

CZECH REPUBLIC

The evolution of the Czech tax system in 2007 has been affected by parliamentary election result in 2006. The Czech Social Democratic Party, the leader of government coalition 2002-2006, was not willing to start any necessary fiscal reform, and in opposite went on “buying the electorate” for the upcoming elections. In spite of this, it lost but the winning conservative-liberal Civic Democratic Party was not able to form a majority government coalition. As a result the Czech Republic remained half a year with provisional government.

1.

The new government based on coalition of three parties – Civic Democratic Party, Christian Democratic Party and Greens – has got parliamentary majority only thanks to support of two social democratic MP's. This situation explains poor government position in relation to solution of imperative fiscal issues: How to cut the budget deficit in order to fulfill again the convergence criteria and adopt the flat tax scheme promised by the Civic Democratic Party election program?

The problem of the Czech fiscal system was the long-term public finance deficit based on rapid growth of government expenses. In 2007, planned government expenditures are 1,040 billion CZK (about 39.5 billion €), whereas the revenues only 949 billion CZK (36 billion €). Including also the other public-sector expenditure, the planned deficit for 2007 is 121 billion CZK (more than 4.5 billion €) or 3.4 % of GDP. The proportion of mandatory expenditure on overall expenditure increased from 52.5 % in 2006 to 54.7 % in 2007, which means an increase of mandatory expenditure by 11.4 %. In order to consolidate the national budget and decrease the deficit back under 3% Maastricht level needed for joining the Eurozone, some kind of fiscal reform was needed.

2.

Instead of cutting budget expenditures, the Civic Democrats turned mainly to the revenue side, to adhere to the election promises. Caught between the Maastricht criteria and the promised system of 15% flat tax, the coalition government designed a system of 15% flat tax paid from the so called “super gross” wage, complemented by generous tax deduction.



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2006: election year

After Parliamentary elections the Social Democratic party lost majority. The winning Civic Democratic party, however, lacked sufficient support to introduce tax reforms

reforms are necessary due to the poor condition of public finance. Expected deficit for 2007 was 3.4% of GDP

Flat tax?

the new government is not planning to cut on expenditures and will have difficulty to abide by Maastricht criteria since it has promise to implement a 15% flat tax.

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The adjective “super gross” means current standard gross wage plus health and social insurance contributions paid by the employer. In fact, the employees will, therefore, pay a tax from a tax, as the compulsory insurance contribution is nothing else than a tax. The comparable tax rate, recalculated for current typical gross wage base, would be about 23 %. Income tax cut has not been very substantial because by the end of 2007 there were four tax brackets for the personal income tax with rates from 12 to 32 % in the Czech Republic.

In the flat tax system, the corporate income tax rate should be equal to the personal one. However, in the Czech Republic, starting also from January 1, 2008, the CIT rate will be 21 % (now 24 %), and in two coming years should drop to 19 %. The PIT rate is planned to be reduced to 12.5% (again from “super gross” wage) by 2009. This cut-down is going to be compensated by a corresponding cut of general tax deduction, so that some taxpayers, especially low- to average-income ones, are going to pay more. However, not significantly more. In general, most of the changes are beneficial in particular for high-income taxpayers and corporations. Contrary to Slovakia, however, there has not been any discussion about the goal of the tax reform. The government keeps talking about the need to rapidly cut budget deficit, but the flat tax doesn't help in any way to fulfill this objective.

Lower marginal tax rates especially for the high-income entrepreneurs and corporations tend to boost the economy from an economic point of view. However, this has not been considered as an ultimate goal, rather as a means to another one – to higher tax revenues in the future.

Another flat tax system target according to the Program Declaration of the Government is to decrease expenditures on the tax system administration as well as tax compliance costs on tax payers' side. In other words, the tax reform objective is quite perverted – to make the tax system more efficient, and push the tax revenues up, although the individual tax burden may go down. For that reason, the whole debate about Czech tax system collapsed into discussion, whether proposed setup of deductibles offsets the increase in tax rate for selected income groups, or provides to some income groups an advantage over others. The whole tax reform has been considered mainly as a tax burden redistribution from the high-income to low-income taxpayers by the political opposition.

High-income taxpayers take benefit from this tax reform, indeed. It is not only due to the marginal tax rate decrease. The reduced VAT rate, which applies to socially-sensitive items such as food, housing and public transport, increases from 5 to 9 % (EU minimum is 5 %), the standard rate stays at 19 % (EU minimum is 15 %). The increase of reduced rate will have a stronger impact on low-income residents, and its only purpose was to regain part of the revenues lost through the PIT rate decrease for high-income groups. Moreover, the introduction of an ecological tax will increase coal and electricity prices. Such tax is also expected to be re

The basis of the tax has been enlarged to include income and social health and social contributions.

The CIT will be cut, in 2008, from 24 to 21% and reached 19% by 2010.

the whole tax reform has been considered mainly as a tax burden shift from high income to low-income taxpayers

Low income households will be penalized even more due to an increase of the reduced VAT rate (from 5 to 9%) and the introduction of a regressive ecological tax (on coal and electricity).

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gressive, i.e. to pose a bigger relative burden on low-income, than on high-income residents. Another significant change on the revenue side is the introduction of a maximum assessment base, or ceiling, for insurance contributions, which will be set as 48 times the average monthly wage.

3.

The proposed reform introduces also some changes in government expenditures. Among the minor ones is the cut of birth grants and better targeting of the social allowance. However, the most discussed effects of the reform are the modifications of the health system. To begin with, no sickness benefits are paid by the state health system for the first three days of sickness. Still, the biggest change is the introduction of regulatory fees per prescription, day of hospitalization, and visit to an accident and emergency department in the hospitals. Although the amount of these fees is rather symbolic than real cost covering, and their main purpose is creation of incentives for rational use of the public health care and savings in the public health care system, this measure provoked strong reaction by political opposition. The expenditure cuts, however, only balanced the slight decrease on the revenue side caused by the tax reform. In 2007, the expenditures raised by 8.3 % (to 43.3 % GDP), compared to 2006. Meanwhile, revenues increased only by 6.9 % (to 39.8 % GDP). Looking on predicted evolution of these two variables for 2008, only slight change of trend, which could be attributed to the fiscal reform, is visible. The expenditures should fall to 42.4 % of GDP and the revenues as a share of GDP are expected to stay roughly unchanged (39.5 %). Another question is, whether the expected growth of 5 % in 2008 is attainable. The International Monetary Fund for example estimates the economic growth at about 4.5 %. This could lead to lower tax revenues and to serious problems with deficit. Due to relatively high inflation of about 5 %, the monetary policy is expected to tighten. This might also lead to lower GDP growth and the inability of current tax system setup to obtain sufficient tax revenues.

4.

It is well known that the government raises tax revenues because it is under pressure of increasing government expenditures. Therefore, every

About health expenditures cut

The plan calls for unpopular cut on health benefits (no compensation for the first three days of sickness, hospital and doctor fees, etc.)


those expenditure cuts are insufficient. Expenditures keep growing faster than revenues.

To conclude...

the reform is more aimed at increasing revenues than at cutting on expenses.

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public finance reform with tax cut as a reform goal should be based on the government expenditure savings. Czech public finance reform 2007 did not have this goal, indeed.

The proposed reform has been focused on the budget revenues. However, too much emphasis has been put on the reform neutrality at the level of tax-paying individuals. That's why the reform could not be very successful in abolition of various tax deductions and in the tax code simplification. Therefore, the only characteristic, which the tax system newly introduced in the Czech Republic has in common with the flat tax, is a flat income tax rate. 

we are very far from a flat tax regime.



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