ministry of Finance. Methodological information on the microdata is available in the annex.
Source: Authors' calculations based on Ministry of Finance of Slovenia tax records microdata.

For all the simulated cuts in employee SSC, the greatest amount of PIT is recovered in the third (34%) rate bracket. Figure 3.7 shows the simulated PIT revenues recovered in each PIT bracket for various reductions in the employee SSC rate (from 22.1% to 16.86%). The extent to which employees move up PIT brackets depends on both the numbers of employees in the bracket and the relative proximity of each employee's taxable income to the next rate threshold. According to an analysis of employee PIT bracket transitions resulting from a one percentage point cut in employee SSCs (to 21.1%), the first bracket would contract by 7 200 employees while the second, third, fourth and top brackets would expand by 4 300, 2 500, 190 and 120 employees respectively. In the first and largest PIT rate bracket, which comprises 50% of all employees, a one percentage point cut in the employee SSC rate would reduce PIT revenues in the bracket by EUR 4 million while increasing them in the second bracket by EUR 13 million, in the third by EUR 18 million, in the fourth by EUR 3 million, and in the fifth by EUR 5 million. By far, the greatest amount of PIT is recovered in the third (34%) rate bracket. This occurs because, given the same one percentage point SSC cut, over 2 500 employees would move up to this bracket and would now pay an average PIT of about EUR 7 000. For the top 50% rate, the same one percentage point SSC cut would add a small number of employees to the top rate bracket, resulting in approximately EUR 5 million in PIT. Similar conclusions can be drawn for the cuts in employee SSC to 20.1%, 19.1%, 18.1%, 17.1% and 16.86%.

Figure 3.7. An employee SSC rate cut is likely to result in the majority of PIT revenues being recovered in the third rate bracket



Note: The analysis assumes no behavioural change and linearity from the employee SSC rate reductions. Total PIT and SSC in the microdata differ from figures reported by Ministry of Finance. Methodological information on the microdata is available in the annex.
Source: Authors' calculations based on Ministry of Finance of Slovenia tax records microdata.

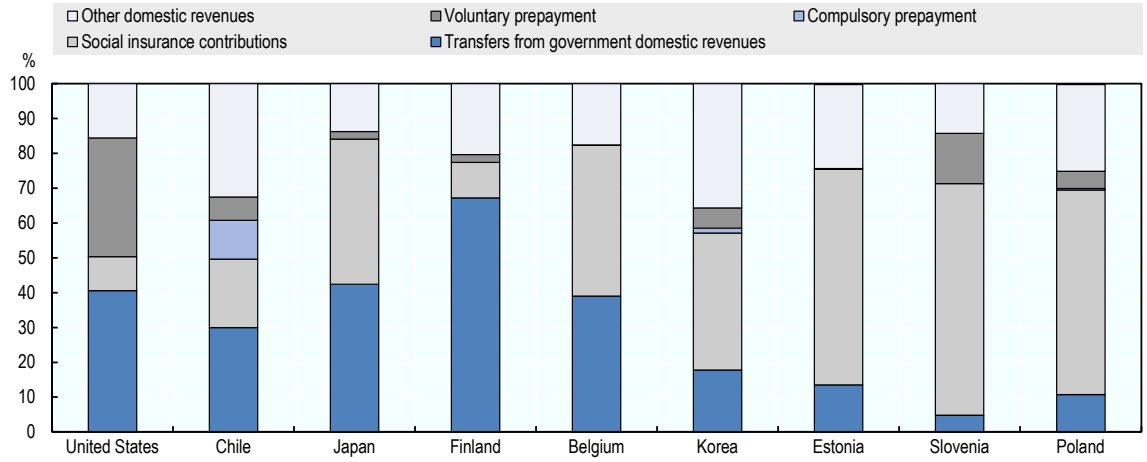
3.3. Find alternative way of financing the welfare system

Lowering the employee SSC rate will have an impact on the financing of the social security system. Slovenia's welfare system relies mainly on funding through SSCs (Figure 3.8). Despite the high SSC rates, the pension and health funds face important funding constraints which are expected to worsen given the rapidly ageing population and the increase in costs associated with pensions and long-term care. Therefore to compensate

for a cut in the employee SSC rate and to ensure sufficient funding for the social security system, different reform options could be envisaged, including financing the welfare system to a greater extent through general taxation or shifting some employee SSC towards employer SSC. These different options will be evaluated below.

Figure 3.8. Slovenia's welfare system relies mainly on funding through SSCs

Financing sources of compulsory insurance by type of revenue, selected countries, 2015 (or nearest year)



Note: "Other" includes compulsory prepayment and other domestic revenues.
Source: OECD (2017[5]).

3.3.1. Financing the welfare system partly through general taxation

Strong arguments exist to finance social benefits through general taxation (e.g. the PIT or other taxes levied on capital income, immovable property or consumption) if there is no strong link between contributions made and benefits received (Brys et al., 2016[6]). This is the case for child benefits or family related tax provisions, and might also apply to unemployment insurance, in particular if the level of unemployment benefits is not strongly linked to contributions made. If a shift towards general taxation is accompanied by a reduction in employee SSCs, it can help reducing labour costs. Levying social contributions through a progressive PIT is also a possibility, in particular if the burden can be shifted to workers and income levels with lower labour income tax elasticities. In addition the PIT can have a broader tax base as it can be levied on capital income, such as the case of France (see Chapter 6).

In a changing world of work, financing social benefits partly through general taxation would not only increase labour market participation but could ensure that welfare support remains available for a large number of people. Structural changes in the economy as a result of digitalisation, automation and other trends are resulting in an increasing number of workers which pay lower levels of SSCs (self-employed, temporary workers and workers with irregular working hours) (OECD, 2017[7]). This trend presents new challenges not only for tax administrations but also for welfare systems financed primarily by SSCs.

Across the OECD, unemployment insurance and maternity benefits are financed through general taxation although differences across countries exist. In Slovenia, the SSCs for unemployment benefits and maternity leave are paid to the general government budget (no special funds are in place) and the state budget pays for the corresponding

spending. Many countries (including Slovenia) finance unemployment insurance with SSCs, but in many cases also with general taxation (which can amount to as much as two-thirds of the program's expenditures) (Office of Research, Evaluation and Statistics, 2016[8]). Maternity benefits are often funded mainly through general taxation (European Commission, 2017[9]). In some countries, such as Poland, family benefits are paid through general taxation (World Bank, 2007[4]).

As a measure to cut employee SSCs in Slovenia, the SSCs for unemployment and maternity leave could be abolished. The corresponding benefits could be financed through general taxation, as is already the case. Such a reform would require an increase in general taxation to compensate for the cut in SSCs. However as the respective rates are low (0.14% for unemployment insurance and 0.10% for maternity leave) this would not entail a large reduction in the overall employee SSC rate (from 22.10% to 21.86%). The impact on both the net personal average wage and the average tax wedge would be minimal.

Slovenia might consider other reforms to reduce employee SSCs beyond a cut in the contributions for unemployment and maternity leave. Different options exist, as will be discussed further in this chapter, including financing the health system partly through general taxation. In addition, the pension system could increasingly be funded from general taxation, as is already partly the case.

3.3.2. Shifting employee SSCs to employer SSCs is not the way forward

While shifting SSCs partly from the employee to the employer would stimulate labour market participation, it might reduce job creation in the private sector. The current SSC mix in Slovenia relies more heavily on employee than on employer SSCs, in contrast to the SSC mix in most other OECD countries (Figure 3.1). This raises the question of whether the tax mix could be partly shifted away from employee towards increased employer SSCs. In the short run, with fixed wages, a cut in employee SSCs financed by an increase in employer SSCs would increase household disposable income and increase the total labour cost for the employers. In that sense, the shift would be similar to an increase in gross wages across all sectors and for all workers irrespective of workers' productivity.

By increasing labour costs, an increase in employer SSCs might make it too expensive for employers to hire certain types of workers particularly those workers who already face challenges in finding employment, such as low-skilled and older workers. As increased labour market participation is the most straightforward strategy for Slovenia to put the funding of its welfare system on a secure footing for the future, financing a cut in employee SSCs by higher employer SSCs might not be a first-best strategy.

Slovenia implements a minimum SSC base for workers earning less than a minimum income threshold. For gross earnings below the minimum income threshold, SSCs are calculated on the basis of the minimum SSC base and not on actual gross wage earnings. Employees are liable to pay employee SSCs on their actual gross earnings. However, the employers are liable to pay, in addition to the employer SSCs levied on workers' gross earnings, the employee and employer SSC rate on the gross wage earnings below the minimum income threshold. A minimum SSC base applies also to self-employed workers.

The minimum SSC base for regular employees is legislated to increase significantly over the following years. The minimum SSC base has been increasing from 52% of the AW to 54% of the AW in 2018. It will increase further to 56% of the AW in 2019, 58% in 2020 and 60% in 2021. Self-employed workers already face a 60% of the AW minimum

SSC base in 2018. The different bases for regular employees and self-employed workers are therefore planned to converge over time.

The minimum SSC base significantly increases the effective employer SSC rate for low-income workers. The minimum SSC base has the effect of increasing the SSC rate which employers have to pay on low incomes as follows:

*Employer SSC rate = statutory employer SSC rate + (employer SSC rate + employee SSC rate) * [Max (minimum SSC base – employee gross wage earnings, 0) / employee gross wage earnings]*

The increase in the effective employer SSC rate is decreasing in income, thereby leading to a perverse effect that the tax system makes it more expensive (in terms of SSCs that need to be paid) to hire low-income than high-income workers. Table 3.5 present results for the effective employer SSC rate for different levels of gross earnings. The results show that the effective employer SSCs rate exceeds the statutory rate of 16.1% in 2018 significantly, in particular for very low incomes. In fact, the increase in the employer SSC rate is increasing in the difference between the minimum SSC base and actual gross earnings. The lower are gross earnings, the higher is the effective employer SSC rate. No extra employer SSCs have to be paid for workers earning more than the minimum SSCs threshold.

The minimum SSC base offers another argument not to shift from employee to employer SSCs. As the minimum SSC base increases the effective employer SSC rate, a further increase in the employer SSC rate might significantly distort the labour market and in particular the employment opportunities for low-income workers. Following practices in other countries (Box 3.1), Slovenia could abolish the minimum SSC base, or, if not possible in the short run, lower it to an income level that corresponds more closely to the minimum wage.

Table 3.5. An extra employer SSC has to be paid up to an income threshold

With a minimum SSC base of 60% of the AW

Employee wage earnings (% of the AW)	40%	45%	50%	55%	60% and more
Statutory employer SSC rate (%)	16.1%	16.1%	16.1%	16.1%	16.1%
Additional employer SSC rate (%)	7.6%	5.7%	3.8%	1.9%	-
Effective employer SSC rate (%)	23.7%	21.8%	19.9%	18%	16.1%

Box 3.1. SSCs thresholds and rates: approaches followed by OECD countries

In most OECD countries, employee social security contributions are payable by all taxpayers on their first unit of earnings.

Minimum thresholds

Some countries implement minimum income thresholds below which social security contributions are not payable. This is the case with all forms of employee social security contributions in seven countries – Austria, Belgium, Iceland, Ireland, Norway, Sweden and the UK – as well as some (but not all) employee SSCs in Canada (pension and health contributions), Luxembourg (dependency insurance) and the Slovak Republic (health insurance).

While some countries exempt low incomes from SSCs, others implement minimum SSC liabilities. In the Slovak Republic, Spain and Turkey, full-time workers are deemed to earn a minimum amount of income subject to SSC. This minimum SSC tax base tends to correspond to the legal minimum wage.

Ceilings

SSC ceilings are more common than minimum income thresholds. Total employee SSCs are capped at a maximum level when an income ceiling is exceeded in 16 OECD countries – Austria, Canada, Chile, the Czech Republic, Germany, Greece, Israel, Italy, Latvia, Luxembourg, Mexico, the Netherlands, the Slovak Republic, Spain, Sweden and Turkey.

In 2017, gross earning ceilings in countries where total SSCs were capped ranged from 0.69 times the average wage in the Netherlands to 6.49 times the average wage in the Slovak Republic.

In most of the countries where total SSCs are capped, the gross earnings threshold at which the maximum SSC contribution is reached is below the threshold at which the top statutory PIT rate begins to apply, which implies that SSC rates do not increase the marginal personal tax rate (encompassing PIT and employee SSC) beyond the top statutory PIT rate for taxpayers facing this top rate. The exceptions are the Czech Republic, Italy, Latvia, the Slovak Republic and Turkey, where taxpayers continue to pay SSC after their income has exceeded the threshold at which the top PIT rate applies.

Rates

Social security contributions are usually levied at a flat rate. The flat rates result in a constant average burden of employee SSCs for most countries between 33% and 167% of average wage earnings. Some examples of a constant proportional burden for employee SSCs for over the eight model family types, are (in decreasing order of rates) Slovenia (22.1%), Hungary (18.5%), Poland (17.8%), Greece (15.8%), Turkey (15.0%), the Czech Republic and Portugal (11.0%), Latvia (10.5%), Norway (8.2%), the United States (7.7%), Chile (7.0%), Switzerland (6.2%) and Estonia (1.6%).

Source: OECD (2017[1]); Torres, Mellbye and Brys (2012[10]).

3.4. Reform the SSCs paid by self-employed

Self-employed individuals in Slovenia pay SSCs within minimum and maximum income bands. SSCs for self-employed workers, irrespective of whether they are taxed under the regular or the "flat-rate" regime, are calculated on 75% of the profit earned in the previous fiscal year. There is also a minimum SSC base, which is as of January 2018, equal to 60% of the AW. Hence, self-employed workers who earn a profit (reduced by of 25%) lower than 60% of the AW, pay SSCs on this minimum income base irrespective of their actual income. In addition, a maximum contribution base is set at 350% of the AW. About half of OECD countries apply a SSC ceiling. A few countries have no thresholds, or only apply a minimum one. Very few countries apply a lump-sum charge (Denmark, Japan, and Mexico) (see Box 3.1 and the OECD Tax database for more information).

The SSC rate for the self-employed in Slovenia is high. The SSC rate equals the sum of the employee and employer SSCs rates for regular employees. On average in the OECD, the self-employed SSC rates are usually higher than the employee SSC rates but lower than the sum of the employee and the employer SSC rates (Table 3.6). Slovenia could therefore consider lowering the SSCs paid by the self-employed similar to the recommended cut in employee SSCs for regular employees.

Table 3.6. Self-employed in Slovenia pay high SSCs

SSCs in %

	Self-employed SSC	Regular employee		
		Sum employee and employer SSC	Employee SSC	Employer SSC
Austria	26.2	36.6	15.1	21.5
Hungary	8.5-10-22	40.7	18.5	22.2
Poland	30	34.1	13.7	20.4
Slovak Republic	47.2	48.6	13.4	35.2
Slovenia	38.2	38.2	22.1	16.1

Note: Some countries have multiple SSCs schedules like Hungary.
Source: OECD (2017[1]).

Having a separate SSC regime for the self-employed might allow countries to lower the tax burden for the self-employed in order to stimulate entrepreneurship. Such an approach may stimulate job creation, in particular in countries where SSCs are high such as in Slovenia. However, such a differentiated social security system typically also results in differences in benefit entitlement, which reduces the equity of the tax and benefit system.

In dual income tax (DIT) systems which tax labour and capital income differently for tax and SSC purposes, a separate SSC regime for the self-employed could reflect that the income of the self-employed consists partly of remuneration for work and partly of a return for the capital invested. Capital income is taxed at lower rates than labour income and SSCs are levied on labour income only under a DIT system. The differential SSC regime in Slovenia for employees and self-employed and, in particular, the 25% exemption of profits for the self-employed, could then be seen as the introduction of a, albeit unsophisticated, mechanism to introduce a differential tax treatment for capital and labour income for the self-employed.

Running different SSC regimes also entails costs for tax administrations and it complicates compliance for workers, in particular for individuals who are both

regular employees and self-employed. It also makes shifts from employment into self-employment (and vice-versa) burdensome and may even involve a loss in benefit entitlement. It may also stimulate tax avoidance and evasion when employees become self-employed just for tax purposes or when they are obliged by their employer to work under a self-employed status (so called bogus self-employment).

In a changing world of work where employment is increasingly becoming flexible, in particular because of digitalisation, tax systems should not create a hurdle to work. Modern labour income tax systems should be adjusted to ensure that workers can benefit from the flexibility of the modern labour market while maintaining the fairness of the system. As a result, there seems a lot of merit of continuing to tax regular employees and the self-employed under the same SSC regime in Slovenia. Moreover, modern auditing techniques and administrative and IT tools might help to increase tax compliance among the self-employed.

The SSC regimes for the self-employed and regular employees in Slovenia are relatively similar in particular in terms of rates. The main differences between the regimes are: i) the self-employed can reduce their SSC base by 25%, which does not apply to regular employees; ii) the self-employed can benefit from a special flat-rate regime (see below); and iii) the self-employed need to pay SSCs within a minimum and maximum income bound. Differences in benefit entitlements also exist.

The SSC regime for regular employees and the self-employed in Slovenia could converge gradually over time. The two SSC regimes are already aligned in terms of rates, and are converging in terms of minimum SSCs threshold by 2021. Further aligning the two SSC regimes would mean implementing a SSC cap for regular employees at 3.5 times the average wage or abolishing the SSC ceiling for the self-employed. The latter would then require abolishing the maximum pension ceiling for the self-employed (or increasing the maximum pension) in order to maintain the link between SSC paid and benefit entitlements. Moreover, such a convergence of the two regimes would not only have implications for SSCs that are paid but also for the benefits that are received. Benefits would have to be determined following the same rules for both types of workers, which currently is not the case. Box 3.2 presents an estimate of the impact of the introduction of such a cap for employees.

The minimum SSC base for workers ensures that self-employed workers pay a minimum amount of SSCs and, hence, are entitled to a minimum amount of benefits. On average, self-employed workers earn very low income in Slovenia. Close to 70% of the self-employed pay SSCs on the minimum income base at 60% of the AW (Ministry of Finance of Slovenia).

However, a minimum SSC base which is set at a high income level may create cash flow problems and prevent workers from becoming self-employed. Slovenia has therefore installed a special regime that provides for a reduction in SSCs for the first two years after creating a new self-employed business. Nevertheless, Slovenia should consider abolishing the minimum SSC base or reducing it to an income level which corresponds more closely to the minimum wage.

Box 3.2. Estimates of a SSC cap at 3.5 times the average wage for employees

This box estimates the employee and employee SSC revenue loss associated with introducing a SSC ceiling for employees at 350% of the average wage. Using the average wage in 2016 of EUR 19 016, this gives a ceiling of EUR 66 556.

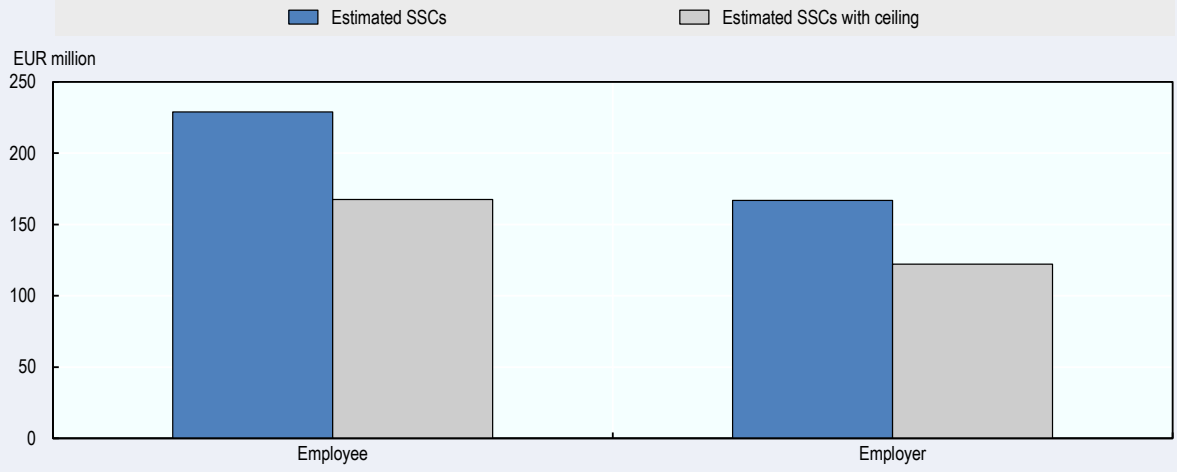
First, employer and employee SSCs are estimated as 22.1% and 16.1% of employment income for each employee in the tax record microdata.

Second, employer and employee SSCs are re-estimated but with a ceiling introduced where SSC payments are capped at 22.1% and 16.1% of EUR 66 556 for employees and employers respectively. In other words, all employees earning above this threshold pay employee SSCs of exactly EUR 14 709 and all employers pay exactly EUR 10 716.

The estimated SSC loss is given by the difference in SSC payments between the two sets of estimates. According to the analysis, the SCC loss associated with introducing a cap at 350% of the average wage for employee is EUR 61 million for employee SSC, and EUR 45 million for employer SSCs, so EUR 106 million in total (Figure 3.9).

Figure 3.9. Introducing an employee and employer SSC cap at 350% of the average wage could reduce SSCs significantly

Total employee and employer SSCs above the 350% of AW ceiling, in EUR million



Note: Only employees are included. The analysis assumes no behavioural change and linearity. Methodological information on the microdata is available in the annex.
Source: Authors' calculations based on Ministry of Finance of Slovenia tax records microdata.

3.5. Align the SSC treatment across different type of employment contracts

3.5.1. Align SSCs across different types of workers

SSCs rates vary significantly across different types of employment contracts in Slovenia. Full-time permanent employees, farmers, short-term work, students, and other types of work pay different SSCs (some examples are illustrated in Table 3.7 and Table 3.8) (European Commission, 2017[9]). While certain differences in tax treatment might be justified, there is significant scope to unify the SSCs across different types of labour contracts in Slovenia.

Different SSCs regimes reduce the tax base which in turn negatively affects the financing of the health and pension funds. While full convergence might not be desirable (e.g. for pensioners, unemployed, etc.), moving toward a unification of treatments for SSCs (both bases and rates) across different types of labour contracts should be envisaged. This would not only improve transparency and prevent tax-induced distortions across forms of work but would also strengthen the financing of the social welfare system.

Table 3.7. SSCs rates vary significantly depending on the type of employment contract

		Full-time permanent employee*	Person performing an activity as an accessory profession	Farmer***	Service contracts and other contracts of civil law**	Temporary and casual work of pensioner	Short-time work	Personal supple-mentary work
Base	Wage or wage compensation	Specific cases of insurance	Basis for inclusion in compulsory insurance		Payment			
Pension & disability	Employee	15.5		15.5				Voucher system
	Employer	8.85				8.85		
	Specific cases of insurance		33.01 EUR/month		8.85			
Health	Employee	6.36	25.78 EUR/month	6.36	6.36	6.36		
	Employer	6.56						
	Injury at work	0.53	8.59 EUR/month	0.53	0.53	EUR 4.86	EUR 4.86	
Unemployment insurance	Employee	0.14						
	Employer	0.06						
Maternity leave	Employee	0.10		0.10				
	Employer	0.10		0.10				

Note: *Are taxed at similar SSCs rates: part-time permanent employment contract, full-time permanent employee (posted worker or posted civil servant), self-employed. **The same rules apply for contracts for copyrighted work and other contracts of civil law. ***For farmers who attain the 'income census' (60% of the average monthly salary), pension and disability insurance is mandatory. They pay the employee SSC for pensions and disability (15.5%) and the employer SSC for pension and disability are paid from the state budget (8.85%). The SSC for health is paid also by the employee (rate 6.36%) and the Health Insurance Institute of Slovenia (HIIS) pays the employer SSC (6.56%). However they are not insured against unemployment. Their insurance base is similar to the base for self-employed workers. Farmers below the income census might opt for voluntary pension and disability insurance. In this case, the contribution base is 60% of the AW (54% of the AW in 2015; 56% of AW in 2016; 58% of the AW in 2017).
Source: Ministry of Finance of Slovenia.

Table 3.8. SSC bases vary for health insurance

	Contribution base	Minimum
Regular employee	Gross wage	yes
Self-employed	Profit in the last year	yes
Farmers	Profit in the last year	yes
Farmers below the income census (i.e. income of at least 60% of the AW)	60% of AW	
Farmers with no pension insurance*	Cadastral income	
Self-payers; daily workers through vouchers	Defined in absolute terms	

Note: *For farmers who are not included in the pension and disability insurance are obliged to be insured in the health insurance if the income per member of a farm household is at least 25% of the minimum wage. The contribution base is then cadastral income and the SSC rate is 18.78%.
Source: European Commission (2017[9]); Ministry of Finance of Slovenia.

3.5.2. Maintain or slightly increase the health SSC rate on pension income

In Slovenia, the pension fund pays health SSCs for pensioners at a rate of 5.96% which is slightly lower than the rate of 6.36% which employees pay. The health SSCs do not reduce the pension which the pensioner receives, so in fact it is a cost paid and borne by the pension fund. The general rationale for imposing SSCs on earned income but not on pension income is that contributions buy an entitlement to future benefits and that pensioners do not have to pay the same level of SSCs as they "saved" in part for their benefit entitlements when they were still active in the labour market (even though in practice, Slovenia operates a pay-as-you-go pension system); levying pension and disability SSCs on the actual pension which pensioners receive would imply double taxation.

The arguments against levying health SSCs on pensions are weak. In contrast to pension SSCs which entitle workers to a pension in the future, health SSCs entitle workers to health insurance in the year when the contributions are made. Pensioners could therefore be asked to contribute for their health insurance even though they are no longer working but receive a pension instead. Indeed, the policy rationale against health SSCs for pensioners indicates that health SSCs which are paid when taxpayers were active in the labour market not only paid for health insurance in that particular period but consists also of a component which builds up health insurance entitlements for when retired. Such an approach would result in very high health SSCs levied on labour income; it seems also unfair as taxpayers who live longer would benefit more. As a result, Slovenia should maintain its current regime of health SSCs levied on pensions and, in fact, could consider further strengthening it.

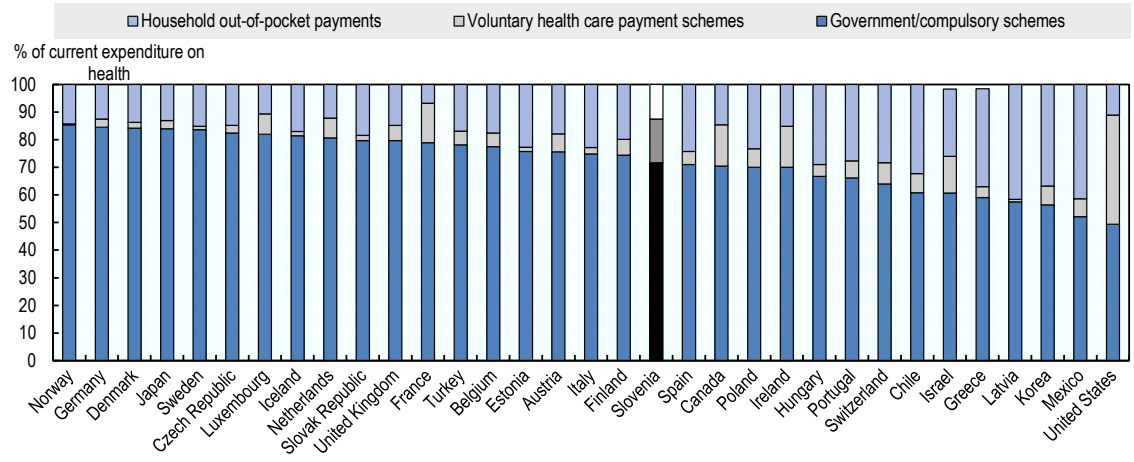
Health SSCs paid by the pension fund could be increased in order to match more closely the health care spending on pensioners. Such a measure would shift the financial burden of health care spending from the Health Insurance Institute of Slovenia (HIIS) to the pension fund and would help strengthening the financing of the health fund. Arguments exist to levy health SSCs on pensions directly; i.e. health SSCs would not only be a cost for the pension fund, as currently is the case in Slovenia, but would actually reduce the pension received. However, this would lower the pensions received, which are already low for most pensioners. The impact of health SSCs on low income pensioners might have to be compensated through, for instance, PIT relief.

3.6. Increase the financial resources for health care

3.6.1. The Health Insurance Institute of Slovenia carries out a wide range of tasks

The health system in Slovenia operates through the HIIS. It is complemented by three private insurance companies, which provide voluntary insurance to cover the co-payments. Plans exist to integrate these insurances in the HIIS. In 2015, 72% of the health financing came from public funding (Figure 3.10). This is lower than in many OECD countries and below the European Union (EU) average (79%). Complementary health insurance is rising. About 87% of the population has now a voluntary health insurance (OECD and European Commission, 2017[11]), which is among the highest in OECD countries, while out-of-pocket health expenditure by households remains relatively low.

Figure 3.10. The share of public health financing is relatively low in Slovenia



Source: OECD Health database.

The HIIS provides universal health coverage and has a wide range of tasks: health services (primary health care, dentistry, specialist out-patient services, hospital and tertiary level services, pharmaceuticals etc.); health resort treatment, rehabilitation treatment, transport by ambulance and other vehicles, medicaments, medical devices; sick pay during temporary absence from work exceeding 30 days; the reimbursement of travel expenses tied to obtaining health services.

Sick leave benefits amount to 11% of the HIIS expenditures in 2017 (European Commission, 2016[12]). Slovenia is one of the two countries (with Bulgaria) where sickness benefits can be provided for an unlimited duration. In other EU countries, the maximum legal duration of sickness benefits for work absence ranges from 22 weeks to three years.

Since 2008 the HIIS has performed activities going beyond the pure provision of health care. The HIIS was also in charge of paying for certain non-service delivery items such as health professional training and specialization, medical research, and postgraduate education. These activities have been recently transferred to the State budget.

Nevertheless, additional opportunities for the HIIS to focus on its core activities exist. For example, there is room to rationalise the hospital network to raise efficiency. Indeed, Slovenia has still many small regional hospitals, and the bed occupancy rates are below the

EU average, suggesting overcapacities. Opportunities also exist to improve the implementation of core activities, such as improving care coordination, substituting day cases for inpatient care, and reducing the reliance on (expensive) specialists (OECD and European Commission, 2017[11]). An independent health technology assessment would help a better allocation of resources and improve the recently implemented public procurement system. Other sources for improved efficiency include improving the relationships between supervisory institutions, or reinforcing clarity among their responsibilities (OECD and European Commission, 2017[11]). An in-depth analysis of these issues goes, however, beyond the scope of this report.

3.6.2. The health system in Slovenia is financed primarily through SSCs

The HIIS is largely funded through SSCs and not through general taxation. Health systems can be financed through SSCs, general taxation or a combination of both sources of financing. Different approaches bring both advantages and disadvantages; see Table 3.9 for a discussion. Nearly all other health systems in Europe raise significant funding from general taxation (World Health Organisation, 2016[13]).

Table 3.9. Different ways of financing health systems presents strengths and weaknesses

	Pros	Cons
General taxation	Pool risks for whole population Potential for administrative efficiency and cost control Redistributes between high and low risk and high- and low- income groups in the covered population	Risk of unstable funding and often underfunding due to competing public expenditure Inefficient due to lack of incentives and effective public supervision
Health SSCs	Generate stable revenues Often strong support from population Provides access to a broad package of services Involvement of social partners Redistributes between high and low risk and high- and low- income groups in the covered population	Poor are excluded unless subsidized Payroll contributions can reduce competitiveness and lead to higher unemployment Complex to manage governance and accountability can be problematic Can lead to cost escalation unless effective contracting mechanisms are in place

Source: ILO.

3.6.3. The Health Insurance Institute needs more financial resources

Despite the high health SSCs, the HIIS faces challenges to finance its tasks. The HIIS is not allowed to engage in deficit spending. Therefore it must either reduce prices, shift costs onto the complementary health insurances, or delay payments to health providers (World Health Organisation, 2016[13]). This has resulted in losses for some public hospitals. Reforms have been implemented to raise more revenues for the HIIS and reduce expenses, including higher contributions paid by the self-employed, restrictions to the entitlements to free services, increased co-insurance rates, reduced prices of drugs and health services, etc. (World Health Organisation, 2016[13]). However, the funding challenges remain and will only increase as a result of the ageing of the population.

Several options exist to provide the HIIS with more (diversified) financial resources. Those options are described below. However an overall independent assessment of the efficiency and functioning of the HIIS seems warranted and would need to be conducted prior to any reform aimed at raising more revenues. This would help identifying the HIIS funding gaps, it would increase accountability of both the government and the HIIS (evaluation of public spending, better management of public funds, etc.) and it would contribute to improved quality of the services delivered.

First, the HIIS could perform a more limited number of core tasks. Several options exist. The entitlements to sick leave benefits financed by the HIIS could be restricted over time. Instead of being on sick leave for very long periods of time, people would receive a disability benefit or a pension instead. While this will not necessarily reduce overall government expenditure, it will involve a shift in how these benefit entitlements are financed, away from the HIIS which is funded through SSCs towards general taxation. As long-term care insurance in Slovenia is covered by the HIIS, another option would be to assign all long-term care responsibilities to a newly created "long-term care" fund. This new fund could then be financed through general taxation.

Second, the employee health SSC base could be broadened by limiting the differences in contribution rates and bases and by treating different types of incomes for SSC purposes more alike. These issues have been discussed before. Such a reform would have to take the possible differences in benefit entitlements into account.

Third, the health employee SSC rate could be maintained. Given the overall cut in employee SSCs which this report calls for, this would then imply that pension employee SSCs would be cut considerably and that pensions would be financed increasingly through general taxation. The level of health contributions could be re-evaluated once the independent review of the Health fund has been undertaken.

Fourth, the health SSCs paid by pensioners could increase. This option was discussed in more detail in section 3.5.2.

Most importantly, an increase in the number of people who are at work and an increase in the effective retirement age would significantly increase the financial resources for the HIIS. Increasing labour market participation is crucial for government to finance its health care system over the decades to come.

If these measures are insufficient to finance the HIIS, government could introduce other measures. These could include partly financing the HIIS with revenues from general taxation. General taxation could possibly finance the well-defined non-core activities performed by the HIIS such as sick leave benefits. Such a shift must be limited to safeguard the country's financial stability. Moreover, a shift towards general taxation would require a strong health budgeting framework and an independent assessment of the efficiency and functioning of the HIIS. Such an assessment would include an objective analysis of the gap in revenues for the HIIS in light of its spending needs over the next decade(s).

Excise duties on alcohol and cigarettes can also contribute to the financing of the HIIS. However, strong arguments exist against the earmarking of tax revenues to finance the HIIS and this route should not be taken by Slovenia. Excise duties generally levy relatively small revenues and, when the rates are set too high, can lead to cross-border shopping. In that context, a further increase in excise duties should be introduced gradually and rates should not be set too high (see Chapter 5). Even if revenues from alcohol and tobacco taxation could contribute to the financing of the HIIS, these excise duties should continue to be paid to the general state budget and not be earmarked to finance the HIIS.

The different options for reforms can be complementary and introduced gradually. The employee SSC base broadening and the employee health SSC rate increase would be the priorities, followed by the financing of non-core activities through general taxation. In a second stage, if the recent transfer of tasks from the HIIS to the Ministries of Health and Education, combined with the compensation of the HIIS from general taxation for specific tasks, do not raise sufficient revenues, alternative source(s) of financing could be considered.

3.7. Main recommendations

Box 3.3. Recommendations to strengthen the social security system

Objective: Reduce employee SSCs

- Reduce the employee SSC rate across all income levels significantly
- Evaluate how the role of the PIT could be strengthened to ensure that the benefits of the employee SSC reduction are shared more equally and have the largest bang for the buck in terms of increased labour market participation
- Abolish the contributions for maternity leave and unemployment, and continue to finance the corresponding benefits from general tax revenue
- Reduce pension employee SSCs and, possibly, increase employee health SSCs (but such that the overall employee SSCs decrease)
- Maintain employer SSCs at their current rate

Objective: Lower the minimum SSC income base

- Lower the minimum SSC base to prevent excessively high effective employer SSCs being levied in respect of low income workers

Objective: Align the SSCs for regular employees and the self-employed

- Reduce the self-employed SSCs across all income levels (i.e. similar to the cut in employee SSCs)
- Align the employee and self-employed SSC regimes as much as possible
  - Maintain similar SSC rates (i.e. sum of employee and employer SSC rates for employees equal to self-employed SSC rates)
  - Abolish the minimum SSC base for the self-employed, or if not possible in the short run, lower it to a level that corresponds more closely to the minimum wage
  - Evaluate the SSC ceiling at 350% of the average wage. Possibly abolish it and increase the maximum pension for self-employed
- Instead of exempting 25% of the profits earned by the self-employed from tax, evaluate whether a more explicit distinction can be made between the return for labour and capital invested in the self-employed business, and tax the different earning streams separately

Objective: Broaden the SSC base

- Streamline the different SSC treatments across different types of labour contracts (in particular for health SSCs)
- Increase labour market participation of young and older workers in particular as a strategy to strengthen the financing of the welfare system
- Maintain, or slightly increase, the health insurance SSC paid by the pension fund. Possibly levy a health SSC rate paid by pensioners but offset the impact on low pensions through PIT relief

Objective: Evaluate the link between SSCs paid and benefits received

- Increase the link between SSCs paid and benefits received without imposing an excessively high tax burden on labour income

Objective: Increase and diversify the financial resources dedicated to health care

- Conduct an overall independent assessment of the efficiency and functioning of the Health Insurance Institute of Slovenia (HIIS)
- Allow the HIIS to focus on its core tasks
  - Limit the entitlement to sick leave benefits financed by the HIIS over time
  - Possibly transfer the responsibilities of long-term care to a newly created fund
- Over time, and if necessary, increase the share of general taxation in health financing, including the revenues from excise duties on alcohol and tobacco.
- Prevent earmarking of tax revenues to finance the HIIS

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Chapter 4. Strengthening the design of the personal income tax

Scope exists to strengthen the role of the PIT. Any cut in employee SSCs needs to go hand in hand with re-designing the PIT rate schedule to maximise labour market participation, to share the gains of the employee SSC reduction fairly across the income distribution and to help finance the reform. The PIT increases the tax burden on labour income, particularly for higher income earners. The top PIT rate is high and reducing it would come at a relatively low cost. The tax base is relatively narrow as a result of exemptions and special tax provisions. Tax provisions take the form of tax allowances, which is in contrast to best practice in the OECD, where tax credits are more widely used as they provide the same benefit to all taxpayers irrespective of their income and marginal tax rates. Broadening the tax base could be achieved by abolishing the tax exemption for the reimbursement of home-work travel expenses and meals during work and by taxing annual and performance bonuses as regular taxable income. Families with children are taxed significantly less than single taxpayers as they can benefit from both child tax allowances and child cash benefits. High tax burdens on labour income reduce the incentives for entrepreneurship. In response, Slovenia has introduced an alternative "flat-rate" regime which is overly generous and prevents businesses from growing.

4.1. Redesign the personal income tax rate schedule

The personal income tax (PIT) rate schedule is progressive. It is composed of five tax brackets similarly to the OECD average in 2016, with a top statutory PIT rate of 50% (Table 4.1). Certain types of income are taxed at a flat rate and are discussed in section 6.2.1. As described in Box 1.2, before the 2016 PIT reform, Slovenia had four tax brackets. The reform has introduced as of January 2017 an additional tax bracket (34%) and has lowered the second highest tax rate (from 41% to 39%).

Table 4.1. Tax schedule in 2018

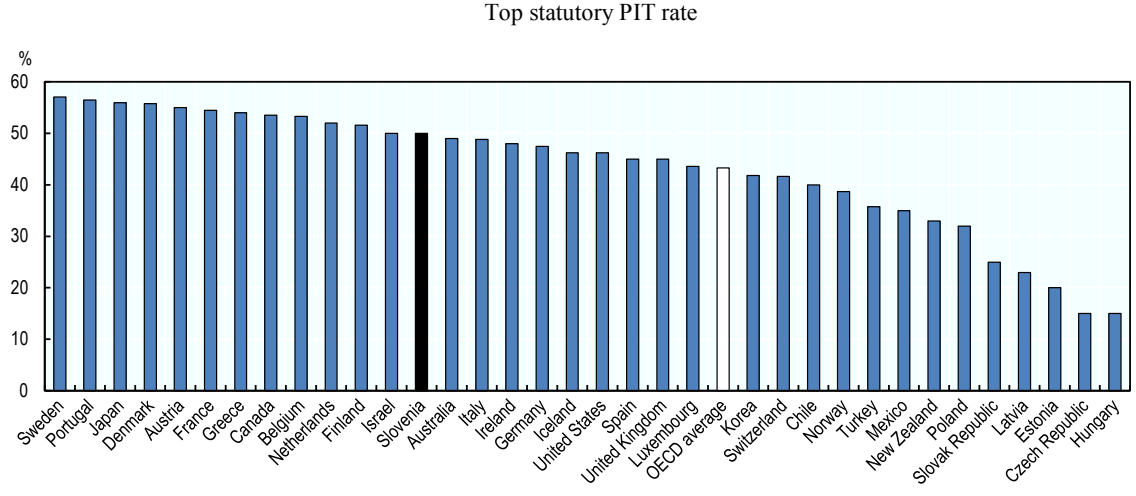
Taxable income (EUR)		Tax on lower amount (EUR)	Rate on excess (%)
Up to	8 021.34	0	16
8 021.34	20 400	1 283.41	27
20 400	48 000	4 625.65	34
48 000	70 907.20	14 009.65	39
Over	70 907.20	22 943.46	50

Source: Ministry of Finance (2018[1]).

4.1.1. The top PIT rate is high

The top statutory PIT rate in Slovenia is 50%, which is among the highest top PIT rates in the OECD (Figure 4.1). The top PIT rate in Slovenia has to be paid on gross earnings above 5 times the average wage (AW), which is a relatively high income level. The top PIT rate kicks in at lower income levels in the Slovak Republic (at 3.5 times the AW), Italy (2.7 times the AW), and the Czech Republic (0.3 times the AW). However, the top PIT rate kicks in at higher income levels in Austria, Germany and France, for instance.

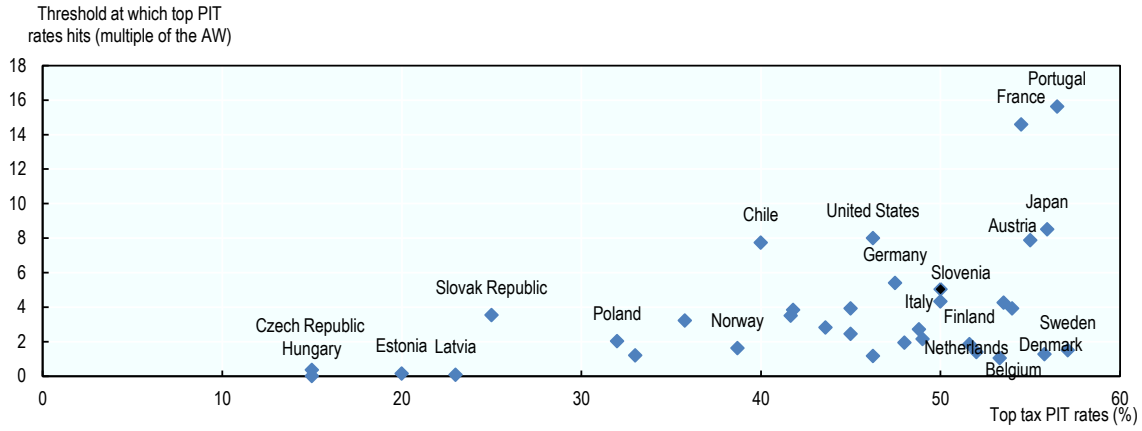
Figure 4.1. The top statutory PIT rate in Slovenia is among the highest in the OECD



Source: OECD Tax database.

A comparison of top PIT rates and top income tax brackets (i.e. the income level where the top PIT rate hits first) point at major differences across the OECD (Figure 4.2). Many East European countries have a low top PIT rate which hits at low income levels while Nordic countries have a high top PIT rate which has to be paid at low income levels. France and Portugal (and to a lesser extent Austria) have both a high PIT rate and a high top income tax bracket. In this sense, Slovenia is more similar to Italy and Austria than it is to other South East Europe (SEE) countries.

Figure 4.2. The top PIT rate in Slovenia is levied on high incomes only



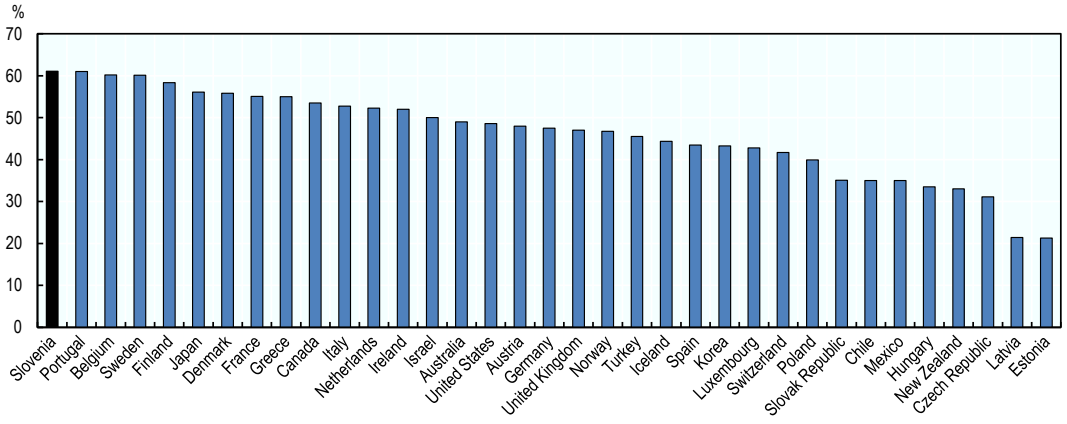
Source: OECD Tax database.

The combination of a high top PIT rate and high employee social security contributions (SSCs) results in high marginal effective tax rates for high income earners. The top "all-in" marginal tax rate, which takes the top PIT rate and employee SSCs into account, in Slovenia is 61.1% which is the highest rate in the OECD (Figure 4.3). On each additional euro earned, a taxpayer in the top PIT income tax bracket pays 61 cents in tax and keeps 39 cents in net pay only. This could induce taxpayers to work less or engage in tax avoidance behaviour. High effective top PIT rates may also make it difficult for firms to attract highly skilled foreign workers and retain Slovenian workers who may prefer to work abroad where working pays more.

The top PIT rate results in very high personal average and marginal tax rates for high-income taxpayers. Figure 4.4 presents net personal average and marginal tax rates at different income levels. The analysis shows strong increases in effective tax rates starting from the income level where the top PIT rate hits first. The net personal marginal tax rate increases with 8.5 percentage points from 52.5% to 61% at the top income tax bracket.

Figure 4.3. The top marginal tax rate which employees have to pay is very high

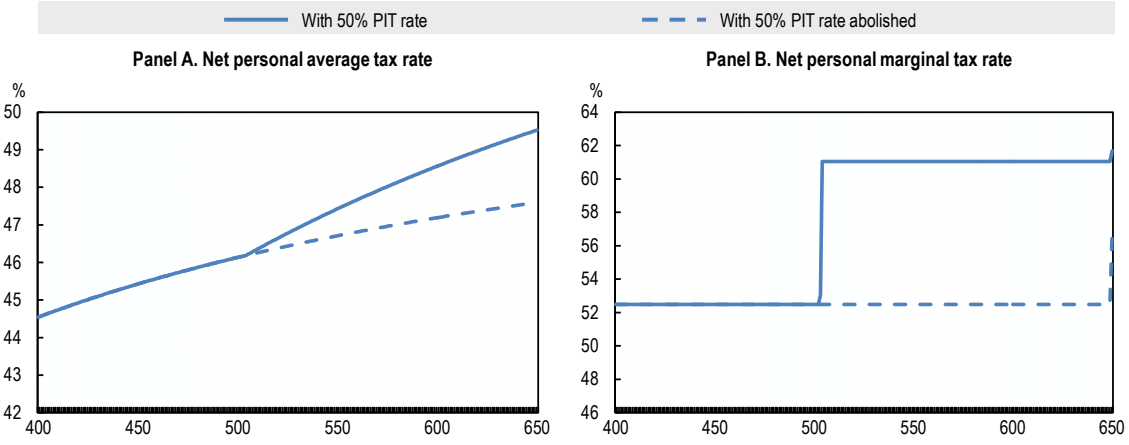
Top marginal "all-in" tax rate, taking into account PIT and employee SSCs, 2017



Note: The top "all-in" tax rate is calculated as the additional personal income tax, plus employee social security contribution, resulting from a unit increase in gross wage earnings at the earnings threshold where the top statutory personal income tax rate first applies. It takes account of the effects of tax allowances, tax credits, etc.
Source: OECD Tax database.

Figure 4.4. Abolishing the current top PIT rate would significantly reduce personal average and marginal tax rates

As a % of the AW



Note: The net personal average tax rate is defined as the sum of PIT and employee SSCs, minus cash benefits as a percentage of gross wage earnings. The net personal marginal tax rate shows the part of an increase of gross wage earnings that is paid in PIT and employee SSCs net of cash benefits.
Source: OECD (2017[2]).

The current revenues raised from the top PIT rate are relatively minor. In 2016, the top PIT rate was paid by only 3 581 taxpayers (Ministry of Finance of Slovenia tax record microdata). This reflects the condensed wage distribution in Slovenia, and possibly also the fact that taxpayers have organised their economic activities such that they can avoid paying the top PIT rate (e.g. through incorporation). The tax revenue cost of lowering the top PIT rate would be relatively modest, as presented in Box 4.1, while it would reduce

significantly the tax burden on labour income and, therefore, strengthen the functioning of the labour market.

A significant cut in the top PIT rate in Slovenia would be necessary in order to align the country's top "all-in" marginal tax rate with the "all-in" rates in neighbouring countries. Slovenia's "all-in" marginal tax rate is the highest in the OECD (Figure 4.3) at 61.1%. For a given level of employee SSCs (either the current 22.1% rate or a reduced rate), Table 4.2 presents the top PIT rate which Slovenia would need to levy in order to reach a top "all-in" marginal tax rate equal to the rate levied in the country of comparison. In all the scenarios which are presented, Slovenia would have to lower its top PIT rate significantly. For example, with a 5 percentage points cut in employee SSCs to 17.1%, Slovenia's top PIT rate would need to be reduced to 43.1% in order to levy the top marginal "all-in" tax rate of 52.8% in Italy. For smaller cuts in employee SSCs, Slovenia's top PIT rate would have to be reduced even more. However, the comparison of top PIT rates should also take into account the income level where it kicks in; that complexity is not taken into account in Table 4.2.

Table 4.2. Slovenia's top PIT rate should decrease significantly in order to align the country's top "all-in" marginal tax rate with the rates in neighbouring countries

Top PIT rate in Slovenia for different levels of employee SSCs

	Employee SSC (%)*	Top statutory PIT rate (%)	Top marginal all-in tax rate (%)	New top PIT rate in Slovenia with a cut in employee SSC of…					
				5 pp to 17.1%	4 pp to 18.1%	3 pp to 19.1%	2 pp to 20.1%	1 pp to 21.1%	0 pp to 22.1%
Italy	9.49	47.2	52.8	43.1%	42.4%	41.7%	40.9%	40.2%	39.4%
Germany	20.78	47.5	47.5	36.7%	35.9%	35.1%	34.3%	33.5%	32.6%
Austria	17.98	48	48	37.3%	36.5%	35.7%	34.9%	34.1%	33.2%
Poland	17.83	32	39.9	27.5%	26.6%	25.7%	24.8%	23.8%	22.8%
Slovak Republic	13.40	25	35.1	21.7%	20.8%	19.8%	18.8%	17.7%	16.7%
Czech Republic	11	15	31.3	17.1%	16.1%	15.1%	14.0%	12.9%	11.8%
Hungary	18.50	15	33.5	19.8%	18.8%	17.8%	16.8%	15.7%	14.6%

Note: * Average employee SSC for a single person at the AW without children.
Source: OECD Tax database; OECD (2017[2]).

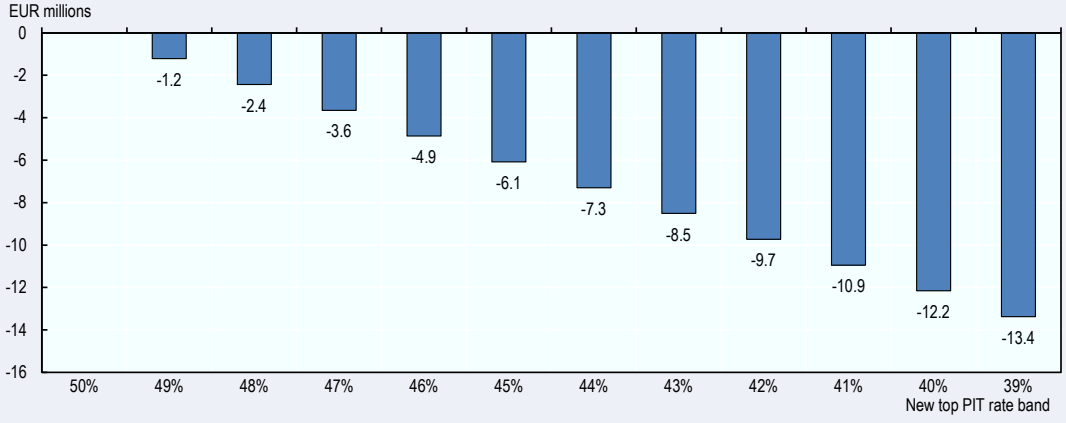
Box 4.1. Estimation of the loss in revenues with a reduced top PIT rate

In 2016, there are approximately 3 000 employees with taxable income above EUR 70 907.20, the threshold for the top 50% PIT rate. This cohort has EUR 122 million of taxable income above the threshold which is subject to the top rate. Therefore, assuming no behavioural change and linearity, a reduction in the top PIT rate to 45% is associated with a PIT loss of about EUR 6 million (Figure 4.5). The abolition of the top rate, modelled by reducing the rate to the second from top 39% rate, is associated with a loss of EUR 13 million or 0.03% of GDP.

Although such estimates are uncertain, they can indicate the likely extent of the tax loss – in this case, the PIT loss associated with abolishing the top PIT rate is likely to be very small relative to total PIT collected. At the same time, this loss could be compensated for by creating actual and perceived incentives for a range of potentially positive behavioural responses, which could improve economic efficiency. For example, these high income employees may respond by working more or decreasing the extent to which they avoid taxes. Furthermore, it may reduce emigration of high skilled employees and provide a signal to foreign companies to relocate their activities to Slovenia.

Figure 4.5. The PIT loss associated with abolishing the top PIT rate is likely to be very small relative to total PIT collected

Estimated PIT revenue loss from various reductions of top 50% rate



Note: The analysis assumes no behavioural change arising from the PIT rate reduction and linearity. Methodological information on the microdata is available in the annex.
Source: Authors' calculations based on Ministry of Finance of Slovenia tax records microdata.

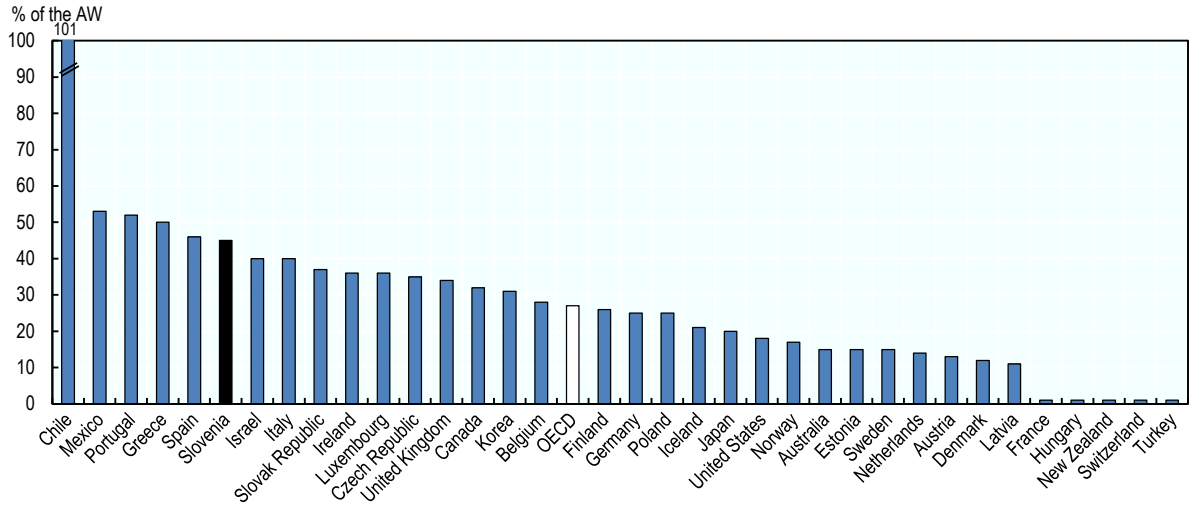
4.1.2. The bottom PIT rate hits at a relatively high income level

Single taxpayers start paying income tax at 45% of the AW. This is above the OECD average and the selected East European countries (Figure 4.6). The income level where taxpayers effectively start paying PIT depends on the level of tax allowances and/or the width of the zero rate bracket (if present) in the PIT rate schedule. As families with children and married couples may benefit from additional tax allowances or cash benefits, those families will have to start paying PIT at income levels typically higher than single taxpayers.

Employee SSCs increase the income level where taxpayers effectively start paying PIT. In almost all OECD countries, employee SSCs are deductible from taxable personal income. The higher the employee SSCs, the higher the income level where the PIT hits first. A reduction in employee SSCs in Slovenia would also imply that households would have to start paying PIT at lower income levels.

Figure 4.6. The bottom PIT rate hits at a relatively high income level

Income level where the bottom PIT rate hits first



Source: OECD (2017[2]).

4.1.3. The PIT increases the labour tax burden significantly

Single employees without children face high tax burdens on their labour income. The combination of high employee SSCs and PIT rates result in high net personal income tax rates across the income distribution (Figure 4.7). Average tax wedges, which include also the impact of employer SSCs, are even higher. At low income levels, the steep increases in the net personal average tax rate were driven by the specific design of the general tax allowance before its most recent reform. In addition to the general tax allowance of EUR 3 302.70, an additional general allowance of EUR 3 217.12 was available to lower income taxpayers (with taxable income below EUR 10 866.37); taxpayers with taxable income between EUR 10 866.37 and EUR 12 570.89 could benefit from an additional tax allowance of EUR 1 115.94. Once the taxpayer earned income above the particular income thresholds, the tax allowances were lost, which resulted in very high marginal effective tax rates.

The basic allowance system was reformed in 2018 (see Table 4.8). The reform will reduce the two peaks observed in the net personal marginal tax rate, as the allowances will be gradually reduced when income rises. However, the tapering out will result in somewhat higher marginal tax rates over the income range where the additional tax allowances are tapered out compared to the results presented in Figure 4.8. Slovenia should evaluate the impact of the new basic allowance on work incentives and should evaluate whether the additional basic allowance, instead of tapering it out with income, could be integrated within the standard basic allowance of EUR 3 302.70. In order to prevent that higher

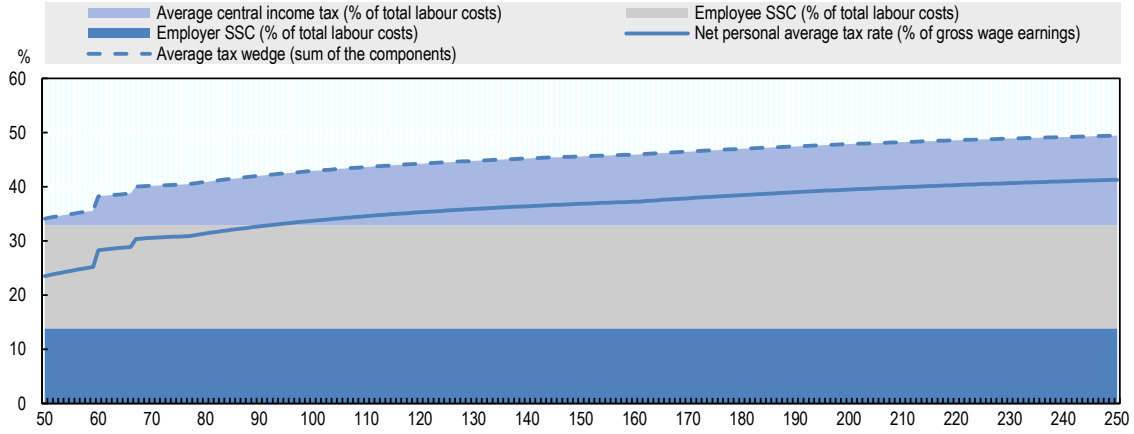
incomes would gain, the first rate bracket of 16% could be increased. Moreover, the basic tax allowance could be turned into a basic tax credit to further limit the regressive effects.

Both low and high income taxpayers face high tax burdens. The net personal average tax rate for taxpayers earning 250% of the average wage amounts to 41% of gross wage earnings, which is significantly above the tax burden on average in the OECD (at 34%). These results are driven by the high employee SSCs and the progressive PIT rate schedule (as pointed out in Chapter 2). High employee SSCs result in high tax burdens on low incomes. For instance, lower-income taxpayers earning 50% of the AW pay 23% of their gross wage earnings in tax, which is above the average rate of 17% on average in the OECD.

Analysis of tax return data confirm the high average tax burdens paid by employees (Box 4.2). In contrast, the effective average tax rates paid by full pensioners (i.e. pensioners who, besides a pension, do not have another source of wage or business income) or the self-employed are significantly lower.

Figure 4.7. The relatively high PIT rates increase the labour tax burden significantly

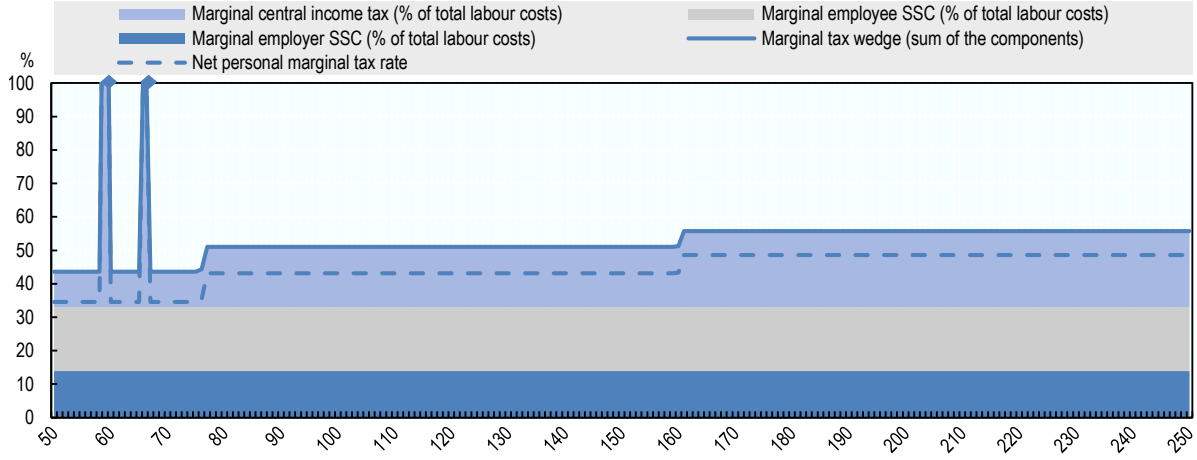
Average tax wedge decomposition by level of gross earnings expressed as a % of the AW, single taxpayer without children



Source: OECD (2018[3]).

Figure 4.8. The new basic allowance system will reduce the peaks observed in the net personal marginal tax rate at low income levels

Marginal tax wedge decomposition by level of gross earnings expressed as a % of the AW, single taxpayer without children



Source: OECD (2018[3]).

Box 4.2. The labour tax burden in Slovenia is high

Figure 4.9 shows PIT and SSCs as a share of total labour costs by percentile in 2016 for employees (Panel A), full pensioners (Panel B) and self-employed (Panel C).

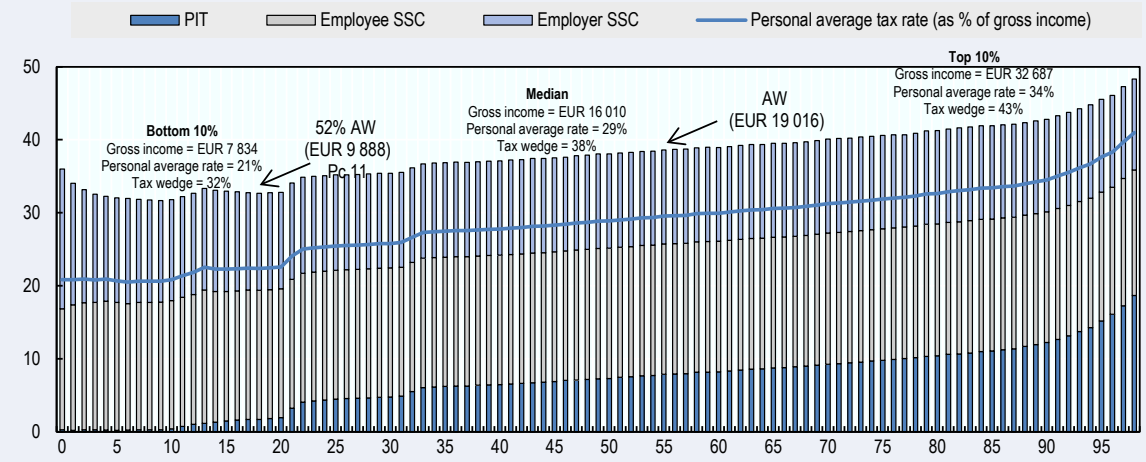
For employees, PIT as a percentage of labour costs is extremely low at the bottom of the distribution and increases slowly but progressively for higher incomes. For the first 10 percentiles, it is at or below 0.3% and for the first 30 percentiles it remains below 5.0%. It does not exceed 10% until the 78th percentile. In absolute terms, employee SSCs are always higher than the employer SSCs over the income distribution (except for the first percentile) and the difference increases progressively for higher income levels.

The average tax wedge increases slowly but progressively for higher levels of earnings - from a low of 32% to a high of 48%. For example, at the bottom 10th percentile, where average total labour costs are EUR 9 102 (average gross incomes are EUR 7 834) the average tax wedge is 32%. At the median, where average labour costs are EUR 18 392, the tax wedge is 38%. In the 90th percentile, the tax wedge is 43%.

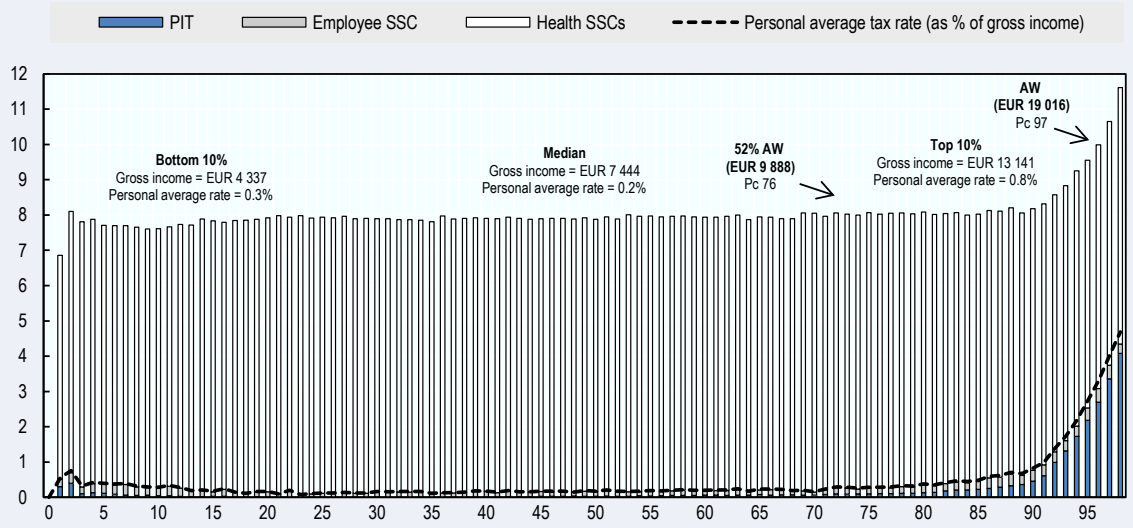
Figure 4.9. The labour tax burden is high in Slovenia

PIT and SSCs as % of total labour cost, personal average tax rate as % of gross income, 2016, by labour cost percentile

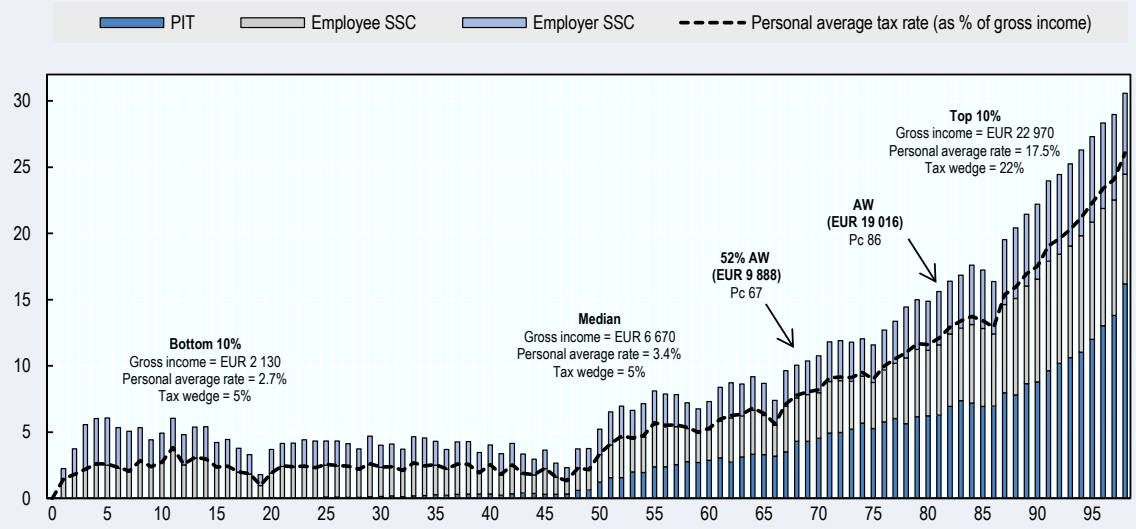
Panel A. Employees



Panel B. Pensioners



Panel C. Self-employed



Note: Gross incomes are averages within decile. Panel B: Health SSCs refer to payments made for medical care and sickness leave on behalf of pensioners by the employer Pension Fund to the Health Fund. Methodological information on the microdata is available in the annex.
Source: Authors' calculations based on Ministry of Finance of Slovenia tax records microdata.

4.1.4. Taxpayers are concentrated in the lower rate bands

Employees pay a large share of PIT. Most taxpayers are employees (53%) or pensioners (42%) and a small proportion are self-employed (5%) (Table 4.3). The proportion of income held by employees is 70% while the share of the PIT paid is 89%. For pensioners, the proportion of income held is 26% while the share of the PIT paid is 7%. For self-employed, both shares are 4%. This is reflected in the effective PIT rates for employees (12%), pensioners (2%) and self-employed (9%).

Pensioners and self-employed are concentrated in the first rate band. In 2016, 87% of pensioners and 84% of self-employed are in the 16% tax bracket. Their base for taxable income is narrowed by a combination of high employee SSCs and substantial allowances (and to a lesser degree by tax credits in the case of pensioners) resulting in very small effective PIT rates and associated PIT. Therefore, most of the very small amounts of overall PIT paid by pensioners and the self-employed are paid by the remaining narrow base of taxpayers. For example, half of all PIT (48%) paid by pensioners is paid by 1.4% of taxpayers (7 973 individuals) in the top two brackets. Similarly for the self-employed, 60% of all PIT paid by the self-employed is paid by 4.6% (3 146 individuals), again in the top two brackets.

Table 4.3. Taxpayers are concentrated in the lower rate bands

EUR million, 2016

	Number of taxpayers	Labour costs	Gross income	Allowances	Taxable income	PIT	Employee SSC	Employer SSC	Effective PIT rate (%)	Personal average tax rate (%)	Tax wedge (%)
Employees	**741 670**	**16 767**	**14 629**	**4 221**	**7 361**	**1 685**	**2 952**	**2 138**	**12%**	**32%**	**40%**
16%	372 162	4 856	4 221	2 442	1 149	184	855	635	4%	25%	34%
27%	296 684	7 591	6 620	1 382	3 741	749	1 357	971	11%	32%	41%
41%	69 803	3 779	3 308	377	2 131	613	656	471	19%	38%	46%
50%	3 021	541	480	20	339	139	85	60	29%	47%	52%
Pensioners	**583 530**	**5 919**	**5 452**	**3 557**	**1 872**	**134**	**135**	**467**	**2%**	**5%**	**12%**
16%	505 910	4 141	3 820	3 277	745	12	40	321	0%	1%	9%
27%	69 647	1 367	1 257	248	867	58	56	110	5%	9%	16%
41%	7 702	366	334	30	232	53	34	32	16%	26%	32%
50%	271	46	42	2	29	11	5	4	28%	41%	46%
Self-employed	**69 000**	**803**	**772**	**429**	**277**	**69**	**41**	**31**	**9%**	**14%**	**18%**
16%	57 944	438	424	346	52	8	17	13	2%	6%	9%
27%	7 910	192	181	48	100	20	15	11	11%	19%	24%
41%	2 884	137	131	27	94	28	8	6	21%	27%	31%
50%	262	37	36	8	32	13	1	1	37%	39%	40%

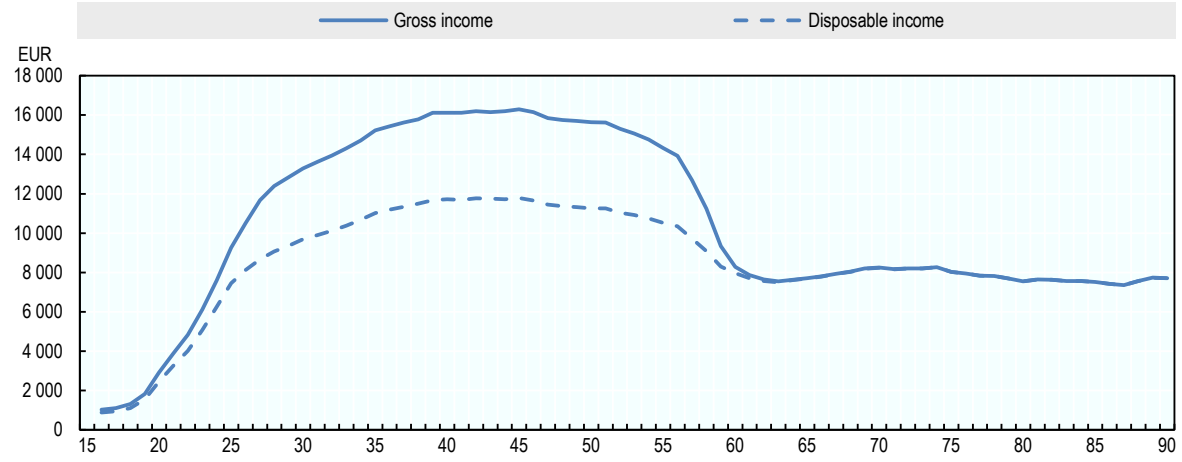
Note: The table presents only four tax brackets as the fifth tax bracket introduced in 2016 took effect as of 1 January 2017. The effective PIT rate is defined as the amount of PIT divided by gross income. Methodological information on the microdata is available in the annex.
Source: Authors' calculations based on Ministry of Finance of Slovenia tax records microdata.

The vast majority of employees are in the first two bands. 50% of employees are in the 16% rate band, and 40% in the 27% rate band. These first two bands account for 55% of the PIT, and 70% of the PIT and SSCs combined. The 3 021 employees (less than 1% of all employees) in the top band earn 3.3% of all income and pay 4% of total tax and SSCs (as a share of gross income).

Disposable income declines only modestly across age in Slovenia. Even though most taxpayers who are at work pay the bottom PIT rates only, the combination with high employee SSCs reduces their disposable income significantly. Pensioners, on the other hand, pay only small amounts of SSCs and their pension is on average so low that they pay hardly any PIT. The combination of these factors explains why disposable income remains relatively constant when workers move into retirement. Figure 4.10 shows median gross and disposable income in 2016 by age in Slovenia. There is a significant difference between gross and disposable incomes for the working-age population but the gap virtually disappears for those aged over 65. For example, while median gross incomes declined sharply (by 26%) between the ages of 58 and 60, disposable incomes declined only modestly (by 12%).

Figure 4.10. While gross incomes decline sharply as taxpayer's transition to old-age disposable incomes decline only moderately

Median gross and disposable income in 2016, by age



Note: Disposable income defined as gross income less employee SSCs less PIT as reported on the tax records. Methodological information on the microdata is available in the annex.
Source: Authors' calculations based on Ministry of Finance of Slovenia tax records microdata.

4.1.5. The effectiveness of the PIT is enhanced by an employee SSC rate cut

This section extends the previous employee SSC rate cut simulation (presented in Chapter 3, section 3.2) to include PIT rate increases. The previous employee SSC rate cut analysis showed that a 5.24 percentage points cut could result in a loss of EUR 519 million (cost of employee reduction of EUR 700 million net of a PIT recovery of EUR 181 million). Table 4.4 extends that analysis by showing the potential additional PIT revenues from increasing the PIT rate in brackets one to four given the employee SSC rate cut and not.

According to the analysis, the overall effectiveness of the PIT is enhanced by an employee SSC rate cut. Employees now have higher taxable income and some employees move up to higher PIT brackets. For example, a two percentage points increase in the PIT rate in the second, third and fourth brackets is estimated to produce EUR 61 million for no change in employee SSC, and EUR 71 million if employee SSCs were reduced to 16.86%. A simulation is also provided showing the impact of PIT rate increases given a significant base broadening - reducing tax allowances for all employees by 15%. The analysis shows that, given a broader tax base, smaller PIT rate increases that are necessary to offset other employee SSCs reductions.

Table 4.4. The effectiveness of the PIT is enhanced by an employee SSC rate cut

Cumulative PIT revenues from selected PIT rate increases, for reductions in employer SSC and allowances

	PIT rate bracket increases of:	1 pp	2 pp	3 pp	4 pp	5 pp	6 pp
Employee SSC rate of 22.1%	First	41	82	123	164	205	
	Second	22	45	67	90	112	
	Third	7	14	21	28	35	
	Fourth	1	2	4	5	6	7
	Total	**72**	**143**	**215**	**287**	**358**	
Employee SSC rate of 16.86%	First	43	85	128	170	213	
	Second	26	51	77	103	128	
	Third	8	17	25	34	42	
	Fourth	1	3	4	6	7	9
	Total	**78**	**156**	**234**	**313**	**391**	
Employee SSC rate of 22.1% and reduced allowances of 15%	First	43	87	130	174	217	
	Second	25	49	74	98	123	
	Third	8	15	23	30	38	
	Fourth	1	3	4	5	6	8
	Total	**77**	**154**	**231**	**308**	**384**	

Note: The analysis assumes no behavioural change and linearity from the employee SSC rate reductions. Total PIT and SSC in the microdata differ from figures reported by Ministry of Finance. Methodological information on the microdata is available in the annex.
Source: Authors' calculations based on Ministry of Finance of Slovenia tax records microdata.

4.2. Unify and broaden the PIT base

4.2.1. The design of the PIT base is complex and rules depend on the type of income earned

The PIT differentiates between six categories of income: employment income, personal business income, income from agriculture and forestry, rents and royalties, capital income (including rental income), and other income. In order to calculate the personal income tax liability, the tax base of each of the different sources of income are determined separately and afterwards aggregated. According to the microdata for 2016, gross income is about EUR 21.2 billion, of which EUR 19.7 billion or over 90% is employment income (Table 4.5). Salaries (64.1% of total income) and pensions (20.6%) constitute the largest share of total gross income. Personal business income, income from agriculture, rental income and capital income comprise 2.7%, 0.5%, 1.8% and 1.4% of total income respectively.

Table 4.5. Gross income comprises mainly salaries and pensions incomes

Based on 1.5 million taxpayers, 2016

	Income (EUR millions)	Income (% of total income)
Gross income	**21 268**	**100%**
Employment	19 740	92.8%
Salary	13 631	64.1%
Pension	4 377	20.6%
Other employment	1 733	8.1%
Business income	579	2.7%
Standard regime	415	1.9%
Flat-rate regime	164	0.8%
Agriculture	103	0.5%
Capital	677	3.2%
Other income	168	0.8%

Note: Methodological information on the microdata is available in the annex.
Source: Authors' calculations based on Ministry of Finance of Slovenia tax records microdata.

The employment income tax base is narrow

For a regular employee, the tax base is income from employment reduced by mandatory employee social security contributions. Employment income consists of: income from an employment relationship including holiday payments, income from other contractual relationships, and fringe benefits such as the use of a personal vehicle for private purposes, accommodation, a loan free of interest or with an interest rate lower than the market interest rate, etc.

However, special tax rules apply that narrow the tax base considerably. From January 2017 onwards, annual bonuses and performance bonuses are exempt from PIT, but not from SSCs, up to an amount equal to 70% (up to 100% from 2018 onwards) of the average salary in Slovenia. Some benefits in kind are also exempt from PIT, including subsidized meals during work, catering, mobile phones and computer equipment, and additional education and training expenses related to the business of the employer, etc. Other exempted benefits in kind include: specific health care doctor visits, vaccination and insurance for work accidents; use of parking places, mobile phones and computer equipment; Christmas gifts to the employees' children younger than 15 years (up to EUR 42); non-cash gifts to employees (up to EUR 15 per month). Other special tax rules include the deduction from the taxable income of premiums of voluntary pension and disability insurance up to 24% of the mandatory contributions for pension and disability insurance, with a maximum of EUR 2 390 per year.

In addition, the reimbursement of expenses incurred in relation to work-related travel is not taxed under the PIT (up to a certain amount). This includes transportation costs to and from work (cheapest public transport from the residency to the workplace, or the cost of the mileage EUR 0.18 per kilometre – see Table 4.6 for the average allowance by employee), expenses for meals (maximum EUR 6.12 for each day with more than 4 working hours – see Table 4.6), and expenses incurred on business travels (from 32 EUR to 64 EUR a day on average). Any amount received above the tax-free threshold is included in the tax base for employment income and subject to PIT and SSCs.

Table 4.6. The transport to work and meal allowances are tax exempt

Yearly average allowance by employee in EUR, 2017

	Private sector	Public sector	Total
Transport to work allowance	967	875	945
Meal allowance	970	661	893

Note: This table presents values that are tax exempt.
Source: Ministry of Finance of Slovenia.

A special tax treatment for student income exists. Students under 26 who earn income from temporary or occasional work can benefit from a special tax allowance. In 2017 (taking effect on 1 January 2018), the special personal tax allowance for student work was increased from 70% to 100% of the general allowance and amounts to EUR 3 302.7. Since February 2015, certain SSCs are paid on student work. These include employee and employer SSCs for pension and disability insurance (8.85% and 15.5%), employer SSC for health (6.36%) and employer SSCs for injury at work (0.53%).

Two different regimes exist for the taxation of personal business income

Personal business income can be taxed under the regular regime which allows for the deductibility of actual costs incurred or under the flat-rate regime. In the actual costs regime, tax losses can be carried forward indefinitely (subject to some limitations, such as non-performance businesses). In the flat-rate regime losses cannot be carried forward (or backward). The actual cost regime is the regular regime; taxpayers can choose to be taxed under the flat-rate regime if certain conditions are fulfilled.

- Under the actual costs regime, the base for taxation is the profit derived by deducting actual costs from actual revenues. In that regime taxpayers can use tax deductions and/or allowances, and must keep appropriate books and records. The net business income (profit) computed with the actual costs regime is subject to the progressive PIT rates schedule (Table 4.1). In 2016 the effective tax rate for taxpayers in this regime was 4.1% but 66% of taxpayers had an average effective tax rate of less than 2%.
- Under the flat-rate regime (also called the 20:20 regime), actual business income is reduced by a presumptive amount of costs equal to 80% of business income irrespective of actual costs incurred; businesses that have low costs clearly benefit the most from the flat-rate regime. The net income is taxed at a 20% rate which results in a 4% effective PIT rate. No other allowances relating to business activity or personal allowances can be deducted. The taxpayer needs to meet the following conditions:
  - Income from activities in the previous fiscal year does not exceed EUR 50 000. In this case the nominal expenses in the amount of 80% of income shall be considered but not more than EUR 40 000.
  - Income from activities in the previous fiscal year does not exceed EUR 100 000 and the taxpayer covered full-time compulsory insurance for at least one person for an uninterrupted period of at least five months. In this case the nominal expenses in the amount of 80% of income shall be considered but not more than EUR 80 000.

Most self-employed choose the actual cost regime. There were 111 600 self-employed taxpayers in 2017, of which 66 400 are self-employed under the actual cost regime and

45 200 under the flat-rate regime. However, the number of self-employed under the flat-rate regime is increasing. Compared to 2016, the number of taxpayers under the flat-rate regime increased by 18% (+32% from 2015 to 2016) while the number of self-employed under the actual cost regime declined by more than 7% (-6% from 2015 to 2016). In 2016, the amount of PIT collected under the actual cost regime (EUR 56 million) is higher than under the flat-rate regime (EUR 28 million) (Table 4.7). The self-employed which choose for the flat-rate regime operate in the following sectors: legal/accounting jobs, arts, IT and communication, and manufacturing. The actual cost regime is chosen by the self-employed who operate in the construction sector, wholesale and retail trade, manufacturing, legal/accounting jobs, transportation, and accommodation and food.

In the actual costs regime, the self-employed who operate in the cultural sector benefit from a special tax treatment. Self-employed who operate in the cultural sector benefit from a reduction in the tax base of 15% up to EUR 25 000. The same special tax relief applies for journalists and athletes.

Table 4.7. PIT revenues levied under the actual regime are higher than under the flat-rate regime

	Mean (EUR)		Total (EUR millions)	
	Flat-rate regime	Actual regime	Flat-rate regime	Actual regime
Labour costs	13 556	10 646	322	483
Gross income	12 719	10 390	302	471
Business	5 981	8 420	142	382
Salary	4 390	966	104	44
Capital	525	129	12	6
Allowances	3 534	7 611	84	345
PIT	1 194	1 240	28	56
Employee SSC	1 144	317	27	14
Employer SSC	837	256	20	12
PIT	9%	12%	9%	12%
Tax wedge	23%	17%	23%	17%

Note: In a very small number of erroneous cases, taxpayers report being in both schemes. Methodological information on the microdata is available in the annex.
Source: Authors' calculations based on Ministry of Finance of Slovenia tax records microdata.

4.2.2. PIT allowances are numerous

Tax allowances narrow the PIT base considerably. The PIT system in Slovenia includes many tax allowances (Table 4.8). Generous tax allowances come at a significant tax revenue cost, increase complexity, create distortions and may be more beneficial to richer than poorer households. Countries that have generous tax allowances often have very high tax rates in order to compensate for the revenue cost. Certain allowances are common practice in the OECD countries such as employee SSCs which are deductible from taxable PIT or tax provisions for third pillar private pension savings. Nevertheless, there is significant scope in Slovenia to broaden the tax base.

Table 4.8. Tax allowances and tax exempt income in Slovenia in 2018

	Amount (EUR)
General allowance	3 302.7
Additional general tax relief for low income[1]	
Income up to 11 166.37	*3 302.70 + 3 217.12 (max 6 519.82)*
Income between 11 166.37 and 13 316.83	*3 302.70 + (19 922.15 -1.49601 x income)*
Income above 13 316.83	*3 302.70*
Personal allowance	
For disabled person	17 685.84
For student	3 302.70
For dependents	
First dependent child	*2 436.92*
Second dependent child	2 649.24
Third dependent child	4 418.54
Fourth dependent child	6 187.85
Fifth dependent child	7 957.14
The sixth and subsequent children	+1 769.30
Disabled child	8 830
Other dependent family member	2 436.92
Other	
Special deduction for voluntary additional pension insurance payments	Up to 24% of the mandatory contributions for the pension & disability insurance (max 2 819.09)
Credit for pensioner (% of pension)	13.5
Tax exempt income	
Transport to work allowance[3]	945[2]
Meal allowance[3]	893[2]
Performance bonuses (13th salary)[4]	
Annual bonuses[4]	

Note: [1]The additional general tax relief for low income has changed on January 1, 2018. A taper rate of 1.49601 has been introduced for income between EUR 11 166.37 and EUR 13 316.83. [2] These are average by employee for 2017. Table 4.4 provides more detailed information. [3] Both the transport to work and the meal "allowance" are average amounts of exempt income. [4] As of January 1, 2018, up to 70% of the average wage is exempt from the income tax (up to 100% in 2017), but not from SSCs.
Source: Ministry of Finance of Slovenia.

Many countries have turned their tax allowances into tax credits. The main argument in favour of tax credits, which are deductible from tax liability while tax allowances are deductible from taxable income, is that the value of tax credits is independent of income while the value of tax allowances is increasing in the taxpayer's marginal tax rate and so tax allowance benefit higher incomes more (OECD, 2006[4]).

Various PIT base broadening opportunities exist including thee tax treatment of transport costs in relation to work, which is overly generous and has negative environmental effects. As pointed out, the reimbursement of expenses incurred in relation to work-related travel, including transportation costs to and from work, is not taxed under the PIT. These tax provisions were installed in a context of limited transport infrastructure in Slovenia. However, the policy rationale for this generous tax treatment has become weak. Moreover, it stimulates transport and commuting, and therefore creates negative environmental effects. The current tax regime in relation to work travel should be revised. As the basic PIT tax allowances are already generous, an additional allowance for transport expenses may not be required. In fact, the main policy rationale for the basic allowance in

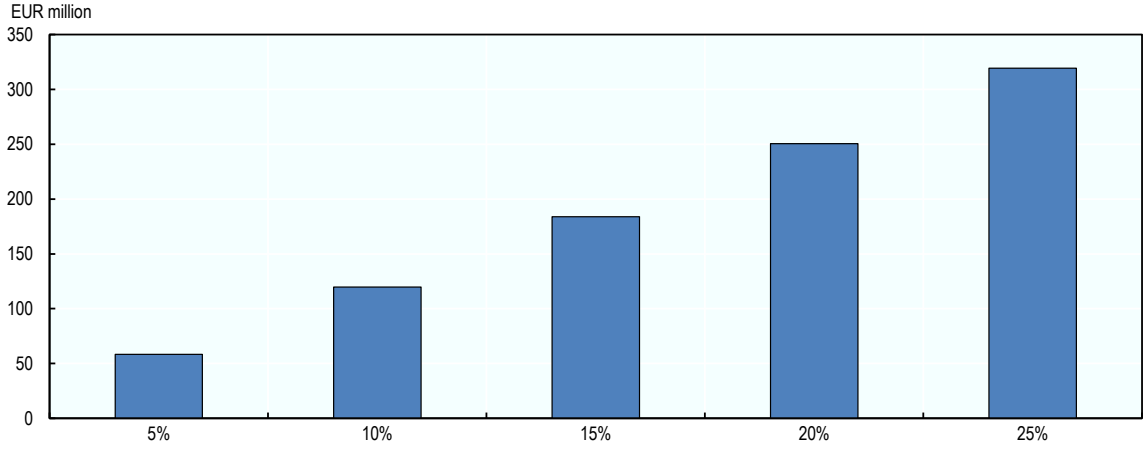
the PIT is that it covers the minimum costs incurred to earn taxable labour income; this includes work-home travel (and meal allowance). Any remuneration for transport costs or food at work should be treated as taxable personal income. In addition, the meal allowance could be treated as regular taxable income under the PIT and SSCs. Moreover, the performance bonuses and annual bonuses, which are currently tax exempt up to the average wage, could be taxed as regular income under the PIT. Slovenia should also evaluate whether some of the fringe benefits which are tax exempt could be brought within the reach of the tax system.

Slovenia should continue with its plans to include a tax expenditure report as part of its annual budget cycle to inform policy makers of the tax expenditure costs. Tax expenditure reporting assists in the management of the overall fiscal position and budget allocations. It involves the estimation of the tax revenue foregone of tax expenditures. This allows governments to assess whether the tax expenditure meets its objectives compared to the cost involved. More generally it can serve for the evaluation of public policies. Tax expenditure reporting also enables the distributional assessment of tax relief across different taxpayers and helps increasing transparency of government policies.

Reducing allowances would significantly increase revenues. To simulate the impact of reductions in tax allowances (personal allowance, family allowance, etc.) on PIT revenues, allowances on the tax records are reduced to 95%, 90%, 85%, 80% and 75% and substituted into estimated taxable income (Figure 4.11). According to the analysis, reducing tax allowances by 5%, 10% and 15% could increase PIT through higher taxable incomes by EUR 58 million, EUR 120 million, EUR 184 million, EUR 251 million and EUR 319 million respectively.

Figure 4.11. Relatively small reductions in allowances could change PIT significantly

Estimated PIT revenue associated with reducing allowances by 5% to 25% respectively



Note: All taxpayers included. Not all tax allowances are available on the tax records such as the child allowance. The analysis assumes no behavioural change and linearity. Methodological information on the microdata is available in the annex.
Source: Authors' calculations based on Ministry of Finance of Slovenia tax records microdata.

4.2.3. Tax provision for families with children are generous

Slovenia provides both tax allowance and cash benefits for children

In addition to child tax allowances (see Table 4.8), Slovenia also has a system of (tax-exempt) child cash transfers (OECD, 2018[3]). The cash benefits are calculated for each child separately according to the level of net family income per family member (over 8 income classes), the ranking level of the child (3 levels: first, second, third and any subsequent child), and the school level (primary, secondary) (Table 4.9). In 2017, the maximum annual cash benefit for children in primary school in a two-parent family was EUR 1 371.72 for the first child, EUR 1 508.76 for the second child, and EUR 1 646.16 for the third child (or subsequent child). For children living in a one-parent family, the cash benefit is increased by 30% and by 20% when a pre-school child does not attend childcare.

Table 4.9. Child cash benefits are generous

Monthly cash benefits for a child from birth to the end of primary school in a two-parent family, 2017

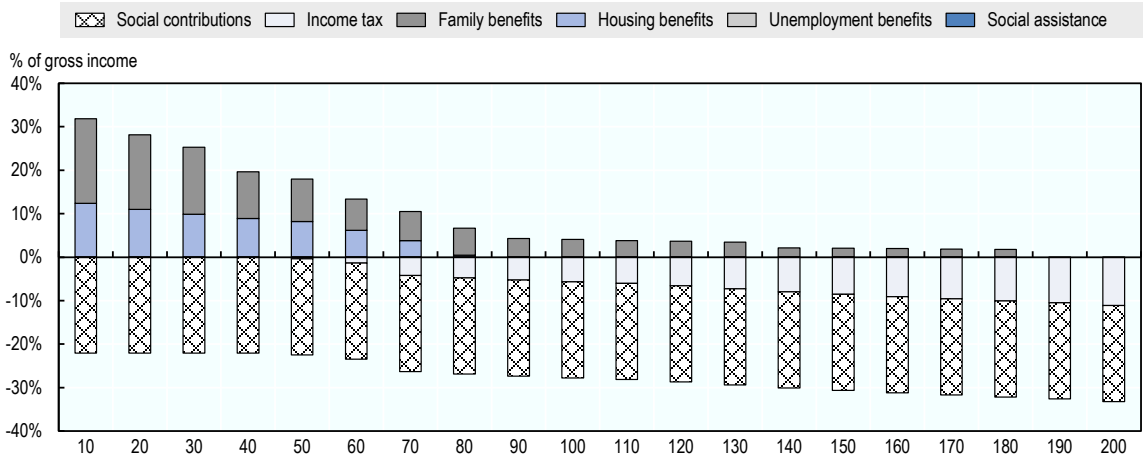
Number of income bracket	Net family income per family member as a percentage of the average net wage	1st child	2nd child	3rd and subsequent child
1	Up to 2 225.15	114.31	125.73	137.18
2	2 225.15 – 3708.58	97.73	108.04	118.28
3	3 708.58 – 4 450.29	74.48	83.25	91.98
4	4 450.29 – 5 192.01	58.75	67.03	75.47
5	5 192.01 – 6 551.82	48.04	56.06	64.03
6a	6 551.82 – 6 922.68	30.44	38.10	45.71
6b	6 922.68 – 7 911.63	30.44	38.10	45.71
7	7 911.63 – 10 136.76	22.83	30.44	38.10
8	10 136.76 – 12 238.32	19.88	27.50	43.11

Note: Transfers for children in the seventh and eighth income classes have been re-introduced as of January 2018. This is a temporary measure, which applies up to the year following the year in which economic growth exceeds 2% of gross domestic product. The monthly amounts of child benefit for a child included in the secondary school (but only for the child younger than 18) in the income bracket 6b increased to: EUR 43.44 for 1st child; EUR 51.10 for 2nd child; EUR 71.17 for 3rd and subsequent child.
Source: OECD (2018[3]).

Housing cash benefits are paid to low-income families. Married couples with two children at low levels of income can receive significant housing benefits in addition to their family/child cash benefits (Figure 4.12). While family/child cash benefits are large, also the additional housing cash benefit results in considerable additional income for low income households. Cash benefits are reduced when income rises, but at modest rates. For instance, families at average earnings continue to receive significant child and housing benefits (Figure 4.12).

Figure 4.12. Child and housing benefits are generous

Married couple with two children with the second earner at 67% of the AW, as a % of the AW, in 2015



Note: This chart takes into account the child allowance.
Source: OECD Benefits, Taxes and Wages dataset.

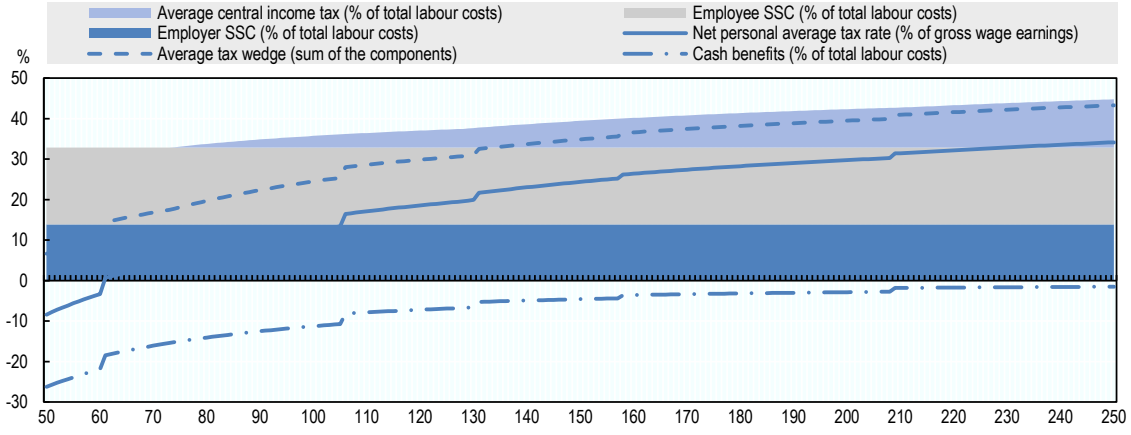
Child tax allowances and child benefits reduce the tax burden for families with children significantly

Child cash benefits and child tax allowances significantly lower the net personal average tax rate for families, especially at lower incomes. For instance, the net personal average tax rate for a one-earner married couple with two children is 2.6% at 67% of the AW, 12.3% at the AW and 27% at 167% of the AW (Figure 4.13). It is significantly lower than for single taxpayers without children; the difference in effective tax rates ranges between 32 percentage points at the lower end of the income distribution and 7 percentage points at higher income levels (Figure 2.5). The difference in the net personal average tax rate for single taxpayers without children and one-earner married-couples with two children at AW earnings in Slovenia is 21 percentage points, which is among the highest in the OECD (Figure 4.14). Poland (at 30 percentage points) and the Czech Republic (at 23 percentage points) subsidise children even more strongly than is the case in Slovenia.

The net personal marginal tax rate increases step-by-step but shows peaks at income levels where the cash benefits are reduced (Figure 4.15). Peaks are observed at 60%, 105%, 130%, 157% and 208% of the AW. Single taxpayers without children and one-earner married couples with two children face the same net personal marginal tax rate at gross earnings above 160% of the AW; this result does not apply to the net personal average tax rate because of the impact of child tax allowances (Figure 2.5).

Figure 4.13. Cash benefits reduce the net personal average tax rate for families with children

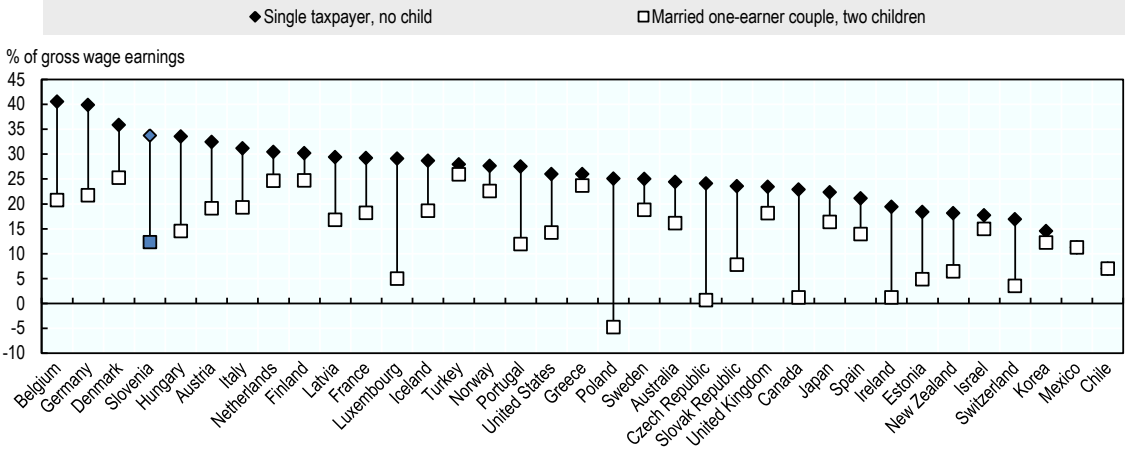
Average tax wedge decomposition by level of gross earnings expressed as a % of the AW, one-earner married couple with two children



Source: OECD (2018[3]).

Figure 4.14. The difference in the tax burden between a married one-earner couple with two children and a single taxpayer without children at the AW is very high

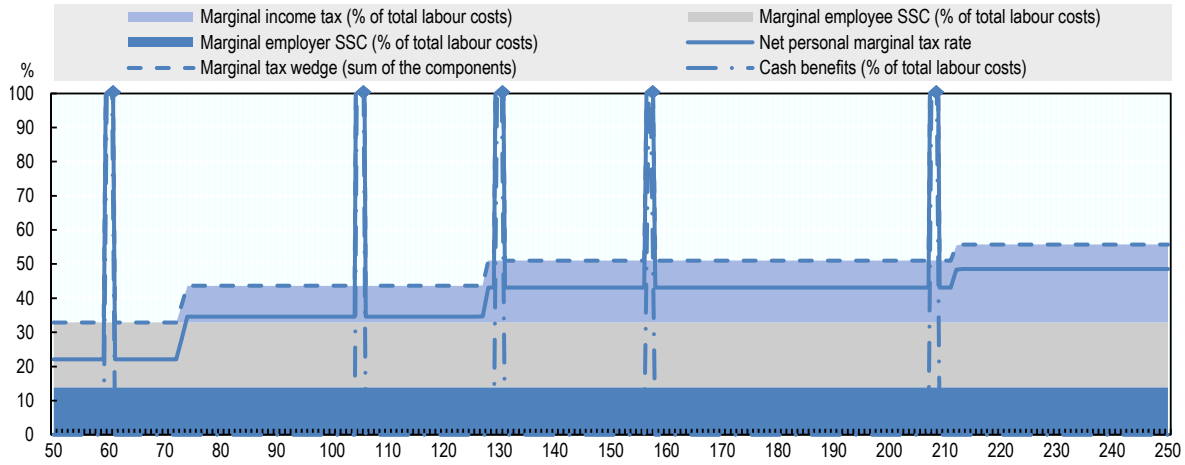
Income tax plus employee contributions less cash benefits as % of gross wage earnings, by family-type earning 100% of the AW, 2017



Source: OECD (2018[3]).

Figure 4.15. The net personal marginal tax rates are high at income levels where cash benefits are reduced

Marginal tax wedge decomposition by level of gross earnings expressed as a % of the AW, one-earner married couple with two children



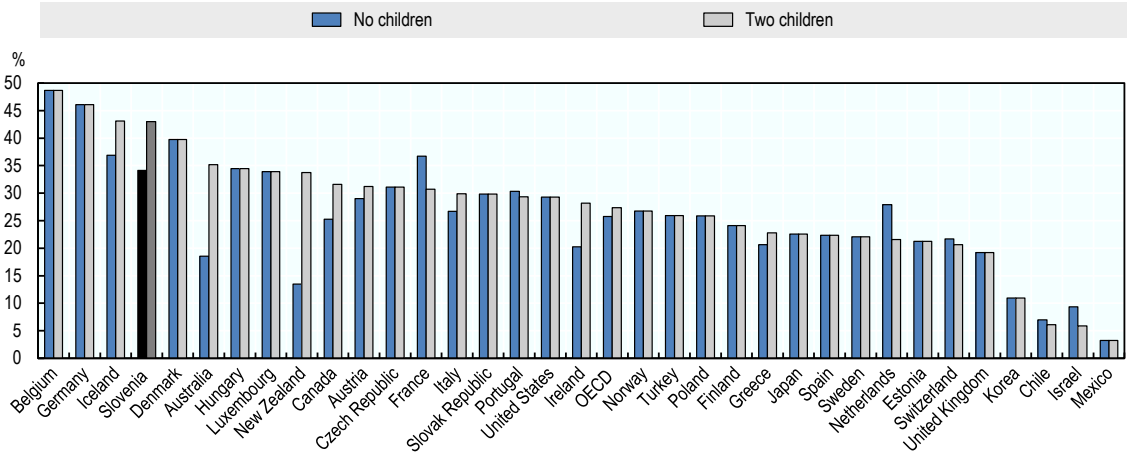
Source: OECD (2018[3]).

Child tax allowance and cash benefits reduce incentives for second earners to participate in the labour market

Tax and cash benefits targeted at children create a disincentive for second earners to participate in the labour market and to work more hours. The net personal average tax rate for a second earner at 67% of the AW in a married couple with two children with a partner (the principal earner) at 100% of the AW is 43% in Slovenia, which is very high compared to average tax rates for second earners in other OECD countries (Figure 4.16). In contrast, a second earner without children in Slovenia faces an average tax rate of 34%. The high net personal average tax rate for second earners is a combination of the high employee SSCs and PITs in Slovenia and because the principal earner who claims the child benefits and child tax allowances will lose some of the advantages when the second earner starts working because of the increase in family income. This loss is added to the tax burden of the second earner and therefore results in significant reduced work incentives.

Figure 4.16. Second earners are not encouraged to work in Slovenia if they have children

Net personal average tax rate for second earners at 67% of the average wage, with principal earner at 100% of the AW, 2015



Source: Thomas and O'Reilly (2016[5]).

The design of the child tax allowances and cash benefits is complex

Most countries, including Slovenia, lower the net personal average tax rate for families with children through a combination of PIT reductions and cash transfers (Table 4.10). Five countries provide PIT reductions only; nine countries only provide child benefits. The Netherlands is the only country which reduces employee SSCs for families with children (OECD, 2018[3]). Whether to choose for cash transfers and/or PIT reductions depends on different factors. Cash transfers can reach individuals who do not file a tax return. On the other hand, PIT relief for children does not require government to create a separate cash transfer system.

Table 4.10. Most countries lower the net personal average tax rate for families with both a reduction in PIT and cash transfers

Decomposition of differences in net personal average tax rate, number of countries

	Number of countries
Reduction in PIT only	5*
Cash transfers only	9**
Reduction in PIT + Cash transfers	17
Reduction in PIT + Cash transfers + Reduction in employee SSC	1

Note: Three OECD countries (Australia, Iceland and Mexico) have not been included as the net personal average tax rate is the same for married couple whether or not they have children. * Korea, Portugal, Spain, Turkey, the United States. ** Canada, Denmark, Finland, Ireland, Japan, Luxembourg, Norway, Sweden, United Kingdom.
Source: OECD (2018[3]).

The design of the support for children in Slovenia is complex and not very transparent regarding the overall benefit they provide across incomes. One the one hand, the cash transfers are decreasing in family income (Table 4.9). On the other hand, the tax allowances for children are constant (although higher allowances are available for each extra child) (Table 4.8) and, as is typically the case with tax allowances, their value is increasing in taxpayer's income.

Slovenia should consider whether the current system of support for children could be reformed. Different reform options exist. The tax allowances could be turned into tax credits. Alternatively, the current tax allowances could be abolished and replaced by higher cash benefits for children. As Slovenia has a condensed wage distribution, the cash benefits could be provided to all families irrespective of their income level. Such an approach would prevent that marginal tax rates would be increased when the benefits are tapered out. This would also tackle one of the underlying causes of the high tax burdens, and therefore reduced work incentives, for second earners in Slovenia. Alternatively, the cash benefits could be reduced at high income levels only in order to limit the impact on work incentives as much as possible.

4.3. Reduce tax disparities between different legal forms

4.3.1. The flat-rate regime is too generous and needs to be reformed

Many tax reliefs apply for business income. Personal business income can be taxed under the regular regime, which allows for the deductibility of actual costs incurred, or under the flat-rate regime, which reduces actual business income with a presumptive amount of costs equal to 80% of business income (see also section 4.2.1). No additional allowances are available under the flat-rate regime. Under the actual costs regime, additional deductions in the form of tax allowances can be claimed, including (non-exhaustive list):

- Tax allowance of 100% of the R&D investment;
- Tax allowance equal to 40% of investment in equipment and long-term intangible assets;
- For employment of young and older workers: additional reduction in the tax base amounting to 45% of the salary paid to a new employee younger than 26 or older than 55 and previously long term unemployed;
- For employment of disabled persons: additional reduction in the tax base from 50% to 100% of the salary of the disabled employee.

SSC treatment differs between unincorporated and incorporated businesses. The SSC regime for self-employed entrepreneurs was described in section 3.4. While it is overall very similar to the tax regime for regular employees, including manager-owners of closely held corporations, the main difference is the SSC ceiling for the self-employed which does not apply for regular employees.

The flat-rate regime distorts the labour market and leads to tax evasion

The flat-rate regime was created to stimulate entrepreneurship. The flat-rate regime was introduced in 2013 during the economic crisis to encourage individuals to start their own business. The main objective of the regime was to lower the tax administrative burden for small businesses – there is no requirement to keep books of accounts but only records – and to provide more transparency and certainty about future tax liabilities.

The number of taxpayers within the flat-rate regime is steadily increasing. The number of taxpayers increased from 14% of self-employed businesses to 35% in 2016 (which represents around 38 300 taxpayers) (Ministry of Finance of Slovenia, 2016[6]). In 2015, up to 55% of businesses fulfilled the criteria to be taxed under the flat-rate regime. This shows that many more businesses could potentially choose to be taxed under the flat-rate regime.

The flat-rate regime induces self-employed entrepreneurs to conceal their income. An in-depth evaluation of the regime by the Ministry of Finance has found that the regime

induces taxpayers to under-report their income below EUR 50 000 in order to qualify for the regime (Ministry of Finance of Slovenia, 2016[6]). Stricter tax enforcement therefore seems justified, although this increases the risk that the regime will induce taxpayers to work less in order to stay below the income threshold.

The flat-rate regime distorts the functioning of the market. The regime can cover hidden employment relationships. Bogus self-employment (people forced to take that business status to work for an employer) is estimated to have doubled from 3.8% of total employment in 2012 to 6.6% in 2015 (European Commission, 2017[7]). The flat-rate regime is particularly vulnerable to be misused for these purposes. Slovenia has attempted to deal with these challenges by introducing anti-avoidance provisions in the flat-rate system in 2017 (with effect as of January 2018) (see Box 1.1). However the reduction of the 80% cost rule (to 60% or 70%) was not implemented.

The flat-rate regime needs to be reformed because the effective tax burden under the regime is very low (at 4% effective rate on income) and because it induces businesses not to grow – or to split up their business – in order to qualify for the regime. Several reform options could be considered:

- The presumptive costs of 80% of income could be lowered significantly; in addition, the low tax rate of 20% could be increased.
- The regime could be phased out over time. This would ensure that the flat-rate regime is used for individuals to start a business only but, once the business has proven to be economically viable, the self-employed would be taxed under the regular regime.
- Another option would be to abolish the flat-rate regime but, instead, (continue to) provide self-employed a temporary cut in SSCs or a PIT credit for the first years after having created a business.

4.3.2. Entrepreneurs face a tax-induced incentives to incorporate

The significant difference in the tax burden on labour and capital income creates tax-induced incentives for business owners to incorporate. The tax burden on labour income in Slovenia is very high as a result of the combined effect of PITs and high SSCs, as discussed earlier in this report. Although the self-employed can lower their effective PIT burden if they choose for the flat-rate regime, they will continue to face the high self-employed SSCs. The SSC ceiling for the self-employed reduces the tax burden on labour income, but the ceiling hits at 350% of the AW only. The tax burden on capital income is significantly lower (see Chapter 6). While top wage earnings are taxed at a top PIT rate of 50%, the tax rate on distributed dividends at the individual level is 25% only (39.25% if the corporate income tax, CIT, is taken into account as well). These differences in the tax treatment of labour versus capital income create a strong incentive for self-employed businesses to incorporate their business. In order to minimise their tax liability, managers-owners of closely-held corporations then face an incentive to pay a low wage only and to get the remuneration the form of dividends. Alternatively, they can retain the profits within their corporation and distribute them later or realise the capital gains when they sell the shares in their business.

In order to limit this type of tax-arbitrage behaviour, countries may want to oblige manager-owners of closely held corporations to pay themselves a "minimum" wage. In Belgium, for instance, manager-owners have to pay themselves a salary of at least EUR 36 000 (IMF, 2017[8]) and this wage has recently been increased even further. Slovenia requires closely-held corporations to pay their manager-owners a "minimum"

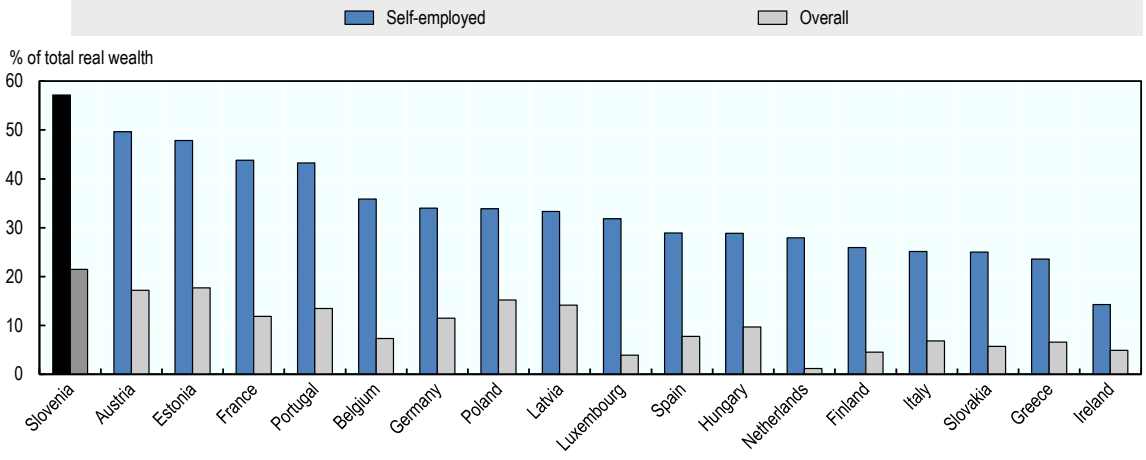
wage of only 54% of the AW. This is low and creates many opportunities to actively engage in tax arbitrage opportunities to limit overall tax liabilities.

Closely-held corporations face a tax-induced incentive to accumulate funds within their corporation. The capital gains tax rate which is levied on realised capital gains is reducing in the holding period of the shares (see Chapter 6). If the shares are held for more than 20 years, no capital gains tax has to be paid. As a result, manager-owners of closely-held corporations can reduce the tax burden to the CIT levied on retained profits. The very high level of wealth that is kept within businesses (Figure 4.17) seems to confirm that these types of tax-arbitrage behaviour are actually occurring in practice.

Indeed wealth held in self-employed business - regardless of whether the business is incorporated or not - is substantial in Slovenia. In households with a self-employed head of household, self-employment wealth is three times higher than average holdings of self-employment wealth across the entire population (60% of total real wealth vs. 20%) (Figure 4.17). This is above the average: the households where the head of household is self-employed hold 33.9% of their total gross wealth inside their self-employed business, compared to 10.1% on average in the total population. As the number of self-employed remains around 10% of total employment, this likely suggest that most of the wealth is held in incorporated businesses.

Figure 4.17. Wealth held in self-employed business is substantial in Slovenia

Self-employed wealth among the total population versus the employed, as a share of total gross wealth



Source: OECD (2018[9]).

Several options exist for reducing the tax-induced incentives for businesses to incorporate. First, the "minimum" wage which manager-owners of closely-held corporations have to pay could increase considerably. Currently the threshold is set at 54% of the average wage. Slovenia should consider raising that level to (at least) the AW. Further efforts might be welcome to better align the tax burden on capital and labour income. Reducing the top PIT rate of 50% and increasing the taxes on capital income at the individual level (see Chapter 6) would be an integral part of such a reform. Another option would be to introduce a capital gains tax which is constant over time and does not decrease with the holding period. This option, however, would not enable taxation of income of non-residents in Slovenia, as, under tax treaties, such capital gains are usually taxed only in the residence jurisdiction.

4.4. Main recommendations

Box 4.3. Recommendations to strengthen the design of the PIT

Objective: Redesign the PIT rate schedule

- Abolish the top PIT rate bracket and rate of 50%
- Increase the PIT rates in the second, third and fourth tax bracket and evaluate the design of the PIT brackets in response to a significant cut in employee SSCs
- Evaluate the impact of the multiple basic tax allowances, and their taper rates, on personal marginal tax rates and work incentives
  - Possibly integrate the additional basic tax allowance (which is reduced when income rises) within the main basic allowance and increase the bottom PIT rate of 16% to offset the impact on higher incomes

Objective: Broaden the PIT base

- Enlarge the PIT base by abolishing the tax exemption for:
  - Annual bonuses
  - Performance bonuses
  - Remuneration for home-work transportation costs
  - Meal allowance
- Tax fringe benefits as much as possible as regular income
- Turn tax allowances into tax credits

Objective: Redesign the provisions that provide support for children

- Consider increasing the generosity of the child transfers and abolishing the child tax allowances
- If the current design mix of both tax provisions and cash benefits for children is maintained, turn the child tax allowances into child tax credits
- Consider turning the cash benefits into amounts that do not vary with the taxpayer's income to prevent distortions in work incentives; alternatively, phase out the child benefits at high incomes only

Objective: Reduce tax disparities between different businesses legal forms

- Reform the flat-rate regime
  - Reduce the 80% assumed costs significantly while increasing the 20% tax rate
  - Introduce a time limit so that the self-employed can only benefit from the regime during the first year's after the start-up of the business
  - Alternatively, abolish the flat-rate regime but, instead, maintain for a certain length of time a reduction in SSCs when a new self-employed business is created
- Reduce tax-induced incentives to incorporate

- Increase the "minimum" wage that manager-owners of closely held corporations have to pay to, at least, the average wage
- Align the tax burden on labour and capital income (see also Chapter 6) by
  - Lowering the top PIT rate levied on wage earnings
  - Increasing the tax rate on dividends at the individual shareholder level
  - Increasing the capital gains tax rate and do not lower the rate for longer holding periods for closely-held corporations

Objective: Improve transparency

- Publish an annual tax expenditure report, make it publicly available and develop its scope and content gradually over time

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Chapter 5. Improving the design of indirect taxes

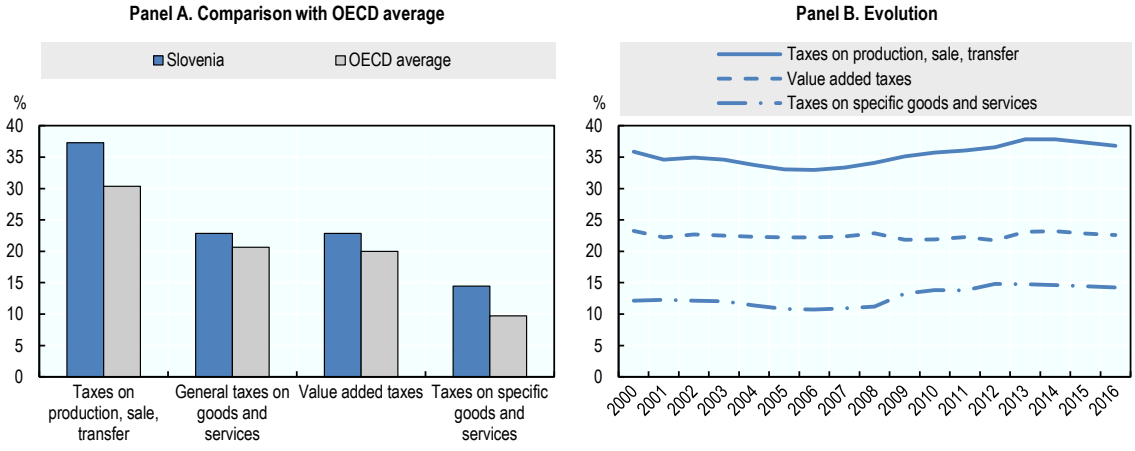
Slovenia's tax mix relies heavily on consumption taxes. The standard VAT rate is high and the reduced VAT rate, which is relatively low, applies to a large number of goods and services. As the VAT rate in neighbouring countries is lower, increasing the standard VAT rate might come at significant costs in terms of cross-border shopping. Instead Slovenia should keep its standard VAT rate at its current level. However, there is scope to address regressive distributional effects of the reduced VAT rate. Some of the products and services which are taxed at the reduced VAT rate benefit the rich more than the poor both in relative and absolute amounts. This is the case for cultural activities, hotels, restaurants, and air transport. Over time and when neighbouring countries would continue to increase their rates, there might be some scope to further increase excise duties, in particular on alcohol and tobacco.

5.1. Slovenia has a standard VAT rate above the OECD average levied on a narrow base

Slovenia raises a significant amount of revenue from consumption taxes. As discussed in Chapter 1, Slovenia's tax structure is tilted towards consumption taxes (40% of total revenue in 2016). Among consumption taxes, Slovenia relies mainly on value-added taxes (VAT) (22.6% of total revenues) and taxes on specific goods and services (14.2% of total revenues) (Figure 5.1 Panel A). Their shares have slightly increased over time (Figure 5.1 Panel B). In this context, scope to increase revenues from consumption taxes exists but is limited.

Figure 5.1. Slovenia raises a high amount of revenues from consumption taxes

% of total taxation

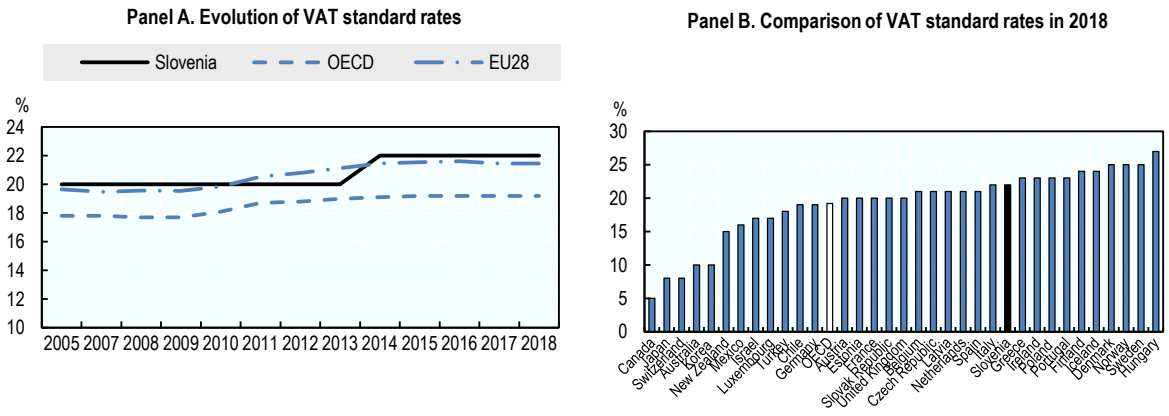


Note: Panel A: 2015 data.
Source: OECD Tax database.

Slovenia's standard VAT rate is above both the OECD and the European Union (EU) averages. Slovenia has increased its standard VAT rate in 2014, from 20% to 22% (Figure 5.2 Panel A). It is above the OECD average (19.2%). The standard VAT rate in Slovenia also exceeds the rate in neighbouring countries such as Austria or the Slovak Republic (20%) and other South East European economies where it ranges between 17% and 20%. The rate is equal to the rate in Italy, and lower than in Hungary (27%) (Figure 5.2 Panel B). As the VAT rate is relatively high, Slovenia should not aim to raise the rate further but instead maintain it as its current level.

Slovenia's reduced VAT rate applies to a large number of goods and services including food, non-alcoholic beverages, supply of water, medicines, hotel accommodation and restaurants. The reduced VAT rate was 8% in 2001, 8.5% in 2002 and to 9.5% in 2013. The reduced VAT rate applies to 22 categories of goods and services, similarly to the Czech Republic, but the VAT base is narrower than in Austria, Hungary, Italy, and the Slovak Republic (Table 5.1). In 2016, tax expenditures related to the VAT reduced rate amounted to EUR 745 million (Ministry of Finance of Slovenia).

Figure 5.2. Slovenia's standard VAT rate is relatively high



Source: OECD Tax database.

Table 5.1. Many goods and services are taxed at a reduced VAT rate in Slovenia

	Czech Republic	Slovenia	Italy	Austria	Hungary	Slovak Republic
Foodstuffs and non-alcoholic beverages	x	x	x	x	x	x
Supply of water	x	x		x		
Pharmaceutical products	x	x	x	x	x	x
Medical equipment	x	x	x		x	x
Transport of passengers	x	x	x	x		
Supply of books	x	x	x	x	x	x
Newspapers and periodical	x	x	x	x		
Admission to shows	x	x	x	x	x	
Reception of radio and television			x	x		
Supply of services by writers	x	x	x	x	x	
Provision, construction, renovation	x	x	x		x	
Renovation and repair of private dwellings	x	x	x			
Cleaning in private households	x	x				
Supply of goods and services for use in agricultural production	x	x	x	x		
Hotel accommodation	x	x	x	x	x	
Restaurant		x	x	x	x	
Admission to sporting events	x	x	x	x		
Use of sporting facilities	x	x				
Supply of services by cremation services	x	x	x			
Supply of goods and services by organisations devoted to social wellbeing	x		x	x		
Supply of services provided for street cleaning	x	x	x	x		
Repairs (bicycles, shoes, clothing)		x				
Domestic care services	x	x	x			
Hairdressing		x				
Provision of medical and dental care	x					
Supply of children's car seats	x					
Total	**22**	**22**	**19**	**15**	**9**	**4**

Source: Taxes in Europe database.

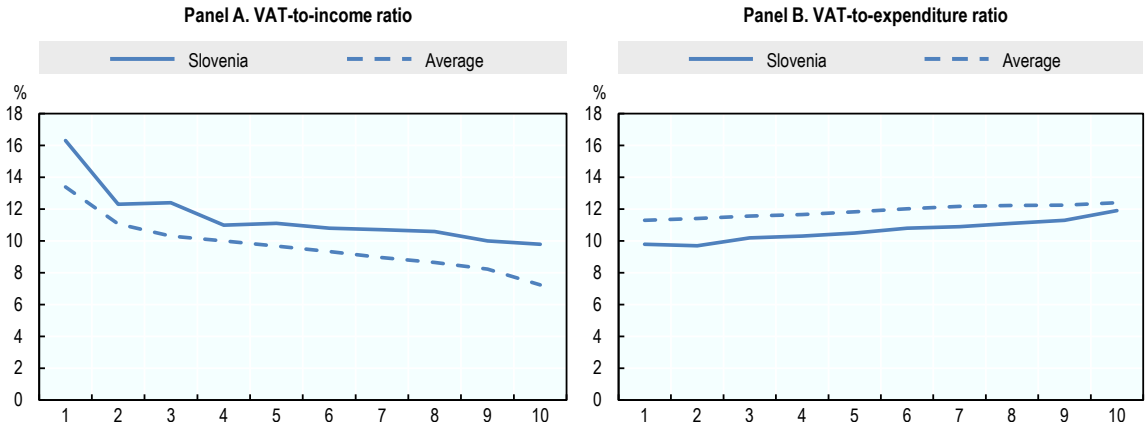
5.2. Scope exists to improve distributional outcomes of the VAT system

VAT payments as a share of disposable income are regressive, on average, as the VAT burden decreases with disposable income (Figure 5.3 Panel A). These results are driven by household savings as saving rates tend to increase with income. As a result, higher income households tend to have proportionately less of their income subject to VAT in the current year and therefore pay less VAT as a proportion of income in the current year than poorer households (OECD/KIPF, 2014[1]).

VAT payments as a share of expenditure are slightly progressive as the VAT as a share of pre-tax expenditure across income deciles shows a progressive pattern on average (Figure 5.3 Panel B). This approach removes the influence of borrowing and saving. Both Slovenia and OECD averages are slightly progressive. This occurs because higher income households tend to spend a greater share of their expenditure on standard rated goods and services rather than on reduced (or exempted) items.

Figure 5.3. VAT as a share of pre-tax expenditure is progressive

Average VAT rates across income deciles

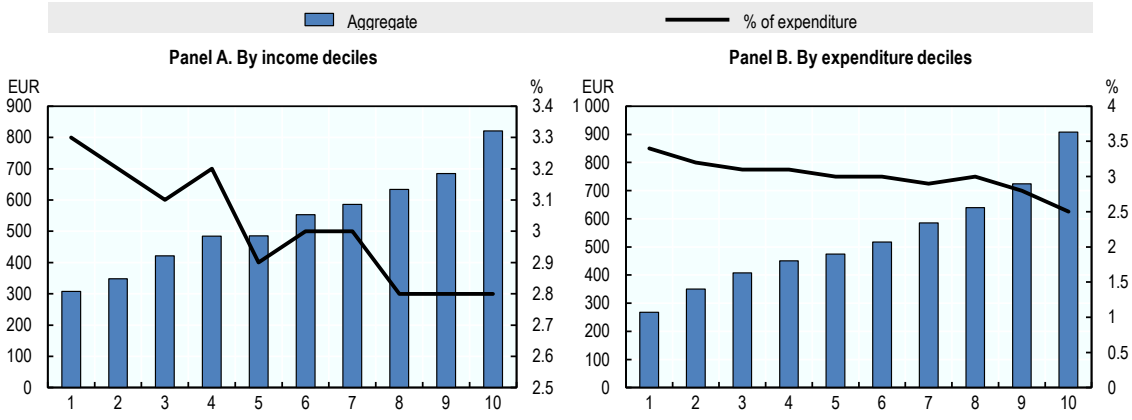


Note: The average results are a simple average for the 20 OECD countries examined in OECD/KIPF (2014).
Source: OECD/KIPF (2014[1]).

The reduced VAT rate provides significant support to richer households, but the overall effect remains progressive (Figure 5.4). While households in each decile gain from the reduced VAT rate, those in the higher income/expenditure deciles benefit more in absolute amounts. The top income decile receives a tax expenditure that is more than double (triple in the case of the top expenditure decile) that of the bottom decile. However, while these differences are large, looking at their size relative to household expenditure shows that the poor still gain proportionately more than the rich. This shows that overall reduced VAT rate do have a progressive effect in Slovenia.

Figure 5.4. The reduced VAT rate has a progressive effect in Slovenia

Average tax expenditure per households from reduced VAT rate



Note: Solid bars present the Slovenia simple average of the household average tax expenditures across income deciles and expenditure deciles. The lines present the same results as a percentage of household expenditure.
Source: OECD/KIPF (2014[1]).

Despite being poorly targeted, reduced VAT rates have the desired progressive effect when they are introduced for the distinct purpose of supporting the poor but not necessarily in other cases:

- **Reduced rates aimed at supporting the poor (food; pharmaceutical products; water supply) have a progressive effect in Slovenia**. The reduced rate on food provides the majority of support received by low-income and low-spending households. It has a progressive effect but is not well targeted at poor households, as richer households gain more from the reduced VAT rate on those goods in absolute amounts. It is similar for pharmaceutical products where the reduced rate tends to benefit the middle income/expenditure households most proportionately. Finally the aggregate tax reduction from the reduced VAT rate on water supply is relatively evenly distributed across the income/expenditure distribution. These trends are similar to what is observed on average in other OECD countries.
- **Reduced rates aimed at supporting cultural activities and social goods are regressive in Slovenia and the benefits for rich households are large**. For books, cinema and museums, the aggregate tax expenditures increase substantially as income/expenditure increases, so as the tax expenditures received. The results for newspapers are more balanced: the reduced rate still has a regressive impact.
- **Finally reduced rates introduced for non-distributional and non-cultural purposes are also regressive in Slovenia (hotel, restaurant, air transport)**.

Given that redistribution is one of the prime rationales for having reduced VAT rates, Slovenia could reassess the merits of its reduced VAT rate for a range of products and services, and bring within the scope of the standard rate goods currently taxed at the reduced rate but of which the richer gain the most in relative and absolute amounts. This includes hotels, restaurants, air transport, books, newspapers, periodicals and cinema and museum tickets. Table 5.2 presents revenue gains simulations from removing some reduced VAT rates.

The imposition of the VAT increases poverty in Slovenia, but to a lesser extent than other EU countries on average (Thomas Alastair, to be published[2]). The conclusion that the VAT is generally not regressive does not mean that policymakers should not be concerned about its impact on poverty. On average in Slovenia the imposition of the VAT increases the poverty headcount (proportion of the population that are below the poverty line of 50% of median disposable income) by 2.7 percentage points, from 4.2% to 6.9%. This increase is below the OECD average increase (3.1 percentage points) and Slovenia remains one of the countries with the lowest poverty headcount based on net expenditure. Same trends are observed when looking at poverty gap (how much additional expenditure on average is needed to move the poor out of poverty) and poverty severity (taking into account the degree of inequality among the poor).

Table 5.2. Broadening the VAT base can raise significant additional tax revenue

Removing reduced VAT rates on…	Revenue gains		
	EUR million	% of GDP	% of total tax revenues
All reduced VAT rates	686.7	1.7%	4.84%
Books; admission to shows*	9.4	0.0%	0.07%
Books; admission to shows*; newspapers and periodicals	27.3	0.1%	0.19%
Hotel accommodation; restaurant food	67.5	0.2%	0.48%
Passenger transport**	16.7	0.0%	0.12%

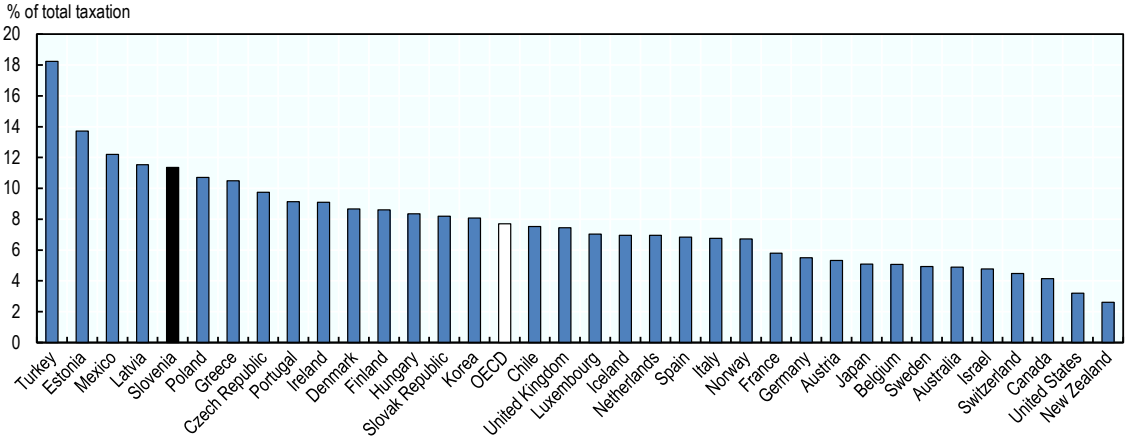
Note: Based on 2016 tax rules applied to 2010 household expenditure microdata inflation-adjusted to 2016 values, and assuming no behavioural response by taxpayers to the rate changes. According to the Ministry of Finance of Slovenia, in 2016, tax expenditure related to VAT reduced rate amounted to EUR 745 million. Calculations are based on GDP figures from the Statistical Office of Slovenia for 2016 (EUR 40.418 billion in 2015, current prices). *Admission to shows include: cinema, theatre, concerts, museums, and zoological gardens. ** This includes domestic air transport, but not international air transport.
Source: OECD consumption tax microsimulation models.

5.3. Excise duties can play a bigger role in financing the health system

Revenues from excise duties in Slovenia are high. In 2017, excise duties represent almost 10% of tax revenues (Ministry of Finance, 2018[3]) which ranks Slovenia among the countries with the greatest reliance on such taxes (Figure 5.5). The share of excise duties in taxation has progressively increased in recent years. In 2012, the specific excise duties were increased for cigarettes and fine tune tobacco (but the ad valorem excise rate decreased) (Krasovsky and Tesche, 2016[4]). In 2014, excise duties on alcohol and alcoholic beverages were raised by 10% and 5% for all tobacco products. However, the excise duties on cigarettes and alcoholic beverages in Slovenia remain low in comparison to other countries (Figure 5.6 Panels A and B). In contrast, excise duties on energy products are somewhat higher by international standards (Figure 5.6 Panels C and D) although the effective tax rates on gasoline for road use, for instance, remains in the range of the effective tax rates that can be found in other OECD countries (Figure 5.7). Nevertheless, excise duties on energy products collect a significant amount of tax revenues because of the important international transit traffic going through the country.

Figure 5.5. The revenues from excise duties are high in Slovenia

2016 or latest year available



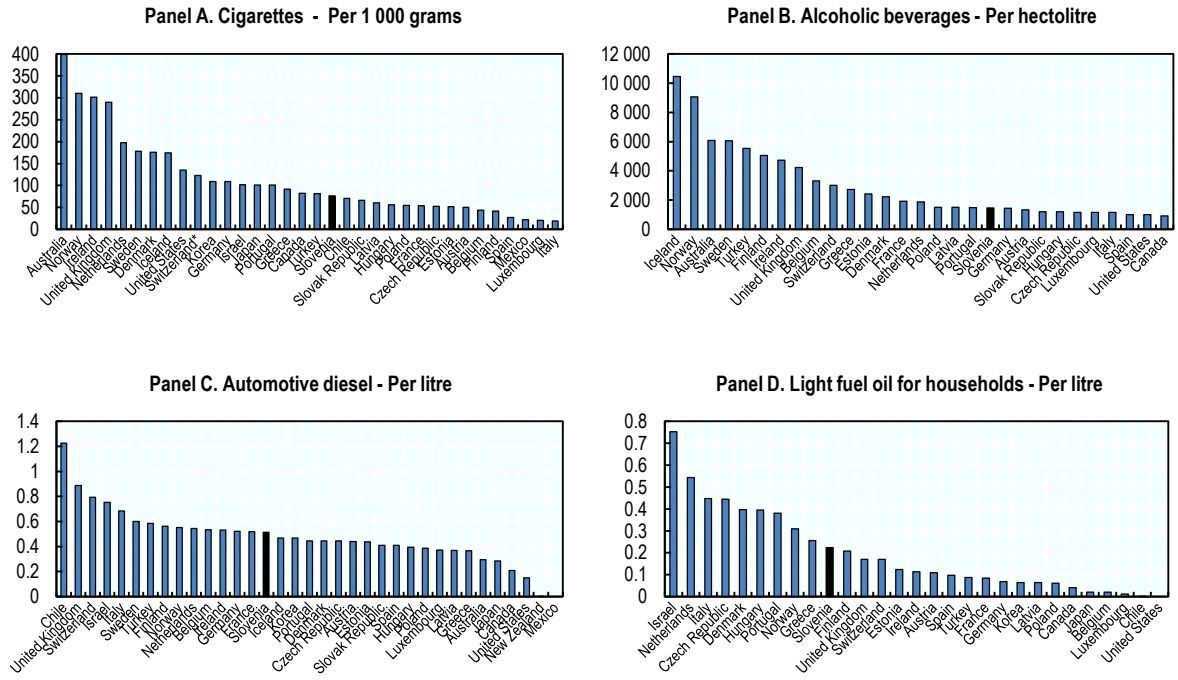
Source: OECD Revenues Statistics database.

Some OECD countries partly finance the public contribution to health care from excise duties on alcohol and tobacco (i.e. so-called sin taxes) (OECD, 2015[5]). To some extent, there is a good case for such an approach. Excise duties on alcohol and tobacco internalise some of the costs which the consumption of alcohol and tobacco imposes on society, in particular in terms of extra health expenditure that can be linked to their consumption. There are also other external costs, such as reduced labour market productivity including sick leave, which can be attributed to alcohol and tobacco consumption, although these costs are not necessarily borne by the health system but rather by employers. However strong arguments exist against earmarking of tax revenues. A significant concern is that it reduces flexibility in government budgeting. For example, if more revenue is raised in a particular year from an earmarked tax than is necessary for the related expenditure, the excess revenue cannot be used to address budget shortfalls elsewhere or to finance other budget priorities. While revenues of excise duties on alcohol and tobacco should continue to feed into the general budget, government could consider sharing (part of) its revenues with the Health Insurance Institute of Slovenia (HIIS), if such an approach would be necessary to put the financing of the HIIS on a solid footing in the future.

Excise duties on alcohol and tobacco need to be aligned with the excise duties that are levied in neighbouring countries as too high rates will result in cross-border shopping and smuggling. Recent experience with increases in excise duties in Slovenia have shown that setting rates too high may even lower the revenues collected from excise duties. Slovenia may further increase its excise duties on alcohol and tobacco in particular when neighbouring countries follow the same path.

Figure 5.6. Excise duties on energy products are high compared to those on cigarettes and alcoholic beverages in Slovenia

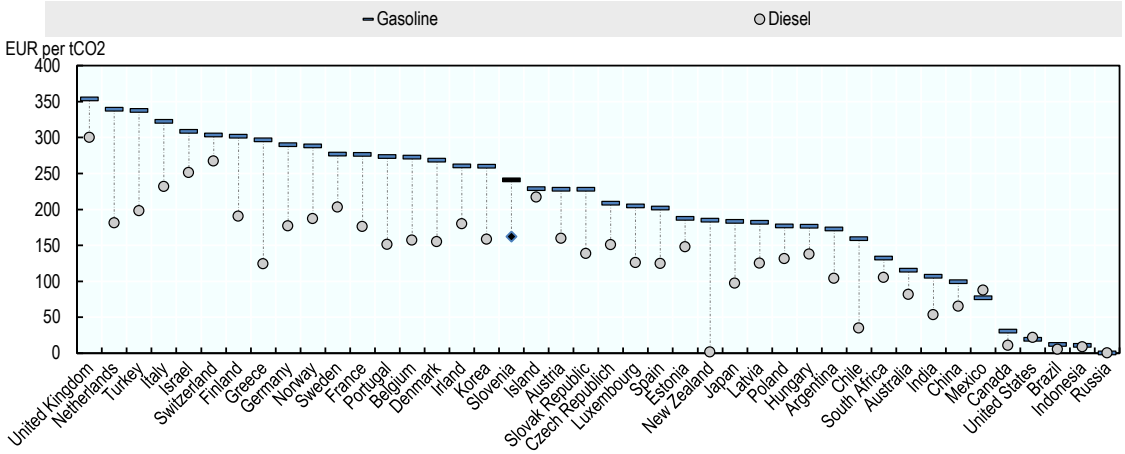
Excise duty, in USD, in 2015



Source: OECD Consumption tax trends.

Figure 5.7. The effective tax rates on gasoline for road use remains in the range of other OECD countries

Effective tax rates on gasoline and diesel for road use in EUR/tCO2, 2015



Source: OECD (2018[6]).

5.4. Main recommendations

Box 5.1. Recommendations to improve the design of indirect taxes

- Maintain the 22% standard VAT rate
- Broaden the VAT base
  - Bring within the scope of the standard rate goods currently taxed at the reduced VAT rate but of which the richer gain the most in relative and absolute amounts (such as hotel accommodation, restaurant food, books, admission to shows, newspapers and periodicals, passenger transport)
- Increase excise duties on alcohol and tobacco, in particular when neighbouring countries increase their rates further

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Chapter 6. Strengthening the taxation of capital income at the individual level

The recent move towards the automatic exchange of financial account information between tax administrations creates opportunities for Slovenia to revisit the way it taxes household savings. Tax rates on capital income at the individual level are not particularly high and effective tax rates on household savings vary widely across assets. Some assets, such as owner-occupied and rental immovable property and voluntary private pension savings, are taxed lightly. The capital income tax system lacks progressivity, which tends to be more common under dual income tax systems. Increasing the progressivity of the capital income tax system would require administrative reform as taxpayers would have to start declaring their capital income annually. Recurrent taxes on immovable property should also play a more significant role in the tax mix. The introduction of the new real estate tax is much-awaited as it creates opportunities to rebalance the tax mix and to reform the financing mix of local governments.

6.1. Slovenia faces modest opportunities to rebalance the tax mix towards higher taxes on capital income at the individual level

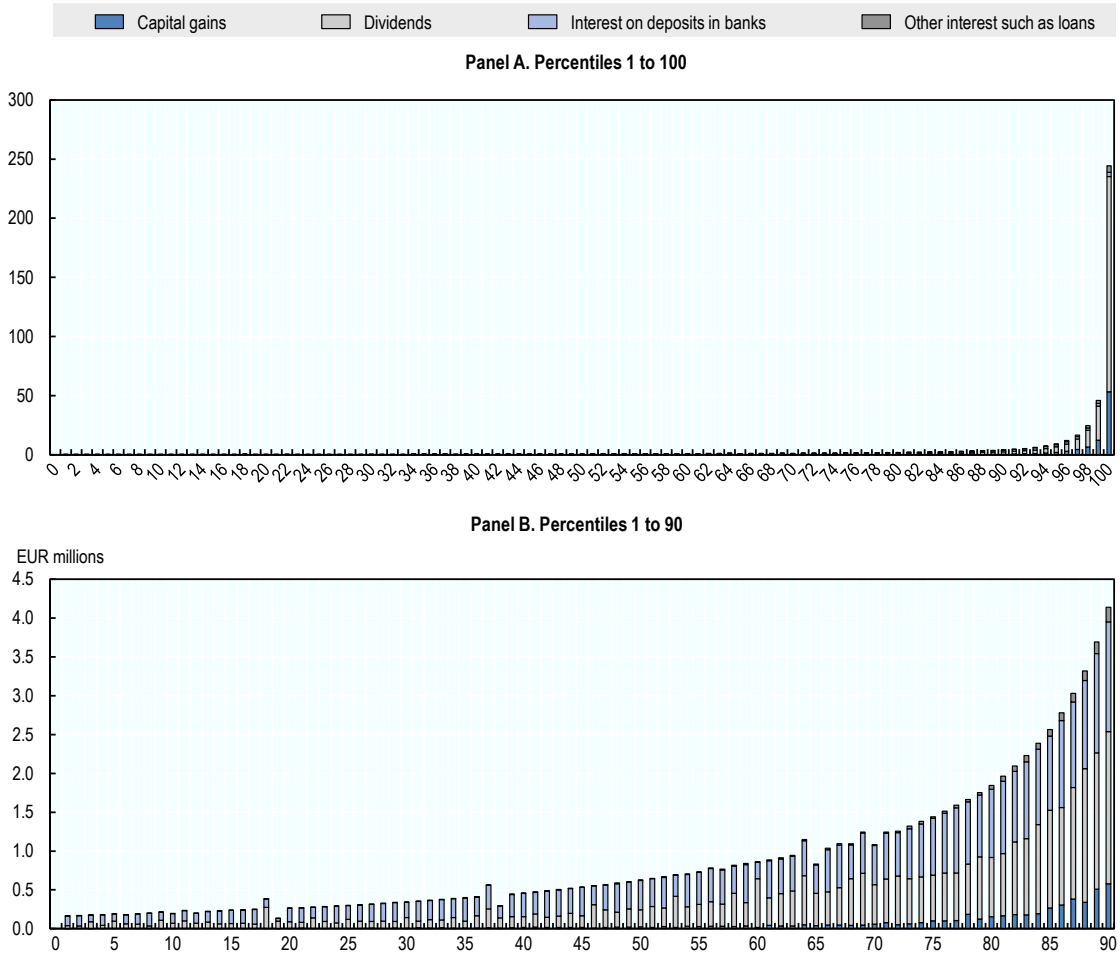
Slovenia has opportunities to strengthen the way it taxes capital income at the individual level. Households' savings in Slovenia are relatively high compared with other countries. In 2016, Slovenians saved 7% of their disposable income, which was in the upper half of the distribution among OECD countries. The analysis in this chapter will show that current tax rates on savings in Slovenia are not particularly high, although effective tax rates vary significantly across asset types. Moreover, the recent move towards the automatic exchange of financial account information between tax administrations creates opportunities to revisit the way countries tax savings. For example, it will be easier to levy taxes on capital income without income and assets necessarily shifting offshore in response (OECD, 2018[1]).

The shift in revenues from taxes on labour towards capital income might be limited because of relatively low levels of capital income earned. As labour income constitutes a much larger share of total income, any shift from labour to capital income taxes will therefore be modest.

Capital income in Slovenia is highly concentrated in the top income deciles, suggesting that increasing capital income taxation at the individual level will be borne by the wealthier individuals (Figure 6.1 Panel A). For all percentiles, the vast majority of capital income is comprised of interest income from bank deposits and income dividends. At the bottom of the distribution, the composition is mostly the former while at the top it is mostly the latter. Due to the high level of concentration in the top decile, Panel B presents the capital income distribution for the first 9 deciles. It is seen that, for the first half of the distribution, interest income from bank deposits typically comprises between half and three-quarters of capital income, with most of the remainder being dividends. Income from capital gains does not start to become a significant component of capital income until after about the 85th percentile. While increasing tax rates at higher income levels may be more equitable, governments should know that increased rates may also induce some taxpayers to shift their capital income elsewhere.

Figure 6.1. Capital incomes are highly concentrated at the very top of the distribution

Capital income distribution by type, by capital income percentiles, 2016



Note: Analysis only includes taxpayers with capital incomes of at least EUR 100. Capital income is comprised of dividends, capital gains (shares), income from interest on deposits in banks and savings banks (interest on deposit) and income from other interest such as loans and debt securities). Methodological information on the microdata is available in the annex. The total capital income decreases in some percentiles due to identical values for different taxpayers are assigned to the same percentile. Methodological information on the microdata is available in the annex.
Source: Authors' calculations based on Ministry of Finance of Slovenia tax records microdata.

6.2. Strengthen the taxation of household savings

Capital income is primarily comprised of income from dividends. Overall, there is EUR 455 million in capital income in Slovenia and EUR 92 million is collected in personal income tax (PIT) (Table 6.1). The effective rate, defined as PIT as a percentage of income, is 20.2%.

Table 6.1. Capital income is primarily income from dividends

Capital income, by type, 2016

	Income	PIT	Effective rate (%)
Total capital income	**455**	**92**	**20.2%**
Dividends	290	70	24.3%
Capital gains	92	14	14.7%
Interest on deposits in banks	58	5	8.0%
Other Interest such as loans	16	3	21.3%

Note: Analysis only includes taxpayers with capital incomes of at least EUR 100. Capital income is comprised of dividends, capital gains (shares), income from interest on deposits in banks and savings banks (interest on deposit) and income from other interest such as loans and debt securities. The effective tax burden on capital is higher than presented here as the analysis does not include corporate income tax. Methodological information on the microdata is available in the annex.
Source: Authors' calculations based on Ministry of Finance of Slovenia tax records microdata.

6.2.1. Statutory tax rates on capital income remain relatively low

Slovenia's statutory corporate income tax (CIT) rate has increased from 17% to 19% in 2017 (see Box 1.2) but the rate remains relatively low internationally. While the CIT rate in Slovenia is equal to the rate in the Czech Republic and in Poland, it remains significantly below the average rate in the OECD (23.9% in 2018), although above the rates in other South East European economies where it ranges between 9% and 15%.

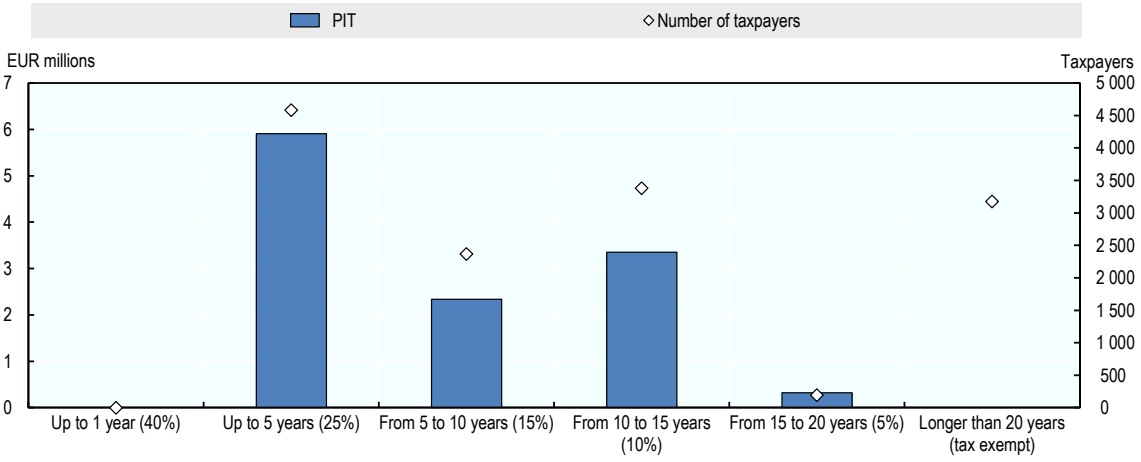
Dividends, interest and rental income are taxed at a flat final withholding tax of 25%. The first EUR 1 000 of interest from bank deposits is tax-exempt. The tax rate on realised capital gains decreases with the length of the period that the asset has been held. The capital gains tax rate is 25% for a holding period up to 5 years; 15% for a holding period from 5 to 10 years; 10% for a holding period from 10 to 15 years; 5% for a holding period from 15 to 20 years and assets that have been held for more than 20 years are tax exempt.

The effective rate on capital income is lower than the statutory tax rate (Table 6.1) due to different tax rates for capital gains depending on the holding period and the tax exemption up to EUR 1 000 for interest income on bank deposits. Increasing the rate will therefore be more effective at increasing capital income tax from dividends than from capital gains for example. About one-third of taxpayers have a capital gains tax rate of 25% indicating that gains were realised within a five year period (Figure 6.2). 23% of taxpayers paid no capital gains tax suggesting a holding period of 20 years or more.

Several other countries tax shareholder income via a final withholding system, including Austria, the Czech Republic, Italy, and Poland. Under this system, tax is withheld either by the distributing company or by the withholding agent on behalf of the individual shareholder and no further tax is payable at the shareholder level. While such a system reduces tax compliance costs for taxpayers who do not have to declare the dividend income in their annual tax return and tax administration costs, it comes at a cost in terms of tax policy design. Final withholding systems typically levy a flat tax rate instead of taxing dividends at progressive rates and/or exempting a basic amount of dividend income from tax.

Figure 6.2. About one-third of taxpayers have a capital gains tax rate of 25%

Income from capital gains, by rate and holding period, 2016



Note: Analysis only includes taxpayers with capital incomes of at least EUR 100. Holding periods are inferred through the effective tax rates that are calculated for each taxpayer in the microdata and categorised. Only tax rates with the rate categories shown are included in the analysis.
Source: Authors' calculations based on Ministry of Finance of Slovenia tax records microdata.

The combined "top" statutory tax rate on dividends in Slovenia is close to the OECD average. The overall tax burden on capital income consists of the tax rates levied at the corporate and individual level, and takes into account the interaction of the tax rates levied at both investor levels (if any) (Figure 6.3). The combined top statutory rate on dividends is 39.25% in 2018 (taking into account the increase in the statutory CIT rate) (Figure 6.3 Panel A). This rate is close to the average rate of 40.4% in the OECD and below the rates in Italy and Austria although above the rate in the Czech Republic and Hungary (31.2%) (Harding and Marten, 2018[2]). Combined top statutory tax rates on dividends are lower in some of the other South East Europe (SEE) economies. For instance, the rate was 10% in Bosnia and Herzegovina and Kosovo, 27.8% in Albania and Serbia, 19% in the Former Yugoslav Republic of Macedonia, and 17.2% in Montenegro.

The combined "top" tax rates on capital gains are significantly lower than the tax rate on dividends. The statutory tax rates on capital gains on assets which have been held for more than 20 years in Slovenia are particularly low (Figure 6.3 Panels C and D) because of the capital gains tax exemption; hence only the statutory CIT rate is paid. For shares which are sold earlier, the combined top tax rate on capital gains ranges between the top tax rate on dividends and the statutory CIT rate.

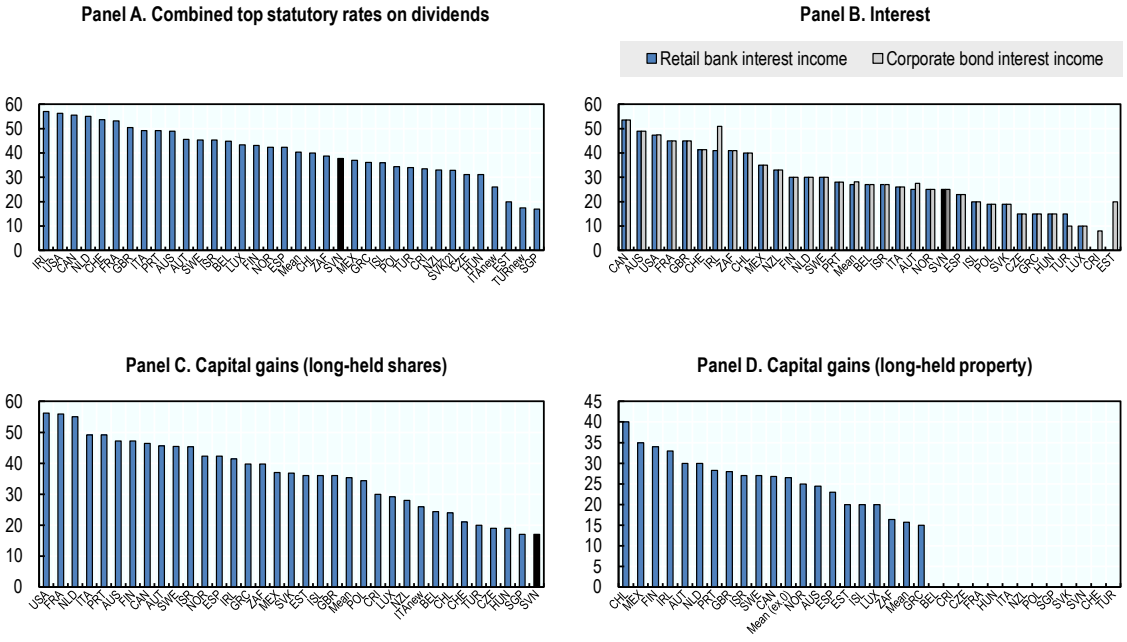
The statutory tax rate on interest income is also relatively low. Irrespective of the source of interest income (retail bank accounts or corporate bonds), the tax rate is 25%. This is lower than in Austria or Italy but above the rate in the Slovak Republic (19%) and the tax rate in Hungary and the Czech Republic (15%) (Harding and Marten, 2018[2]). Other SEE economies levy also very low tax rates on interest. The rate is 15% in Albania and Serbia, 10% in Kosovo and the Former Yugoslav Republic of Macedonia, 5% in Montenegro and 0% in Bosnia and Herzegovina.

The combined top statutory tax rates on capital income are significantly lower than the top tax burdens on labour income in Slovenia. As pointed out in section 4.3.2, the

important tax differential between labour and capital income creates significant tax-induced incentives for businesses to incorporate.

Figure 6.3. The combined "top" statutory capital income tax rates in Slovenia are below the OECD average

In %, 1 July 2016



Note: Combined statutory tax rates take into account both the statutory CIT rate (if applicable) and the statutory tax rates on capital income at the individual level (including final withholding tax rates, if any), as well as the interaction of both tax rates (if any). OECD calculations based on questionnaire responses. The rates presented are "top" rates meaning that they take into account the top capital income tax rates levied at the individual level. Panel A: The unweighted mean includes the tax rate on new equity in Italy and in Turkey and not the tax rates on existing equity. Panel C: The unweighted mean includes the tax rate on new equity in Italy and in Turkey and does not include the tax rates on existing equity. If the combined tax rates on existing equity were used, the unweighted average combined rate would be 36.8%. Panel D: The unweighted means does not include the capital gains tax rate for the United States, which varies under a certain number of assumptions.
Source: Harding and Marten (2018[2]).

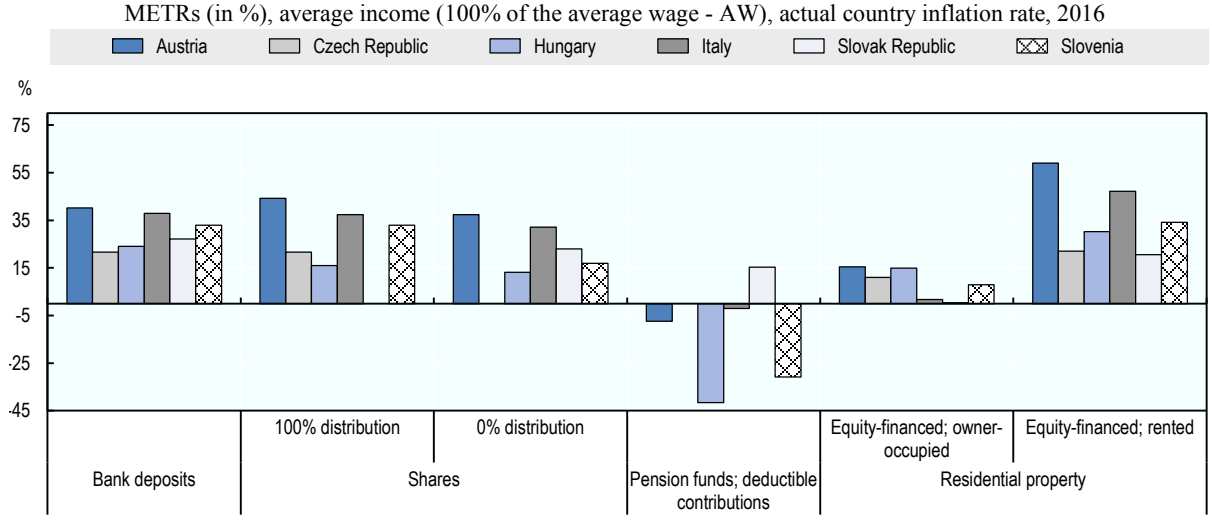
6.2.2. METRs on household savings vary widely across asset types

The effective tax rates on household savings in Slovenia differ from the statutory tax burdens. Figure 6.4, Figure 6.6 and Figure 6.7 present marginal effective tax rates (METRs) on a wide variety of saving vehicles. In contrast to the analysis in the previous section, these METRs only include the taxes levied on capital income at the individual level; they do not take into account the CIT. The OECD calculates METRs on household savings to assess the impact of a wide range of taxes and tax design features on the incentives to save in different assets; large differences in METRs reflect significant tax-induced incentives for households to adjust their savings portfolio in order to minimise their capital income tax liabilities. The METR calculations take into account all taxes levied on household savings, deductions and variations in the tax base, different asset holding periods and the potential build-up of untaxed or tax-deferred returns. METRs also incorporate the impact of inflation, which can impose a substantial additional tax on the return to savings.

The taxation of nominal rather than real returns increases METRs considerably. In 2016, the METR on bank deposits and dividends in Slovenia was 33% rather than the 25% withholding tax rate as a result of the taxation of the inflation component in the return that is earned. The lack of indexing of returns in Slovenia, as is the case in most OECD countries, results in METRs on savings which are increasing in the inflation rate.

Equity-financed investment in owner-occupied residential properties is taxed lightly in Slovenia. Across the OECD, investment in owner-occupied housing is taxed at low rates (Figure 6.7). The METRs on equity-financed investment in owner-occupied residential property are particular low in Slovenia, although they are even lower in Italy and in the Slovak Republic (Figure 6.4). The effective tax burden on rental properties in Slovenia is higher but remains relatively low compared to other OECD countries (Figure 6.4).

Figure 6.4. Marginal effective tax rates on savings in Slovenia are relatively low



Source: OECD (2018[1]).

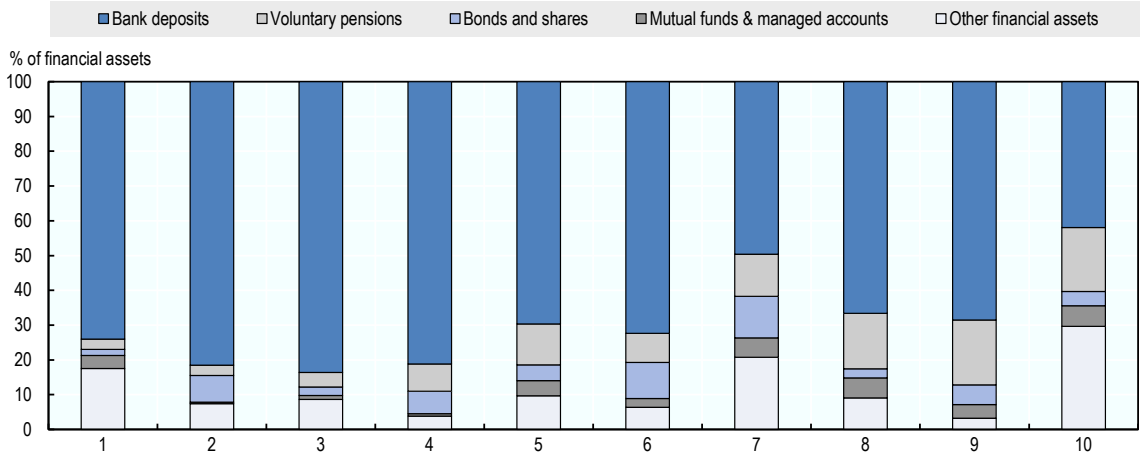
Voluntary private pension savings in Slovenia are tax-favoured, especially for richer households. Many countries provide a special tax treatment to induce households to save for an additional pension. Such a strategy is often justified because of pressures on the financing of adequate pensions in the future often linked to the ageing of the population. When private pension savings are deductible (up to certain limits in most countries) from taxable personal income, the marginal effective tax rate is low or even negative as the tax gain that arises because of the upfront deduction offsets the taxes on the return on investment. Negative METRs arise when the tax rate at which pension savings can be deducted is higher than the tax rate at which the pension is eventually taxed. If the value of the upfront deduction of private pension savings increases with the taxpayer's marginal tax rate, METRs will be lower for taxpayers with higher incomes. This is the case in Slovenia, where those on higher incomes benefit the most from the tax treatment of private pension savings (Figure 6.6).

The effective tax rates on interest income (bank deposits and bonds) exceed the rates on capital gains and other tax-favoured saving vehicles. As interest is not taxed under the CIT while the return on equity is typically taxed at both corporate and individual shareholder level, slightly higher taxes on interest at the individual level may be a way to integrate the differential tax treatment of debt and equity at the corporate level. In European

Union (EU) countries including Slovenia, bank deposits are the most common form of financial asset and make up a larger share of the asset mix for those at the bottom of the income distribution (Figure 6.5). This means that higher levels of taxation of interest on bank deposits hit poorer households more as richer households typically hold a more diversified savings portfolio. Nevertheless, the overall effective tax burden on interest income (Figure 6.4 and Figure 6.6) remains relatively low in Slovenia, in particular when compared to wage earnings. Moreover, the negative distributional impact of higher taxes on interest income in Slovenia has been offset through the EUR 1 000 of interest exemption.

Figure 6.5. Bank deposits tend to make up a greater share of wealth for lower-income households in Slovenia

Financial assets as a share of total financial assets by income deciles

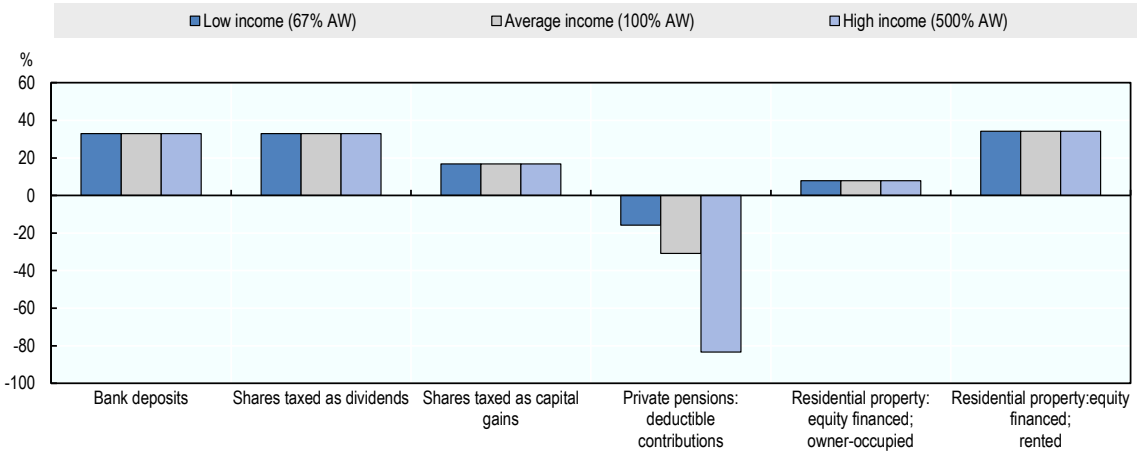


Source: OECD (2018[1]).

METRs do not increase with income in Slovenia. The proportional tax rate on capital income is reflected in METRs that are constant across income levels, with the exception of private pensions (Figure 6.6). Proportional tax rates are a typical characteristic of dual income tax systems which are widespread in the OECD. Some countries, however, tax capital income at the individual level at progressive rates, the effect of which is reflected in the 40-country average results presented in Figure 6.7.

Figure 6.6. The proportional rate on capital income in Slovenia results in METRs which are constant across income except for private pension savings

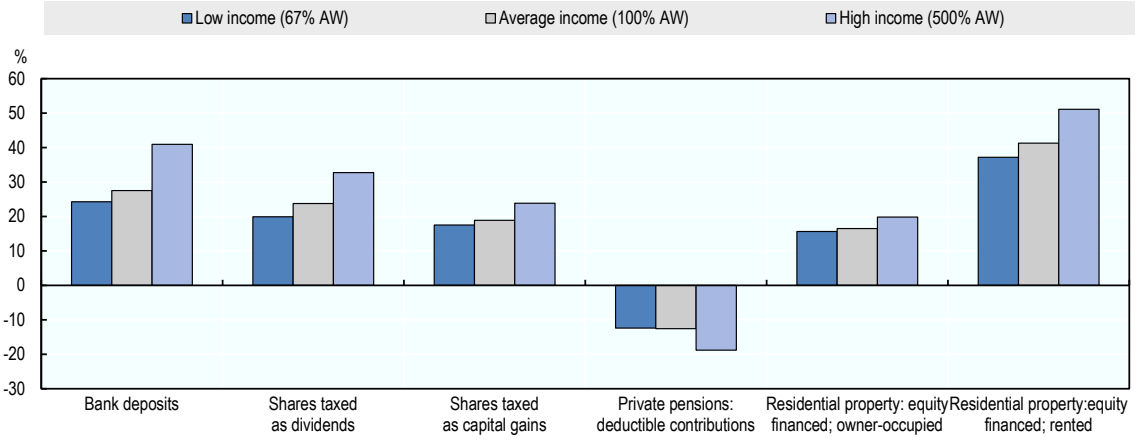
METRs (in %), Slovenia, actual country inflation rate, 2016



Source: OECD (2018[1]).

Figure 6.7. Marginal effective tax rates on household savings are increasing with income on average across the OECD

METRs (in %), average for 40 countries, actual country inflation rate, 2016



Source: OECD (2018[1]).

6.2.3. Slovenia faces different capital income tax reform options

Slovenia faces several reform options to raise more revenues from taxing capital income at the individual level while increasing the tax system's progressivity.

- As combined and effective tax rates on capital income in Slovenia are relatively low, the flat tax rate of 25% on dividends, interest, and rental income could be increased modestly. This would raise additional revenues and enhance the progressivity of the tax system as richer households typically earn more capital income. Box 6.1 presents estimates of the impact on revenues from an increase in the capital income tax rate.

- While the use of a final withholding tax reduces administrative costs, it limits the tax policy design options. While withholding of taxes by third parties remains the best solution to ensure tax compliance, the tax administration should reform its administrative processes such that taxpayers can be asked to file their capital income as part of their annual tax return (as is already the case for interest income from bank deposits). This will allow Slovenia to tax capital income at progressive rates.
- Slovenia could consider broadening the scope of the EUR 1 000 of exempt interest income to other types of capital income including interest on bonds and dividends. This would prevent the current tax-induced distortion against investment in businesses.
- Slovenia could abolish the phasing-out of the capital gains tax with the holding period or levy a minimum capital gains tax rate for longer-held assets. While a too high tax rate on capital gains might create lock-in effects in the sense that shareholders would prefer to hold on to their shares instead of realising their gains, a similar distortion arises when the capital gains tax rate is decreasing in the asset's holding period. A minimum capital gains tax rate would also help reducing the tax-induced incentives for self-employed businesses to incorporate and it would reduce incentives to invest in real estate over other types of investment.

In order to increase the progressivity of the tax system, Slovenia could consider moving from a (semi-) dual income tax towards a dual progressive income tax system. As is the case in many other OECD countries, Slovenia implements a (semi-) dual income tax system. Dual income tax systems tax different types of income separately at different tax rates. Capital income is typically taxed at low (and often flat) rates while labour income is taxed at higher and progressive rates (OECD, 2006[3]). Dual progressive income tax systems would maintain the separation between capital and labour income, but would tax both types of income at, albeit different, progressive rate schedules.

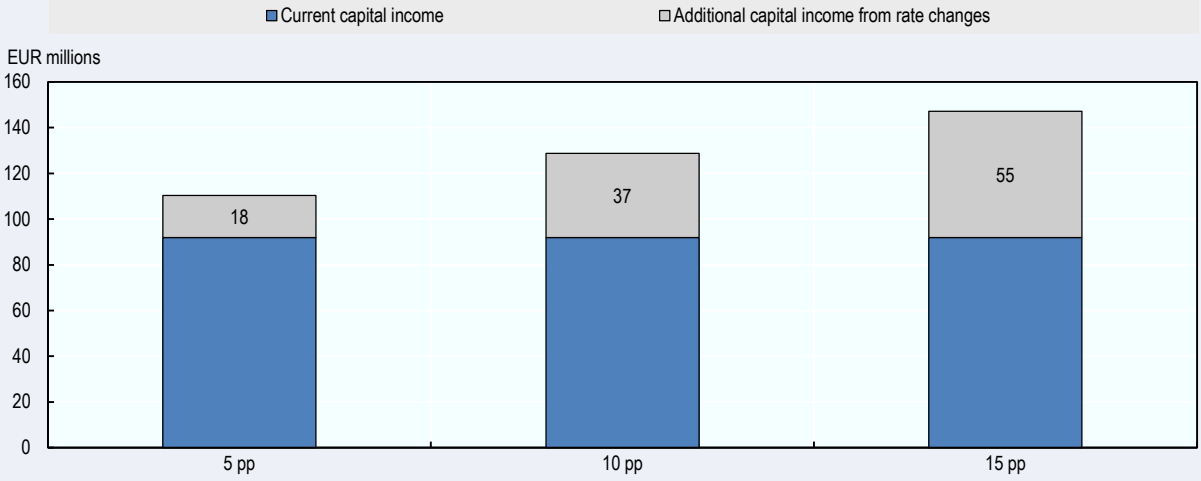
The social security tax base could be broadened to include capital income at the individual level. Box 6.2 presents the example of France where contributions for the social security system are not only levied on wages but on a broader tax base which includes capital income. In designing such a broad based social tax, countries need to take into account that SSCs can be challenging to implement when levied on the income of non-residents. According to a decision of the European Court of Justice in 2015, social security contributions (SSCs) cannot be levied on foreigners as they are not entitled to social security benefits in the jurisdiction where they have paid SSCs.

Box 6.1. Impact of an increase in the capital income tax rate

Total income from capital in 2016 is EUR 455 million and PIT is EUR 92 million, or an effective rate of 20.2%. The analysis shows that increasing the capital income tax rate by 5, 10 and 15 percentage points could cumulatively produce an additional EUR 18 million, EUR 37 million and EUR 55 million respectively (or approximately EUR 18 million for each 5 percentage points increase), assuming no behavioural changes in response to these tax rate increases (Figure 6.8).

Figure 6.8. EUR 18 million can be raised for each 5 percentage points increase of the capital income tax rate

Estimated capital income tax from increasing the capital income tax rate by 5, 10 and 15 percentage points



Note: The effective rate is taken as a proportion of the statutory rate (25%), which is assumed to be constant for further rate increases. On this basis, an increase to the rate of 26% for example would only produce about four-fifths of that percentage in PIT (or an effective rate of 21.0%) or EUR 3.7 million. The estimate assumes no behavioural changes in income shifting or compliance and that linearity for higher rate increases.
Source: Authors' calculations based on Ministry of Finance of Slovenia tax records microdata.

The tax privileges for voluntary (third pillar) private pension savings benefit richer households more. Taxpayers may deduct voluntary private pension savings from taxable personal income up to 24% of the compulsory contributions for pension and disability insurance with a maximum of EUR 2 819.09 per year (Ministry of Finance, 2018[4]). Contributions above the cap are not tax deductible (OECD, 2015[5]). On average, low incomes in Slovenia do not save very much for a tax-favoured third pillar private pension. Private pension savings constitute 16% to 19% of total financial assets in the top three income deciles while they constitute only 3% to 5% of total financial wealth in the bottom three income deciles (Figure 6.5). In light of the low public pensions and the increasing ageing related costs, Slovenia might evaluate whether the design of the tax privileges for private pension savings is effective. Possible reform options to consider include: 1) express the maximum amount of tax-deductible private pension savings in EUR rather than as a percentage of compulsory pension SSCs; 2) allow the un-used tax privilege to be carried

forward over time; and 3) turn the tax allowance into a tax credit such that the value of the tax deduction is similar for low and high income earners.

The recent move towards the automatic exchange of financial account information (AEOI) between tax administrations offers an opportunity to revisit the way countries tax capital income at the individual level. AEOI will provide information to the tax administration of the capital income earned by tax residents in other jurisdictions. Evading taxes by moving assets offshore and not declaring the income in the jurisdiction where the tax payer is tax-resident is becoming increasingly difficult. AEOI therefore creates opportunities for countries to tax capital income at slightly higher rates than currently is the case and/or to shift part of the capital income tax burden from the corporate to the individual level, without running the risk that assets leave the country in response (OECD, 2018[1]). However, in order to seize the opportunities created by AEOI, the Slovenian tax administration will have to strengthen its operational framework and data analysis tools in order to be able to process the taxpayer information it will receive from other jurisdictions.

Box 6.2. Broadening the tax base to passive income for financing social security system: the case of France with the contribution sociale généralisée (CSG)

In France, the CSG was created in 1990. The CSG is the most sizeable of all the various taxes earmarked for funding social insurance. Contributions are based on all sources of household income (wages, income from financial assets and investments, pensions, unemployment benefits, disability benefits and gambling proceeds) and are withheld at source.

Revenues from the CSG went up from EUR 58 billion in 2000 to nearly EUR 84 billion in 2010, exceeding income tax revenues by nearly EUR 30 billion. The CSG now represents two-thirds of earmarked tax revenues for social insurance financing. One of the effects (and advantage) of the CSG is the diversification of sources of funding for social protection which is based on both SSCs and taxes (i.e. the CSG). The CSG has largely replaced regressive contributions based on wages and salaries with a proportional and very broad base contribution based on all sources of household income. In parallel wage-based contributions (primarily levied on employers) have progressively declined.

Contrary to its initial objectives of simplicity and transparency, the CSG has become complex. The CSG has now six different rates depending on the types and levels of income (instead of one proportional rate). In addition the CSG combines different progressivity elements whereas at the start it was designed to be strictly proportional. Finally different taxes following the same logic of the CSG (i.e. with the same tax base) have been created without being merged with the CSG (such as social contributions on capital income), thereby further increasing the complexity of the tax system.

Source: OECD (2017[6]); Cour des comptes (2011[7]).

6.3. Raise more revenues from taxes on immovable property

Slovenia should strengthen the role of immovable property taxes. Revenues from property taxes in Slovenia are currently low (0.5% of GDP in 2015) and below the EU and the OECD averages (1.1% of GDP). Slovenia faces a significant opportunity to rebalance its tax mix away from more distortive taxes towards recurrent taxes on immovable property which is considered to be the least distortive tax for economic growth. The new recurrent

tax on immovable property, which is scheduled to be implemented over the coming years, creates great opportunities for Slovenia to rebalance its tax mix. Slovenia should consider levying a higher recurrent tax on second houses and holidays homes.

Significant revenues could be raised if revenues from recurrent taxes on immovable property were increased to the average level in the OECD. Estimations presented in Table 6.2 show that this would increase tax revenues with EUR 280 million (compared to 2015). Table 6.2 also presents how much additional revenues could be raised if Slovenia were to collect revenues similar to the level of the OECD's best performers (the United Kingdom, Canada, France, or the United States), which levy between 2.5% and 3.1% of GDP in revenues from recurrent taxes on immovable property.

Table 6.2. Recurrent taxes on immovable property could raise significant additional revenues

	% of GDP	EUR billion	Additional revenues raised compared to 2015 (EUR million)
2015 (latest info available)	0.5	0.19	
Scenarios	1.1*	0.48	280
	2.5**	1.08	890
	3.1**	1.34	1 150

Note: Calculations are based on GDP figures from the Statistical Office of Slovenia (EUR 38.837 billion in 2015; EUR 43.278 billion in 2017, current prices). * OECD average in 2015. ** OECD best performers.
Source: OECD Revenues Statistics database.

Slovenian households hold a larger share of their total gross wealth in the form of real assets rather than in the form of financial assets (OECD, 2018[1]). The main residence is by far the largest single asset category in Slovenia. Table 6.3 describes the taxes that are levied on occupied and rental property in Slovenia. Rental income is currently taxed at a flat 25% tax rate whereas it is typically taxed at progressive rates in other countries. As part of a property tax reform, Slovenia may also want to assess whether it could tax rental income at higher and, possibly, progressive rates.

Table 6.3. Tax treatment of property at different stages

	Owner-occupied residential property	Rented residential property
Acquisition	No tax relief for mortgage interest paid. Transaction tax only	
Holding	No capital income tax on the imputed rental income, but recurrent property tax	Rental income is taxed at flat rate of 25%
Disposal	Tax on capital gains (recurrent property tax) phasing out with holding period	

Note: Capital gains derived by the disposal of immovable property purchased or otherwise obtained before January 2002 are not taxable (Article 153 of the PIT Act).
Source: OECD (2018[1]).

Distributional analysis indicates that there might be scope to increase the taxes on property rental income in Slovenia. In 2016, approximately 90 000 taxpayers earned rental income representing EUR 216 million in income and EUR 48 million in tax revenues. Table 6.4 shows a breakdown of income and tax revenues from rent for taxpayers with

rental property income by rental income decile. The top 20% of taxpayers pay 80% of property rents. Due to limited deductions on property rent, the proportion of income that is taxable remains approximately stable at 90% across the income distribution. In addition, those with property have relatively high gross incomes. Even those in lower deciles have higher than the average income in the taxpayer population. For these reasons, increasing the PIT on rental property could be both effective and equitable.

Table 6.4. There is scope to increase property rental income

EUR

	Number of taxpayers	Mean rental income	Total rental income	Mean gross income	Mean PIT	Total PIT
Bottom decile	8 978	5	42 563	17 462	1	9 573
2	8 974	14	122 934	17 250	3	27 605
3	8 974	26	235 854	17 712	6	52 995
4	8 975	51	459 445	18 487	12	103 946
5	8 974	195	1 747 534	18 042	44	398 368
6	8 976	760	6 821 042	17 045	167	1 495 698
7	8 975	1 465	13 148 947	18 340	316	2 840 409
8	8 971	2 442	21 904 071	21 885	529	4 748 545
9	8 979	4 123	37 018 490	24 124	906	8 138 786
Top decile	8 975	15 000	134 627 370	38 126	3 345	30 019 091

Note: Methodological information on the microdata is available in the annex.
Source: Authors' calculations based on Ministry of Finance of Slovenia tax records microdata.

6.3.1. The revision of the recurrent property tax is on going

The 2013 Real Property Tax Act was annulled by the Constitutional Court in March 2014, two months after entering into force, and the previous legislation was reinstated. The goal of the reform was to substitute the two existing property tax systems with a unified real estate tax with a tax base linked to the market value of the property using a computer assisted mass appraisal system. The introduction of a revised version of the real estate tax which will broaden the tax base has been postponed until 2019 (European Commission, 2017[8]).

The current property tax system consists of two taxes which owners of real property have to pay: the property tax and the "charge for the use of building land" (Ministry of Finance, 2018[4]). The property tax base for premises (building, apartment, secondary houses etc.) is the value ascertained according to special criteria issued by the government and local communities. The tax rate depends on the type of property (dwellings, premises used for rest and recreation, business premises) and its value. Exemptions include buildings of less than 160 square meters; buildings used for agricultural purposes; business premises used by the owner or user for business activity; and cultural or historical monuments. In addition, a 10-year temporary exemption applies to taxpayers who own a newly constructed building or repaired or renovated buildings if the value of the buildings has increased by more than 50% as a result of the renovation. Finally, for a taxpayer with more than three family members who lives in the owner's house, the tax decreases by 10% for the fourth and every additional family member.

The charge for the use of building land is levied on vacant and constructed building land owned by individuals or legal entities. It is set by local communities and paid on an

annual basis by both individuals and companies. The tax administration collects the tax based on information provided by municipalities.

6.3.2. Slovenia should use the current property tax reform as an opportunity to rebalance how municipalities are financed

Municipalities rely heavily on PIT revenues which are shared between central and local government (see Chapter 1). Financing local governments mainly through revenues from PIT is uncommon and has disadvantages. PIT revenues are more volatile than property taxes. It results in large disparities in revenues as municipalities with a larger share of higher-income inhabitants will receive more funding. It also reduces incentives for municipalities to optimally use the recurrent tax on immovable property, which is the main tax used to finance sub-central governments across the OECD.

Raising more property taxes would give financial leeway to the general government to finance a cut in employee SSC. Additional revenues from recurrent taxes on immovable property could progressively, and partially, replace transferred PIT revenues from the general government to municipalities. As a result, more revenues from the PIT would gradually remain for the general government, which could be used to finance a decrease in employee SSC.

The new recurrent tax on immovable property should be turned into a local tax. Central government, however, should define the tax base and provides valuation guidance. Municipalities should not receive the power to provide tax exemptions. Central government might also want to set the tax rates within a minimum and maximum band to avoid a race to the bottom type of tax competition. Finally the central government could introduce a fiscal equalisation grant system to provide additional funding to municipalities that are collecting too little revenue from the new property tax. Sharing of PIT revenues with local governments should be as limited as possible to ensure that municipalities have an incentive to use the recurrent immovable property tax efficiently.

Additional revenues from the recurrent tax on immovable property would allow changing the financing mix of municipalities, away from a heavy reliance on PIT revenues. Recurrent taxes on immovable property are a more stable source of revenues than the PIT, and this is reflect in that they are the most widely used source of local financing across the world.

The formula that assigns additional tax revenues to municipalities could be lowered and adjusted to take into account the extent to which municipalities face the opportunity to collect revenues from recurrent taxes on immovable property. The higher the property values in a municipality, the greater potential for that municipality to collect revenues from recurrent taxes on immovable property and the lower the share of PIT revenues it should receive. Such a reform would strengthen the role of property taxes in Slovenia and would allow a significant reduction in the overall share of PIT revenues which are shared with municipalities – currently 54% of PIT revenues are shared – which would free-up PIT revenues which could be used to finance other priorities. In 2014, for instance, municipalities received PIT revenues equal to about 3% of GDP (Figure 1.13). Given the current revenues of 0.5% of GDP, an increase in recurrent taxes on immovable property with about 1% of GPD, would allow reducing the overall 54% sharing ratio with one-third to 36%. Raising revenues from immovable property equal to 2.5% of GDP, which is similar to the OECD best performers, would allow reducing the sharing ratio with two-thirds, to 18%. Central government should lower the PIT revenue sharing ratio from 54% to 36% once the recurrent tax on immovable property is put in place and then continue lowering the ratio gradually over time to a ratio between 30% and 18%.

6.4. Main recommendations

Box 6.3. Recommendations to improve the taxation of capital income at the individual level

Objective: Raise more revenues from taxing capital income at the individual level

- Consider increasing moderately the taxes on capital income at the individual level to help finance a cut in employee SSCs
- Consider moving towards a dual progressive income tax system
  - Tax capital income at mildly progressive rates
  - Broaden the scope of the interest exemption (of EUR 1 000) to other types of capital income
- Strengthen the efficiency of the tax-privileges for voluntary third-pillar private pension savings
  - Express the ceiling in EUR rather than linking it to pension SSCs paid
  - Replace the deduction for private pension contributions with a tax credit
- Strengthen the capital income tax administration
  - Strengthen IT tools in order to use information received from foreign tax administrations under the AEOI effectively
  - Make it compulsory for individual taxpayers to declare capital income on an annual basis (as is already the case for interest on bank deposits), but maintain the withholding of taxes at source

Objective: Revise the tax treatment of immovable property

- Tax owner-occupied property at higher rates than currently is the case
- Tax rental income at higher and possibly progressive tax rates
- Implement the real estate tax reform as quickly as possible
- Levy a higher recurrent tax on second houses and holidays homes

Objective: Reform the financing of municipalities

- Turn the new recurrent tax on immovable property into a local tax
  - Ensure that the tax base is set by central government and ensure that local governments can value property according to central government rules
  - No longer allow municipalities to introduce tax exemptions and special tax provisions
  - Set rates within a minimum and maximum band to avoid a race to the bottom type of tax competition between municipalities
  - Adjust the formula that shares PIT revenues such that municipalities with higher valued properties receive less PIT revenues
  - Adjust the fiscal equalisation grants such that municipalities which are not able to collect sufficient revenues from recurrent taxes on immovable property are compensated
- Lower the 54% PIT revenue sharing ratio to 36% once the new recurrent tax on immovable property is operational and continue lowering the ratio gradually over time

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Annex A. Methodology

Microdata

The microdata analysis in this paper is based on the Slovenian Financial Administration's administrative income tax records, which follow the entire population of approximately 1.85 million taxpayers over the period 2015 to 2016. The microdata, provided by the Financial Administration, represent the most comprehensive source of information on incomes, taxes and social security contributions (SSCs) in Slovenia. For the purposes of the microdata analysis, small amounts of reported gross income are removed below EUR 500, which would otherwise skew the distributional data, which has virtually no effect on total income but reduces taxpayer observations to 1.5 million in each year.[1]

Comparison with survey data

Compared with survey data, tax record data have several advantages (Jenkins, 2011[1]). First, coverage of the full taxpayer population allows for specific sub-group analysis while retaining adequate sample size. Second, it is an offence to submit a false tax return so incomes are mostly free from measurement error such as misreported incomes. Third, as noted by Jenkins, tax records are often 'used as a validation gold standard against which to assess measurement error in survey-based income data'. For example, it gives a scarce insight into income dynamics at the very top end, where the tax records are more representative.

There are also limitations to administrative data. For example, the data is confined to those who complete tax returns and does not cover those entirely reliant on untaxed benefits. For example, the total population also includes individuals which do not interact with the tax system including 300 000 persons under 15 years of age and around 80 000 unemployed. Unlike most survey data, tax record data have limited demographic data, such as educational attainment. It also does not include all benefit data such as direct transfers such as child benefit transfers. In addition, while the tax records are based on the gross incomes of taxpayers, survey data are typically based on an equivalisation of the disposable incomes of households, which reduces comparability.

Tax coverage of microdata

While microdata total personal income tax (PIT) and SSC for 2015 and 2016 are broadly similar to official tax revenues reported by the Ministry of Finance of Slovenia (2018), it is important to note that they do not match exactly for a number of reasons (Table A.1). For example, it is not possible to identify part-time employment in the microdata provided, and where the tax rules differ, it is not always possible to distinguish who is receiving certain income.

Table A.1. Tax revenue coverage of microdata

PIT and SSC (EUR millions)

	2015		2016	
	Financial administration microdata	Ministry of Finance	Financial administration microdata	Ministry of Finance
PIT	1 785	1 986	1 899	2 079
Employee SSC	3 072	2 893	3 190	3 020
Employer SSC	2 590	2 125	2 685	2 233

Source: Authors' calculations based on Ministry of Finance of Slovenia tax records microdata.

Total income by income category

In Slovenia, there are six categories of income: employment, business, agriculture, rental, capital (interest, dividends and capital gains) and other income. According to the microdata for 2016, Slovenia earns over EUR 21.2 billion in incomes, of which EUR 19.7 billion or over 90% is employment income (Table A.2). These are largely salaries (64% of total income) and pensions (21%). Income from business, agriculture, rental and capital comprise 2.7%, 0.5%, 1.8% and 1.4% of total income respectively.

Table A.2. Average and total incomes, by income type

Based on 1 498 185 taxpayers 2016

	Mean (EUR)	Total (EUR millions)	%
Gross	14 196	21 268	100
of which:			
Employment	13 176	19 740	92.8
of which:			
Salary	9 098	13 631	64.1
Pension	2 921	4 377	20.6
Other employment	1 157	1 733	8.1
Business	387	579	2.7
of which:			
Actual cost regime	277	415	2.0
Flat-rate regime	110	164	0.8
Agricultural	69	103	0.5
Rental property	144	216	1.0
Other	112	168	0.8

Source: Authors' calculations based on Ministry of Finance of Slovenia tax records microdata.

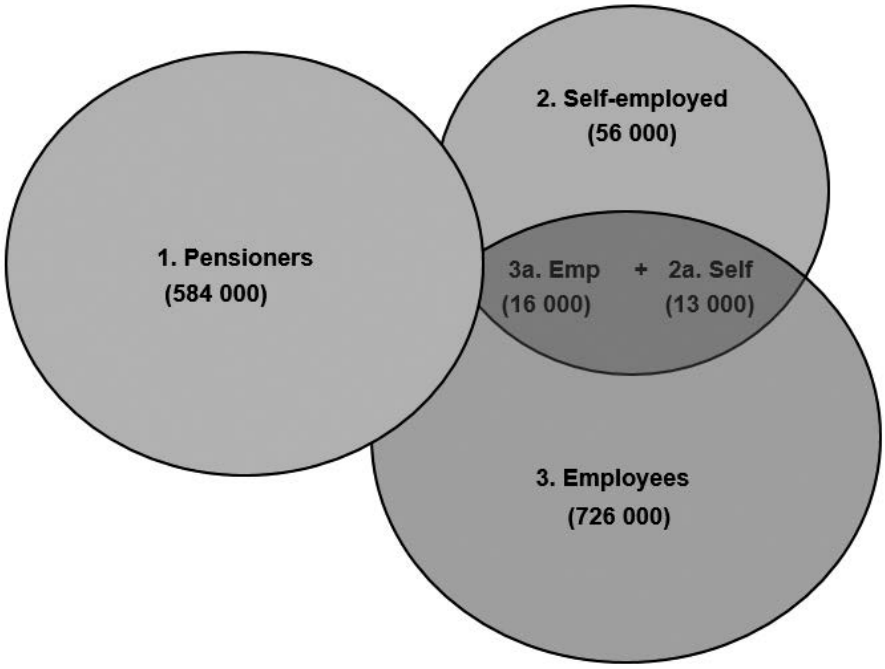
Taxpayer classifications

Taxpayers can derive income from multiple sources; sometimes at the same time. For the purposes of the microdata analysis, taxpayers are defined and classified into three mutually exclusive groups as follows: pensioners, self-employed and employees. A stylised illustration of the groups is shown in Figure A.1.

- First, pensioners are defined as taxpayers with *any* pension income (even where they have additional employment or self-employment income).

- Second, the self-employed are defined as taxpayers that have no pension income but have a self-employment income which is at least 15% of salary and self-employment income combined. The purpose of this definition is to capture those taxpayers with significant self-employment activity.
- Third, employees are defined as taxpayers with a salary income and no pension income. Taxpayers that have predominately a salary income but also a small self-employment income (up to 15% of salary and self-employment income combined) are also classified as employees. In this way, when taxpayers have both employment and self-employed income, they are assigned to one group based on the extent of their self-employment income. By construction then, those defined as employees or the self-employed do not have any pension income.

Figure A.1. Stylised illustration of taxpayer groups, 2016



Note: Circle sizes are stylised and do not correspond to taxpayer numbers. Numbers rounded to nearest thousand for illustration.
Source: Authors' calculations based on Ministry of Finance of Slovenia tax records microdata.

For each category, a stricter definition can be applied to include only those taxpayers that exclusively derive their income from that category (i.e. 100% of their income). For simplicity, these are referred to as 'full' employees, self-employed and pensioners.[2]

The Table A.3 shows taxpayer numbers for the total and full groups in 2016. In 2016, there are approximately 742 000 employees, 584 000 pensioners and 69 000 self-employed. Together, the three groups represent a comprehensive picture of the taxpayer population – they account for over 93% of taxpayers and 98% of gross income. Taxpayers not included are, for example, those who exclusively derive income from capital, agriculture, rent or 'other employment' (all groups also have some mix of additional income from such sources).

Table A.3. Number of taxpayers, by group 2016

	Total taxpayers (A)	'Full' taxpayers (B)	(A) / (B)
1. Employees	741 670	725 655	98%
2. Self-employed	69 000	56 234	81%
3. Pensioners	583 530	537 182	92%

Source: Authors' calculations based on Ministry of Finance of Slovenia tax records microdata.

Methodology of the costing of the main recommendations

This report produces various simulations to estimate the potential impacts of tax rate changes and base broadenings in Slovenia. The analysis is based on all 741 670 employees for 2016 in the microdata (with the exception of the allowances simulation which includes all taxpayers).

The analysis begins by simulating reductions in the employee SSC rate. It then extends this analysis by simulating PIT rate increases across the first four brackets and a reduction in the top PIT rate - for both a cut in employee SSCs and not. Next, the PIT implications of a base broadening measure are provided where tax allowances are reduced from 5% to 25%. In addition, an estimate of the SSC loss from capping employee SSCs is calculated.

The broad approach taken has been to reduce the reported employee SSC on the tax records and to substitute this into an estimate of taxable income – income from employment less employee SSC less allowances. Conceptually, both reduced employee SSCs or allowances will increase taxable income for all employees and will push some employees into higher PIT rate brackets. Consequently, the 2018 PIT schedule is reapplied retrospectively to the 2016 tax record data and new PIT brackets and PIT are estimated for each employee. Given this framework, PIT rate increases can be readily applied to newly estimated levels of taxable income. Similarly, reduced levels of allowances reported on the tax records can be readily substituted into the taxable income estimate. An evaluation of these estimated variables confirm that they provide reasonable estimators – estimated taxable income and estimated PIT are within EUR 1 000 and EUR 500 of actual reported amounts respectively for 90% of employees.

To simulate the impact of reduced employee SSC rates on overall SSC and PIT revenues, three methodological steps are undertaken as follows.

- First, the employee SSC amount on the tax records is assumed to be 22.1% of employment income for all employees. This assumption allows for applying a range of reduced employee SSC rates which are associated with reduced SSC amounts for each employee.
- Second, a new taxable income variable is defined and estimated as income from employment less employee SSCs and less allowances. Given these re-estimated variables, it is possible to simulate new levels of taxable income for each employee by substituting the reduced SSC employee amounts into estimated taxable income. Conceptually, reduced employee SSCs increase taxable income and push some employees into higher PIT rate bracket.
- Consequently, given new levels of taxable income, PIT must also be re-estimated for each employee using the PIT rate schedule. To do this, the latest 2018 schedule is applied retrospectively to the 2016 tax record data. An evaluation of these estimated variables confirm that they provide reasonable estimators – estimated taxable income and estimated PIT are within EUR 1 000 and EUR 500 of actual

reported amounts respectively for 90% of employees. The estimated PIT, with employee SSC set at the current 22.1%, is used as the comparison counterfactual for the simulated reforms.

Finally, two caveats are important. First, the analysis assumes no behavioural change and linearity. Second, while the microdata PIT and SSCs are broadly similar to total tax revenues reported by the Ministry of Finance of Slovenia, they do differ for various methodological reasons.

Notes

[1] Since no such cut-off threshold is used for other variables, the average of these variables may appear relatively lower than gross income.

[2] For the self-employed this would include only those taxpayers with 100% self-employment income (and no pension or employment income), for employees only those taxpayers with 100% salary income (and no business or pension income)[2] and for pensioners only those with 100% pension income (and no employment or self-employment income). These groups are loosely referred to as pure pensioners, pure self-employed and pure employees.

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(23 2018 27 1 P) ISBN 978-92-64-30388-1 – 2018

OECD Tax Policy Reviews

Slovenia 2018

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This report provides a comprehensive tax policy assessment of the taxes paid by individuals in Slovenia as well as tax reform recommendations. The report is divided into six chapters, with a summary of the main findings upfront, followed by more detailed recommendations at the end of chapters 3 to 6. Chapter 1 sets the scene for tax reform in Slovenia. Chapter 2 focuses on the labour market, social policy and tax policy related challenges. The ensuing chapters assess the financing of the social security system (Chapter 3), identify strategies to strengthen the design of personal income tax (Chapter 4), indirect taxes (Chapter 5), and the taxation of capital income at the individual level (Chapter 6).

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ISBN 978-92-64-30388-1
23 2018 27 1 P