Czech Tax Mix and Welfare Regimes of Labour Taxation

Jaroslav Vostatek*

Abstract. To great extent, tax models are interconnected with welfare regimes of individual social security branches. This is shown in tax mixes – as these are significantly different in four basic welfare regimes and labour taxation models: a liberal, conservative, social-democratic and neo-liberal model. By the OECD definition, tax wedges do not include contributions to mandatory private insurance and savings.
Regarding welfare regimes, the Czech tax mix is indistinct, the assumptions of the 1993 reform have not been fulfilled and complex reforms of pensions and health care have not been realized. Therefore, we focus "only" on options of simple rationalization of labour taxation including social security contributions that will however reflect in the reported tax mix.

Keywords: Czech tax mix, labour costs, welfare regimes, social security contributions

JEL Classification: H24, H55, J32

1 Introduction

Almost ten years ago, a paradigmatic reform of income tax consisting in the introduction of flat-rate tax was realised in our country. It should had been followed by major restructuring of social security contributions, including the increase of gross wage level to the level of total labour costs. This neo-liberal system should have been complemented by privatisation of social security; in this regard, we witnessed an unsuccessful attempt to perform a partial privatisation of the Czech "pension insurance" only. The aim of this paper is first to formulate the role of labour taxation (personal income tax and social security contributions) in Czechia from the perspective of welfare regimes, as they were defined by Esping-Andersen (1990); we extend his range of welfare regimes with a neo-liberal regime. We submit a comparative analysis of the Czech labour taxation and of the whole Czech tax mix with the welfare regimes and corresponding typical foreign tax mixes and systems of labour taxation and with average labour tax burdens of OECD and EU countries. We start with the question of definition of the tax which reflects in the measurement of components of the tax mixes and labour taxation. Then we demonstrate the extent of policy inertia (Turner, 2016) in our country, in comparison with the foreign standards.

OECD includes compulsory social security contributions paid to general government in total tax revenues. Imputed and voluntary contributions plus those paid to private funds are not treated as taxes. Not including contributions to mandatory private pension savings or health insurance schemes might be in line a neo-liberal welfare regime, but it results in a dramatic distortion when we compare e.g. the Czech tax mix with the Chilean one. Conversely, the inclusion of social security contributions into the tax mix for the comparative purposes is very practical (Kubátová and Vítek, 1997), albeit it does not correspond to the social-economic definition of social insurance in a conservative and social-democratic welfare regime, where social insurance is mainly understood as an instrument to apply the principle of equivalence between the benefits and premiums (in professional literature, the term „Bismarck model" is often used, with earnings-related benefits). As opposed to this scheme, there is a Beveridge model where the benefits do not depend on earnings or the premiums paid. The contradiction of these two models is very important in our country, as in principle, the two main public expenditure programmes do not have a character of social insurance. Often, we quite legitimately speak of the "health tax" and "pension tax".

2 Taxation Welfare Regimes

Leaving aside the times when liberals principally refused to assess citizens' income (and thus an entire system of yield taxes supplemented with excises was implemented in practice), liberalism can be characterized by the dominance of the income tax in the tax mix. Therefore, the income tax as the queen of the liberal tax system may or should have been proportional, the tax should not change income relations formed in the market. After the World War I, a new significant tax "channel" (pillar) came to existence not only in our country – turnover tax as a general consumption tax, introduced "due to a pitiful state of public finances" in the post-war period; from the personal

* prof. Ing. Jaroslav Vostatek, CSc.; University of Finance and Administration, Estonská 500, Prague, Czechia, jaroslav.vostatek@vsfs.cz

and material tax bearability perspective, it will not stand up to criticism (Engliš, 1929). In recent decades, the star of value added tax (VAT) rises to prominence, this tax stands up to the criticism regarding its material tax bearability, due to missing „cascade" effect. If the current liberals are fine with the existence of the VAT (or sales tax in the US) as a fact, they might as well as "be happy" with the existence of a progressive income tax – as a counterbalance to the degressive VAT.

The tax system of the New Zeeland before the last tax reform may serve as an example of a modern liberal tax mix. In 2009, the personal income tax (with moving progression of rates from 12.5% to 38%) returned 53% of all tax income, with the share of VAT (GST) being 21% and corporate income tax 17% (the remaining 9%: excises, custom duties and some fees). The social security contributions are practically non-existent there (only a contribution to mandatory insurance of non-occupational accidents of employees at 1.45% rate from earnings up to 118 191 $ annually). The state provides a rather generous flat-rate pension to all residents. Since 2014, the tax reform has emphasized the role of a significantly universal VAT tax: its flat rate has been increased to 15%. Personal income tax rates have been reduced to 10.5% - 33%, corporate income tax rate dropped from 30% to 28%. The income taxes contributed to the New Zeeland's tax mix with 55.4%, the taxation of consumption with 38.4% and property taxes with 6.2%. Thus, the liberal labour taxation model is very simple; it consists from progressive personal income tax only.

The modern conservative (Christian-democratic) tax mix is different from the modern liberal mix "only" by the existence of distinct social insurance premiums. We neglect here a frequent existence of state provisions for civil servants financed from public budgets. From the perspective of defenders of a conservative welfare regime, the social insurance is outside the state budget and the premiums are at most a parafiscal receipt, and at any case they do not represent a tax. However, for the sake of our comparison, we must consider these premiums as part of the total labour costs. At the same time, fundamental construction parameters of social insurance are important; 4-5 social insurance branches have separate premiums paid to autonomous social insurance funds (e.g. 6 industrial and 6 local health insurance funds operate in the Austrian worker health insurance). Earnings caps are applied to great extent for the calculation of premiums and the same caps are used for the calculation of cash benefits. As a rule, these caps amount up to 200% of the national average earnings (NAE) in the given system. There are also (usually somewhat higher) caps for the mandatory participation in individual branches of social insurance; if the income exceeds this limit, the insured may leave the system. Halving the premium between the employer and the employee is (was) explained as a token of alignment of possibilities and interests of both social partners in the social market economy, it is a typical feature of the conservative regime; the exception being social accident insurance where the premiums are paid by the employer, as this concerns a labour risk as such; it is usually the smallest component of the total premiums so the fact that the premiums for social accident insurance are not divided may be neglected. Here, the theory can also explain any potential state subsidies of some areas of the social insurance - by doing so, the state may and should finance e.g. non-contributory periods in social pension insurance (e.g. day-long care for small children), The employee premiums on social insurance are deducted from the tax base of an employee's salary.

Germany is an example of a conservative tax mix. The social insurance premiums are consistently not reported as part of the tax system. From 2015 OECD data follows that these premiums represent 38% of the total revenue from taxes and premiums – and is the main German tax channel. The income tax in all forms (31%), or personal income tax (23%) is the second biggest tax channel. In Germany, the wage tax is progressive owing to the progression of rates (with the maximum rate being 45%), wage up to €8,652 annually is exempt from tax. The taxation of consumption (28%) is the third tax channel, and it includes the VAT (19%). In Germany, the total labour taxation significantly dominates over the taxation of consumption and as part of labour taxation, premiums prevail over the personal income tax (38:23). The conservative regime of labour taxation thus consists in social insurance premiums and secondly, in a progressive wage tax. We may add that contribution-financed systems which are funded and most-often administered by bipartite or tripartite governing bodies independently of the government budget, have historically tended to be more generous since contributions are earmarked for specific benefits and thus do not depend on overall government budget decisions (Morel and Palme, 2012).

Social-democratic tax mix also "works" with social insurance premiums, however these premiums are exclusively paid by employers and they do not fund health care for employees (and their families) as opposed e.g. to Germany and Austria. Here, the social insurance premiums are (relatively more) used for the purposes of economic and social policy, such as to support employment of young and elderly persons. In a way, this policy is and may be financed by the non-existence of the earnings cap to pay the premiums, while caps are applied in relation to employees, e.g. when determining the contribution to pension savings/insurance (with a cap around 120% NAE).

Sweden is an example of a social-democratic tax mix. Personal and corporate income taxes represent approx. 38% from total tax revenue. The share of the personal income tax alone is roughly 27%. Social security contributions have a 34% share, and it is estimated that approx. 60% of these contributions have a character of tax and only

40% can be considered standard social insurance premiums (Skatteverket, 2016). The employees pay a contribution to NDC pension insurance at 7% rate (16% is credited to their personal NDC account), however this contribution is deducted from their personal income tax. The employers pay a 31.42% payroll tax without the earnings cap. The consumption taxation (VAT and excises) represent approx. 29% of total tax revenues. The total labour taxation amounts to approx. 60% of all tax revenues, while the social security contributions participate in the total labour taxation with 56%, the remaining revenue represents personal income taxation (Skatteverket, 2016). The role of the above-mentioned employee contributions to NDC may be subject to discussions. A special role of the state income tax – with two rates (20% and 25%) and non-taxable minimum, which is higher than NAE, is also interesting. Regional income taxes have proportional rates in the range from 29.2% to 34.7%, with considerably lower non-taxable minimums; revenues from regional taxes represent approx. 90% of all income tax revenues. Among other, regions finance health care. The social-democratic model of labour taxation (in its Swedish version) thus consists in approx. 55% of social security contributions in the form of proportional income tax and approx. 45% of flat-rate municipal income taxes and dual-rate state income tax, the progressivity of which is given by non-taxable minimums. The deduction of employee contributions to pension insurance from the income tax base has a specific role here, most likely it reduces the progressivity of the income tax.

The neo-liberal tax mix "does not know" social insurance premiums, as in this welfare regime the entire social security is cancelled, privatised, the ideal taxation being the consumption taxation, preferably a universal one. The disadvantage of the VAT (or American sales tax) is that it does not reflect on the poor; this may be partially "rectified" by the differentiation of the VAT, i.e. in Great Britain. From this perspective, the ideal tax would be a general expenditure tax, with a tax return where sufficiently non-taxable minimum would be applied. However, such consumption taxation is not very practical and therefore current neo-liberals recommend to "keep" the income tax as the basic tax, which is to be significantly modified by income deductions that are not directly related to consumption – i.e. any capital income. Also, contributions to certified private insurance and savings schemes should be deducted, i.e. particularly contributions to mandatory and voluntary pension savings or insurance, health savings or insurance etc. From this perspective, the economy would also be helped by deductions of interest from mortgage and other loans. The neo-liberal tax welfare regime does not even include corporate income tax, as it does not represent taxation of final consumption. Therefore, a greatly modified personal income tax, supplemented by VAT or single-phase sales tax to split the tax burden into two channels, with lower tax rates is a fundamental part of the neo-liberal tax mix. In the ultimate neo-liberal version, the personal income tax has a flat rate and a tax bonus (or tax-free minimum) that will substitute any social benefits. The neo-liberal model of labour taxation then includes only (a duly modified) personal income tax and (with neo-liberals "gritting their teeth") employee contributions to private savings or insurance, deductible from the income tax base.

Partially, the US may serve as an example of the neo-liberal tax policy, as their key federal income tax has less revenue than amount of tax expenditure related to this tax. Interests from mortgages and similar loans up to $ 1 million annually can be deducted from the tax base. According to Trump, these tax deductions are "key to keeping the country's economy alive". Due to the deductions, the share of personal income taxation in the total US tax mix is "only" approx. 39% (which is much more than the average for OECD countries). "Payroll taxes", collected from employees and employers, take the second place with 24%; rate of "premiums" to health insurance of seniors (Medicare) is proportional, while the premiums to pension "insurance" is degressive, owing to the existence of the income cap. From the neo-liberal standpoint (Friedman, 1962), these taxes are bad, because they are not progressive. The consumption taxation, particularly in the form of sales taxes collected from sales to end-consumers in most US states, is the third American tax channel (17%).

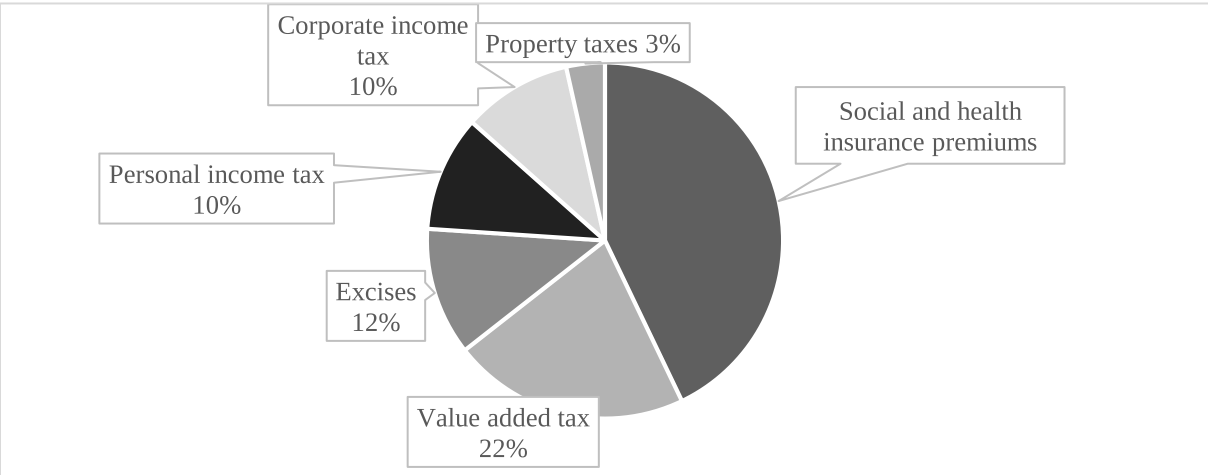
Each of the tax welfare regimes has its own internal logic which is based on the relevant social philosophy. Therefore, they may or might serve as the basis, objective of the tax policy of relevant political parties. If we take into account the existence of the VAT and excises in EU and other countries, it is obvious that individual tax welfare regimes mostly differ in the attitude to social insurance premiums and the role and construction of the personal income tax, and subsequently to the corporate income tax and capital income taxation.

3 The Czech Tax Mix

Social security contributions are the most prominent Czech tax channel (43% of total public revenue in 2016); they consist of "social insurance premiums" and "public health insurance premiums" according to the Czech legislation. The taxation of consumption (34%) with its two basic components: VAT (22%) and excises (12%) is the second most significant tax channel. The income tax (20%) consisting in the personal income tax (10%) and corporate income tax is only the third tax channel – see Figure 1. These data on the Czech tax mix give the impression of a dominating role of the social insurance in our country – the role of these premiums in the tax mix being even greater than in Germany. In principle, the personal income tax is a wage tax; the quantitative significance of self-employed taxation is close to zero in our country.

The Czech public health insurance is not an analogy to the German and/or Austrian statutory (social) health insurance. The health insurance premiums were introduced during the Czech tax reform in 1993; the rate of premiums is 13.5% from gross wages and the premiums are split between the employees and employers in 1:2 ratio. This ratio of premiums was achieved by splitting mechanically the former social security contributions and former wage tax.

Figure 1: Czech tax mix in 2016



Source of data: Czech Ministry of Finance (2017).

In more post-communist countries, the public health insurance is based on individual participation in the insurance, which means that the premiums must also be paid by persons without income from employment or business activities, unless the state pays the premiums for them. The so-called state insured persons, for whom the premiums are paid by the state, are mostly pensioners and children. For these persons, the premiums are assessed at the total rate of 13.5% from artificial calculation bases, with the result being that the calculated premiums are neither adequate to the risk nor the average costs. From the fiscal perspective, the premiums paid by the state is in fact a simple state subsidy, formally calculated from the calculation base "to arrive at the exact sum" allocated to the health sector by the government decision. Other persons without gainful activities pay premiums calculated from the official minimum wage which also do not cover the risks related to these persons – it represents a kind of low head tax. The original intention (in 1992) was to establish a system of "occupational" (departmental, sector-wide, company and other) insurance companies (non-profit institutions) in addition to the General Health Insurance Company; with the result resembling Austrian or German sickness/health funds. 28 occupational insurance companies were established, of which 6 have survived to this day, of which 2 are departmental – i.e. state owned). Although all these insurance companies have a universal licence to provide public health insurance, in fact there is not actually any important competition between them; following the ban on client solicitation by dealers, the numbers of the insured with each of the insurance companies do not significantly change, with the dominant position being held by the General Health Insurance Company. One of the "occupational" insurance companies is in fact related with private network of health care providers. The situation has long been ripe "to turn out one way or another" – more than ever it is necessary to clarify what health care welfare regimes is to be applied here.

The former right-wing governments tended to the Dutch reform of health insurance – a non-consistent neo-liberal model – the major part of premiums continue there to be paid by the percentage from wages, and conversely, the so-called nominal premiums (constructed as a head tax, paid by the employees and other clients) are determined by individual health insurance companies in the absolute amount. The fundamental problem here is that the Dutch health reform did not bring reductions of increasing expenditures on health care. And nobody in Europe wants to introduce an extremely complicated neo-liberal Obamacare. Therefore, "we are left with" the choice of between the model of universal health care, resp. social-democratic welfare regime, and conservative regime of social health (sickness) insurance. Now we are much closer to the first alternative. From the labour taxation perspective, it is a question whether health insurance premiums constructed as proportional payroll tax should further exist. In Great Britain, Mirrlees Review recommended to cancel their national insurance contributions, from which the universal health care is partially financed (Mirrlees et al., 2011). In Sweden and other countries with social-democratic system of health care financing, health insurance premiums have never been introduced and the health care is tax-financed. In Sweden, health care is mostly provided by regions and their main revenue source is the regional flat-rate income tax. The analysis of the Czech health insurance premiums may be concluded by saying that the Czech premiums paid by employees and employers is a proportional income tax that can be fully integrated in labour taxation paid by employees and employers.

The Czech sickness insurance premiums and contribution to the state employment policy are paid by employers in the total amount of 3.5% from gross wages (as part of the so-called social insurance premiums). From our perspective, it is critical that these two social security subsystems have a predominant character of social insurance and the corresponding premiums should exist in the future as well. However, there is a room for rationalization of the benefit construction, e.g. according to the German example.

More than from 60%, the Czech old-age "pension insurance" is a liberal system of a flat-rate pension (Vostatek, 2016), therefore it should not be financed (fully or mostly) from pension insurance premiums. In line with the modern pension theory and policy, it is necessary to divide this "pension insurance" into the solidary pension pillar (financed from general taxes) and social old-age insurance (financed by premiums). The social old-age insurance as such belongs both to the conservative and social-democratic welfare regime. The flat-rate pension fits into both the liberal and social-democratic regime. Our aim here is not to recommend a transition to one or another pension model corresponding to the social policy of a true liberal, Christian-democratic or social-democratic party. Our task is to recommend a "mere" rationalization of the current system of financing of old-age pensions that has a direct impact on the labour taxation in Czechia. At the same time the rationalization of disability and widow/widower pensions is necessary – since all Czech pensions include the same "basic amount" which is annually valorised to 9% NAE. This basic amount of pensions is a remnant of the cost-of-living allowance introduced in 1990 – this benefit should have long been "dissolved" in any construction of old-age, disability and survivor pensions. The modern social-democratic concept of disability pensions assigns these pensions to sickness insurance, minimizes widow/widower pensions to temporary benefits over a span of several months (following partner's death) and transforms orphan pensions into a universal supplement to universal child benefits. With higher universal flat-rate old-age pensions, also the survivor pensions in the liberal pension system no longer make sense and disability pensions are here integrated with other benefits, e.g. unemployment benefits. Conservative systems have experienced minor reforms of disability and survivor pensions from social insurance. The most important fact for our analyses is that setting the flat-rate old-age pensions aside from the social insurance will "free" approx. 11% of the current pension insurance premiums at 28% from gross wages (Vostatek, 2016). For comparison: in Germany, current social pension insurance premiums amount to 18.7% from wages with an earnings cap about 200% NAE (400% NAE in Czechia), employees and employers pay 9.35% each. Germany manages "carefully" the premium rate as the labour cost component; they subsidize e.g. non-contributory periods from the state budget.

4 Rationalization of the Czech Labour Taxation

The need for the transformation to a welfare regime in line with the general conception of the government social policy arises from the analysis of the character of Czech pension and health insurance premiums; the minimum program, or the objective for the academic circles, would be the rationalization of the premiums so that they would only finance real social insurance. In this regard, we have immediately "available" 13.5% from wages (the entire premiums for health insurance) and 11% from the current pension insurance premiums.

The simplest solution to our problem is to cancel premiums paid by the employees at 11% from wages; the integration into the wage tax seems to be the solution. At this occasion, it would be useful to switch the tax base to the gross wage. At the same time, the wage cap in the current pension insurance premiums paid by employees would be cancelled. Conversely, for the sake of simplification, the solidarity surcharge to personal income tax can be cancelled and the progressive nature of the flat-rate income tax can be emphasized by increasing the basic tax credit. The redefining or even reconstruction of tax deductions and credits will be an important "detail". In line with OECD recommendation, it is desirable to cancel the tax credit for spouses.

What should be done with the "unnecessary" social and health insurance premiums paid by employers poses another question. For pension insurance premiums, approx. 17% from the salary should be sufficient, which means that the employee premiums cancelled by us can be considered the current pension insurance premiums at 11% rate from wages. The premiums paid by employers, which is unnecessary in the system, are thus reduced to health insurance premiums. The problem of the necessary reform of the financing of health care system does not have to be necessary connected with the rationalizing tax reform. Therefore, we leave the health insurance premiums at 13.5% rate paid by employers as a proportional labour taxation.

It is said that the labour tax burden in form of social security contributions paid by employers is high in Czechia. According to OECD (2016a), Czechia has the 8th highest tax wedge among the 34 OECD member countries in 2015; the tax wedge with single employee with an average wage amounted to 42.8% in Czechia, while the OECD average stood at 35.9%. With married one-earner couple with 2 children the wedge stood to 26.6% in Czechia, almost identical to the OECD average (26.7%). This may be a token of an above-average intensive support of families with children in Czechia which must however be paid from something from a model perspective – from general taxes. However, for the overall assessment of labour costs in relation to net wages, child-free employees, or their taxation in all known forms, is decisive.

The tax wedge, calculated regularly by OECD, is not a qualified foundation for a potential proposal to reduce employer's social security contributions. As defined by OECD, the tax wedge does not give a true picture of all critical components of overall taxation. The OECD staff is aware of that and therefore they calculate and compare broader compulsory payment wedges in the last period – for OECD countries and for 21 EU countries; this indicator consists of a tax wedge and non-tax compulsory payments (NTCPs) in relation to total labour costs. By doing this, OECD no longer ignores employer and employee contributions to private savings and insurance schemes. NTCPs are very significant at least in 7 OECD countries and thus they modify the overall ranking of countries by the broader tax wedge. We have no NTCPs and thus we were overtaken by the Netherlands in the ranking due to the inclusion of the quasi-mandatory system of occupational pensions. The non-weighted average of OECD countries has increased to 38.6%; the average compulsory payment wedge for EU 21 reached 43.1% - being higher than the Czech wedge at 42.8% (OECD, 2016b). However, the broader OECD tax wedge does not sufficiently reflect full labour costs – e.g. in the USA, there is not reflected the mandatory health insurance introduced by Obama's reform. Adequately, the new workplace pensions in Great Britain and soft compulsion pensions called KiwiSaver in New Zealand should be included into the compulsory payment wedges. Thus, the need to reduce social security contributions in our country does not follow from the tax wedge data. On the contrary, the problem is that OECD continues to publish commonly narrow tax wedges only, while one must search for the broader tax wedges on OECD website.

The necessary rationalization of the Czech labour taxation is relatively simple: it mainly consists in the inclusion of employee contributions to the income tax and subsequent modification of employer social security contributions. The basic problem of its realization is the social security policy procrastination (Turner, 2016).

5 Conclusions

The Czech tax mix is affected by the tax reform introduced in 1993 which could not be based on any looming concept of social policy. Until present day, it is not fully clear which direction the old-age pensions and health care systems should take, due to the extreme extent of policy inertia. The public choice of a pension and health care welfare regime shall strongly impact the Czech tax mix, particularly the income and labour taxation. However, even today we can reflect elementary redistribution processes in the current social security system, particularly the factual dominance of the flat-rate pension in the "pension insurance" and universal provision of health care, which does not give rise to the existence of health insurance premiums, in the rationalization of the Czech labour taxation. The rationalization of the labour taxation thus shall result in the increased share of the personal income tax and reduction of the share of social security contributions. The progressivity of the personal income tax may simply be maintained or increased by valorisation of the basic tax credit.

Acknowledgement

The paper was prepared within the internal project of the University of Finance and Administration "Current trends in development of financial markets" (No. 7773), supported by the Institutional support for long-term strategic development of research organization in 2017.

References

Czech Ministry of Finance (2017): http://www.mfcr.cz/cs/aktualne/tiskove-zpravy/2017/stat-v-lednu-hospodaril-s-prebytkem-9-md-27497

Engliš, K. (1929): *Finanční věda.* Praha: Fr. Borový, 1929.

Esping-Andersen, G. (1990): *The Three Worlds of Welfare Capitalism.* Cambridge: Polity Press & Princeton: Princeton University Press, 1990.

Friedman, M. (1962): *Capitalism and Freedom*. Chicago: University of Chicago Press, 1962.

Kubátová, K. – Vítek, L. (1997): *Daňová politika. Teorie a praxe.* Praha: CODEX Bohemia, 1997.

Mirrlees, J. et al. (2011): *Tax by Design.* Oxford: Oxford University Press, 2011.

Morel, N., Palme, J. (2012). Financing the Welfare State and the Politics of Taxation. In: Greve, B. (ed.). The Routledge Handbook of the Welfare State, Routledge, 2012.

OECD (2016a): *Taxing Wages 2016*. Paris, OECD Publishing.

OECD (2016b): Non-Tax Compulsory Payments (NTCPs) as an Additional Burden on Labour Income. https://www1.oecd.org/tax/tax-policy/Non-tax-compuslory-payments-2015.pdf

Skatteverket (2016): Taxes in Sweden 2015. An English Summary of Tax Statistical Yearbook of Sweden. Swedish Tax Agency, 2016. http://www.skatteverket.se/download/18.3810a01c150939e893f29d0f/1455280476021/taxes-in-sweden-skv104-utgava16.pdf

Turner, J. A. (2016): Social Security Policy Procrastination: A Behavioral Economics Response. Washington, Pension Policy Center. http://www.actuaries.org/cancun2017/docs/4.%20John%20Turner.pdf

Vostatek, J. (2016): *Penzijní teorie a politika.* Praha: C. H. Beck, 2016.