Tax Austerity Package: Support for Reform or Disagreement with Parameters?

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Introduction

The Czech coalition government recently adopted a package of measures to bring additional resources to the state budget to address the macroeconomic situation and high inflation. It focuses on current problems such as the growing state budget deficit and high inflation rate. The following principles are among the principles the government wants to promote during the reform process.

1. LEAN STATE (the government wants to save on salaries and state services)
2. SIMPLICITY (the government wants to remove some elements of the tax system)
3. SOCIAL PEACE (the government makes changes in VAT scheme – e.g., reduces VAT on basic goods)

The government has announced 22 tax exemptions, 58 measures, three tax regimes, and two VAT rate changes. Specifically, corporate tax increase from 19 % to 21 %, and 0 % excise duty for wine and books are planned to be introduced. This is seen as a reform, but some experts see it as a parametric change.

Three commodities will go to a lower VAT rate: food except beverages, construction work and medicines and medical supplies. Pressure from various stakeholders is expected to modify or soften the parameters, but Prime Minister P. Fiala has announced that he stands behind the parameters of the reform package. However, support for austerity measures exists in the society, with three quarters of the Czech citizens agreeing that it is necessary to save public funds. Less than 10% of people agree with the entire package of government measures, and a quarter agree with only a part of the proposals. Two-thirds of citizens disagree with the package (a survey conducted by STEM/MARK in May 2023).

In 2022, the state collected almost CZK 790 bn in taxes for the state budget, a year-on-year increase of CZK 90 bn. Revenues from most types of taxes grew, except for excise duty on fuel. The tax on petrol and diesel was temporarily reduced in 2022 in response to the sharp increase in their prices. The higher collection of most taxes is mainly due to the recovery of the economy. Part of the shared taxes was provided to the budgets of individual municipalities and regions.

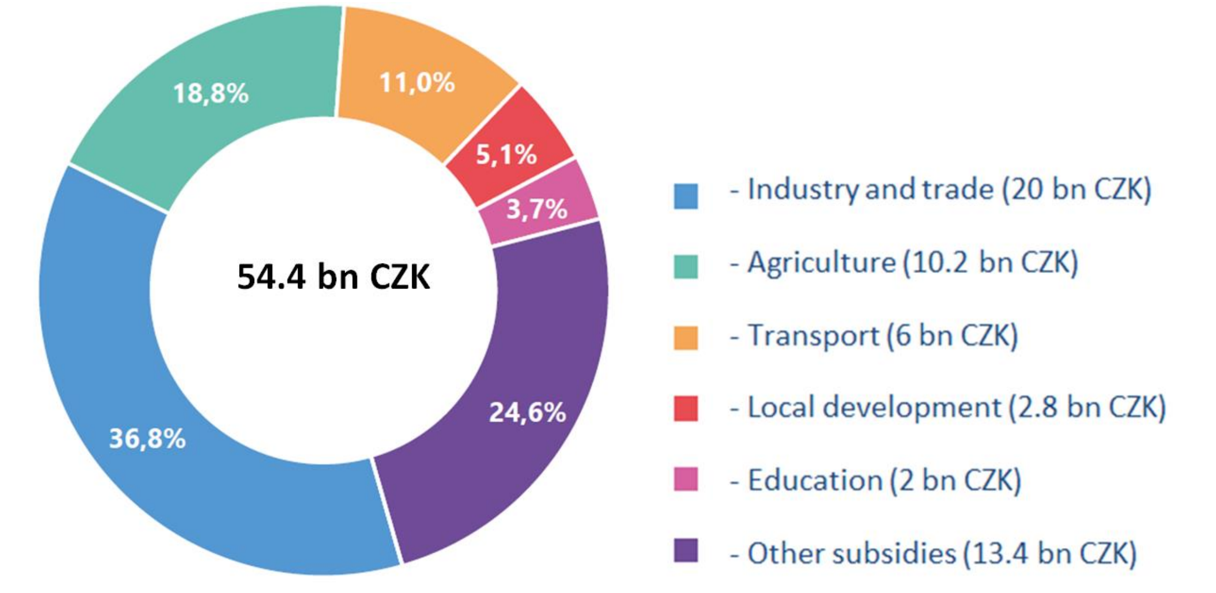
Causes and Analysis

The tax package aims to restore public finances and prevent further debt and an increasing state budget deficit. The government expects a positive impact on the state budget, with savings of CZK 94.1 bn in 2024 and CZK 147.5 bn in 2024 and 2025 combined. The measures should reduce the cost of running the state by CZK 11.2 bn CZK and salaries in the public sector should fall by CZK 9.7 bn CZK.

The leaders of right-wing political party ODS (Civic Democratic Party) – Prime Minister´s party - presented their interest in not raising taxes before the elections, but the situation at home and abroad led them to change their mind. The reform package thus brings an increase in personal and corporate taxes, VAT, and excise tax, as well as an increase in the tax on vices (CZK 1.1 bn beer, CZK 1.5 bn cigarette products, CZK 5.9 bn spirits, and CZK 3.9 bn gambling). VAT will be reformed, with some special features removed, and there will be only two rates: 12% and 21%.

The Czech Republic will reduce VAT on housing, foodstuff (without beverages) and medical products from 15% to 12%, abolish 22 tax exemptions, and simplify VAT from three rates to two. The country has a negligible share of real estate tax collection in GDP and a below-average corporate income tax rate, ranking 16th-18th out of 27 countries in the EU.

Figure 1: Savings on state operations and subsidies



Source: Ministry of Finance, 2023

As a result of the measures announced, the deficits of the past should be gradually reduced. The general government finance forecast (% of GDP) showed and should show the following values: 2020 = 5.8 %; 2021 = 5.1%; 2022 = 3.6%; 2023 = 3.5%*; 2024 = 1.8%*; 2025 = 1.2%* (* = initial estimate MF; the 3% of EU´s GDP). In line with the government's strategy to consolidate public finances, some austerity measures have been taken.

The government proposes to reduce national subsidy titles at most ministries for the period 2024-2025 in the amount of CZK 54.4 bn. This is due to the current situation, which is unsystematic and confusing, and the number of national subsidy titles is disproportionately increasing. Additionally, the effectiveness of the use of national subsidies is decreasing, and the government intends to reduce spending on the operation of ministries and central government institutions by 5%.

A reduction in the volume of funds for funds for salaries in the state sector by 2% in connection with the reduction of state agendas is proposed. This reduction should apply to civil servants and security forces, except for a large group of teaching staff. The reason for this measure is that the salaries of civil servants represent an ever-increasing regular expenditure of the state budget, with a total volume of CZK 250 bn for 2024.

The Cultural and Social Needs Fund is expected to receive only 1% (instead of 2%) of the volume of funds for salaries in 2023. Regional offices of the Financial Administration will be closed (77 offices), and the conditions for the payment of unemployment benefits will be tightened. The Government proposes to reduce the state support to building savings for existing and new contracts to a maximum of CZK 1,000 per year, as this tool was created at a time when the mortgage market was not yet functioning. Banks will also be able to provide a building savings product.

The government proposes to increase corporate income tax from 19% to 21%. The current tax rate of 19% is one of the lower rates compared to the EU levels, and the increase to 21% is intended to bring it closer to the European average. The increase in the rate by 2 percentage points will be one hundred percent state revenue. Employee sickness insurance will be reintroduced at a reduced rate of 0.6%. The reduction in the sickness insurance rate for employees in 2009 was unsystematic and upset the balance of the sickness insurance system. As a result of this and some later measures, the sickness insurance account has shown a negative balance since 2019 (CZK -8 bn in 2022).

The government proposes to increase corporate income tax from 19% to 21%, bringing it closer to the European average. Employee sickness insurance will be reintroduced at a reduced rate of 0.6%, and the real estate tax will be doubled and indexed according to inflation since 2025. The burden on the real estate segment in the CR has been low in the long term, with the share of the revenue from current real estate tax in GDP being only 0.2% (36th position out of 37 OECD countries).

Among the most important details are the abolition/reduction of tax exemptions. Exemptions from corporate income tax should be reduced to restrict the practice of entrepreneurs acquiring luxury cars for private use. Another measure is the abolition/reduction of personal income tax relief. Personal income tax relief should be reduced. It is proposed, e.g., to reduce the tax credit for spouses or to abolish the tax exemption for non-monetary benefits for employees. The limit for the exemption of income from raffles and games of chance should also be lowered, the tax deductibility of still wine as a gift for representation should be abolished, and the exemption for excise taxes on mineral oils should be abolished or reduced.

The government is proposing to reduce state expenditures by digitizing certain activities, increasing the price of the vignette, decreasing the share of co-financing from the European Union funds, increasing the levy burden on self-employed persons, increasing taxes on tobacco products and heated tobacco, and increasing taxes on gambling. The current tax rate on certain games of chance (e.g., lotteries) remains at 35%, while a second tax rate (currently 23%), which applies to e.g., sportsbook, roulette, or horse racing, should be increased to 30%. The government proposes to change the budgetary allocation of taxes so that the revenue from all online gambling will be exclusively income of the state budget and the yield from all land-based gambling will be 65% of the income of municipalities and 35% of the income of the state budget.

The income bracket, within which the 23% personal income tax rate should be paid, should start at three times the wage instead of four times the average wage. This expands the pool of high-income people who pay 23% income tax. Currently, the threshold for higher taxation is lowered from CZK 161,300 to CZK 121,000. This is a solidarity measure. Levy relief for contracts for work should also be capped.

The government is proposing to increase the excise duty on alcohol by 10% in 2024 and by 5% in each year 2025-2027. Compared to neighbouring countries, the CR now has lower alcohol taxation than Slovakia and Poland. The government is also proposing to increase the remuneration for mineral extraction, but only the amount of the rate share is adjusted. The exemption of income from the sale of securities from personal income taxation is limited.

The government proposes to reduce the number of VAT rates from three different rates (10%, 15% and 21%) to two rates (12% and 21%). Books are not burdened with VAT, while items without demonstrable social or health significance are proposed to move to the basic VAT rate. Other items from either of the two reduced rates remain at the unified reduced rate of 12%. The budget-negative aggregate impact of all proposed adjustments to the VAT system creates an anti-inflationary stimulus.

Table 1: Positive impact of the adjustment package on the state budget (in CZK bn)

	2024	2025	Total
Expenditures	62.4	15.9	78.3
Revenues	31.7	37.5	69.2
Total	**94.1**	**53.4**	**147.5**

Source: Ministry of Finance, 2023

According to the National Economic Council of the Government, an advisory body to the government), the measures have a neutral or rather slightly anti-inflationary effect.

Table 2: Overview of the measures of the adjustment package and their impacts on the state budget (in CZK bn)

	2024	2025	Total
EXPENDITURE	**62.4**	**15.9**	**78.3**
Subsidy	45.6	8.8	54.4
Operation of the state	6.1	5.1	11.2
Salaries in the public sector	9.7	0.0	9.7
Other expenditure	1.0	2.0	3.0
REVENUES	**31.7**	**37.5**	**69.2**
Increase in CIT	0.0	22.0	22.0
Introduction of sickness benefit	11.9	1.1	13.0
Property Tax Increase	9.0	0.3	9.3
Tax exemptions	2.3	5.3	7.6
Self-employed persons' contributions	3.0	4.5	7.5
Tobacco tax increase	3.1	2.8	5.9
Gambling tax increase	3.9	0.0	3.9
Modification DPFO	1.8	0.9	2.7
Levies on DPP	1.8	0.2	2.0
Increase in alcohol tax	0.5	0.6	1.1
Other revenue	-1.6	-0.1	-1.7
Revision of VAT rates	-4.1	0.0	-4.1
TOTAL	**94.1**	**53.4**	**147.5**

Source: Ministry of Finance, 2023

Notes: CIT = corporate income tax; DPFO = personal income tax; DPP = agreement to perform work.

The above-mentioned STEM/MARK survey found that people consider it appropriate to lower taxes on certain foodstuffs, higher taxation of tobacco and alcohol, a reduction in the volume of salaries in the public sector, a reduction in national subsidies and higher taxation of companies. However, they reject an increase in self-employed contributions, sickness insurance for employees, an increase in the price of vignettes, an increase in VAT on newspapers and medicines, and a higher property tax.

The opposition criticizes the appropriateness of large subsidy cuts and changes to indirect taxes and VAT. They also criticize the cancellation of the electronic registration of sales (EET), which represents a shortfall in state budget revenues of CZK 13 bn. Part of the opposition is proposing the reintroduction of EET.

Future Expectations and Implication

The Governments National Economic Council (NECG) is confident that the adjustment package proposed by the government will help public companies and not jeopardize the domestic economy. However, NECG believes that systemic changes, not just parametric ones, are needed for a definitive and long-term solution. If implemented, the package will reduce the general public finance deficit below 2% of GDP in 2025 and reduce the structural deficit by approximately 1 percentage point compared to 2022. The Czech Fiscal Council (CFC) estimates that the government should have up to CZK 50 bn in revenues from this year´s budget´, from the Modernization Fund/emission allowances, but it appears that the government will not receive these funds. In addition, the government will have to obtain CZK 15 bn for extraordinary indexation of pensions, which was not planned in the budget.

The austerity package has been criticized by trade unions, employers, two former presidents, and opposition political parties. Experts point to shortcomings such as insufficient scope of measures, changes in parameters, lack of real across-the-board cuts, and illogicality in the inclusion of some items within individual VAT rates. According to a survey prepared by trade unions, the average Czech family will be one fifth worse off after the introduction of government measures. The state budget deficit should reach CZK 295 bn in 2023, but there is a risk of exceeding it. The CFC stated that compliance with the state budget deficit planned for CZK 295 bn is extremely unlikely. Already at the end of May, the deficit reached CZK 271.4 bn. Overall public expenditure frameworks for 2024, 2025 and 2026 should have been available in April 2023, but this did not happen. The Minister of Finance is determined to propose restrictions as early as this year and, if necessary, some measures will be put into force later this year. The unions have given the government an ultimatum to reconsider some changes to the proposed measures, and a strike alert has been declared.

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