THE TAX SYSTEM IN THE CZECH REPUBLIC: IS THERE A NEED FOR REFORM?

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Introduction

Integration in the European Union is a challenging task that requires an adjustment of the Czech economy to the economies of the other member states. The fiscal policy and namely the tax system is one of the main issues that the Czech Republic should pay attention in this phase. Fiscal and tax policies are for future member states not just a question of the Stability and Growth Pact fulfilment, but also a question of convergence and competitiveness. In addition to the harmonisation of some taxes to the EU legislation, the Czech Republic need to adjust the economy to be complementary and competitive in the European market. Are the fiscal policy and the tax system satisfactory for enhancing the convergence to the EU economy or are further adjustments required? Do automatic stabilisers work well enough to keep the budget deficits far from 3 per cent of GDP? Does the Czech tax system, designed in the early Nineties for a relatively closed economy, fit all today's needs? In this brief paper we would like to answer some of these questions and spell out certain criteria that might be helpful in judging a reform or non-reform of the Czech tax system.

The reason why we pay attention to fiscal and tax policy issues is the fact that the Czech Republic has certain problems in this area and does not fulfil the Maastricht 3 per cent of GDP government budget deficit criterion at the moment. This also affects the monetary policy, namely the speed of the accession to the Euro-zone and abandonment of national currency. The roots of the current fiscal imbalance lie on both sides of the general government budget. There is an increase of public expenditure (supporting the validity of the Wagner's law, *i.e.* the fact that public expenditure grows at a faster rate than national income, for the Czech economy) and a decline of budget revenues. Government often refers to the decline of the total tax burden (including social security contributions) in recent years as an argument for increasing taxation. The problem of a tax reform in the Czech Republic can be summarised into some simple questions: Why? When? And how much? We would like to provide some answers to these questions.

The Czech fiscal development shows intrinsic problems. The budget deficit is reaching unsustainable levels due to a decline of the revenue ratio that is not accompanied by a similar tendency of the expenditure ratio. Expenditure growth is affected by the increase of payments based on current legislation (so called "mandatory expenditures"). The government cannot control these outlays in the

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short-run. The increase of these expenditures (e.g. pensions, salaries for public sector employees) crowds out possible discretionary expenditures. There is a need for a reform targeted on both budget sides – revenues and expenditures. Politicians often speak about a reform, but there are not willing to undertake any responsibility and they generally tend to shift the problem to the future, hoping that someone else will carry the negative consequences of fiscal consolidation. This behaviour is allowed by the relatively low Czech public debt. The current debt to GDP ratio is approximately 25-28 per cent and the government sees room for further debt accumulation.

The purpose of this paper is to examine a possible tax reform in the Czech Republic. The paper briefly introduces the latest development; tries to identify unsatisfactory areas within the current tax system and discusses what could be done to improve tax policy.

1. The basic structure of Czech taxes

The structure of the Czech tax system was established during the early stage of the transformation process. Its roots were laid down in the early Nineties and have not been substantially modified yet. The Czech tax system copied the main features of tax systems of the OECD countries It introduced the VAT and simplified the taxation of companies.

The economic reform of the early Nineties was grounded on 4 pillars: price liberalisation, privatisation, internal currency convertibility and a tax reform. A substantial tax reform was prepared during 1991 and 1992 and was implemented on 1st January 1993. It completely transformed the old tax system which consisted of 17 different taxes, into a new one consisting of only 8 taxes. The difference was not just in complexity, the whole philosophy of taxation was rapidly changed to create a tax system consistent with a market economy and greater efficiency of labour and capital markets. For more details see, e.g., Heady and Smith (1995).

During the last 10 years modifications of tax rules were carried out in all transition countries. The Czech Republic was not an exception. The progress and structure of those changes were similar in all these countries: As Mitra and Stern (2003) pointed out, common features were a rapid decline of the corporate income tax revenue to GDP ratio and a growing importance of indirect taxes as a source of revenues. In the Czech Republic the share of corporate income tax on total tax revenues declined from 16.5 in 1993 to 9.8 per cent in 2000. However, the ratio of indirect taxes to Czech total tax revenues remained almost constant with a minimum volatility in the transformation period (32.9 per cent in 1993 and just 32.0 per cent in 2000).

The tax changes in the Czech Republic included the reductions of the corporation tax rate from 45 to 31 per cent and the VAT rate from 23 to 22 per cent. Several allowances were introduced in the personal income tax (e.g., for life insurance and pension savings, for home building/reconstruction savings). Foreign investors were granted some tax holidays. As a result of a fight against tax deceptions and judicial decisions, the tax law became voluminous and complex.

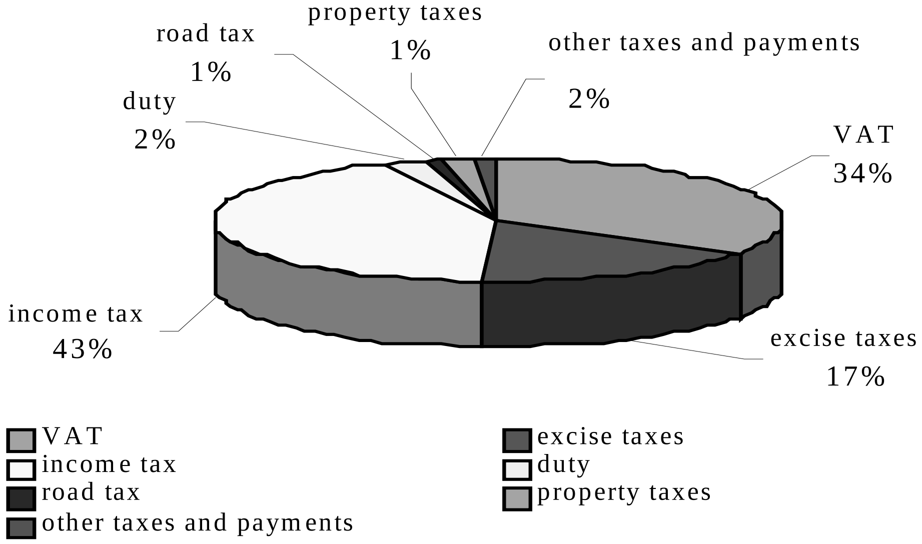
Taxpayers are subject to one or more of these taxes:

Corporation income tax	current tax rate: 31 per cent
Personal income tax	tax rate: 15-32 per cent
Value added tax (VAT)	5 per cent on services, 22 per cent on goods
Excise taxes	on petrol, tobacco and alcohol products
Road tax	1200-4200 CZK on cars, 1800-44100 CZK on trucks
Real estate transfer tax	5 per cent of the estate price
Inheritance and gift tax	between 7 and 40 per cent

Labour income is also subject to social security and health contributions. The most important budget revenue sources are indirect taxes (51 per cent) and income taxes (43 per cent). Other taxes and payments play a limited role and an increase of their revenue share could be seen as desirable. The structure of tax revenues is shown in Figure 1.

Figure 1

Structure of Tax Revenues in 2001



Source: CNB.

Table 1 compares tax revenue ratios in the Czech Republic and some surrounding countries with the EU and OECD weighted averages. Because a comparison based on tax rates would not provide an accurate picture – due to variously specified tax bases in different countries – a look at a share of a particular tax on total tax revenues (including social security contribution) seems to give better information. The Czech Republic has the highest social security contribution among these countries. However, combining the personal income tax and the social security contribution, overall labour taxation is still lower than in Germany and approximately the same as in Austria. Czech politicians often admit that the proportion of property taxes is low and need to be increased. They see property taxes as an easy target for increasing government revenues. But, as shown in Table 1, the share of property taxes on total tax revenues (1.3 per cent) is very similar to Austria and Hungary.

High taxation of labour (personal income tax and health and social contributions) and high amount of arrears are among the main problems of the tax system. High taxation of labour creates opportunities to work in the shadow economy (some individuals prefer to avoid the personal income tax and social contributions by declaring themselves as unemployed, while in fact they are

Table 1

Share of Taxes on Total Tax Revenues (Including SSC) in 2000

	Indirect taxes	Personal income tax	Corporate income tax	Social security contribution	Personal income tax and social contribution	Property taxes
Austria	28.4	22.1	4.7	34.2	56.3	1.3
Czech Republic	32.0	12.7	9.8	43.8	56.5	1.3
Germany	28.4	25.3	4.8	39.0	64.3	2.3
Hungary	40.5	18.6	5.7	29.3	47.9	1.7
Poland	36.6	23.2	6.9	29.4	52.6	3.3
EU-15 average	30.0	25.6	9.2	27.5	53.1	5.0
OECD average	31.6	26.0	9.7	24.8	50.8	5.4

Source: Revenue Statistics 1965-2001, OECD (2001).

employed in the shadow economy). Another reason for the high underpayments is the time-consuming enforcement of payments. In some cases, smaller companies operate as a "tax shell" – they cumulate tax obligations for a certain period of time and instead of a repayment, they just go bankrupt. During the liquidation of these companies it may be found out that there are no other assets that could be used to settle the tax debt.

The efficiency of tax collection could be improved. A part of the inefficiency stems from the low chances to collect revenues from liquidated firms that did not settle their former tax duties. Another stems from a widespread attitude towards taxation: tax evasion is considered more like a sign of heroism than a moral offence. There are still considerable opportunities to avoid taxation: tax inspections are not a sufficient threat to manipulate the accounts of small enterprises (many self-employed persons show in their business accounts as tax costs items which are related to their personal consumption rather than to their business activities). Big companies have larger opportunities to have their incomes taxed in countries with lower or no tax rates. The government is trying to eliminate these opportunities; as a result of this action, tax legislation becomes more complex.

The ratio of total tax arrears to total tax revenues is relatively stable and reaches values between 4 and 5 per cent. This indicator has not changed dramatically since 1995 and exhibits surprisingly high persistence. The tax administration is able to collect around 15 per cent of enforcing arrears. The success of enforcement is higher for the arrears of lower amount; the amounts exceeding 10 mil. CZK are usually unassailable. The Czech tax administration has dramatically increased its activity in enforcing arrears. Just for an illustration: in 1995 there were around 31 thousands of such cases, while in 2001 there were approximately 196 thousands. This increase of tax arrears is not accompanied by a higher "productivity of enforcement": the average amount of cashed arrears (total amount of additionally obtained tax revenues divided by the total number of case) has declined. This raises serious questions about the cost-effectiveness of the tax administration effort. It is fair to point out that the discussion of tax arrears could be somewhat misleading: tax arrears are taxes that have been declared, but have not been paid in time. It does not say anything about the taxes that have not been declared at all. Elimination of tax evasion should be another challenge for the tax administration.

Another problem is connected to the tax holidays granted to certain foreign investors. On one hand these incentives harm the fair competition between (or equal conditions for) domestic firms and new foreign investors, on the other hand they seemed necessary for attracting those investors. New investments certainly contributed to lower unemployment rates in some regions and speeded real economic convergence. It is highly probable that some of the firms that enjoy tax holidays would close down soon after the tax advantage disappears and move to another country granting tax incentives. It is questionable whether the Czech government is prepared for this. Sooner or later some manufacturing firm may move their location to countries that does not tax the labour that much and can provide a lower company income taxation.

2. The Czech tax system and the European Union

EU fiscal rules requires member states to pursue budgets which are close to balance or in surplus in the medium-term. Actual fiscal developments in the Czech Republic are far from these objectives. The general government deficit does not fulfil the 3 per cent of GDP level. Certain quantitative and qualitative steps should be undertaken. Restructuring of both sides of the budget should not just bring it to balance, but also enhance growth perspectives of the economy. Adaptation of the revenue side should be a part of this process.

From a qualitative point of view, Czech taxes are compatible with EU requirements. There are still some differences (mainly in indirect taxation), but they will be removed before the Czech Republic enters the EU. But one should also consider whether other aspects of taxation should be modified even if changes are not required by the EU law.

Labour taxation (personal income and social security and health contributions) is one of the highest in Europe. This raises labour costs and discourages work in the official economy causing high unemployment even during cyclical upswings. The state budget loses potential revenues and foreign investors are more likely to set up their branches outside the Czech Republic. Lately, we have witnessed a ”corporation tax rate cut race” in many countries that tried to become more attractive for foreign investments, but the labour costs are for investors as important as is the corporation tax.

Coordination of tax policies within the EU regards indirect taxes. As a result, the Czech Republic has adjusted the VAT and excise duties to be compatible with other EU members. The tax law of EU is not static and evolves, so new adjustments could be necessary in the future. In the context of accession the Czech Republic had to narrow the list of items that are taxed with the reduced VAT tax rate, decrease the threshold for required VAT tax payer registration, increase excise duties on tobacco and petrol products to a minimal EU level and close dawn duty-free shops on borders. Most of these steps have already been taken. Some changes are planned for this year. In some exceptional cases the Czech Republic tried to obtain a longer transitional period. This applies to the reduced VAT tax for telecommunication, heating and building services. The EU requirements on direct taxation are less rigid and give us more space for individual handling. The tax competition between acceding countries for attracting foreign investments leads to a decline of corporate income tax rates. In personal income taxation the Czech government aims at reducing special allowances and achieving a higher “tax fairness”.

The target of tax policy – as stated in several official documents – is that of stabilising the “composite tax quota” (the total tax burden including social security contributions to GDP). This variable has automatically declined during the transformation process. The government would like to reverse the trend. Reference to “stabilisation of a tax quota” may be less clear to the public than explicit reference to an increase of taxation. The fact is that the Czech total tax burden is already relatively high in comparison to other OECD countries – in 2000 it was 39.4 per cent while the OECD unweighted average was 37.4 per cent and the EU-15 average was 41.6 per cent (see Table 2). Looking just at tax developments in the Czech Republic and ignoring those of other countries could be misleading and could harm the Czech economy, destroying its competition capability. The taxation in the Czech Republic is higher than, e.g., in Germany, Hungary or Poland (naming just the neighbouring countries) and only 10 OECD countries reach higher values. Increasing the total tax burden necessarily means higher taxation of the Czech economy than in the geographically nearest countries and adverse substitution effects and loss of the competitiveness. The Czech government ignores the international context of taxation, looking just at the past development of taxation in the country. Such approach would be feasible in a large close economy, which the Czech Republic is not. A fiscal reform that would increase the tax burden without solving the problems on the expenditure side would negatively affect the future growth perspectives of the Czech economy.

Table 2

Total Tax Burden Including Social Security Contributions
(percent of GDP)

	1993	1994	1995	1996	1997	1998	1999	2000
Czech Republic	42.9	41.3	40.1	39.3	38.6	38.1	39.2	39.4
OECD average	36.3	36.3	36.1	36.5	36.7	36.8	37.1	37.4
EU-15 average	40.2	40.5	40.0	40.6	40.9	40.9	41.5	41.6

Source: OECD Revenue Statistics (2002).

3. The role of the Czech central bank in a tax reform

It may be a little controversial that a monetary authority takes position about fiscal policy issues. In principle, in a country where the monetary policy is independent, a central bank could ignore the fiscal and tax policy design and take for its monetary decision these two policies as given. But the Czech Republic is making an effort to get ready for monetary union. The country should join the Euro-area only after the Czech fiscal and tax policies have been prepared to compensate for the loss of monetary autonomy. The Ministry of Finance is sometimes too much concerned about day-to-day problems or the political consequences of changes and devotes less attention to long-term conceptual issues. The central bank tries to compensate for this and often steps into the fiscal policy debate to stress the economic side of changes and their long-term benefits.

Why is it important for a central bank to monitor the tax policy? The answer is very simple: tax policy is an important part of fiscal policy. Knowledge of the timing of tax changes gives important information for setting the monetary policy instruments in the inflation-targeting framework. Especially changes in indirect taxation have a direct influence on the price level and determine the consumer price index behaviour. The development of the revenue side of the government budget and the announced changes of taxation provide more precise information about the government budget deficit trajectory. Involvement in the tax reform process can give a significant information advantage to a central bank. On the other hand the central bank may be more exposed to political pressures.

The implementation of a tax reform needs a broad political support. Every change in taxation has different impacts on different social and political groups. It is obvious and well described in the theoretical literature (see, e.g., Alesina and Drazen, 1991) that it is often easier for politicians to maintain the existing tax system, which may be inefficient, than introduce a reform and risk their chances in the next election. It is therefore a task for economists to influence the political debate and support the reform process.

4. Criteria for a tax reform

To put some structure in our discussion of the tax reform, it may be useful to try to find some criteria why a tax reform may be needed. These criteria can be derived from economic theory and be valid for all counties. Alternatively, one can stress more country specific conditions.

As a tool for judging whether the tax system should be modified and a tax reform is needed, one can use the standard economic tools that were developed to solve optimal taxation problems. The economic theory focuses on the microeconomic aspects of taxation – e.g., welfare effects, redistribution and markets distortion. Any tax reform (or tax adjustment) is usually discussed within a simulation model that can estimate the effects of proposed changes on the variables relevant for policy makers.

Taxation is often discussed on the basis of three criteria (for more details see, e.g., Newbery, 1995 or Heady, 1996):

- minimisation of disincentive effects (economic efficiency),
- “fairness” of taxes,
- minimisation of administrative transaction costs (and practical enforceability).

In the theoretical literature (pioneered by Mirrlees, 1971) the search for optimality leads to the specification of the social welfare functions and microeconomic analysis. This paper focuses on policy-oriented issues. A limitation in the practical implementation of the theoretical results is the fact that there is a huge uncertainty about the parameters used in the models or simply a lack of data that could be used for modelling the impacts of intended changes. More empirically oriented simulation of tax reforms based on microdata analysis, *i.e.* the estimation of demand systems as described, e.g., by Baker, McKay and Symons (1990), could be used in economies in which the consumption patterns and habits of households are stable over time. Dramatic changes during the transformation period limit the use of household data from Family expenditure surveys for future predictions, due to sizeable changes in household expenditure habits. Although it may be possible to model a particular tax change by assuming that household habits have remained unchanged, as Blow and Crawford (1997) did for a duty tax on petrol in the UK, there are severe data limitations for an application to the Czech Republic. The Family expenditure surveys carried out by the Czech Statistical Office are not detailed enough to provide complete information about some commodities that are taxed by duty taxes.

In addition to the optimality criteria mentioned above, one can list other reasons why a tax reform should be implemented. For the Czech Republic the following justification can be suggested:

- strong need of fiscal consolidation,
- reinforcement of automatic stabilisers,
- increasing tax effectiveness,
- retaining fiscal competitiveness.

Once can think of other reason for a reform as well, but let us first describe in more detail each of these factors that seems to be the most relevant.

4.1 The need for fiscal consolidation

The Czech Republic went through a transformation process when it tried to develop a market-oriented economy. Over a very short period of time the state cumulated a large debt (it was large relatively to the starting value, although not in a European context). The structure of the state changed and new entities were introduced into the fiscal system. A characteristic feature of this period was the decline of budget revenues measured as a ratio to GDP and an increase of expenditures. The gap between expenditures and revenues tend to open over time.

Moreover, during the transformation process public finances benefited from large privatisation receipts. This blurs the Czech budget deficit history: budget deficits in the Nineties would have been much worse without these temporary revenues. Since there is no much state-owned property left for a future privatisation, policymakers should bring the public finance soon back to its balance without relying on further extra revenues.

The difficulties of the current fiscal development in the Czech Republic can be seen from Table 3 that shows expected budget deficits (as percentage of GDP) of candidate countries. The reliability of these figures is somewhat questionable. All these countries are trying to send positive signals to the EU and do not have enough incentives to show their imperfections. Some of them might be too optimistic about their future fiscal development. Moreover, the future budget deficit in the candidate countries is also highly dependent on a state of the banking system. Through a transformation process, that was similar in all candidate countries, bad loans were cumulated in the banking system. Some countries have already undergone a deep consolidation of the banking system; some are in this process now. The Czech Republic is trying to be very open about this issue and deficits shown in the table are rather conservative estimates. The decomposition of the budget deficit into its

Table 3

Budget Deficits in the Candidate Countries
(percent of GDP, according to ESA95)

	2002	2003	2004	2005
Bulgaria	–0.8	–0.7	–0.5	0.0
Cyprus	–2.6	–1.9	–0.6	–0.3
Czech Republic	–6.4	–6.0	–5.7	–5.5
Estonia	–0.2	0.0	0.0	0.0
Hungary	–6.0	–4.5	–3.0	–2.5
Latvia	–1.8	–2.5	–2.2	–2.0
Lithuania	–1.9	–1.7	–1.6	–1.5
Malta	–5.2	–4.6	–3.9	–3.1
Poland	–4.1	–3.6	–3.3	–2.2
Romania	–2.7	–2.4	–2.4	–2.4
Slovakia	–4.6	–4.1	–3.1	–2.6
Slovenia	–1.8	–1.3	–1.0	0.8
Turkey	–13.2	5.9	–3.0	–0.5

Source: Preparation of the candidate countries for participation in economic policy coordination and European Commission, 2002.

cyclical and cyclically adjusted component shows that the cyclical part plays only a minor role and the problem lies in the cyclically adjusted part.

The overall deficit is not the only problem of the Czech fiscal policy. The parliament has created several local governments to decentralise the decision process of the state executive. Several state off-budget funds or vehicles were set up and the formerly unified central government budget was split into several budgets. The reason for this was an attempt to give a longer investment horizon to some institutions (in the case of off-budget funds) or to hide some transformation costs (in the case of the other off-budget vehicles). Unfortunately, some of these institutions are heavily dependent on temporary privatisation revenues and do not have regular incomes. Similarly the new local governments do not have direct revenues, but are dependent on transfers from the central state budget.

Table 4 shows the development of the Czech public debt since the foundation of the Czech Republic in 1993. The consolidated public debt reached 24.7 per cent of GDP in 2002. Non-consolidated estimates for 2003 corresponds to approximately 28.1 per cent GDP, with the consolidated likely to be close to this value.

The Czech tax system was originally designed for a different (much simpler) structure of the budgets. Although some adjustments have been introduced, the revenue side of the government does not correspond to the dramatic changes on the expenditure side. It would be advisable to cancel most off-budget institutions and integrate them back into the state budget and to reform the tax system in such a way that every institution gets a regular source of income. This solution can however apply only to the off-budget institutions of the central government. As to local governments, a tax reform could decentralise allow them to impose their own taxes or modify the tax rates in the area of their jurisdiction. On the other hand, the Ministry of finance prohibit local governments to create new debts.

We created several local governments to decentralise the decision process of the executive. Several national off-budget funds or vehicles were also set up. The formerly unified central government budget was split into several budgets. These reforms aimed at giving a longer investment horizon to certain institutions (in the case of off-budget funds) or to hiding some transformation costs (in the case of the other off-budget vehicles). Unfortunately, some of these institutions are heavily dependent on temporary privatisation revenues and do not have regular incomes. Similarly the new local governments do not have own direct revenues, but are dependent on transfers from the central state budget. The fact that a substantial proportion of sub-central governments' and off-budget vehicles' revenues comes from sources where they have no formal (or any) control is dangerous and needs to be improved.

The tax system should be structured in a way that prevents debts to be generated in the different levels of the general government. Moreover the decentralisation of taxation should not bring additional transaction cost and should be done within the Tax service office.

Table 4

Public Debt in the Czech Republic
(billions of CZK)

	1993	**1996**	**1999**	**2000**	**2001**	**2002**	**2003***
Public debt (consolidated)	192.1	206.7	275.2	332.4	514.4	562.6	n.a.
as a percent of GDP	*19.2*	*13.2*	*14.5*	*16.7*	*23.9*	*24.7*	*n.a.*
Public debt (non consolidated)	192.2	213.5	287.8	351.9	517.9	565.7	658.1
as a percent of GDP	*19.2*	*13.6*	*15.1*	*17.7*	*24.0*	*24.9*	*28.1*
Consisting of:							
State debt	158.8	161.6	228.3	289.3	345.0	396.0	516.4
State consolidation agency	n.a.	n.a.	n.a.	n.a.	123.1	109.3	80.0
Local governments	3.4	28.1	40.3	41.4	49.0	56.7	58.0
State funds	0.1	0.4	2.0	0.0	0.0	3.0	3.4
Health insurance agencies	0.0	1.2	1.2	0.7	0.5	0.4	0.3
National property fund	29.9	22.2	16.0	20.5	0.3	0.3	0.0

Note: Forecast figures.

Source: Czech National Bank.

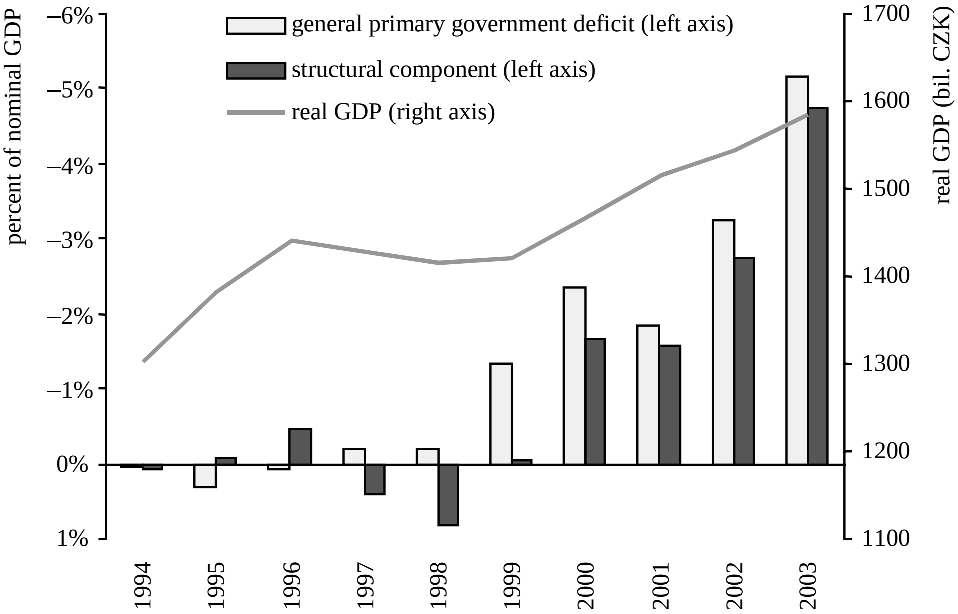
4.2 Reinforcement of automatic stabilisers

Taxes play an important macroeconomic role. It would be tempting for government to smooth business cycle by discretionary fiscal policy, but past experience shows that fiscal policy has been very often in pro-cyclical. Figure 2 shows the general government deficits, its structural part and business cycle development in the period between 1994 and 2003.

Fiscal stance, defined as a change of the cyclically adjusted general government budget, has been pro-cyclical for most of the Nineties. Fiscal policy involuntarily contributed to deepening the business cycle. The obstacle for an active discretionary fiscal policy stems also from often revisions of GDP data. Often such revisions modified the view of the current position in the business cycle. Moreover, since fiscal policy cannot be adjusted over a short period of time, it is not hard to see that discretionary policy decisions cannot be the best tool to minimize business cycle swings. A better solution is that of developing stabilizers that would work

Figure 2

General Government Deficit, Its Structural Component and Real GDP



Source: Czech National Bank and own calculations.

automatically without requiring discretionary government decisions. This can be achieved not just on the budget expenditure side, but also on the revenue side.

The advantage is no information and implementation lags and a relatively fast impact. On the expenditure side the strength of automatic stabiliser is dependent on the generosity of unemployment subsidies and the sensitivity of unemployment to GDP fluctuations. On the budget revenue side key parameters are the progressivity of the tax system and the size of the public sector. Important factors are also the openness of the economy and the flexibility of factor markets – see, e.g., Brunila, Buti and in’t Veld (2002). The design of the automatic stabilisers should allow a symmetrical impact during the business cycle.

While designing the current tax system, the Ministry of finance did not pay much attention to the creation of effective automatic stabilizers. The main concern in 1992 was the design of a new tax system compatible with a market economy. An effort was made to implement tax changes that would allow the evolution of market structures and would not limit the economy as the previous system. At the same time the tax system would have to generate the same amount of tax revenues, so that fiscal soundness would not be endangered. The new tax system was introduced on New Year’s Day, 1993, which was also the date of splitting Czechoslovakia into two parts. It was a period of high political and economic uncertainty. Understandably, the issue of automatic stabilizers was not a priority with respect to the more urgent need to guarantee stable revenues.

Since 1993 the tax system has remained very much the same. However, many changes to individual taxes have been introduced. A common denominator of those adjustments was the attempt to minimize the room for tax evasion. Early stages of the process building a market economy were characterized by large tax avoidance. This was a consequence of undeveloped fiscal authorities, the emergence of thousands new companies and a common social climate. Most changes in tax legislation were motivated by the effort to eliminate these factors. A discussion about the connection of fiscal policy and business cycle was too academic and so remote from more urgent fiscal problems that it would not bring fruitful results.

However, as time moves on, the Czech fiscal authorities should start to improve the existing tax system, also in view of optimising its business cycle behaviour. Unfortunately, the discussion is still at the preliminary stage. Most tax changes are introduced as a result of the EU harmonisation requirements and there is no time or energy left for more detailed economic analysis of the proposed tax changes. One problem in building automatic stabilizers in a small open economy is that of a relatively low correlation between the business cycle and the domestic economic variables (e.g., the unemployment rate behaves quite acyclically and the room for automatic stabilizers that would be dependent on labour taxation – *i.e.*, personal income tax or social contributions – is very limited) which could be related to the potential tax base. This depends on the Czech business cycle being highly dependent on economic development abroad: the growth of domestic GDP is determined by foreign demand (*i.e.*, the net exports). One possible solution would be to impose some anti-cyclical import/export duties. However, the possibility to adopt this solution is limited by the international commitments of the Czech Republic. Moreover, the main trade partners of the Czech Republic are the members of the EU. Such duties would have to be imposed only on non-member countries that do not play a significant role in the Czech net exports.

The building of automatic stabilizers seems problematic in the Czech Republic. The domestic candidates for a tax base do not show a strong relationship to the business cycle; the foreign trade candidates are practically excluded, because export/import with non-EU countries will play a marginal role.

4.3 Increasing tax effectiveness

An ideal tax system should induce a minimal behavioural response of taxed subjects, *i.e.*, cause minimal distortions in the economy. Moreover, the tax system should minimise the administration costs. The tax administration in transition economies faces in general very similar problems. Mitra and Stern (2002, p. 37) provide this list:

- a culture of mutual mistrust between tax payers and tax authorities;

- no tradition of voluntary compliance with tax legislation;
- no tradition of appeals to the courts against the decision of tax authorities which, by enhancing trust in the fairness of tax administration, would encourage voluntarily compliance;
- no tradition of self-assessment, which would shift the burden of appraisal to the private sector and reduce administrative demands placed on the tax authority.

All this factors are relevant for the Czech Republic. Tax design has to take into account the cultural and institutional framework to increase its efficiency. In practise this may be rather tricky. A permanent effort of the government to fix imperfections in the legislation which allows to escape taxation complicates the tax law. As a consequence, tax legislation becomes complex even for the tax administrators and the previously well-intended changes turn out to be counter-productive in the end. The Czech tax system in recent years evolved in the opposite direction than the tax systems of many other countries. The Czech Republic should now reverse this trend and follow the examples of countries that were able to simplify the tax system (see Herd and Thorgeirsson, 2001).

Some taxes have a stronger impact on economic behaviour and impose a higher burden, some are less harmful and modify the behaviour only negligibly. Increasing the tax effectiveness means finding sources of taxation that minimise the burden to the economy. It is often agreed that the labour taxation modifies the work behaviour of the population and creates distortions on the labour market. Blundell, Duncan and Meghir (1995) present a method for estimating the effects of reforms of labour taxation. Štěpánková (2002) discusses microeconometric modeling approaches and their potential for the Czech Republic in more details. These and similar studies should be used to evaluate the tax reform now under discussion. When the current tax system was designed in the early Nineties the room for similar analysis was limited by the dramatic structural change and the discontinuity in households' behaviour.

Increasing the tax effectiveness also means an effort for suppressing the "shadow" economy. Simpler and clearer tax rules, that can be easily checked and enforced, could bring additional revenues not just from lowering the administration costs, but also from enlarging the base for taxation. Previous effort of the Ministry of Finance went in an opposite direction: in order to minimise the room for tax evasion, gaps in legislation were filled and the complexity of legislation was increased. The result is that the previously publicly understandable norms became readable only by tax professionals – the tax consultants and tax administrators. The effort should have gone rather in a different way: simplification, rather than extensive definitions, would close opportunities to avoid taxation. Nevertheless, any reform that would try to simplify the system would be first criticised by the tax consultants, because they would lose a part of their know-how concerning how to minimise tax obligations.

4.4 Tax competitiveness

International fiscal competitiveness is an important aspect in the design of a tax system. A small country has to consider the development of the tax systems of surrounding countries, otherwise it would lose competitiveness. The Czech Republic need to look at tax development in Poland, Slovakia and Hungary. A look at Germany or Austria could also be important, but it is necessary to keep in mind that those economies are in a different period of development. There is also a need to monitor tax developments in other acceding countries. If taxation of income and capital were be too different in the Czech Republic and those countries, one could expect that companies and capital would move quickly to an area with better conditions (*i.e.*, less taxation).

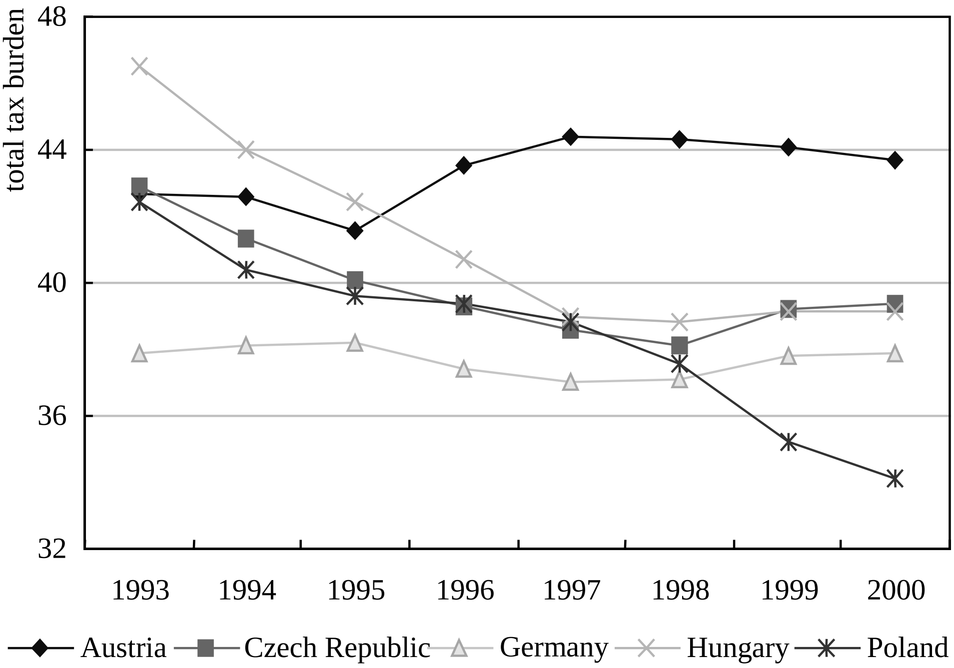
Figure 3 examines the tax burden (including the social security contributions) in Austria, the Czech Republic, Germany, Hungary and Poland. The Czech Republic

Figure 3

Total Tax Burden

(including Social Security Contributions)

(percent of GDP)



Source: OECD Revenue Statistics.

shows similar pattern as Germany and Hungary, while Poland was able to decrease the total tax burden sharply. The government's plan to return the total tax burden back to its former values may have a considerable negative impact on the attractiveness of the Czech Republic in the region. It is also a matter of opinion if the Czech Republic can be compared with developed economies like Germany and Austria or other EU members. It may be advisable to set tax and fiscal policies considering primarily the transition economies that are in a similar phase of development.

5. Summary

The Czech public finances are not balanced at the moment. The expenditure side of the general government budget tends to grow faster than GDP (as would predict the Wagner's law); the ratio of revenues on total output is meanwhile declining. Temporary revenues – such as massive privatisation receipts – that improved the budget position in the past, cannot be expected to occur again. Steps on both budget sides are required to solve this fiscal imbalance. Ineffective public expenditures should be reduced. An adjustment of the revenue side would also be appropriate. The Czech tax system is therefore a suitable candidate for a reform or at least an adjustment.

The current fiscal imbalance is not the only reason for a change of tax policy. The tax system was designed in the early phase of transformation of the economy from a planned to a market one. At the beginning of the Nineties the Czech economy was rather close and the imports and exports of goods and capital did not have the important role they have now. The opening of the economy creates also pressure on taxation; the government does not have a strong control over the tax base, since capital moves freely to countries where there are better conditions. Tax competition between countries puts a stronger pressure on the Czech government and limits the room for levying additional taxes.

The European approach to fiscal policy is based on building sufficient automatic stabilizers that would work freely without the need for government discretionary action. The elimination of discretionary policy and the development of automatic stabilizers is one of the challenges for the Czech Ministry of Finance. It is also a motivation for tax reform. Another challenge is the elimination of excessive burdens and ineffectiveness that hamper the growth potential of the country. The complexity of the tax law, which depends on the several incremental changes introduced in legislation, worsens the comprehensibility of tax regulation for economic subject and produces additional administration cost. Simplification, raising overall flexibility, competitiveness with neighbouring countries, deeper harmonisation with EU principles and a reflection of national constitutional changes are the main reasons why the Czech tax system should undergo a reconstruction.

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