WORKING PAPER
No 308
Pavia, febbraio 2004

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TAX POLICY IN NEW EU MEMBERS: CZECH REPUBLIC

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This paper is part of a wider research on Tax systems and Tax Policy in EU New Members, carried on at this Department, under the direction of L. Bernardi, M. Chandler and L. Gandullia, and the supervision of V. Tanzi.

JEL CLASSIFICATION: H20 – H24 – H25

KEYWORDS: Taxation, Tax Reforms, EU New members, Czech Republic

TAX POLICY IN NEW EU MEMBERS: CZECH REPUBLIC

by
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Abstract
This paper is a part of a wider research program on taxation in EU New members, directed by L Bernardi, M. Chandler and L. Gandullia under the supervision of V. Tanzi. It aims at discussing the main features of Czech Republic's tax system, its recent reforms and those underway. After the introduction and an executive summary (par. one), the paper goes (par. two) to the structure of the Czech fiscal system at the end of the 1990s and to its development from the early to the late 1990s. Next the apportionment of revenues among Government tiers and fiscal federalism are discussed., to conclude with a broad comparison among the Czech and the other EU members' tax systems. Paragraph. three is devoted to a survey of quantitative and institutional features of the main Czech tax items. In the fourth paragraph the distribution of tax charge is discussed according to economic function and to implicit tax rates. Tax burden is then compared with the EU case and with reference to the trend of income inequality during the transition period. The last paragraph concludes, by discussing the current Czech economic and budget outlook, the recent and still underway tax reforms, as well as the further steps needed to make the Czech tax system closer to the EU standards.

JEL Classification numbers: H20, H24, H25
Key words: Taxation, Tax Reforms, EU New members, Czech Republic
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January 2004

[1] A preliminary version of this paper has been carefully revised by Jan Pavel of University College, Prague, and by Leos Vitek, University of Economics, Prague, to whom I express my warmest thanks.

1. Introduction and executive summary

Before the 1993 splitting of the previous Czechoslovakia unitary state, the Czech economy had been in transition from a planned economy system to a market-oriented economy. The main goals of economic reforms were three: the privatization process of both enterprises and bank system; the liberalization of prices and of foreign trade; the fiscal reform. All of these goals have been almost completed. During the 1990s Czech Republic made progresses in restructuring and modernizing its economy but difficulties arose from both the political and the economic side.

In the early 1990s about 80 per cent of all national enterprises were privatized and today only a little part of strategic industries is still in public hands. The 1990s reforms induced then a revolution in the country, so that it was important to maintain the social cohesion during the transition to the market model economy and balance the sacrifices of new tax system with the benefits of public expenditures (Šujan and Šujanová 1994).

Czech Republic is a traditional industrial country and today its plants and equipment are rather obsolete. Its economy mainly depends on foreign trade, but this was in imbalance during most of the 1990s. In the early 1990s Government debt was very small: in 1996 it reached just about 13 per cent of GDP. However during last years it rapidly increased because expenditures have grown more than revenues, in spite of large privatization receipts.. Until 1995 the Government budget continued to be in a moderate surplus, while the budget of the following years has been in an increasing deficit. It is important to notice that an increase in poverty levels and in income inequality took place during the transition. Czech income per capita Gini coefficient increased from 0.20 in 1988, to 0.23 in 1992 and to 0.26 in 1996 and probably it has been still increasing during last years. Czech per capita GDP is not more than about 40 per cent of EU-15 average (unweighted PPP values), but is the highest in comparison with EU New members' ones.

The fiscal reform started in 1993 and the new tax system is close to EU model. Mainly it is made up by the personal and corporate income taxes, the value added tax, the excise duties, the real estate tax, the road tax, the inheritance and gift tax and other minor taxes. During the following years the system was repeatedly amended, but no great improvements were made in the areas of direct taxation and in the value added tax. In fact one of the main current problems concerns VAT harmonization according to the EU standards, in particular with respect to tax rates and tax exemptions; important changes are planned for the next years. The structure of revenues is somewhat different from the EU standards. The main share of total revenues (44 per cent in 1998 and not different until today) is still given by social contributions, which thus stay as the most important levy imposed on individuals and corporations. Czech Republic social contributions are among the highest around the world. By adding up social security contributions to personal income tax the negative consequence arises of a very high taxation of labor. This can create distortions in labor market, open opportunities to shadow economy and induce a loss of competitiveness, in comparison with other countries (especially New EU members).

VAT constitutes the second most important tax. In 1998 its revenue amounted to 6.6 per cent of GDP and to 17 per cent of total revenues and is about 50 per cent of indirect taxes. There are two rates, 22 and five per cent, but the list of goods taxed at five per cent will be reduced since the beginning of 2004.

The personal income tax has a progressive structure, which is given by four brackets and some allowances. The rates go from 15 to 32 per cent, but more than one half of the taxpayers fall into the lower bracket and the average effective tax rate is not higher than 10 per cent. Although inflation was very high during the last decade, income tax structure has not been fully compensated for fiscal drag. Corporation income tax revenue amounted to 3.7 per cent of GDP and to 17 per cent of total tax revenue in 1998; it was also introduced in 1993 and its structure is close to the EU model. Starting from the year 2000, it is applied at a flat rate of 31 per cent, but it was at 35 per cent up to 1999; a rate reduction down to 28 per cent is planned for 2004 (it will be 24 in 2006), to better compete with other New EU members, which have introduced lower corporation tax rates during last years.

Czech fiscal Government structure was made up only by two tiers but since 2001 there are three tiers: the Central Government, Regions and the Municipalities. These are in the number of more than six thousands and their average size is very small. However, the Constitution makes a provision for also some larger Regions, but before 2001 these new Regions were not realized. Their functions were performed by 77 district offices that were no more than not autonomous arms of the Central Government. From 2002 14 Regions started, but they were totally funded by the Central Government till 2003. This structure will be completed during next years because today there is an insufficient monitoring on the Local Governments' debt and expenditures and there are no adequate fiscal equalization transfers. The main aim of local budget reform is to increase the share of local sources of revenues and the Municipalities' own taxes.

By considering now the 1998 distribution of fiscal burden on specific factors, it can be noticed that employed labor was the factor most heavily taxed, at an implicit tax rate of 38.6 per cent, while the implicit tax rate on consumption was just 15.6 per cent, a value very low in comparison with the standard VAT rate of 22 per cent. From 1993 to 1998 only the taxation on employed labor steadily grew, from 16.9 GDP points to 18.5, while the share of revenues of the other factors decreased: that on consumption from 13.2 GDP points in 1993 to 11.1 in 1998; that on self-employed labor from four GDP points to 2.9 and that on capital and business from 8.9 GDP points to 5.7 (a decrease due to the need of reducing corporate incomes tax rates from their initial levels).

The current Parliament debate mainly focuses on reducing the budget deficit, to avoid an expected steep increase of public debt during next years. Since 1997, in fact, public debt had continued to rise, because the increasing budget deficit has been financed through the issuance of Government bonds purchased by private sector, in spite of large privatization receipts. But Czech Governments are very reluctant to adopt the necessary reforms, as to make expenditure cuts, industrial restructuring and to reform the legislation system and financial market transparency; instead bank privatizations has been completed in 2001.

The deterioration of budget balance has been due both to an increase in spending and to a decline (or a lesser increase) in tax revenue. According to new data, fiscal revenue has been steady in the last years: in 2000 Czech total fiscal revenue was 39.3 per cent of GDP, 39.1 per cent in 2001 and 39.8 per cent in 2002. Instead, the level of public expenditure (excluded net lending) was 42.1 per cent of GDP in 1998, 43.7 in 2000, 44.2 in 2001, 46.6 in 2002; levels that are too high to achieve the Maastricht rule of three per cent budget deficit. Some reforms could not be postponed, in order to stop the primary unbalance increase. A recurrent proposal is to reform the social security system, to take better in account demographic development: retirement ages should go up, as it is required in almost any other EU country. The pension system, in fact, operates as a pay-as-you-go system and absorbs about nine per cent of GDP and 24 per cent of public expenditures.

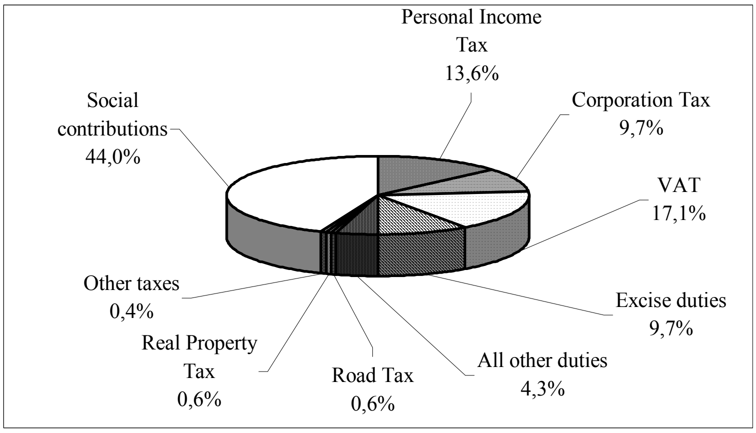
So the most important issue of fiscal policy would be the sustainability of public finances in the medium run. No basic steps had been made during last years but finally a reform was approved by Government and Parliament in summer and autumn 2003. At present the equilibrium of the public finances is not under control. The reduction of the budget deficit will have to become the highest priority of the Czech Government in the next years. The institutional framework and the low public debt, mixed with the new market power economy starting in the 1990's, were negative ingredients (from the political point of view) to create a good environment for economic growth and institutional stability during the last decade (Bronchi and Burns 2000).

2. The structure of the system at the end of the 1990s and its development after the collapse of communist regime

2.1 A broad view at the current structure of taxes and social contributions

In 1998 Czech Republic total fiscal revenues were 38.3 per cent of GDP. Total tax revenues amounted to 56 per cent of total fiscal revenues and to 21.4 of GDP, while the remaining 44 per cent was given by social contributions that were the main source of revenue with a share on GDP of 17 per cent. This share came high and exaggerated if compared with the EU average level. Still in 1998 the net rate of employee contributions was 7.5 per cent and the net rate of employer contributions was 22.75 per cent of labor income. Then social security contributions' composition was also unbalanced, because of the higher value of those imposed on employers than that on the employees and because the low charge on self employed (about two per cent of GDP).

Figure 1 Structure of the total revenue in 1998



Source: EU Commission, 2000.

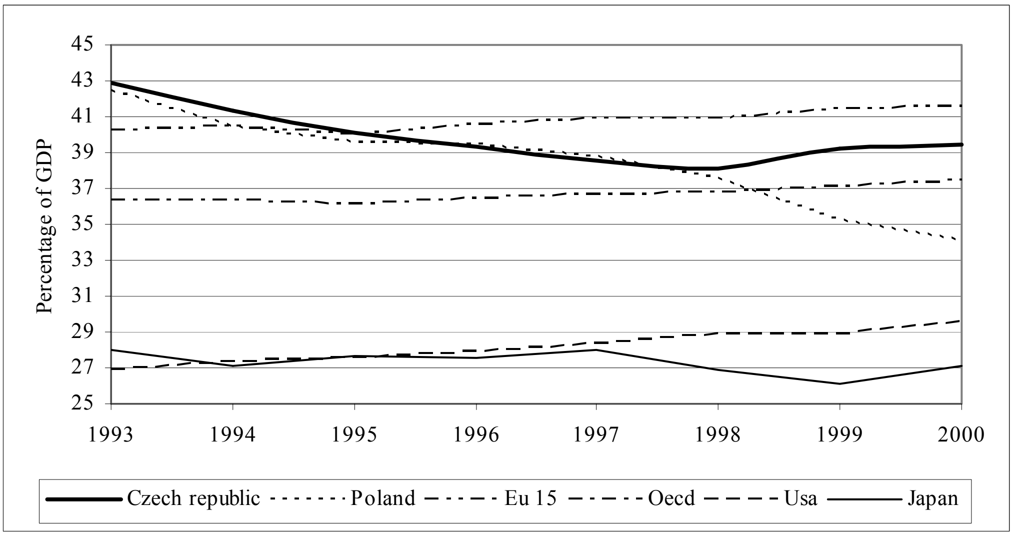
Direct taxes were lower than the indirect ones and this was due to the low level of personal income tax that amounted only to 5.2 per cent of GDP and to 13.6 per cent of total revenue. Corporation income tax revenue amounted to 3.7 per cent of GDP and to 9.7 per cent of total revenue. The second most important tax was then VAT and its revenue amounted to

6.6 per cent of GDP and to 17.1 per cent of total revenues. Its both standard rate and share of total taxation as well as its share of indirect taxes equaled about the UE average. The share of excise duties was 9.7 per cent of total revenue and 3.7 per cent of GDP.

2.2 The development of the system from the early to the late 1990s

During ten years, from 1993 to 2003, Czech Republic fiscal system did not basically change because already in the early 1990s it was scheduled as the EU model. Despite this, the transition process and the EU harmonization required some changes. As it is shown in Table 1, Czech total fiscal revenue decreased by 10 per cent and this was made by cutting total tax revenue from 26.3 per cent of GDP in 1993 to 21.4 in 1998, while social contributions' level has been relatively stable during this period. In the same years expenditures have been cut only by four per cent and this gap is at the origin of net borrowing increase during last years.

Figure 2 Total fiscal revenue from 1993 to 2000 as a percentage of GDP



Source: OECD Revenue Statistics, 2002.

The most relevant changes in total tax revenue composition have been the reduction of both direct and indirect taxes. The direct ones decreased by two GDP points from 10.9 per cent in 1993 to nine per cent in 1998 and this difference can be split into a reduction by 50 per cent of corporation tax revenue and an increase from 3.8 per cent of GDP to 5.2 per cent of personal income tax revenue. The cut has been more evident with respect to indirect taxes that decreased from 15.4 per cent of GDP in 1993 to 12.4 in 1998. This relevant decline was due not only to the VAT rate reduction from 23 to 22 per cent but also to the increasing list of goods taxed at the reduced rate. VAT reduction has contributed for one third to the total indirect taxes cut, while excise duties have been steady and the other indirect taxes have been cut by 1.9 GDP points.

At the beginning of 1990s it was strictly necessary for Czech tax system to decrease the rate and the share of corporation tax (16.5 per cent of total revenues in 1993), because their level was one of the highest in the world and it would not have been consistent with a market system. These cuts came very big and fast: the tax rate was 75 per cent in 1986, 55 in 1991, 45 in 1993, 39 in 1996, 35 in 1998 and now (2003) is 31 per cent. The profits taxation as a per cent of GDP was 7.1 in 1993, 5.6 in 1994, 4.0 in 1996 and 3.7 in 1998 but still today stays high in comparison with both the EU average and EU selected New members' level (seven per cent of total revenues in EU area, 9.7 in Czech Republic and 6.4 in the other EU New members).

Although social security contributions remained relatively stable from 1993 to 1998 as a share of GDP, their share of total revenues has increased from 38.6 to 44 per cent, but this is due to the decreasing of total tax revenue. It is important to notice that in this period social contribution revenues have exceed the social expenditures but this surplus will be necessary in the future because health and pension expenditures are increasing as it can be observed in other EU countries.

2.3 The apportionment of revenues among Government tiers and fiscal federalism

Czech fiscal Government structure was made up by just two tiers until 2001: the Central Government and the Municipalities that are in number of more than six thousands with a very small average size (80 per cent of Municipalities have less than one thousand people and 90 per cent less than two thousands people). Their number grew by 50 per cent from 1990 to 1992 because at that time a "Municipality Act" established the liberalization of Municipalities' rights and their "absolute" independence. So, because of this breaking up of the country, one of the most important problems of fiscal and administrative structure is the efficiency level of so small bodies.

However the Constitution makes a provision also for larger Regions, but before 2001 these Regions were not realized and their functions were performed by 77 district offices that were arms of the Central Government without any autonomy. From 2002 there are 14 Regions at work but they are totally funded by the Central Government. This structure will be completed during the next years, because today there is an insufficient monitoring on the

Local Governments debt and expenditures and there are no adequate fiscal equalization transfers.

The law, in fact, provides that the debt of Local Governments may not exceed 15 per cent of the previous year's revenues but the local governors want to grow more local spending. Today 65 per cent of Municipalities are carrying same form of debt.

Although local revenues are mainly distributed among Municipalities according to the number of inhabitants, the gap in economic growth and GDP pre capita among the Regions has been growing over time also because a share of revenues was distributed according to the locations of the business activities; the concentration of enterprises and businessmen in the big cities is an important fiscal disadvantage for the poor areas under the current tax sharing system. This gap can affect the opportunity to create an effective system of fiscal equalization transfers, to prevent lower tiers' financial crises and to give to Local Governments an adequate ability to predict their revenues in the medium run. Furthermore, the current structure of distribution of tax revenue among Government tiers increases the competition among Municipalities for the permanent residence of inhabitants. Finally, an important obstacle to further decentralization is the already mentioned size structure of the Czech Municipalities.

In 1998 the share of total revenues accruing to Central Government was 73 per cent of total revenues (44 per cent, excluding social contributions for pensions), that to Local Governments was 12 per cent and that to health funds was 15 per cent. From the early to the late 1990s these shares of total revenue did not change in a relevant way. The share of Central Government decreased only by 4.3 per cent (8 per cent, excluding social contributions for pensions), while the share of Local Governments increased by three percentage points and that of health founds increased by 1.4 per cent (Kamenì kovà 1999).

Table 1 The share of tax revenues accounted for by Government and Local Budgets

	1993	*1994*	*1995*	*1996*	*1997*	*1998*
Government Budget	85.4	80.5	78.3	79.6	79.1	78.6
Local Budgets	14.6	19.5	21.7	20.4	20.9	21.4

Source: Government Final Account of the Czech Republic for 1998, Czech Republic Ministry of Finance.

Table 2 Structure and development of fiscal revenue in Czech Republic, selected EU new members and EU average as % of GDP, 1992-1998

	1992			*1994*			*1996*			*1998*		
	Czech Republic	*New Members*	*EU*	*Czech Republic*	*New Members*	*EU*	*Czech Republic*	*New Members*	*EU*	*Czech Republic*	*New Members*	*EU*
Direct Taxes, of which	10.9	10.1	13.5	10.3	10.0	12.9	9.2	9.6	13.4	9.0	9.2	13.7
Personal income	3.8	6.4	9.6	4.6	7.0	9.3	5.1	7.1	9.3	5.2	6.7	9.3
Corporation income	7.1	3.6	2.3	5.6	2.9	2.4	4.0	2.5	2.7	3.7	2.5	3.0
Indirect taxes, of which	15.4	15.6	13.4	14.4	16.5	13.7	13.5	16.9	13.7	12.4	15.5	13.9
VAT	7.6	5.1	6.7	7.3	7.4	6.8	7.0	7.4	6.9	6.6	7.9	7.0
Excise duties	4.0	3.4	3.4	4.0	4.2	3.5	3.9	4.1	3.4	3.7	4.1	3.5
Others	3.9	9.3	3.3	3.2	5.0	3.4	2.6	4.9	3.4	2.1	3.6	3.5
TOTAL TAX REVENUE	26.3	25.7	26.9	24.7	26.4	26.6	22.7	26.5	27.1	21.4	24.7	27.6
Social contributions	16.5	16.1	14.5	16.6	15.7	14.9	16.5	14.3	15.3	16.9	14.2	15.0
Employers	10.2	10.0	8.1	10.7	9.0	7.9	10.9	8.0	8.3	11.0	7.9	8.2
Employees	3.8	5.3	4.8	3.9	5.1	5.2	3.8	4.8	5.1	3.9	4.8	5.0
Self employed	2.5	1.8	1.6	2.0	1.6	1.8	1.8	1.5	1.9	2.0	1.6	1.9
TOTAL FISCAL REVENUE	42.8	41.8	41.4	41.3	42.2	41.5	39.2	40.8	42.4	38.3	38.9	42.6
Administrative level												
Central government	33.2	25.9	22.8	31.1	25.8	22.4	29.1	25.4	22.4	28.0	23.9	22.9
Local government	3.9	3.0	3.0	4.9	3.5	3.2	4.7	3.4	4.0	4.6	3.7	4.0
Social Security	5.8	12.9	14.5	5.4	12.9	14.9	5.4	11.5	15.2	5.7	11.4	14.9

Sources: EU Commission (2000) for Czech Republic and selected EU new members (unweighted average); Eurostat (2000) for EU-15 (1997 unweighted average).
Notes: Czech data start in 1993 and Social security is only health.

The Czech total revenue share of sub-national level can be split in 47.7 per cent of tax revenues (of which 90 per cent from income tax and 5.6 from property tax), 36.3 per cent of non-tax revenues and 16 per cent of grants (1999 data). This share is lower than both that existing in EU area (27 per cent) and that in selected EU New members (19 per cent). During the 1990s grants became less important than in the previous system and other kinds of revenues have been increased, as the sharing to personal income tax and to corporate income tax. But the most popular local tax, i.e. the property tax, has a small rule in Municipalities' revenues and in income redistribution; its share on total revenues is very low. This tax is collected by Central Government and its revenue is transferred to Municipalities, and this is not an efficient system to provide for the political independency of this tier of Government. Besides this, the cadastral system should be modernized in the future.

In conclusion, Czech Republic Local Governments have limited tax autonomy in comparison with the dimension of their spending responsibilities and local needs; this is a problem especially for the smaller Municipalities that have a bigger gap between tax capacity and expenditure needs than that of other Municipalities. At present, Central Government regulates the public services under Local Government competence and finances a high share of spending. In fact, only a share of Municipalities' revenues derives from own taxes and a relevant share derives in form of grants from the State level. This structure can not be efficient in allocating competences among tiers and can tempt Local Governments to increase spending. In fact, some small Local Governments has bankrupted in the last years, but Czech system is just emerged from the centralist era that characterized the communist regime and the fiscal reform of early 1990s already incorporated some important elements of decentralization that will helpfully be completed in the next future (OECD 2002).

2.4 A comparative view with other selected EU new members and the average of EU

At the end of the 1990s, Czech Republic total fiscal revenue was similar to that observed for the other selected EU New members but more than four percentage points lower than the EU average. This difference is very important for fiscal planning because the expenditure level was four GDP points higher than the total revenue.

Fiscal revenue was six GDP points lower than the EU average (27.6 per cent) while social contributions were two GDP points more than the EU average and three GDP point more than

EU new members mean level. In comparison with the other new members, the same level of total revenues was characterized by a different tax mix: Czech Republic total tax revenue was three GDP points lower than in new members, whereas social contributions were three GDP points higher. As to the share of total tax revenue, Czech Republic had the same level of VAT and excise duties, a lower level of personal income tax and a higher level of corporation tax.

The splitting of taxes in direct and indirect ones was different from the EU standard, which is characterized by a share of 50 per cent for both the indirect and the direct ones. This disparity is due to the level of personal income tax that is four GDP points lower than the EU average. Both revenue and rate of corporate income tax are instead were close to the EU mean levels.

Indirect taxes show a total amount which is 1.5 GDP points lower than the EU average and three points lower in comparison with new members mean value. However their share of total fiscal revenue is similar to the EU average and not very different from EU New members' mean level. Both VAT and excise duties levels are similar to the EU ones'. But other indirect taxes give a low yield, including real property tax, real property transfer tax, gift and inheritance tax, road tax, local levies.

Czech total social contributions as a share of GDP are well above both the EU (15 per cent) and the new member average values (14.2). The gap can also be due to the level particularly high of employer contributions. Anyway, as a share of total fiscal revenue, Czech contributions were nine per cent higher than the EU average and eight higher than EU new member mean value.

3. Some quantitative and institutional features of main taxes

3.1 Personal Income Tax (*Daň z příjmu fyzických osob)*

The personal income tax was introduced in 1993, when the Czech Republic was founded. At the time of the communist regime, it didn't exist also because the redistribution of income was pursued by subsidies to consumption goods, as in the other planned economies. Before the 1990s, different sources of income were taxed at different rates and the whole system was almost not progressive. Wage earnings were taxed at a flat rate as well, but the level of the rate changed according to taxpayer's age, sex, marital status and number of dependants. The current personal income tax is similar to that observed in many European countries.

However, the aggregate income is not all-embracing, because many sources of income are taxed under a separate regime. The taxing unity is the individual and the tax is paid by both residents and non residents: the world-wide income principle is put on the residents whereas the non residents are taxed on their Czech source income.

Income from different categories is aggregated to form the tax base and, after excluding the deductions allowed by law, a progressive rates schedule is applied. This is made up by four brackets with increasing marginal rates: the lower rate is 15 per cent and the highest is 32. From 1993 to 1999 there were five brackets and the highest rate was at 40 per cent. The subsequent reduction of the brackets was due mainly to two reasons. First, few taxpayers were taxed at the highest bracket and, second, the accepted fundamental paradigm to broaden the taxable base and to reduce the number and the level of the rates. The top rate of 32 per cent is lower in comparison with those mainly existing in the EU countries but it is similar to those in force in the other EU New members.

There are several categories of taxable income:

a) *income from wages and salaries;*
b) *income from business activity and independent services;*
c) *income from leasing or rents;*
d) *income from capital assets;*
e) *other incomes.*

Social security contributions paid by employees are deductible in full while, according to the tax code, donations fur purposes of science, educations, culture, medicine, ecology, sports and religion are deductible up to 10 per cent of the taxable base.

There are other tax allowances to promote horizontal and vertical equity. If the allowances exceed the taxable income, the taxpayer simply pays no tax because there is not a negative income tax system, but losses (only for business activities) can be carried forward for seven years. Today (2003) the basic personal allowance per year is 1,188.75€ (38,040 Kč), and the others depend on family's status. If the taxpayer's spouse has an annual income lower than the basic allowance it is granted to the taxpayer an additional allowance of 678.75€ (21,720 Kč,); there is also an allowance of 734.40€ (23,520 Kč,) for each dependent child living in the taxpayer's household.

The taxable base from business activity and intellectual rights is determined with the similar rules in force for the corporate income tax but is taxed with the progressive rate schedule of the personal income tax. The general rule provides that the expenses are deductible in detail from the income but the taxpayer may determine the taxable base from all business activity by a lump sum deduction applied to these sources of income. The amount of deduction differs according to the type of business. Income from leasing or rent is taxed according to general rules.

Table 3 Structure of the income tax in Czech Republic

Dan z prìjmu fyzickych osob 2003 - Values in Euro

Brackets	Marginal Rates	Basic Allowance	Allowance spouse	Allowance for a son
UP TO 3,230.20	15	1,188.75	678.75	743.40
3,230.20 - 6,460.40	20	1,188.75	678.75	743.40
6,460.40 - 9,880.61	25	1,188.75	678.75	743.40
OVER 9,880.61	32	1,188.75	678.75	743.40

Income from dividends and interest paid to individuals is not aggregate to the taxable base of the income tax but is taxed under a separate regime: it is provided a 25 per cent final withholding tax on dividends and a 15 per cent final withholding tax on interest from saving accounts and from dividends and interest paid by a Pension Funds. The capital gains basis is the difference between the selling and the purchasing price but almost all capital gains realized outside corporation income are tax exempt.

The beneficiary is both the Central and the Local Governments: 44,2 % of the revenue from the income tax on self-employed (42,35 % to municipalities, 1,86 % to regions) and 25,19 (3.1% regions, 22.09% municipalities) per cent of the revenue from withholding tax on wages and salaries of the employee accrue to Local Governments and they are distributed among Municipalities according to the number of inhabitants; instead the 23.69 per cent from withholding tax on wages and salaries of the employee and the revenue from taxes withheld on interest and dividend accrue to Municipalities (20.59 per cent) and Regions (3.1 per cent). The rest accrues to Central Government.

3.2 Corporate Income Tax (*Daň z příjmu právnických osob*)

Corporation tax was also introduced in 1993. During the communist regime, State gave the production plans to enterprises, showing what they had to make; the prices were state-controlled and they had a poor role in the allocation process. Taxes on enterprise surpluses were subject to negotiation and set with respect to national industrial policy objectives. They yielded more than ten per cent of GDP and the tax rate was far higher than those applied in

EU countries. It was 75 per cent in 1988 and 55 per cent in 1991. Then State appropriated a high share of enterprise profits. The new corporation tax is quite similar to that applied in EU countries. Both public and private companies and non commercial bodies are taxed on their worldwide income and the base is given by net profits of each company because no group taxation is granted. There are also specific regulations on transfer pricing and thin capitalization. Losses can be carried forward for seven years. Non resident companies are taxed on their Czech source income but permanent establishments of foreign companies are taxed like domestic companies.

Interests and dividends are included in the recipient's taxable income and royalties and capital gains are included in enterprise gross income. Dividends are taxed both at the company and at the shareholder level. The double taxation is alleviated by means of a 50 per cent lump-sum tax credit against enterprise tax liability of the withholding tax on the dividends paid out. For holding companies there is a system of tax exemption for distributed and the tax rate is specified in the respective international double tax avoidance treaty.

Expenses that are granted are those borne for obtaining the gross income. Tangible assets with a useful life less than one year are fully deductible in the year of acquisition and those ones with a useful life more than one year are deductible at a rate ranging from 0.33 per cent to 25 per cent, according to the depreciation category. It is allowed both linear and accelerated depreciation. Inventories may not be depreciated. Intangible assets are deductible for a period ranging from four to 12 years but only if their initial price exceeds 1,266.75€; other intangible assets are fully deductible in the year of acquisition.

Royalties, interest, donations (in the limit of two per cent of taxable income), paid real estate tax, social security contributions, road tax and lease expenses (if the leasing period is above 20 per cent of the useful life of assets and at least three years) are deductible from the Corporate income tax.

At the time of communist regime, there were tax incentives for direct investments; today these incentives have been abolished and replaced with many activity-specific allowances, tax credits or relief on new assets, temporary exemptions from corporate income tax for new investment and subsidies for education of employees. Starting from 2000, it is applied a flat rate of 31 per cent, but it was 35 per cent up to 1999. However investment companies, investment funds and pension funds are taxed at 15 per cent but this treatment will be abolished since 2004. Four fifth of revenue from corporate income tax accrue to Central Government and one fifth to Local Government (on the basis of population).

3. 3 Value Added Tax (*Daň z přidané hodnoty*)

The main difficulty of transition for the Czech fiscal system has been the shift from the turnover tax applied before 1993 to the value added tax according to EU standards. The turnover tax was applied to all goods and it was very complex both for the number of the rates, ranging from -.74 to 733 per cent, and for that of the commodities groups (1,506). A lot of necessary goods were subsidized.

Now Czech VAT is similar to the EU model but there are some differences that will have to be got over. The basis of assessment is the price of the taxable supply excluding the VAT and the tax is payable on imports too. The beneficiary are the Central Government, Regions and Municipalities. Only individuals and entities with a turnover above 15,834.31€ must be registered to the value added tax.

According to the EU directive that provides only two rates (a standard rate higher or equal to 15 per cent and a reduced one between 5 and 15 per cent on some goods), Czech Republic adopted a standard rate of 22 per cent and a reduced rate of 5 per cent on water, agricultural, food and pharmaceutical products, constructions and restaurant services, but the list of goods taxed by 5 per cent rate must be reduced according to the EU harmonization because changes planned for the 2004 are not sufficient. Exports, financial services and many public services are tax exempt.

3. 4 Excise duties (*Spotřební daň*)

Czech Republic has several excise duties that were introduced during the tax reform of 1991 and 1992. Main items are:

a) *Hydrocarbon Fuels and Lubricants* – The tax is charged on petroleum products and oils that are produced or imported. The beneficiary is the Central Government and State Fund of Transport Infrastructure. Rates range from 258.10€ per one thousand liters of motor oils to 343.29€ per one thousand liters of motor car and aircraft petrol. There are many exemptions: ad example, the duty on light heating oil is refunded if it is used for heating purpose.
b) *Alcohol* – The basis of assessment is the number of liters of ethyl alcohol and the rate is 7.41€ per liter of ethyl alcohol and 3.00€ for fruit spirits distilled by fruit growers. The tax

is paid by producers, importers and processors of alcohol and liquors. The beneficiary is Central Government.

c) *Beer* – The basis is the hectoliters and the rate depends to the annual production: 0.76€ per hectoliters if the annual production is more than 200,000 hectoliters and five rates ranging from 0.38€ per hectoliters to 0.68€ applied to five brackets if the production is less than 200,000 hectoliters. The beneficiary is Central Government and the tax is paid by producers and importers of beer.
d) *Wine* – The rates range from 0.076€ per liter to 0.74€ per liter according to the wine qualities. The tax is paid by producers and importers of selected products and the beneficiary is the Central Government.
e) *Tobacco* – The basis is the kilogram of tobacco for cigarette tobacco for production of cigarettes, tobacco refuse for smoking and pipe tobacco and the unit for cigarettes. The rates range from 0.021€ (for filter cigarettes) to 27.07€ (for tobacco refuse for smoking). The taxpayers are the producers and importers of tobacco products and the beneficiary is the Central Government.

3. 5 Local taxes

a) Real Property Tax (Daň z nemovitostí) – An annual tax is imposed on buildings and land. Taxpayers are the owners of buildings and land and all revenue accrues to Local Government. The base for buildings is the area of the ground plan of the overhead part of structure in squares meters and rates range from 0.032€ per square meter to 0.127€. For the land the bases are average prices in the cadastre areas and rates range from 0.25 per cent to 0.75 of average price for cultivated lands. The rate for build-up area is 0.0032€ per square meter and that one on developed land is 0.032€ per square meter multiplied by coefficients according to the size of the municipality.

b) Levy on Withdrawal of Land from Agriculture and Forestry – A lump sum levy calculated depending on environment, climatic and other factors is payable by subjects who ask for permanent withdrawal of land. 40 per cent of revenue accrues to Municipality and 60 per cent to State Found of Environment.

c) Other taxes – Infrastructure Tax, Resort and Recreation Fees on visitors, Waste Tax, Dog Tax, Recreational Unit Tax, Entry Tickets Tax, tax on operating slot machines, tax on operating gambling machines and tax on use of public space are paid to Municipality.

3. 6 Social security contributions

Social security contributions, applied to labor and self-employed income, were introduced in 1993. They are fully deductible from the personal and corporate income tax bases. The base of both social and health insurance of employees is the gross wage and the total rate is 47.5 per cent, of which 12.5 per cent is paid by the employee and 35 per cent by the employer. The base of the self-employed is 35 per cent of net income but there is a minimum of 579.54€ (1368.84€ for health insurance) and a maximum of 15,390.95€ tax base. The minimum health insurance tax base for employees is twelve times the minimum wage. The beneficiary for social insurance taxes is the Central Government and they enter the general budget. Health insurance taxes are earmarked and health insurance funds maintain individual account for each insured person.

3.7 Other minor taxes

a) *Road Tax (Silnicnì dan)* – Commercial cars used for an entrepreneurial activity in the Czech territory are taxed by the Road Tax. For passengers cars the tax rate ranging from 38.00€ to 133.01€ and the basis is the cylinder capacity in cubic centimeters; other vehicles are taxed from 57.00€ to 1596.098€ and the basis is the total weight in tons and number of axles. The beneficiary is the Central Government.
b) *Inheritance Tax* (*Dan dedickà*) – The heir of a property is taxed on the value of the property. Spouses and relatives in direct line are tax exempt. Relatives in collateral line are taxed with rates ranging from 3 per cent to 12 per cent, while all other persons from 7 per cent to 40 per cent. The beneficiary is the Central Government.
c) *Gift Tax* (*Dan darovacì*) – The acquirer of donated property is taxed too. There are three categories as the Inheritance Tax: spouses and relatives in direct line are taxed on donated property from 1 per cent to 5 per cent, relatives in collateral line from 3 to 12 per cent and other person from 7 to 40 per cent. There are some exemptions according to the value of the donated property. The beneficiary is the Central Government.
d) *Real Property Transfer Tax* (*Dan z prevodu nemovitostì*) – Sellers of real property must pay to Central Government 5 per cent of contracted price of transferred real property.
e) *Customs Duties* (*Cla*) – The importers of goods are taxed on the custom value of imported goods according to the Customs Tariff. All revenue accrues to the Central Government.

f) *Highway Fee* (*Poplatek za uzìvànì dalnice a rychlostnì silnice)* – All drivers of motor vehicles using highway pay this fee to Central Government (State Fund of Transport Infrastructure) on the basis of tonnage of vehicles.

4. The fiscal burden

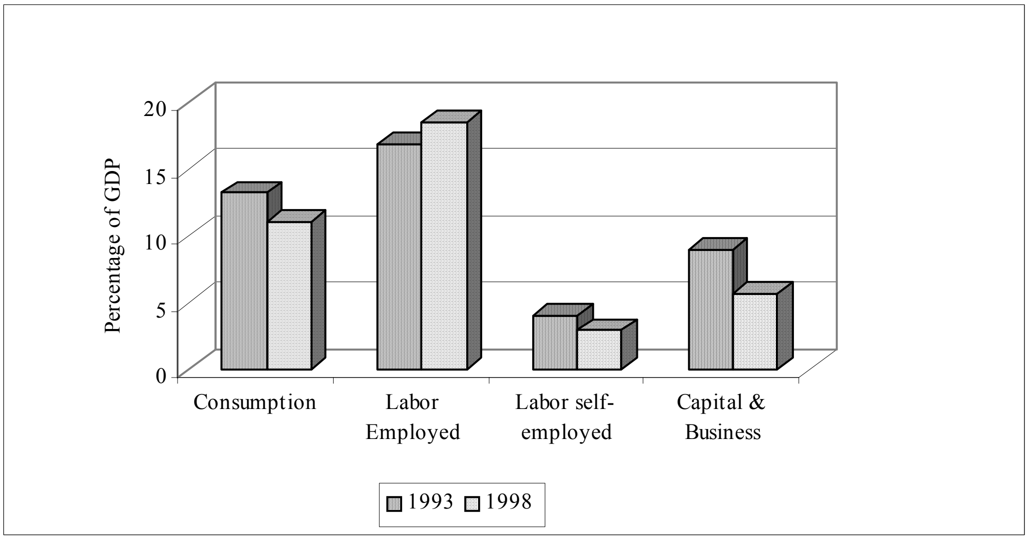
4.1 The distribution of taxation change: taxation by economic function and by implicit tax rates

The distribution of fiscal burden by economic function and by implicit tax rates from the early to the late 1990s are depicted in the Table 4. Looking at the classification according to economic function (that shows the ratios between the overall tax burden on different factors and a common large basis, given by GDP), it can be noticed that in 1998 the most important contribute to the total fiscal revenues was originated from employed labor, that amounted to 48.4 per cent of total revenues and to 18.5 GDP points (of which 60 per cent paid by employers), while 2.9 GDP points (7.6 per cent of total revenues) arose from self-employed labor, 11.1 GDP points (30 per cent of total revenues) from consumption and 5.7 (15 per cent) from capital and business (of which 65 per cent from profits, 10.5 from real estate and 12.3 from shares and saving).

From 1993 to 1998 only the taxation on employed labor steadily grew from 16.9 GDP points to 18.5, with an increase by 9.5 per cent. Its total increase can be split in 12.5 per cent on employers and 87.5 per cent on employees. The share of revenues from the other factors of production decreased: that of consumption from 13.2 GDP points in 1993 to 11.1 in 1998 (with a decrease of 16 per cent), that of the self-employed labor from 4 GDP points to 2.9 (with a decrease of 2.8 per cent) and capital and business from 8.9 to 5.7 (with a decrease of 36 per cent, that was necessary to reduce the rates on corporate incomes from their initial non-market levels). Thus the 4.5 GDP points' reduction of total fiscal revenue which took place in 1990s was obtained by cutting both consumption and capital and business revenues and increasing taxation on labor.

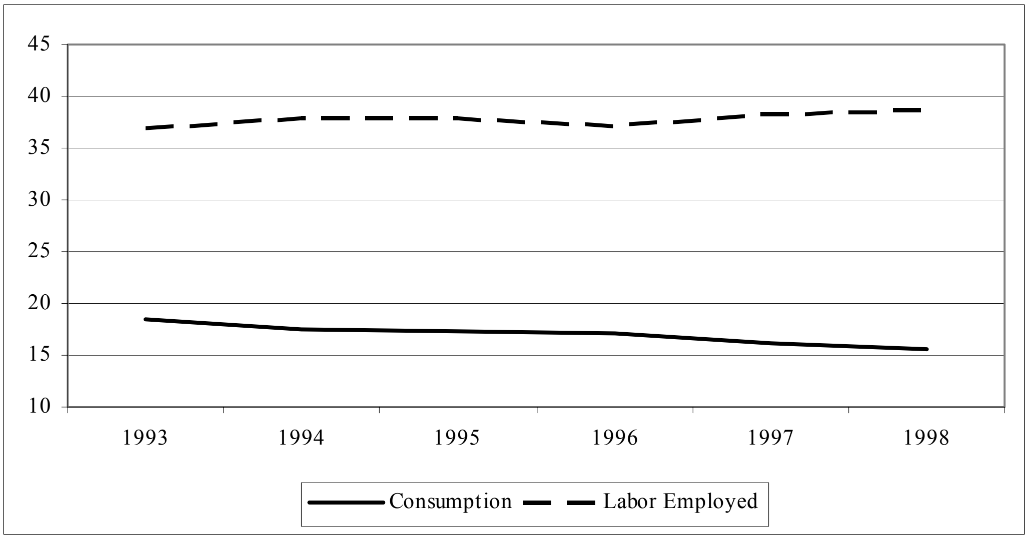
Looking now at the implicit tax rates, that show the ratio between the total tax revenue on each factor and the total tax base of the same factor (including all taxes), we can see that in 1998 employed labor was the most heavily taxed, at an implicit tax rate of 38.6 per cent, while the implicit tax rate on consumption was only 15.6 per cent, a value very low in comparison with the standard value added tax rate set at 22 per cent (EU Commission 2000).

Figure 3 Taxation by economic function in Czech Republic in 1993 and 1998



Source: EU Commission, 2000.

Figure 4 Implicit tax rates in Czech Republic from 1993 to 1998



Source: EU Commission, 2000.

Data for capital and business are available just for 1995 and 1996 and were, respectively,

Table 4 Structure and development of taxation by function and by implicit rates in Czech Republic, new members and EU 15, 1992-1998

	1992			*1994*			*1996*			*1998*		
	Czech Republic	*New Members*	*EU*	*Czech Republic*	*New Members*	*EU*	*Czech Republic*	*New Members*	*EU*	*Czech Republic*	*New Members*	*EU*
Economic functions												
Consumption	13.2	13.6	10.9	12.8	14.5	11.2	12.2	14,7	11.3	11.1	13.5	11.4
Labor Employed	16.9	19.7	20.6	17.6	19.4	20.7	18.1	19,0	21.4	18.5	17.9	21.2
Labor self-employed	4.0	2.9	2.4	3.1	2.8	2.4	2.8	2,6	2.4	2.9	2.6	2.3
Capital & Business	8.9	4.3	7.2	7.8	5.0	6.8	6.0	4,3	7.1	5.7	4.5	7.5
Implicit tax rates	43.0			41.3			39.1			38.2	38.5	42.4
Consumption	18.4	16.3	16.2	17.5	17.4	16.5	17.1	17.8	16.7	15.6	16.6	16.8
Labor Employed	37.0	37.1	39.0	37.8	38.3	40.2	37.2	37.4	42.0	38.6	38.0	41.9
Capital & Business	-	-	32.2	-	-	30.3	-	-	30.5	-	-	31.1

Sources: EU Commission (2000) for Czech Republic and selected new members (unweighted average); Eurostat (2000) for EU-15 (1997 unweighted average).
Notes: Taxation according to economic function is as per cent of GDP. Total may stay over Total fiscal revenue in Tab. 2, because of same double counting.
All Czech rates and Estonia's 1992 implicit refer to 1993. Implicit rates for Capital & Business are not avariable for all New members, except Estonia.

41.7 and 38.4 per cent. The dynamic of the employed labor's implicit tax rate from the early to the late 1990s was slightly growing, with an increase of 4.3 per cent (from a value of 37 per cent in 1993). The implicit tax rate on consumption, instead, was constantly decreasing, with a reduction of 15 per cent from 1993 to 1998.

4.2 Other indicators of fiscal burden

Czech Republic social contributions are among the highest around the world, thus the adding up of contributions to personal income tax has the negative consequence of an high taxation of labor, that can create distortions in labor market, open opportunities to shadow economy and originate a loss of competitiveness, especially in comparison with other New EU member countries.

In 1998 the labor cost was 135 per cent of net wage, a value that can not be compatible with an economy in transition and is high in comparison with the value of other countries at the time they were at the current Czech level of development. In the next future tax wedge on labor is planned to decrease but politicians will have to solve the problem (like in almost all developed countries) of reducing the existing generous pension schemes in a contest of aging population.

The cut of the corporation tax rate has gone in the right direction but now further steps (as changes of the taxable base and an increase of the effectiveness of the system above all for the foreign investors) should be done because a low statutory rate is important, but only effective average rates can affect Czech capacity to attract foreign investment, and only effective marginal rates can be decisive for the choice of how many investments to do. As to capital incomes, we can notice that they are taxed at very different rates: marginal tax rates on personal income and rates on interest are substantially lower than corporation income tax rate, interests are fully deductible from corporation tax base and the "all-in" tax rate on corporation income is different according to the firms' decisions concerning dividends distribution: these differences affect firms' financing decisions and have raise to a preference for the debt. Thus there are significant differences in marginal effective forward rates, according to the sources of financing (debt financing or financing with new equities) and to the specific type of assets (Holeckovà, Vitek, and Pubal 2002).

At the time of communist regime, the share of GDP coming from private sector activities was very small, earnings and social benefits were extremely equalized**,** redistribution of income came up basically with the indirect taxation (prices subsidies) and there were only a small number of big enterprises. The 1990s reforms involved the introduction of market competition, large privatization and liberalization: then it was important to maintain the social cohesion during the transition to the market economy and balance the sacrifices of new tax system with the benefits from public expenditures. For these reasons a real evaluation of the political and economical changes of the transition period can be done only by considering together taxation and expenditures and the income redistribution.

On the road to a market society, during the 1990s income inequality has risen considerably (mostly because of the fast advance of the top decile share) and incomes structure has undergone important changes. In the meantime, both pension schemes and the social transfers were reformed; unemployed benefits and guaranteed minimum wage were introduced. The communist countries had a lower value of Gini coefficient (0.2) in comparison with the market driven countries, and Czech Republic was not an exception: Czech income per capita Gini coefficient increased from 0.20 in 1988, 0.23 in 1992 and 0.26 in 1996 and probably it has been still increasing during last years (Vecernik and Stepankova 2002).

Table 5 Gini Index on household income

Per household			Per capita		
1988	1992	1996	1988	1992	1996
0.29	0.32	0.33	0.20	0.23	0.26

Source: Microcensus 1988, 1992 and 1996.

From the late 1980s to the first half of 1990s, the fiscal system became more progressive. After-tax incomes became much more even than before-tax, while during the communist regime the tax-induced reduction of inequality was insignificant. In 1988 the last quintile paid 39.7 per cent of revenues and in 1996 it paid 53.6 per cent. In 1988, 67 per cent of total transfers come up to the first three quintiles while in 1996 it increased up to 77 per cent.

Table 6 Distribution of taxes and transfers according to quintile shares

Quintiles	*1*	*2*	*3*	*4*	*5*
Taxes					
-1988	1.7	11.1	20.2	27.3	39.7
-1996	1.8	5.4	14.1	25.1	53.6
Transfers					
-1988	27.5	23.4	17.1	15.8	16.2
-1996	27.5	30.6	20.4	12.7	8.8

Sources: Microcensus 1988, 1992 and 1996.

However it is important to underline that more than half of total population is taxed inside the two lowest brackets of income tax while very few taxpayers are taxed within the highest one. Then the most relevant limit of the existent fiscal system as to income redistribution is the lack of a negative income tax: some equitable effects could be obtained at the advantage of lowest income taxpayers if personal income allowances were replaced by tax credits. This change could induce an increasing loss of revenues. It could be compensated for an increase of the share of real property tax, that in Czech Republic stay at a very low level (about 0.6 per cent of total revenues in 1998).

Table 7 Distribution of household income according to decile shares

	Per household			*Per capita*		
	1988	1992	1996	1988	1992	1996
1	2.5	2.9	2.8	5.3	4.9	4.3
2	4.1	4.1	3.9	6.6	6.4	5.9
3	5.9	5.8	5.6	7.4	7.3	6.8
4	7.6	6.9	6.7	8.1	7.9	7.6
5	9.3	8.1	7.9	8.8	8.6	8.3
6	10.7	6.9	9.4	9.6	9.2	9.1
7	12.0	11.1	10.9	10.6	10.1	10.1
8	13.2	12.8	12.7	11.8	11.3	11.5
9	15.1	15.2	15.4	13.6	13.1	13.7
10	19.6	23.5	24.7	18.2	21,1	22.6

Sources: Microcensus 1988, 1992 and 1996.

4.3 A comparative view with other EU New members and the average of EU

In 1998 the Czech structure of revenue according to economic function was about close both to EU and EU New member average, but we can observe same differences in the 1990s dynamic and in 1998 values. In this year the share of consumption was the same as the EU average and two GDP points lower than that of New members, while the share on employed labor was the 87 per cent of the EU average (21.2 per cent of GDP) and two GDP points more than that of new members. The share of self-employed labor was quite higher than both EU and New member averages, while that of capital and business was three fourth of EU average and it was 1.2 GDP points more than that in New members.

During the 1990s it can be noticed that the trend of consumption revenues has been decreasing in Czech Republic while it was basically steady in both EU and New members. The opposite happened for employed labor: it has been basically steady in EU countries, steady from 1992 to 1996 and decreasing from 1997 to 1998 in New members and quite rising in Czech Republic. Both EU and New members self-employed average has been steady in this period, while it was decreasing by more than one GDP point in Czech Republic; the same has happened for capital and business average.

In 1998 the Czech implicit tax rate on consumption was 1.2 GDP points lower than the EU average and one point lower than New members' one. During 1990s it has been decreasing in Czech Republic and steady in the other countries, while implicit tax rate on employed labor has been increasing in both EU and New members as well as in Czech Republic, but the increase has been more evident in EU countries (3 GDP points) than in New members (1.6 point in Czech Republic and only one point in the other countries).

5. Tax reforms and further steps to get closer to the EU

5.1 Macroeconomic and budget outlook

Over the last decade the macroeconomic situation in Czech Republic has considerably changed mainly because of two factors: the split of the previous Czechoslovakia Republic and the transition, starting in 1991, from the communist regime to a market based economy. The radical economic reform wanted to obtain macroeconomic stability, low inflation and balanced state budget, also because during the 1980s the average Czechoslovakian real GDP growth rate declined dramatically from 4.8 per cent to 1.5 per cent. Then prices and enterprises were liberalized, the private sector was promoted, an adequate Welfare State was launched, both domestic and foreign demands were stimulated, effective monetary and fiscal policies were implemented.

However in the early 1990s the demand for consumer goods and investments were very low and Czech GDP growth rate was negative (also because of a restrictive budget policy targeted to obtain a low deficit), while prices liberalization and VAT introduction determined a drastic increase of inflation rate. However the consequent devaluation of the national currency resulted in an increase of exports. In 1992 unemployed rate was still very low, near to full employment, but it increased during the following years. Economic recession stopped only in 1994 and inflation dynamic was decreasing, albeit in a swinging way, for the rest of the decade. Both public debt and state budget deficit were very low.

In the second half of 1990s further economic and political difficulties came up: a new recession started in 1997 as a consequence of a currency crisis: the GDP growth rate then was -0.8 per cent. Recession ended only in 2000, when the growth rate recovered to 2.9 per cent

(3.6 in 2001). During this period the unemployed rate rapidly increased from 3.5 per cent in 1996 to 9.4 in 2000 and to 8.9 in 2001, while inflation rate continued its decreasing trend from 8.8 in 1996, 10.7 in 1998, 2.1 in 1999 and 4.7 in 2001. The macroeconomic stabilization policy, aimed at the restructuring of the economy, facilitated the inflation decrease. As a result, total domestic demand increased by 3.9 per cent in 2000, sustained by an increase in productivity growth of the industrial sector (OECD 2001).

However these results have been initially obtained with an expansive fiscal policy that became a structural feature of budget policy also after the end of the economic recession: the general Government budget deficit was 1.7 per cent of GDP in 1996, 2.7 in 1997, 3.8 in 1998, 4.0 in 1999, 4.2 in 2000, to further increase to 7.5 in 2001 and to 9 per cent in 2002.

According to new data, fiscal revenue has been steady during the last years: in 2000 Czech total fiscal revenue was 39.3 per cent of GDP, 39.1 per cent in 2001 and 39.8 per cent in 2002. Instead, the level of public expenditure (excluded net lending) was 42.1 per cent of GDP in 1998, 43.7 in 2000, 44.2 in 2001, 46.6 in 2002; levels that are too high to achieve the Maastricht rule of three per cent budget deficit. This is due also to the very low level of public debt (that was about 24 per cent of GDP in 2001 but only 12.9 in 1997) in comparison with Maastricht 60 per cent level. It can be an advantage or, at a contrary, a problem for admission into EU area, because the politicians can under valuate the necessity of radical tax and expenditure reforms and to go on with a further accumulation of the debt. Today, on the expenditure side, "general government deficits are not of cyclical character" and "expenses are only partially allocated in areas that would generate positive multiplication effects in the long run" (Ministry of Finance 2003).

During last years public expenditure has raised more than revenue and, from a political point of view, this has been possible because of the already mentioned low level of public debt and the large privatization receipts that have contributed to control the debt increase. But more attention will be carried out in the next years according to the EU accession requirements: without reforms the debt is expected to grow to 40-45 per cent of GDP in the next years. If this will happen, Czech Republic will see a rapid increase of interest expenditure that will make more difficult to stay within EU budget deficit limits, through the reduction of other budget items (Jurajda 2001).

Despite the stop and go movements of the 1990s, Czech economy is at the top among the EU New members: its economic level was and is very high in comparison with all the other post-communist countries for both GDP per capita level and unemployment rate. It was the first post-communist countries to receive an investment-grade rating by international credit institutions. However without structural reforms it will be difficult to go on with a strong GDP growth and a rapid fall of the unemployed rate, also because Czech industrial plants and equipment are rather obsolete. The only way is to promote a more competitive industry and a well-functioning capital market and to continue in bank and telecommunication privatization (Matalìk and Slavìk 2002; Mitra and Stern 2003).

In this way it could be possible to improve the current low level of private investment, that negatively affect the profitability of enterprises and then to revitalize the industrial sector and increase foreign investment. As a result, a higher GDP growth rate could facilitate the reduction of the budget deficit, if these policies will mix with a more effectiveness in the control of public expenditure. In fact a fast growth is forecast for the period 2003-2006, sustained by private consumption and investment; in particular, 2.3 per cent in 2003, three per cent in 2004, 3.5 in 2005 and four per cent in 2006 (Ministry of Finance, 2003). However the needs of a tight fiscal policy targeted to budget consolidation can affect the effective growth under Czech potential rate.

5.2 Recent or planned tax reforms

A decade after radical changes in the fiscal system, now Czech Republic has to consolidate the obtained results. However, as we have seen, during the last five years the consolidation of the fiscal system proceeded slowly. Only in 2001 the Parliament adopted a number of amendments to the previous tax legislation.

The brackets of the personal income tax were reduced from five to four and tax allowances were increased; no changes in tax rates are expected for the next years, but a lower tax progression is planned, through an increase of child allowances to 109.01€ per month. It has been calculated that this measure could increase the share of taxpayers exempt from the tax from the current 1.7 to 4.3 per cent in the case of a households with an employed head and to 19.7 in the case that the tax allowance is allowed for every depended child. However this measure could cost about 30 per cent of income tax current revenue (1.7 per cent of GDP). However to make this reform budget compatible, probably tax rates will be increased. In the period 2003-2006 important changes are not forecast; only the allowance for children will be raised.

As to corporate income tax, some adjustments were adopted with respect to the tax base (intangible assets and their depreciation) and the tax treatment of foreign enterprises. From 2000 the tax rate was reduced from 35 per cent to 31 and from 2004 a new reduction to 28 per cent is foreseen, because other EU New members have introduced lower tax rates during last years. Also in 2000 (and amended in 2001) a new law was passed on investment incentives for domestic and foreign investors. For the next years a reduction is foreseen to 26 per cent in 2005 and to 24 per cent in 2006; in addition there will be changes in the tax base.

The VAT domain shows the main difficulties. According to the EU directives, Czech Republic adopted a standard rate of 22 per cent and a reduced rate of 5 per cent, but the list of goods taxed with this latter rate must be reduced because of the EU VAT harmonization. The new Government has planned to start this change by 2004 when many goods and services will shift to the standard rate. Only food, medicines, books, newspapers will not be affected by the new law. In addition, the turnover limit for mandatory registration to VAT was reduced from 93,750€ (3 million Kč) to 62,500€ (2 million Kč) starting to October 2003 and it will be reduced to 31,250€ (1 million Kč) in 2004. Other increases are planned for tobacco products, alcohol, fuels and other excise duties. However all these changes must be implemented gradually, in order not to provide negative consequences on economic growth.

Due to tax evasion and to Government decision to slow down the VAT harmonization and to subsidy the consumption of a lot of goods, we can notice that VAT productivity (the ratio among VAT revenue on GDP and the statutory standard VAT rate) is very low in comparison with other countries. Only less than a half of goods and services consumed in each year was taxed at the standard rate but in 2003 the share is 40 per cent. In fact, VAT productivity was decreased during the 1990s: it was 60 per cent in 1993, 57.4 in 1997 and 50 per cent in 1998. In the future it will be possible to broaden the consumption taxable base and to reduce the standard rate that today is high in comparison with other countries.

At legislation level, although an equal treatment for foreign and domestic investors has been introduced in these years, a new bankrupt norm according the EU model, restrictions on special investment incentives and new holding company structure taxation will be introduced, in particular to allow the intra-group compensation of the losses.

After the 2002 elections, the new Minister committed itself to reduce budget deficit before 2006 at the range of 4.9-5.4 per cent of GDP, through a mix of tax increases and expenditure cuts, but the increase of fiscal revenue on incomes and consumption, as proposed, meets political opposition. Instead, according to the Economic Forecasts for the Candidate Countries of European Commission (April 2003), the level of public budget is 5.5 per cent of GDP in 2001, 6.5 (expected) in 2002, and 5.9 in 2004 (provisional data). Without reforms the budget deficit forecast is around eight per cent of GDP and the debt around 47 per cent (Budgetary Outlook 2003-2006, Passive scenario).

According to the proposal, tax revenue will raise as a consequence of excise duties' increases and changes to value added tax. Expenditures should be cut through reducing the number of public employees, modifying the system for the calculus of the pensions, reducing some state contributions. However the adjustment process will be inevitably slow and it is unlikely that Czech budget deficit will less than three per cent of GDP at the year of EU admission.

So the most important issue of fiscal policy would be the sustainability of public finances in the medium run. No basic steps had been made in the last years but finally this reform was approved by Government and Parliament in summer and autumn 2003. This is the right direction, also because one of the most important objectives of Czech Republic in the next years is to maintain a modern social state. A radical reform could affect the economic performance at least in the short run, but it is important for the credibility in the long run. In addition, there are other problems to be considered for an appropriate tax policy in Czech Republic: the rate of taxation is above the level in comparison to the other development countries and it is lower than that in the EU countries. This situation is not positive for the potential growth of this country and for the "tax competition" after the EU accession. On the other hand a radical change is not possible because of the budget constraints.

5.3 The need for further steps

Because of the net borrowing's increase of last years, it will be important for Czech Government to slow down the decline of total revenue: this is happened from 1998 to 2001 but Government diligence in 2002 has not been sufficient because many revenues came from the privatization receipts that have financed the shortfall of revenues of the last two years.

An expenditure control and a reduction of tax evasion (Hanousek and Palda 2002) are both essential because a further increase of Czech revenues and net borrowing could have negative consequences on country's economy, its competitiveness and its future growth rates.

An intervention that can sustain domestic industry should be helpful, albeit without affecting Government spending. On the other hand there is the need to implement a new structure of the mandatory expenditures and subsidies to enterprises, to reduce expenditure level, to favor the sectors with the highest development potentials, and to increase public investment in less developed areas.

At the moment, problems arise both with reference to total tax burden and to public expenditure. A quite high tax burden can reduce both the attractiveness for foreign investments in the country and the profitability for existing ones, and then to undermine the potential economic growth of Czech Republic. Besides this, during the last years some budget items as health and pensions expenditures had a growth faster than national income. Then by the next future the present decoupling between expenditures and revenue has to be attentively kept under control (IMF 2002).

The Government will have to increase the decentralization to Local Governments as to control the expenditures growth, to make Local Governments more responsible, and to allow more flexibility in determining tax rates and fiscal independency. This requires an increase of local own taxes, as the property tax, that today gives only a small revenue to the Municipalities in comparison with other countries. Greater coordination among regional, municipal and central levels of Government will be the required to reach well coordinated economic policy's aims, to make budget process more effective and to reduce growth and employment differentials across regions.

Also tax expenditures and public pension need a reform: the first to make it more targeted and harmonized with the general social policy; the second to decelerate the expansion trend of this budget item that now is 24 per cent of Government expenditures, nine per cent of GDP (it is expected to grow to six per cent of GDP in 2030 without reforms).

To sum up, by imposing market discipline on the enterprise sector, establishing a good climate for foreign investments and security of property rights, simplifying regulatory procedures, from 1993 to 1998 the private sector share on GDP increased as the number of firms (from 1993 to 1997 more than two million business licenses for physical persons were issued) but their average size is very small. The share of employment in small enterprises increased from 24 per cent in 1993 to 56 per cent in 1998 and consequently the share of value added in small enterprises also increased. This created difficulties in Tax administration and, to minimize the room for tax evasion, the law's complexity was increased. It is impossible to have an efficient tax collection when tax-payers increase so rapidly, also because it is difficult to clearly distinguish the private consumption income from the business profit (Vitek, Pavel and Krbovà 2003).

Instead, costs to collect taxes are around 1.5 per cent of total revenues, a value similar to that of the other countries, while the number of Tax administrative employees is around 15 thousands people. During the transformation process the collection costs increased but the efficiency of tax administration is low and there are a lot of small tax offices. The major costs are for the collection of the small property taxes, road tax and VAT. (Vitek, Pubal and Pudil 2003; Vitek, Pavel and Pubal 2003).

Table 8 Number of taxpayers

Taxpayers	*2001*	*2002*
Corporate Income Tax	2,685 938	2,877 730
Personal Income Tax	305,517	321,487
Road Tax	921,492	970,825
VAT	432,282	433,837
Excises	4,824	4,858

Source: Czech Ministry of Finance Annual Reports.

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