

## 6 Quality of Public Finances

Within the years of the outlook, the revenue and expenditure composition of public finances will presumably undergo significant changes in connection with the measures adopted in accordance with the government's Policy Statement. On the revenue side, these include, among others, adjustments related to the Concept of Reform of Direct Taxes and Levies for 2012–2013. At first, individual acts will be amended, with intended effectiveness from 1 January 2013, and in the second phase a new act on income taxes will be approved, integrating direct taxes and the mandatory insurance premium. The motivation for these amendments lies in simplifying and clarifying the system, but also in increasing its efficiency.

Adjustments on the expenditure side follow the course of the fiscal consolidation already initiated and aimed at balanced financing. These include reforms of the labour market and social benefits, as well as pension and health care reforms. At the same time, optimisation of the public administration's operation cannot be ignored.

### 6.1 Changes on the Revenues Side

#### 6.1.1 Value Added Tax

Newly introduced changes include the possibility to adjust the value added tax obligation for registered uncollectible receivables and the principle of the purchaser's/VAT payer's guarantee for a supplier's payment of the tax. The purchasers have the option to withdraw from the guarantee by voluntarily paying the tax for the supplier directly to the Tax Office. The amendment also decreases the limit for exemption from VAT for deliveries from countries outside the EU from EUR 150 to EUR 22 from 1 April 2011.

Starting from 2012, the reduced VAT rate will be increased by 4 percentage points to 14% while the standard rate will remain unchanged at 20%. From 2013, the two rates will be unified at 17.5%. As of the same date, the level of turnover for mandatory registration will be decreased from CZK 1 million to CZK 750,000. These changes are to cover the fallout of revenues from the social insurance in relation to introducing the second pension pillar.

#### 6.1.2 Personal Income Tax

Building saving interest credited to the client's account after 1 January 2011 is newly taxed with a 15% withholding tax.

For 2011, the tax exemption is temporarily decreased by CZK 1,200 per year per taxpayer. The selected funds will be purpose-bound for repairing damage caused by floods.

The tax reform concept from 2013 counts upon limiting the basic tax credit per taxpayer at 4 times the average wage. The tax benefit for having a child will be increased from the current CZK 11,604 to CZK 13,404 per year, and the maximum limit for the total annual amount of the tax bonus will increase from CZK 52,200 by CZK 8,100. The remaining standard tax credits will remain unchanged.

The personal income tax will now be 19% and its base will only be the gross wage. The premium for public health insurance will be limited to 6 times the average wage and for social security insurance to 4 times the average wage. For payers with income from employment and fringe benefits which account for costs in achieving income, an annual tax credit should be introduced in the amount of CZK 3,000 per year. The social security premium rate and the contribution rate for health insurance will be set at 6.5%. The same rate will be applied for self-employed persons.

Among other measures, it is planned to keep the 15% withholding tax on royalties, on income under contracts for services up to CZK 5,000 per month, and on interest and dividends. It is also planned to abolish a number of exemptions in the tax code.

#### 6.1.3 Corporate Income Tax

From 2013, in connection with the Tax Reform Concept, there will be a replacement of the social and health insurance on the level of employers with a 32% tax on total wages. The base will be total income from employment and fringe benefits, the tax will be capped at 4 times the average wage times the number of employees, and also part of the base will be income under contracts for services above CZK 5,000. The revenue will be divided by means of the budgetary designation for taxes.

The tax rate will remain on the level of 19%. A tax credit in the amount of tax withheld from dividends will be newly introduced, which will eliminate double taxation and will support investment. Creation of provisions will also be simplified, as will adjustments for receivables and there will also be zero taxation on collective investment entities.

With anticipated effectiveness from 1 January 2012, the exemption of incomes of operators of lotteries and similar games will be abolished. Except for demonstrable costs (paid winnings and mandatory fees),

parts of the proceeds formerly representing mandatory payment (support to sport, etc.) will be taxed.

#### **6.1.4 Excise Taxes**

From January 2012, the tax rate on cigarettes, cigars and cut tobacco will increase. The government plans a further increase of the excise tax due to European regulation (minimum excise tax of EUR 90 per 1,000 cigarettes) from the beginning of 2014.

#### **6.1.5 Social and Health Insurance**

The premium rates for social security on the side of the employers remain for this year the same as in 2010, i.e. 25%. However, employers, with exceptions, will no longer be able to deduct half of the recorded wage compensation for periods of sickness from the premium. Also the ceilings on premium contributions for social and health insurance remain at the level of 72 times the average wage for 2011.

For self-employed persons, the minimum advances on social and health insurance will increase. The premium

base for social and health insurance will be 100% of gross income and the total rate will be 13%. Benefits from the social security system will be adapted to the amount of payments.

#### **6.1.6 Inheritance and Gift Tax**

For inheritance and gift tax, the exemption for the 1<sup>st</sup> and 2<sup>nd</sup> groups will be retained, and linear rates will be introduced (20% for the gift tax and 10% for the inheritance tax). The exemption limit will increase for the 3<sup>rd</sup> group from CZK 20,000 to CZK 50,000. From 2013, these taxes will be transformed into the income tax.

Part of the amendment to the law on supporting the use of renewable energy resources is also a change in the law on the inheritance, gift and real estate transfer tax, whereby electricity producers will be taxed on emission permits acquired free of charge by the gift tax at 32%.

## **6.2 Changes on the Expenditure Side**

### **6.2.1 Unemployment Benefits**

With the change of the act on employment in early 2011, new rules for providing unemployment compensation came into effect. Their objective is especially to increase personal responsibility of job applicants in case they terminate the employment relationship with their employer. An employee who has terminated employment voluntarily or by agreement is only eligible for 45% of the average monthly net income or for 45% of the assessment base. If the employee receives notice of termination of employment, he or she is eligible for compensation in the standard amount.<sup>9</sup> The duration of the compensation period is set at 5 months for persons under 50 years of age, 8 months for those 50 to 55 years of age, and 11 months for those older than 55. The compensation beneficiary will have the compensation delayed for the number of months for which he or she received severance pay, and then he or she may begin drawing support in the regular amount and duration. The possibility for additional income while drawing unemployment compensation is terminated. Moreover, unemployment compensation is refused to anyone who in the last 6 months before enrolling as a job-seeker repeatedly

and voluntarily terminated suitable employment mediated by the labour office without a serious reason.<sup>10</sup>

### **6.2.2 Sickness Pay**

Another component of the short-term measures to correct the public finances deficit is the employer's obligation to provide wage compensation to an employee for the first 21 calendar days of incapacity to work (in contrast to the former 14 days paid by employer and the rest paid from public insurance) in the period from 1 January 2011 until 31 December 2013.

### **6.2.3 Pensions**

During preparation of the CP, the Chamber of Deputies advanced for its second reading the government's proposed amendment to the act on pension insurance and certain other acts with the aim to harmonize the legal regulation with the findings of the Constitutional Court (for more details see Chapter 5.2.1).

The pension reform, being prepared with the objective to create a system financially sustainable over the long term and providing adequate revenue, should be effective from January 2013. The main elements of the pension reform are presented in Chapter 5.2.2).

### **6.2.4 Health Care System Reform**

A reform of the health care system is in preparation, consisting of the legislative intent of the act on health

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<sup>9</sup> The standard amount of unemployment benefit is 65% for the first 2 months of the compensation period, 50% for the following 2 months, and 45% of the average monthly net income or of the assessment base for the remainder of the compensation period.

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<sup>10</sup> However, this stipulation will probably be terminated from 1 January 2012.

insurance companies and of a set of health care reform acts: draft legislation on medical services and the terms and conditions of their provision, draft legislation on specific medical services, and draft legislation on emergency medical service. Effectiveness of the reform package is assumed from January 2012. Within the amendment of the act on health insurance companies, the reform also counts upon (among other things) fees collected from patients as components of income for the health insurance companies and continuing operation of the health insurance companies on the non-profit principle. Furthermore, it is planned to retain the institutional separation of commercial insurance in health care (after defining above-standard care) and the possibility of its operation purely in the form of joint-stock companies (outside the public sector).

Draft legislation to amend the act on public health insurance has already been submitted to the government, aiming to increase the revenues and optimise the expenses of the public health insurance system. Establishment of health care standards covered by public insurance is in preparation, with the possibility to pay more for above-standard care.

Effective from 1 April 2011, the act on temporary decrease of prices of medicaments became valid, decreasing the valid maximum prices of all medicaments and food for special medical purposes by 7% for a maximum of one year.

## 6.3 Composition of Public Expenditure

The composition of public expenditure in 2009 is shown in the following graph, as well as the expected structure of expenditure in 2014. While in nominal terms, total public expenditure shows an increase due to the growth of other macroeconomic variables, total public expenditure as percent of GDP will record a decrease from 45.9% of GDP in 2009 to 42.0% of GDP in 2014.

Chart 6.1 clearly shows only a marginal shift from the redistribution segment and expenditure on private activities towards education and health care.

Comparison of categories in time and on the basis of GDP proportion (see Table A.3 in the Table Annex) must be examined with caution, as in 2009 there occurred an exceptional decrease of GDP and a resulting increase in the individual expenditure categories relative to GDP. Except for the environmental segment, decline in relative terms is expected in all categories of public expenditures.

Regarding regulatory fees, the government approved an increase in the fee for a stay in a hospital or medical facility (from CZK 60 to CZK 100). Also a fee (with exceptions) for a visit of a specialist without a previous recommendation from a general practitioner should be introduced. The change of fees should become effective from 2012.

A reform of long-term care is also under preparation.

### 6.2.5 Birth Allowance

Only the poorest families (with income under 2.4 times the minimum living wage) can claim birth allowance, and then only for the first child (the exception being firstborn twins).

### 6.2.6 Social Benefit

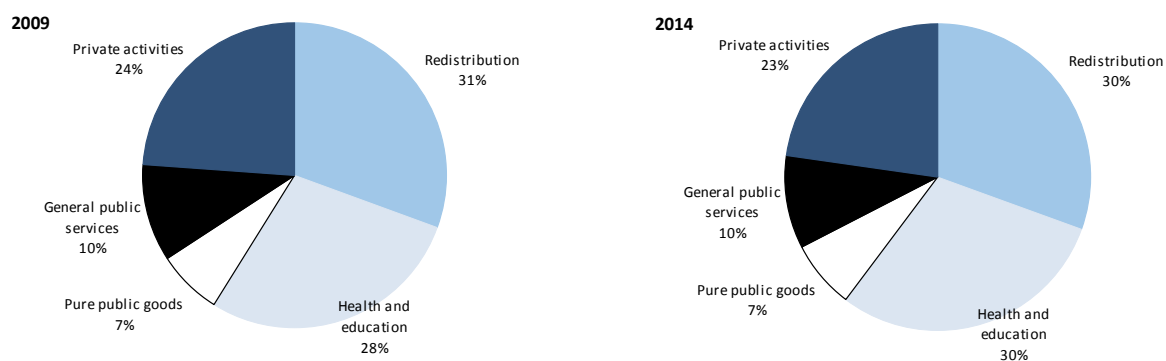
This will remain in effect until 31 December 2012 for families caring for at least one long-term sick or physically disabled dependent child, or if at least one of the caring parents is long-term sick or physically disabled.

### 6.2.7 Wages in the Public Administration

In the public administration, the minimum range of wage tariffs between the lowest and the highest wage levels was cancelled. The range of wage levels was retained, while for wages in executive positions it is possible to negotiate wages contractually.

In the area of economic affairs, a decline is assumed, as a result of (among other reasons) application of the amendment to the act on public contracts (see Chapter 7) and an expected gradual increase in the number of projects financed in partnership with the private sector (so-called PPP projects). In the case of the aforementioned environmental category, we expect a moderate increase as a proportion of GDP in relation to assumed expenditures for cleaning up environmental damage from the past. Housing support will also record a minor decline, due in part to reduction in the state subsidy for building savings. In the case of health care, the trend continues toward partial transfer of the responsibility for health care, as well as direct co-financing of treatment, to the patients. Finally, in the case of social protection, we assume a decline of public expenditures relative to GDP due to the approved amendment to the act on employment and targeting support to the truly socially needy.

**Chart 6.1: Structure of General Government Expenditure, Divided by Function**



*Note: The category "Pure public goods" includes "Defence" and "Public Order and Security". The category "Private activities" is a sum of "Economic Affairs", "Environmental Protection", "Housing and Community Amenities", and "Recreation, Culture and Religion". For details about the division see ECB (2009). A 10-figure functional division of general government expenditures can be found in the Annex, Table A.3.*

*Source: CZSO (2011d). MF CR calculations.*