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Phillip J. Bryson
phil_bryson@byu.edu

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The Property Tax in the Slovak Republic: Major Reforms and Striking Results

BY PHILLIP J. BRYSON, PHD

This article is based on a presentation given on August 24, 2005, at the International Property Tax Institute’s 8th International Conference on Property Tax in Transition held in Prague, Czech Republic.

When the communist era ended with the Velvet Revolution in 1989, Czechoslovakia embarked on a program of transition to a market democracy. Public sector foundations featured the creation of local government finance and intergovernmental fiscal arrangements, including limited use of local user fees. After institutions were established on the basis of legislation, the two countries agreed in 1993 to go separate ways in what came to be called the Velvet Divorce. The division opened the way for the pursuit of divergent fiscal practices, but for the first decade of the separation, there were no fiscal changes to signal movement into new, divergent directions.

Efforts to establish genuine fiscal decentralization were not impressive in either country before talk of accession to the European Union began. As that happened, both republics became committed to adopt “reforms of public administration” and to move from two levels of governance—central and municipal—to four. They prepared to submit themselves to governance from Brussels and also to add a regional level of government to share the burdens of subnational public service provision. Legislation provided for the necessary institutional changes in both countries, but it was in Slovakia that the reform of public administration was seen as a complement to, rather than a substitute for, fiscal decentralization.

This article reports on recent Slovak efforts to pursue these institutional changes. First, it will review the early characteristics of Slovak fiscal decentralization focusing on the property tax as the most important source of locally generated revenues. Next will be a discussion of the divergent developments in the fiscal systems of the two republics despite their similar fiscal decentralization programs. The reforms of public administration pursued in the early 2000s is the next topic; here, too, some of the implications of the widely discussed Slovak introduction of the “single tax” along with other changes that were part of a new fiscal system implemented at the beginning of 2005. The final section offers some concluding observations.

Philip J. Bryson, PhD, is the Douglas and Effie Driggs Professor of Economics in the Marriott School of Management at Brigham Young University. He earned his PhD in economics from Ohio State University.
Fiscal Decentralization in the Early Slovak Transition

The Republic of Slovakia has a population of 5,364 million in an area of 49,012 square kilometers. The Slovak population density approximates that of Portugal, Hungary, and France, with significantly more space for the average Slovak than that available for the average Czech. Slovakia has 109 citizens per square kilometer of territory to the Czech Republic’s 131. This compares to 228 citizens per square kilometer for Germany, 105 in France, 28 in the United States, and 32 for Europe as a whole. (Štatistický úrad Slovenskej republiky 1997).

Slovakia was a part of federal Czechoslovakia from 1918 to 1993. After the end of WWII, democracy faltered and the federation continued as a Soviet-type Socialist Republic. With the end of the Soviet Union, the Warsaw Pact, and the Council for Mutual Economic Assistance (CMEA), both the Czechs and the Slovaks have been in transition to democratic, market systems. Reestablishing local autonomy and utilizing the property tax as a fundamental revenue source to finance municipal services are potentially vital elements of this transition. An effective property tax must be based upon the market value of property, since the market is a non-arbitrary reflection of the incomes and the preferences that determine property values.

A property tax system based on market real estate values is just now becoming a reality in Slovakia. For economic and political reasons, a normally functioning real estate market, like the new market system generally, has been developing only gradually. Legacies of the socialist era and constraints on the privatization of property have not been the only roadblocks. Early in the transition, the Slovak central government preferred to ignore local self-government, postponing the dramatic progress that was to emerge later.

Nevertheless, transition reform efforts launched after the Velvet Revolution were rather successful. In 1992, without any formal consultation of the Slovak people, political leaders unilaterally decided to abandon the federation. Slovak leaders rejected any partnership with the Czechs, along with the Czech preference for a rapid transition to a market orientation. Both before and after the opening of the reform era, the Slovaks were substantially less comfortable with departure from the order and security of the Soviet ways than were the Czechs. This philosophical difference was evident in a provision of the new Slovak constitution which “establishes the possibility to stop...the process of privatization and/or restrict business activities and to reverse various measures that already had been taken in this respect.” (Valko 1997, 76)

As one would expect, however, the Slovak self-government and fiscal systems continued for a time to resemble those developed jointly with the Czechs late in the Czechoslovakian era. In the aftermath of the Velvet Revolution, both republics encouraged municipalities to seek independence from some of the forced amalgamations of the previous era. Under socialist rule, local autonomy had largely been lost. From 1950 until 1989, decisions about the quality and type of public services were made by central governments in Prague and Bratislava. Regional governments existed during this period only to administrate and facilitate the policies of the central government. Local government activity was also limited almost exclusively to such “state administration” activities.

It should be remembered that the economic transition of these countries followed hard on the heels of an era in which centralism had been rather absolute. Funding decisions had been based on political and party influence and evinced no close relationship to the citizenry’s needs or demands for public services, especially in the area of capital expenditures. Many local services were provided by the central government, e.g., police, public utilities, fire protection, and education. Socialist systems also
provided a number of services western governments do not, including housing, which was produced and managed by the central government just as medical care was. Still, permitting local governments to function largely symbolically actually ran counter to Slovak tradition.

When the transition era began in 1989, local governments increased in strength and number. There are currently 2,781 of them and only a few have a population in excess of 50,000. The majority of Slovak municipalities have fewer than 500 inhabitants and many have less than 100. Comparing the number of cities per 10,000 inhabitants in nine Central and Eastern European countries reveals that Slovakia (like only the Czech Republic) has significantly more cities than other countries in the region (see table 1).

Of these neighboring countries, only Hungary’s cities and towns compare in number to those of the former Czechoslovakia. The diminutive size of Slovak and Czech municipalities raises the question of whether they have sufficient personnel and resources to administer local government effectively. About 125 of the cities in the republic have created the position of City Manager to assist Slovak elected officials in their management functions. Several supportive organizations have assisted in the development of a professional core of local public managers. There is also an organization of city finance directors whose operations are similar to those of the Government Finance Officers Association in the United States.

These groups offer regular training and professional development. They strive to influence policy relative to intergovernmental financial relationships and local service provision. The existence and activities of these types of groups appear to have been positively influenced by the former U.S. Agency for International Development (USAID) mission in Bratislava, which assisted in establishing local administrative infrastructure in Slovakia and in training managers of local governments.

In Bratislava, the Association of Cities and Towns of Slovakia (Združenie Miest a Obcí Slovenska [ZMOS]) represents local governments in their interaction with the central government. This association is similar to those of numerous other countries. It participates in drafting and reviewing legislation on local government administration and policy and has also organized a foundation to train city employees to perform local government functions. ZMOS has more than 2,700 members and thus represents over 95% of Slovakia’s municipalities.

Table 1. Number of subnational government units in selected transition economies

<table>
<thead>
<tr>
<th>Country</th>
<th>Type of Government</th>
<th>Number Of Units</th>
<th>Country Population</th>
<th>Municipalities per 10,000</th>
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</tr>
<tr>
<td>Russia</td>
<td>Municipality</td>
<td>2000</td>
<td>149,000,000</td>
<td>0.13</td>
</tr>
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<td>Municipality</td>
<td>619</td>
<td>52,100,000</td>
<td>0.12</td>
</tr>
</tbody>
</table>

Decentralization Difficulties and the Property Tax in Transition Countries

Overcoming the legacies of central planning has proven to be a difficult and slow process (Bryson and Cornia 2004). To say that local governments have often remained underfunded is a euphemism, at best. Having no significant sources of independent funding, municipalities have had to wait for transfers and grants from central governments too often gripped with fiscal crises of their own. Central governments have generally been unwilling to abandon the centralist traditions of the previous era, which implies a policy preference for indirect and non-transparent taxes and for public services which provoke no substantive political opposition. Citizens of the localities have been disinclined to pay for public service provision; they have preferred funding through transfers from the center rather than from local taxation. Central governments have been willing to make what transfers they could, but retained control over the programs funded.

As the transition began, the citizens of transitional countries were not always opposed to foregoing generous public goods provision, since they anticipated a larger and more readily available assortment of private goods they perceived to be common in market economies. Thus, they silently accepted the willingness of their local governments not to pursue any substantial efforts to charge fees or impose property taxes that would produce an independent source of revenues. As a result, local officials were not forced to confront their constituencies with taxes to fund badly needed services.

When Czechoslovakia began to decentralize its fiscal system in 1990, legislation established more Western-style institutions. The government borrowed heavily from Western Europe, adopting taxes prevalent there without reference to whether such a system was optimal for transition countries, or whether that system could generate revenues sufficient for their needs. Since the end of communism, fiscal crises have been common in the transitioning countries and transfers of funds from the center have been insufficient to cover needs. Municipalities have been unable to enjoy genuine autonomy, especially because they lacked sufficient sources of independent revenue that a number of countries raise through the property tax.

That tax, potentially the most important source of local revenues, remained strictly the nominal tax it had been under central planning. In the transition period, the four most important revenue sources for the Slovak Republic were the familiar VAT, the personal income tax, corporate income tax, and an income tax on unincorporated businesses. Although all of these were collected by the central government, only VAT revenues were not shared with local governments.

This system was based on identical legislation to that enacted in Czechoslovakia before the Velvet Divorce. After the Velvet Divorce, institutional inertia and preoccupation with other problems kept either republic from making substantive changes in the fiscal system for some time. Overtly, pre-accession motivation provided by the European Union convinced the Slovaks to launch the recent, bold reforms. But before that time, the differences between the two fiscal systems were not always great. The Slovak fiscal system was inclined less toward centralization than its Czech counterpart, although both countries emphasized a desire to achieve decentralization and to develop self-government (samospravy) for their municipalities.

Property Tax Rate and Base

Property tax policy is established by the central government and national legislation, but the day-to-day administration of the property tax is largely the domain of Slovak municipalities. This contrasts with the Czech system in which the central government collects the property tax and redistributes the revenues to the municipalities.

The taxation of land was based on the
area of each individual parcel; similarly, the taxation of buildings was based on the number of square meters of a structure’s floor space, including the land area under the buildings. The tax rate was established separately for the two kinds of properties. In the property tax formula, adjustments were made for the location of land and buildings and for the particular utilization of the taxed unit. These modest, largely symbolic efforts to account for market characteristics were a genuflection to market valuation.

Of the eleven Slovak classifications of land, eight adjusted the assessed tax value for the quality of the land, which was estimated by the Ministry of Agriculture. The data collected on quality and potential productivity were remarkably detailed. Parcels in close proximity sometimes had substantial differences in estimated productivity.

In the transitional property tax system, basic tax rates ranging from one Slovak crown (SKK) to ten Slovak crowns per square meter (adjustable annually) were applied to six classes of buildings ranging from residential to industrial. The basic rate increased by .75 SKK for each floor. The tax on buildings allowed for two additional adjustments:

- Data on the size and type of a building could be multiplied by a population-based coefficient, with that for the largest cities being greater than that for the smallest towns by a factor of 4.5.

- The local administrator could apply a final coefficient to the formula evaluating a building’s location within the city. This could increase or reduce the tax bill by as much as 50%, giving city administrators a modest degree of flexibility in taxing for differential location qualities.

Data on per capita land and building taxes under the transitional system (see figure 1) revealed a pattern of significant revenue generation in Slovak municipalities. With increasing municipal size, per capita revenues from the tax on land declined continuously, although not monotonically. For the tax on buildings, the opposite held: as municipality size increased, per capita tax revenues increased continuously. In larger cities, the tax burden was shifted more to structures. The implications were:

- because land is a resource that cannot be removed from the region to avoid the tax, the land tax is underutilized in Slovak cities, keeping badly needed revenues below their potential. Moreover,

- although there is an intent that these taxes be borne by business, a selling point to local inhabitants, the tax burden will ultimately be shifted to consumers in any case, unless the tax has lump-sum rather than excise characteristics.

The property tax law of the Slovak Republic granted explicit exemptions for state-owned, cultural, religious, and other such properties. An exempt owner of commercial real estate was taxed at a rate of about one-third of that for commercial organizations. In the larger cities, exemptions have represented a substantial portion of the potential property-tax base, severely limiting the revenue capacity of the tax system. Implementing a tax system with capacity to generate sufficient revenues for public services and other exigencies, then undermining the program with exemptions, is clearly self-defeating.

In pursuit of a presumed objective to promote private housing construction, explicit, 15-year exemptions were granted for newly constructed and recently renovated homes. Since the property tax base and rates of the transitional system did not produce a large yield, the incentive effect of this policy had little actual significance. Buildings restituted to former owners were also relieved of property taxes for a 15-year period.

In the transitional system, local govern-
ments were responsible for the collection of property tax data and the tax itself. They relied on the centrally operated cadastre for information pertaining, for example, to the ownership of properties. Specific information on land areas was available from the cadastre, but that agency was of limited help in identifying land. Since it does not record information on building size, it could provide no assistance in assessing the tax on buildings.

In the Slovak property tax system, the municipality/taxpayer relationship has been fraught with asymmetric information. Information laws have prevented the municipalities from verifying important data through the cadastre, rendering them dependent upon taxpayers to supply the details about their taxable land and buildings. Despite this problem, the finance ministry has not publicized any concerns about property tax compliance. Restructuring the fiscal system to increase property tax yields in a substantial manner, however, is likely to produce a compliance problem. It should be no surprise, therefore, that changes in property tax laws in the new era are proceeding gradually.

One expects with an area-based tax that there will be a close relationship between the area of a plot or of a building and the tax revenues either would generate. Interestingly, this is not the case in Slovakia (Bryson and Cornia 2001). Certain classes of land are taxed far more heavily than others; building plots in all Slovakian cities produce more revenue per square meter than arable land or forests. The same holds for taxes on improvements. Industrial and commercial buildings produce much greater revenues per square meter than agricultural or apartment buildings. Apparently, the heaviest tax burden was on commercial and industrial activities, or on capital. Smaller towns and cities were inclined to tax building plots more heavily than arable land. Probably seen as less productive of revenues than farmland, forests were subject to even less tax than the former.

The ratio for arable land is around 1.25 for towns and cities smaller than Bratislava, where the ratio is considerably lower at 0.14. In the transition property tax system, the smaller towns had a tendency to

**Figure 1.** Per capita land tax and building tax by size of municipality, 1996

![Per capita land tax and building tax by size of municipality, 1996](image-url)

Source: Ministry of Finance
put the burden of tax revenues on buildings rather than on land. Commercial and industrial buildings were burdened with consistently higher taxes than buildings for other uses. Apartments and agricultural buildings provided services and products viewed in the communist era as necessaries, so they were subject to whatever subsidization would keep their prices very low. There was, therefore, a central planning legacy of minimal taxation for these items. By contrast, industrial and commercial activities and properties were a targeted source of revenue, a tradition that continued into the transition. It should be noted, finally, that the property tax’s relatively greater importance to municipalities was structured so that the ratio of tax to square meter of building space increased monotonically and significantly as the municipal tax jurisdiction became smaller.

This fairly extensive review of the property tax system of the transition era has been designed to demonstrate the significance of the changes introduced at the beginning of 2005 with the New System.

**The Property Tax and Municipal Budgets in the Transition**

If fiscal decentralization is to succeed, local governments must have access to an autonomous source of tax revenue, rather than be dependent upon the central government for all revenues (Bird, Ebel, and Wallich 1995). The visibility of spending choices made by local public officials, both elected and appointed, generally exceeds that of national officials. The accountability of such officials logically increases with that visibility (Litvak, Bird, and Ahmand 1998), and makes a strong case for local governance and local tax.

The property tax embodies many positive characteristics that recommend it as a local tax. Since taxpayers cannot evade it by engaging in transactions beyond a relevant political border, it is immobile. Since its imposition does not cause changes in the utilization of the services of taxed properties, it is potentially neutral. Since it provides fairly constant revenue yields regardless of the state of the business cycle, it is stable. Since relevant taxpayers are homeowners and property holders, they are more likely to have the means and the ability to pay the property tax. This is in contrast to the highly popular, yet regressive, excise taxes, which represent a larger proportion of lower than of higher incomes. Further, if local public services improve and enhance property values, it is appropriate that the beneficiaries are required to pay for the increased value. Finally, as a direct tax, it is highly visible to taxpayers (Musgrave 1993; Oates 1996).

That visibility is a two-edged sword, of course. Since they are direct and visible, property taxes make citizens and officials less comfortable than indirect taxes (Youngman and Malme 1994). Generally, both officials and citizens prefer excise taxes and local fees on a variety of transactions (Shleifer and Vishny 1998). Too frequently local officials feel the heat of political problems the property tax can provoke (Paugam, 1999).

Implementing the property tax provides both administrative and practical problems:

- For transition countries, it is difficult to establish the market-oriented property values the tax suggests, since there is typically no functioning real estate market in countries beginning the recovery from central planning (Bertaud and Renaud 1994).
- Inflation can erode assessments, which are not automatically linked to inflation or economic growth.
- Cadastral data can be of low quality and impair collection and enforcement efforts.
- The uneven distribution of the property tax base creates inequalities (Netzer 1966).

Fiscal decentralization can succeed
only if the following three conditions hold. First, there must be a correspondence between the expenditure responsibilities of local governments and the availability of financial resources. Second, incentives must be provided for subnational governments to mobilize their potential resources in their pursuit of autonomy. Third, the provision of transfers from the central government must be transparent and based on objective and consistent criteria rather than negotiation and ad hoc bargaining (Bird, Ebel, and Wallich 1995, 59).

It becomes apparent that the implementation of an effective property tax regime requires close attention to institutions of governance. In countries where time and good judgment have permitted these institutions to develop properly, the rewards of political autonomy have been achieved for local governments.

**Moral Hazard Problems in Property Tax Administration**

Principal/agent conflicts can be expected when the “ownership” (in terms of policy prerogatives rather than revenue receipts) and the administration of the property tax are shared by central and subnational governments. Conflicts arising from the lack of clear ownership are common in transition countries, largely owing to the very divergent perspectives and incentives of local and central governments. Moral hazard problems arise when agents pursue their own interests rather than those of the principal. In Slovakia, the property tax is the design of national policy, but it is collected by the municipalities themselves. There is no malingering in the collection effort of the local governments, since the revenues are badly needed.

The significance of these institutional arrangements is apparent when compared to the Czech system, in which local government is the principal and central government acts as the agent. The center both designs policy and collects the tax, so that the local government principal can receive such property tax revenues as the central agent’s collection efforts provide. Not being in a position to monitor the collection effort, revenue-hungry subnational governments can only hope that the national government will exert significant effort.

The data show that revenue from these taxes is suboptimal since the center lacks incentive to exert the effort and resources required to increase the revenue yield. Smaller property tax revenues can, however, be easily offset by greater transfers from other taxes or revenue sources. This is certainly the case in the Czech Republic, where relative to other transition countries, the central government has been anything but a poor provider. The Finance Ministry would also argue that local governments do not attempt to achieve optimal receipts, since they set their property tax coefficients such that their receipts are only about half what they could be (Ministry of Finance of the Slovak Republic 2005).

It is also a form of moral hazard when local government officials, acting as (insufficiently monitored) agents for the citizenry, the true “principal” in a democracy, fail to exert an honest effort to produce the revenues required for the public services citizens demand. Once municipalities become financially dependent on the central government, they become quite willing to avoid full financial responsibility by silently partnering in their principal/agent arrangements. They become comfortable in permitting the center to take all the responsibility for raising municipal funds, thus avoiding any potential political heat a serious property tax might generate. It is easier to conform to central guidelines, mandates, and directives than to take a stand for local preferences that clearly differ from those of the center in a less bureaucratic and centralized system.

Still considering the Czech case, if the center compensates for its lack of effort in property tax collection by providing revenues from other sources—even if lo-
Cal governments are financially no worse off, these alternative revenues often come with “strings attached.” Other moral hazard issues emerge with central government revenue transfers. For example, if the distribution of resources is badly skewed across subnational governments, or if subsidies encourage local governments to pursue activities of high priority to the center, their fiscal redistribution becomes very appealing (Musgrave 1961). But transfers from the center can merely offset revenues that could have been raised locally. If the central government compensates the municipality for the property tax funds it has failed to collect, local officials can act less transparently.

Because the Slovak central government was initially far less generous in providing transfers, Slovak municipalities had to take advantage of their opportunity to collect property tax revenues for themselves. From the 1960s until the end of central planning, local governments in the Czechoslovak federation derived roughly 60% of their total receipts from subsidies. From around 1984, however, central government subsidies began to decline. This trend extended into the transition to market economics and democracy. By the mid-1990s, subsidies represented no more than 25% of the total receipts of Czech and Slovak municipalities (Pekova 1996).

The data for the transition period reveal the relevance of these moral hazard considerations. They are reviewed comprehensively for the period of transitional finance in the two republics from the end of central planning to 2000 by Bryson and Cornia (2004). They reveal Slovakia’s municipalities to be substantially poorer than those of the Czech Republic. After the Velvet Divorce in 1993, Czech municipal budgets were more than twice as large as those of Slovakia. This was at least partly a result of per capita differences in grants from the respective central governments. By the end of the period, per capita public services expenditures for Czech citizens were three times greater than those for their Slovak counterparts. Local budgets in Slovakia were only about 14% of the total national budget, while those of the Czech Republic ranged from 25% to just over 33% of the national budget.

The difference in municipal grants shows why Slovak municipalities were comparatively quite poor. Grants in Slovakia ranged from 1.5 billion Slovak crowns (SKK) in 1993 to 1.1 billion SKK in 1994. The grants paid by the Czech central government to the municipalities ranged from just over 27 billion Czech crowns (CZK) in 1993 to 59.5 billion CZK in 1996. (One should keep in mind that the population of the Czech Republic is twice as large as that of Slovakia, but also that the Czech crown will purchase from 1.25 to 1.3 Slovak crowns.) Interestingly, in the years just prior to Slovak independence (1991 and 1992), the government in Prague provided grants of 7.9 billion and 2.4 billion crowns respectively for Slovak municipalities. Thus, independence from the Czechs turned out to be a financial shock for municipalities in the Slovak Republic, for it separated them from the Czech central budget. In that period, Slovak municipalities also found that politics would separate them from the Slovak central budget. Then prime minister Vladimir Mečiar, preoccupied with what the political opposition termed the “family privatization” of Slovak industry, had no interest in helping solve the financial problems of Slovak towns, cities, and regions. Mečiar’s autocratic leadership style and his lack of interest in municipal development was a clear signal that they could expect no significant transfers or grants from Bratislava.

Since they had far less substantial financial support from the central government, Slovak municipalities were much more diligent in their efforts to harvest property tax yields and thus the property tax represented a significantly larger share of the total revenues of local governments. Using data from the finance ministries of both republics, Bryson and Cornia (2004) calculated that for the years 1993 to 2001,
the real estate tax in Slovakia provided from roughly 11% to 18% of the revenue for municipal budgets (table 2). On average, property tax revenue represented about a 15% share of total receipts for Slovak municipalities. In the Czech Republic, with larger municipal budgets, the real estate tax ranged from 3.28% of total municipal revenues up to a maximum of 4.8%. Although Czech property tax revenues were relatively small in 1993, the trend thereafter was toward smaller receipts. The Slovak municipalities clearly demonstrated greater effort in collecting the property tax.

Table 3 illustrates the disparity between the share of total national budget receipts enjoyed by municipalities in the Slovak Republic and the Czech Republic. Whereas the Czech municipalities received a share of around 30% of total governmental receipts, Slovak municipalities received only around 6%. Given their financially less comfortable circumstances, it is little wonder that Slovak municipalities attempted more diligently to harvest greater property tax revenues.

Both republics struggled in the transition era with periodic fiscal crises, the result of which was often a reduction in municipal revenues. The Czech government was good about avoiding unfunded mandates, but it retained strong influence over the use of centrally provided funds, thus inhibiting local autonomy. The Slovak municipalities had little to work with, but seemed to exhibit more independence with what revenues they did receive.

### The New Post-Transitional Fiscal System in Slovakia

Foundations of the New System were laid in Slovakia in the period preceding accession to EU membership in May 2004. The emphasis of the EU during that stage was not on fiscal decentralization for the two republics, but on a related action, i.e., the reform of public administration.

In marked contrast to the Slovak case, the Czech Republic was interested in a honing of organizational arrangements, seen most graphically in the creation of the new regional level of government. The goal of the reforms was to modernize central administration and provide “territorial public administration” to improve the quality of the public sector’s products as a whole (Bureš et al 2002, 8). Regional governments are ostensibly to “bring state administration to the people” (přiblížit státní správu obcánům), involving rank-and-file citizens in subnational governance processes. But the question whether the reform of public administration could effectively serve as a substitute for municipal autonomy, i.e., for fiscal decentralization, has not yet been adequately addressed.

While pursuing the mechanics of such organizational questions, the Czech finance ministry and political apparatus were developing a social welfare state. That implied more generous provision of the expansive kinds of entitlements provided in most of Western Europe, especially pensions and health care. In doing so, the central government began to run large budget deficits and accumulate a

### Table 2. Real estate tax as percentage of municipal budget revenues

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Source: Bryson and Cornia (2004)

### Table 3. Local budgets as a percentage share of the national budget

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</table>

Source: Bryson and Cornia (2004)
growing burden of debt. It has long since recognized the impossibility of an indefinite expansion of public expectations and commitments. It is now desperately seeking ways to increase national revenues, but the reality of the macroeconomic situation is that it will be necessary to reduce expenditures in the next few years. This essential focus on the national budget has removed the focus of the finance ministry and the political system from the municipal situation and the process of fiscal decentralization (Ministry of Finance of the Czech Republic 2005).

Interestingly, pre-reform Slovakia paralleled the Czech case in that samosprava (local self-government) was performed by elected municipal officials. In a separate office, local “state administration” activities and programs were performed by agents of the central government. An inference as to the resources committed by central government to local state administration can be made from employment figures. Before the reform of public administration in 2000, state administration employed 287,817 Slovak citizens. That represented 84.7% of total government employment. Only 52,100 were employed in self-government at the local level, which was only 15.3% of total government employment. After implementation of the reforms, employment in state administration declined from nearly 85% to 37%, while the number employed in local self-government increased from approximately 15% to 63% (Nižňanský and Kling 2002, 252). In 2001, the total expenditures of local offices of state administration were 58 billion SKK. Local governments in that same year spent only 30.6 billion SKK. So direct spending by the central government for the municipalities was nearly twice as much as the independent municipal governments spent. It was high time for a reform of this unthinkable centralization, although to Slovakia’s central authorities “state administration” represented little more than the state’s solution to the problem of very small municipalities unable to provide for their own management.

The conception and design of the Slovak reform was introduced early by an official paper (Government Office of the Slovak Republic 2000) listing the functions that would continue to be performed by local state administration officials after the reform. These central-government responsibilities included local police services, criminal investigation, military administration, the state veterinary office, the state hygienist office, the environmental office, the cadastral office, the land and forest office, the labor and social services office, and the tax office. This is an imposing list of activities for which Slovak municipalities will have neither responsibility nor managerial prerogatives. As explained earlier, the Slovak municipality, within its fairly narrow range of ceded responsibilities, received little funding but rather liberal managerial authority throughout the transition era.

The Slovak national government intended for this situation to change and the reforms have been bringing about the desired change in a striking manner. Reforms are also moving the municipalities toward substantive change. The Slovaks recognize what this process requires and that a reorganization or reform of institutions cannot be an effective substitute for fiscal decentralization. Effective governmental organization and fiscal decentralization are policy complements rather than substitutes. The Slovak central government conceded (Government Office of the Slovak Republic 2000, 4) that decentralization of public affairs must include “decentralization of functional responsibilities, decentralization of finances, decentralization of political power…” The complex process of decentralization is only effective “if it is implemented in all three dimensions at the same time.”

But while they were reforming, the Slovaks wanted more than marginal organizational change. They considered their economic future imaginatively and were prepared for additional adjustments,
although Slovak economic development throughout the transition period had often been surprisingly strong. Among the struggling transition states, the Slovak Republic has been stronger in relative terms than one would have supposed, especially considering its political situation through the Mečiar era.

The initial economic successes Slovakia experienced in its independence era were due in large measure to a mini-boom in exports. Prosperity and expansion in Western markets provided demand, and the shift was made successfully from the old CMEA markets to the important EU markets. Sensible monetary policy kept inflation within bounds and although development was spotty, leaving some regional unemployment levels high, progress was fairly steady.

So, the introduction of reforms around 2000 brought some striking new policies, including the institution of a “flat tax” (Knáko 2002). This tax featured a common rate of 19% for corporate and personal income tax, as well as for the VAT. Details of the New System were spelled out in a document published by the Ministry of Finance (2004a).

The principal objectives of the tax reform were to achieve fairness and simplicity while eliminating double taxation. One should keep in mind that the fiscal reforms were only a part of the overall reform effort being pursued during this period. Nižňanský and Pilat (2002) cogently present the entire transition era as a pursuit of multi-front reform. Public administration reform alone comprised four processes: changing the territorial arrangement, reforming extant institutions and creating new regions, decentralizing public finance powers and competencies, and modernizing the system’s legislative framework and management. From the perspective of this article, the New System’s ramifications for local finance are of particular importance.

Among the many considerations motivating the reform at the local level, it was significant for Slovak policymakers that the share of revenues from property taxes were considerably lower than in numerous countries in either the European Union or the Organisation for Economic Co-operation and Development (OECD). As a result, the ministry intended to strengthen the property tax as a part of the package of changes designed to promote the process of fiscal decentralization. Following is a discussion of some of the main changes announced by the Ministry of Finance (2004b) that went into effect on January 1, 2005.

Before the reforms, central government had announced their allocation of transferred tax revenues to the municipalities each year in the State Budget Act. This process was “unstable” and did not permit the cities and towns to engage in effective planning until after the announcement had been made. The New System was designed to stabilize the flow of revenues to local governments and give them an opportunity to engage in multiple-year financial planning.

The finance ministry announced that the personal income tax was to become an “own” source of revenues for both regions and municipalities. Of the total revenue from this tax, municipalities were henceforth to receive 70.3% and the regions 23.5%. Only 6.2% of the revenue was to remain a part of the national budget (Ministry of Finance of the Slovak Republic 2004a, 31). The general notion was that roughly one-third of municipal revenues would now come from the personal income tax transfers, one-third would come from grants from the central government and the European Union, and one-third would come from municipal own revenues, i.e., from the property tax, local user fees, and from privatization of publicly-owned assets (ZMOS 2005).

Local governments received the right on January 1, 2005, to set “tax rates” (a term applied, interestingly, not only to the real estate tax, but apparently also to the very limited number of user fees already extant) and to introduce new “taxes.” The municipalities also received full discre-
tion to apply exemptions according to their own preferences. Potentially more important was that municipalities were also given policy control over the property tax. In the first place, they were to use the funds they raised through the property tax, like those transferred to them from the personal income tax, autonomously; the state denied itself any right to specify the uses to which these revenues could be put. Moreover, all the old laws pertaining to the coefficients applied to property classifications under property tax administration were now null and void. The municipalities could use the property tax independently. The real estate tax, along with the charitable donation deduction and the inheritance tax, were eliminated as a part of the tax reform (Zachar 2004, 38). The objective of the new legislation on real estate tax was to create a legal basis for transparent taxation of real estate based on market valuation.

It should be observed that in the short time since the inception of the New System, the property tax has not become a more important source of revenue. There have been no plans to increase revenues from this source in budgets to 2007 (ZMOS 2005). Early in the year of inception, it appeared that municipal self-government had gained by these new developments. At the same time, resources seemed no less scarce at the municipal level. As the new rules came into effect, the larger cities felt that they gained less through the change than some of the smaller ones, but institutional change in resource allocation often produces winners and losers, requiring some modifications or institutional accommodation to the changed system.

The Government of the Slovak Republic (2002, 2) made its own statement of policy intent promising to protect the interests of taxpayers. It promised it would increase the tax revenues of municipalities and define the tax revenues of regions in such a way as to assure that the tax burden on individual taxpayers and businesses would not be increased. This was to be accomplished by the creation of a special law “containing the definition and structure of tax revenues for municipalities and higher territorial units and criteria for their redistribution to municipalities and higher territorial units’ budgets.” This intended assurance does little for the proponent of fiscal decentralization, since that concept seems threatened when central government defines tax structures for subnational governments and for redistributing revenues.

Later in the same document, the Government of the Slovak Republic (2002, 4) addressed the issue of the developing real estate market, the values of which would replace the old coefficient system. It said, “Depending on how realistic real estate prices become, which is a basis for the taxation of property transfers, the Government will revise the current property tax rates and adopt corresponding solutions to unify them.” What the government defines as realistic or what actions it would take in the absence of realistic prices is not stated. However, given past traditions, the policy course would likely involve regulatory activities. This appears to further contradict the current stated policy of letting municipalities work out their own property tax rates.

The perception of the Ministry of Finance (2004b, 33) was that the reform of public administration and the changes connected with the accession of Slovakia to the European Union were the driving forces behind the creation of the new, comprehensive legislative framework developing the budgetary process in the sector of public administration. The finance ministry documents evince a far less distinct tone of centralism.

A Tentative Assessment of Reform Effects

The New System as applied to local governments has been in the implementation phase for too brief a time to say how effective it will be, although it is clear that the effect will depend both on the macro impacts of the new tax system.
on the national budget and the ability of the subnational governments to leverage their new policy maneuverability into enhanced tax revenues.

Since the initiation of the new tax system at the national level late in 2003, Slovakia’s economic performance has appeared to improve. The Republic’s recent growth rates were strong at 5.5% in 2004, finishing the year at 5.8% for the final quarter of the year (Slovensko.com 2005). Growth was expected to be somewhat less in 2005, but it was sufficiently strong, coming during a period of low growth throughout Europe generally, to cause widespread notice and discussion of Slovakia’s improved macroeconomic situation. The International Monetary Fund (2005) and Organisation for Economic Co-operation and Development (2004) found Slovakia’s strongly increased output expansion commendable and noted that the country’s fiscal and external imbalances had diminished considerably in recent years. The increased transparency and greater incentive compatibilities usually attributed to the reforms have helped improve the business climate and attract foreign direct investments. Real Gross Domestic Product (GDP) expanded by 4.5% despite a contraction in domestic demand in 2003. But increased activity in the domestic sector and accommodating macroeconomic policies permitted real GDP growth estimated at 5.25% for 2004. Further progress is still badly needed; employment gains have been uneven across sectors over the period described, and unemployment at 17.75% remains very high.

The World Bank (2004) agreed with this assessment, but observed the need for the Slovak Republic

- to achieve fiscal consolidation supportive of appropriate public finance management;
- to complete ongoing reforms in health, pensions, and public finance;
- to develop income levels convergent with those of Europe by achieving trade competitiveness in EU and world markets; and
- to reduce poverty and unemployment, partially a function of the marginalization of the Roma ethnic group and the east-west development gap in the country.

In the long term, these achievements may be feasible if Slovakia can continue its currently strong economic performance. Data from the Statistical Office confirm the recently strong growth, but it is interesting to put it into temporal context. Table 4 indicates quarterly GDP for 2003 and 2004; table 5 provides greater temporal perspective by showing annual GDP growth from 1993 to 2004 in both current and constant prices, the latter removing the inflationary bias to provide an indication of real growth rates per annum, as indicated in the last column of the table.

These numbers show the recent, positive economic performance, but they do not demonstrate that growth is a response to the stimulus provided by Slovakia’s recent New System of national and local finance, or more specifically that they are a response to tax reductions. Since economic growth had been strong in the early transition period to about 1999, the return to over 4% growth in 2002 could be interpreted simply as some kind of economic recovery. Although European economies were largely stagnating in these slower years and there was a general slowdown in the U.S. economy in 1999 through early 2002, exacerbated by the terrorist attacks of September 2001, it is not likely that the slowdown in Slovakia following initially strong transition performance was simply cyclical. Such an explanation, however, might explain why Slovakia, in an economic environment influenced by the stagnation of some important EU players, likewise entered into a slower growth phase. It does not explain why a
simple recovery beginning in 2000 and 2001 restored the Slovak Republic to its previously high growth rates without changing the stagnant environment responsible for the slowdown. That leaves it necessary to consider seriously the notion that growth over the past two or three years was a function of economic stimulus arising from reduced taxes and increased direct foreign investment in Slovakia.

Crediting the New System with ending the period of sluggish growth, however, does not explain what it was that made Slovakia perform well in the earlier transition period under the old fiscal system. Such an explanation might lean on Slovakia’s reaping the benefits of a successful shift from CMEA markets to what would become EU markets in the early transition period along with positive economic conditions and expectations in the region during the early transition period. These things were followed by a boom in the U.S. economy and the stimulus that phenomenon provided the world economy in the late 1990s.

But the concern here is less with the macro performance of the Slovak economy in this period than with the budget performance. It is of interest to the present study that the growth in the overall economy has not yet translated into higher budget receipts for the government at any level. From the perspective of the Slovak government, the rationale for the New System would have to be that the elimination of some taxes and the reduction in tax levels should provide growth stimulus sufficient to offset the reductions. This has not yet occurred, however.

The third column of table 6 shows accumulated revenues as received monthly, while accumulated expenditures are shown in column four. A simple calculation of the growth of budget receipts and budget expenditures yields results that are interesting to compare with GDP or general economic growth. To make the measurements comparable, the data are taken in current prices.

Government revenues from 2003 to 2004 grew at the rate of only 4.01%, while GDP grew at the rate of 10.35%, again in current prices. (Without an adjustment to constant prices, growth would be overstated proportionately for the general economy as well as for budget receipts and expenditures in the period in question, since some of the growth would be attributable simply to price increases.) So budget receipts did not grow as rapidly as the economy as a whole, reducing the advantage of the rapid economic growth from the perspective of the public sector. It is important to note, as the Slovak Republic currently struggles with national deficits and debt, that policymakers managed to make the growth in expenditures

Table 4. Slovakia GDP, 2003, 2004

<table>
<thead>
<tr>
<th>Year</th>
<th>1Q</th>
<th>2Q</th>
<th>3Q</th>
<th>4Q</th>
<th>Year</th>
</tr>
</thead>
<tbody>
<tr>
<td>2003</td>
<td>272,980</td>
<td>300,801</td>
<td>309,682</td>
<td>317,733</td>
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<td>2004</td>
<td>308,722</td>
<td>330,367</td>
<td>336,791</td>
<td>349,606</td>
<td>1,325,486</td>
</tr>
</tbody>
</table>

Source: Štatistický úrad Slovenskej republiky (2005a)

Table 5. Slovakia GDP growth, 1993-2004 (Constant Prices, 1995=100)

<table>
<thead>
<tr>
<th>Year</th>
<th>Current P’s</th>
<th>Constant P’s</th>
<th>Growth over previous yr.</th>
</tr>
</thead>
<tbody>
<tr>
<td>1993</td>
<td>411,366</td>
<td>512,849</td>
<td></td>
</tr>
<tr>
<td>1994</td>
<td>495,649</td>
<td>544,674</td>
<td>6.20</td>
</tr>
<tr>
<td>1995</td>
<td>576,502</td>
<td>576,502</td>
<td>5.84</td>
</tr>
<tr>
<td>1996</td>
<td>638,449</td>
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<tr>
<td>1997</td>
<td>712,679</td>
<td>640,151</td>
<td>4.61</td>
</tr>
<tr>
<td>1998</td>
<td>781,437</td>
<td>667,107</td>
<td>4.21</td>
</tr>
<tr>
<td>1999</td>
<td>844,108</td>
<td>676,919</td>
<td>1.47</td>
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<td>2000</td>
<td>934,079</td>
<td>690,697</td>
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<tr>
<td>2001</td>
<td>1,009,839</td>
<td>716,845</td>
<td>3.79</td>
</tr>
<tr>
<td>2002</td>
<td>1,098,658</td>
<td>749,937</td>
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<td>2003</td>
<td>1,201,196</td>
<td>783,406</td>
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</tr>
<tr>
<td>2004</td>
<td>1,325,486</td>
<td>826,493</td>
<td>5.50</td>
</tr>
</tbody>
</table>

Source: Štatistický úrad Slovenskej republiky (2005a) and own calculations
(8.21%) more in line with the increased GDP growth, although it was still a little less than the growth of the economy. Whether this rate of growth of expenditures seems justified or appropriate, it still contributed to deficits and debt, since it exceeded the more modest 4.01% growth rate of revenues.

**Concluding Observations**

The strong macro beginnings enjoyed by the Slovak Republic did not secure fiscal well-being for the local governments. The unusual politics of that era left municipalities in a position that made them work very hard to generate all the local revenue they could, which was done mostly through energetic collection of property tax revenues; the imposition of centrally-specified, local user fees; and the privatization of state-owned assets transferred to municipalities at the outset of the transition period.

The development of reforms of public administration, undertaken in the period prior to Slovakia’s accession to the European Union, included the adoption of the New System of national and local finance that caught widespread attention because of the elimination or reduction of many of the country’s taxes, both national and local, and the adoption of a common rate or “flat tax” of 19%.

It was hoped that the New System would provide encouragement for investment (both domestic and foreign) and stimulate economic growth. The economic growth rate did increase substantively, which was unusual given the sluggish conditions prevailing in most of Europe at the time. One might observe that Slovakia had enjoyed relatively strong growth in the early years of the transition and postulate that the growth of the past two or three years was just a return to that normal level of performance. But that explains neither why the original growth rates were not maintained nor why they were resumed. It seems reasonable, as was suggested in the previous section, that the original growth period ended with the incentive incompatibilities of the old finance system, the loss of early transition momentum, and the lack of dynamism in Europe in general. Growth momentum was regained when reforms were given renewed vigor early in the present decade.

It is not helpful to paint a picture more beautiful than the reality it intends to portray. The recent local government provisions of the New System are bold and consistent with the changes made at the national level. They do, in fact, provide municipalities with greater opportunities to find their own way financially, which will enhance their political autonomy. The fact remains that the local governments remain fiscally challenged. As the state assigned the lion’s share of personal income tax receipts to local governments, it simultaneously transferred the responsi-

<table>
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<th>Year</th>
<th>Mo</th>
<th>Revenues</th>
<th>Expenditures</th>
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<td>31,800</td>
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<tr>
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<td>46,400</td>
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<tr>
<td>2003</td>
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<td>2003</td>
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<td>2003</td>
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<td>100,900</td>
<td>128,600</td>
</tr>
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<td>2003</td>
<td>7</td>
<td>127,700</td>
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<td>147,100</td>
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<td>2003</td>
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<td>163,400</td>
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<td>186,800</td>
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<td>203,600</td>
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</tr>
<tr>
<td>2003</td>
<td>12</td>
<td>233,100</td>
<td>289,000</td>
</tr>
<tr>
<td>2004</td>
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<td>2004</td>
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<td>2004</td>
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<tr>
<td>2005</td>
<td>3</td>
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<td>62,246</td>
</tr>
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Source: Štatistický úrad Slovenskej republiky (2005b)
bility to them to fund a large proportion of the education programs previously funded nationally. But greater opportunities were also provided for the subnational governments (regions had been added to territorial samosprava) to act with greater autonomy in the financial realm. The state will not permit municipalities to expand local property tax efforts in a manner that will increase the overall burden of Slovakia’s taxpayers, but municipalities do have opportunities to function much more independently. One continues to hope that more autonomous subnational governments will ultimately be the key to substantial increases in the revenue-generating capacity of the subnational governments of Slovakia.

References


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Additional Sources


