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Tax policy and employment: the case of the Czech Republic

Abstract

This article explores the reduction of the tax burden as an integral part of the armoury of supply-side, neo-liberal economists and right-wing political parties. Within a labour market perspective, it looks at the role of a tax-cutting philosophy in addressing the issue of high labour costs and low levels of flexibility, while improving the entrepreneurial environment. In a situation in which the linkages between economic growth and employment creation have been becoming weaker, the article argues that such approaches are simplistic and misleading. The replacement of progressive taxation with flat-rated systems has taken place in the Czech Republic despite labour costs, like elsewhere in central and eastern Europe, being lower than the EU average. The result has not been an increase in entrepreneurial activity, while tax cutting, in the context of the reduction of overall wages, has led to a drop in aggregate demand – especially dangerous in a situation of economic recession since it has a knock-on effect on the ability of governments to respond to economic crises.

Keywords: *tax system, supply-side economics, flat-rate tax, labour costs, direct tax reduction, progressive tax abolition, employment policy*

Introduction

Pointing to the income tax burden as a factor which negatively influences economic growth and performance, because it supposedly leads to a withdrawal of disposable resources from the hands of entrepreneurs (as the determining subjects on the supply side), is a frequent part of the argumentation of liberal economists and the structures joined with them in the decision-making sphere of individual states.

Supply-side economics is connected with the so-called 'new right' and its application during the governments of Ronald Reagan and Margaret Thatcher. This theory goes back to Say's law, which Keynes put as 'supply creates its own demand'. Aggregate supply plays a crucial role in this theory, while its functioning influences aggregate demand. At that time, few economists belonged to this school but, in the Czech Republic, it seems – despite its highly controversial impacts – to have been rather popular. This may be because of its ideological background and its roots in the Laffer curve, which neo-liberals like to use. However, the case of the US of the 80s does not prove that lower taxes would lead to higher tax collection rates – that did not happen.

A related concept is that of the 'flat tax', which has been adopted by the poorest countries of the EU and by Russia; in this context, it would be interesting to examine to what degree this has contributed to the current crisis in the Baltic republics. However, the crucial point is that supply-side economics, with its linkage to Say, presumes a small state. The lowering of the tax base (however unevenly, the reduction of direct taxes should be somewhat compensated for by an increase in indirect taxes, which have a regressive character) should lead to the greater disciplining of the state – which may end up with the state having insufficient economic power during a crisis, not to speak about greater inequality in the given society.

It has never been theoretically proven that low tax rates would automatically correlate with higher economic growth; such a simple direct linkage does not exist. Our right-wing parties find certain support in the infamous 'Washington Consensus' containing such principles and that these are 'recommended' or even directly requested by institutions such as the OECD or the IMF. This gives them a good ideological backing *vis-à-vis* non-specialist citizens.

Supply-side economics implies a relatively small role for aggregate demand and, hence, not much care for the purchasing power of citizens. However, investment support is not a goal on its own and rests upon 'derived demand' – there is no point in investing if there is not sufficient purchasing power for future products. In the era of over-production, such a theory is unrealistic, as John Bellamy Foster and Fred Magdoff convincingly show in *The great financial crisis: causes and consequences.* Corporate profits in the US have been invested in the financial system, not in the real production sphere, since the 70s because of the lack of investment opportunities and the decreasing rate of profit.

Such an attitude is pushed even more vehemently in the case of production factor markets, especially the labour market. This approach is summarised in the latest *Report on the tax burden impact on employment* as follows:

> The payroll tax, together with social security contributions and health insurance, increases the price of labour and lowers the net wage, which reduces the incentive to work, especially by low-income groups, and may lead to a preference for social security benefits. On the other hand, a substitution effect may occur amongst high-income groups when taxpayers start to prefer free time to work connected with taxed income.

The reduction of the tax burden may, on the contrary, lead to a higher willingness to work and may also enable the commuting of financial possibilities to a wider group of taxpayers.

This ideological base is used to provide the reasons for the concrete measures in employment policy and labour market formation, the pillars of which are attacks on the supposedly high costs of labour and low labour flexibility as factors that hinder the flexible reaction of market forces and, thus, the correct balance between job creation and the maximum effective employment on the labour market.

Globalisation has a very important impact – labour as a factor of production can never reach the 'admired' flexibility of capital, and European wages may hardly decrease to the level of Chinese or Indian ones. The suggestions (such as, for example, of the OECD) do not take into account the global trends on the labour market. The International Labour Organization has been warning that the linkage between GDP growth and the creation of new jobs is becoming weaker. Such suggestions also omit the social dimension of the problem.

Illustrative are the proposals originating from such organisations (e.g. by the OECD) which, in its revised *Employment Strategy* from 2006, recommends, among other things:

- removing the barriers hindering the creation of new jobs
- the need to evade the trap of dependency on social benefits
- instituting tax reform with the goal of increasing work incentives
- ensuring the greater flexibility of employees, which may increase the employment of some groups of citizens (women with children)
- support for 'flexicurity', i.e. improving the conditions for the dismissal and taking on of employees while, at the same time, providing a more effective employment service
- ensuring that the minimum wage is set at such a level that it does not distort the creation of new jobs
- lowering the indirect costs of labour
- facilitating the establishment of new companies
- reducing the control of state competition law and making easier flexible working time schemes
- reforming job security and simplifying dismissals and the development of the tax and contributions system.

A similar policy is, unfortunately, being applied to a large extent within the framework of policy in EU member states, as this excerpt from the *National Reform Plan for the Czech Republic for 2008-2010* documents:

Main directive No. 21

To support flexibility combined with job security and to moderate labour market segmentation with proper consideration of the views of the social partners.

Realised measures:

- extending freedom of contract in labour relations
- training and retraining system for job applicants
- making use of European funds.

Suggested measures (for 2008):

- implementing further steps connected with the modernisation of labour relations
- amending the Labour Code so as to adjust the contractual relationship between employee and employer.

Main directive No. 22

Ensuring the development of labour costs and methods of determining wages and supporting employment.

Implemented and suggested measures (for 2008):

- reducing legal non-wage labour costs through the implementation of ceilings on social security contributions and health insurance
- reducing the health insurance rates paid by employers and employees.

Practically all these recommendations and measures arise from the presumption that the main stimulating factor regarding employment growth and the struggle against unemployment is the 'improvement' of the entrepreneurial environment through the reduction of costs and the abolition of so-called rigidities hindering movement and the upwards revaluation of capital. This philosophy creates, at the same time, many negative effects regarding the reproduction of the labour force, aggregate demand and social cohesion, as well as from the point of view of ensuring economic growth and overall economic prosperity.

In the light of the corresponding statistics on employment and the development of the tax burden in the Czech Republic and in the EU, such opinions and approaches are clearly too simplistic, if not false and misleading.

Table 1 – Ratios of corresponding values at the total level of public revenues in the Czech Republic (in %)

	2000	**2001**	**2002**	**2003**	**2004**	**2005**	**2006**	**2007**	**2008**
Personal income tax	12.8	12.5	12.8	12.8	13.0	12.7	11.6	11.7	10.4
Corporate tax	9.8	10.4	11.8	12.1	11.7	13.0	12.1	12.8	13.7
Indirect tax	28.1	27.1	26.2	25.9	27.1	28.4	28.8	28.8	28.2
Social security contribution	28.7	36.4	37.5	37.4	37.9	37.2	37.7	37.6	37.4

Source: J. Ungermann (2009): K vývoji veřejných financí v posledních letech ČMKOS: Praha (On public finance development in recent years Czech Moravian Confederation of Trade Unions: Prague) and author's own calculations.

This table demonstrates some basic trends. Considering the latest period in particular, there has been a typical reduction in the ratio of personal income tax and, at the same time, an increase in the contribution of indirect taxes in total public finance revenues. The ratio of social security contributions has been stagnant since 2001. Basically, we may state that the structure of total public finance revenues and tax policy has, since 2001, copied the theoretical and practical recommendations of those who consider the reduction of direct taxes and the ratio of so-called indirect labour tax to be an important tool in boosting economic growth and, thus also, employment.

This picture is completed by information on developments in the rate of tax in the Czech Republic.

Legislative changes took place in particular in 2001, 2006 and 2008. The most important parameters are summarised in the following table:

Table 2 – The most important parameters for personal income tax

Year	Tax bracket ceilings (CZK)		Tax rate (%)
	From	To	
2000	0	102 000	15
	102 000	204 000	20
	204 000	312 000	25
	312 000		32
2001 to 2004	0	109 200	15
	109 200	218 400	20
	218 400	331 200	25
	331 200		32
2006 to 2007	0	121 200	12
	109 200	218 400	19
	218 400	331 200	25
	331 200		32
2008 to 2009			15

Source: Report on impacts of the tax burden on employment (Ministry of Finance of the Czech Republic, June 2009)

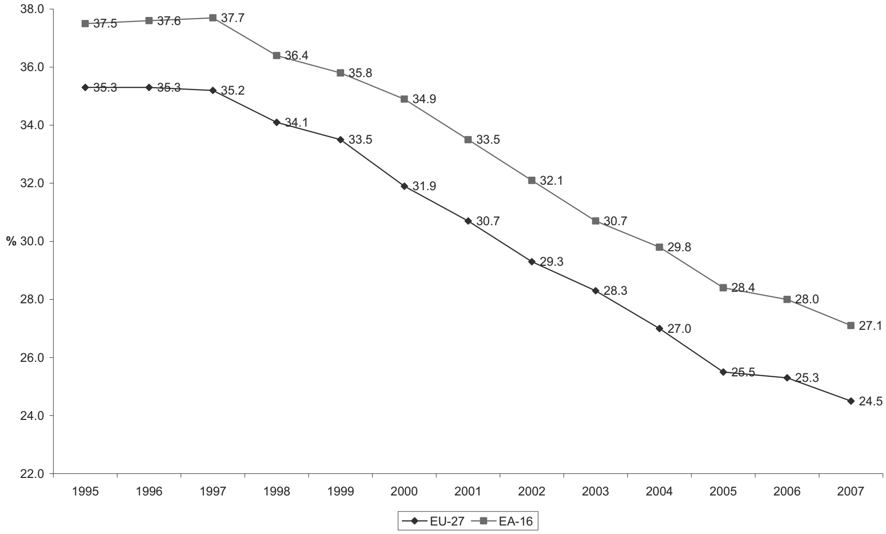
In the given periods, it came down to a change in the tax brackets and the sum of deductible items (2001); the reduction of the lowest tax bracket and the replacement of deductible items through tax discounts (tax breaks) (2006); and, especially, through a change in the method of taxation – the progressive nature of the system was replaced by a flat-rate one in 2008. This rate (15 % since 2008) is, however, calculated from a higher base and so is, in comparison with previous years, really at the level of 22 %.

Evidently, progressive taxation has been abolished in the Czech Republic, at least concerning personal income tax, with a certain version of flat-rate taxation being applied. The same rationale has been applied to corporate taxes; which now stand at 20 % in the Czech Republic and are expected to decrease further to 19 %. Of particular interest is the current practice of implementing flat-rate taxation (or abolishing progressive taxation) in some EU member states. 'Flat-rate' tax rates (at this moment, it is not important which tax base they are calculated from) have been implemented in the Baltic states (Estonia, 22 %; Latvia, 15 %; and Lithuania, 15 %) but also in other countries (Romania, 10 %).

It may seem that the abolition of progressive taxation is, essentially, a matter for the 'new' EU member states (or, rather, the transformation states), but the trend towards the reduction of the tax burden, especially regarding corporate taxation (but also income tax for higher income groups), is a general trend and has had a significant impact on the ever-growing reduction of the revenue element of public budgets.

In the EU, unfortunately, there has not been a joint approach towards pernicious 'tax dumping' policies, which are very often justified in terms of 'maintaining competitiveness', and so the general trend towards the increase of indirect taxation may be observed in almost all countries. George Bush also applied tax reduction policies for the richest in the US, on the basis of the motto which has also become a part of supply-side economics, 'trickle down': the higher disposable income of the richest would 'trickle down' and have a positive impact on the middle and lower classes. Joseph Stiglitz in *Globalization and its discontents* argues that this presumption has been proved wrong in reality. The reduction of direct taxes, especially by corporations, has been also 'supported' by the growing global role of tax havens in previous years.

Chart 1 – The development of corporate tax in EU countries and the Euro area



Source: Taxation trends in the European Union OECD, 2009.

Instructive is also the level of the rates representing so-called indirect labour costs, while especially characteristic is their correlation with unemployment levels in corresponding countries.

Table 3 – The level of unit labour costs (purchasing power standard)

	2002	2006	2007
EU (27)	59.4	57.4	57.1
EU (25)	59.4	57.6	57.3

	2002	2006	2007
EU (15)	61.7	60.1	59.7
Belgium	61.8	62.5	62.4
Bulgaria	15.9	16.7	18.8
Czech Republic	29.2	32.1	32.8
Denmark	75.1	79.1	81.8
Finland	62.4	63.1	62.6
France	60.3	62.1	61.3
Ireland	54.3	57.8	57.7
Italy	53.3	55.8	55.6
Cyprus	48.3	49.6	48.6
Lithuania	22.6	26.7	28.5
Latvia	22.0	27.4	33.2
Luxembourg	88.1	85.4	89.3
Hungary	28.8	31.0	33.4
Malta	35.4	33.9	33.0
Germany	64.1	56.9	56.1
Netherlands	62.0	60.4	60.3
Poland	32.4	24.6	28.0
Portugal	50.9	49.0	48.0
Romania	22.5	27.0	-
Slovakia	17.9	21.2	23.4
Slovenia	45.2	45.0	45.7
Spain	48.9	49.3	48.5
Sweden	70.8	67.6	68.0
Great Britain	72.3	69.8	69.4
USA	80.1	60.3	55.5

Source: T. Kozelský (2009) Labour costs monitoring in the Czech Republic and EU states 2002-2007 VÚPSV: Prague.

This table shows us that labour costs in the Czech Republic (and also other countries of eastern Europe in the EU) are, in the first decade of the new millennium, quite sharply below the average of the EU (especially the so-called ‘old countries’ of the EU). We may also state that the level in the new countries, and thus their distance from older EU members, is not being dramatically reduced (if it is being reduced at all).

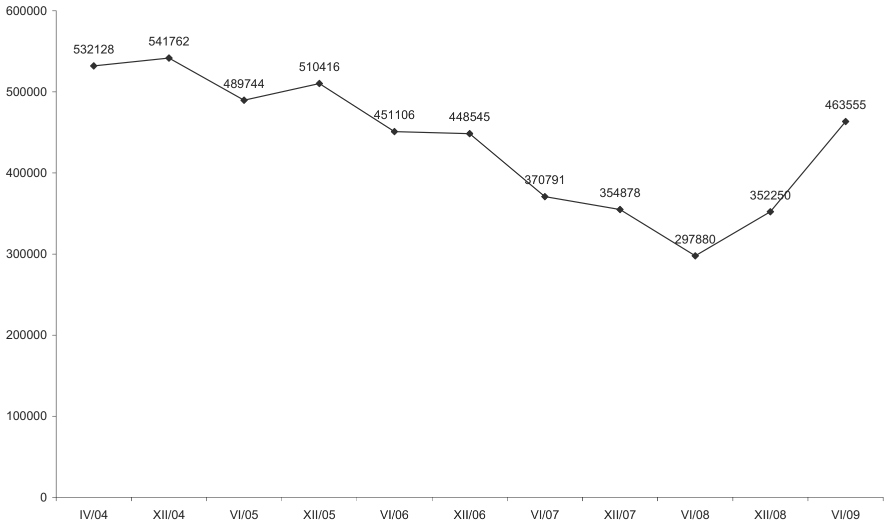
From this data and information, we may quite clearly draw these conclusions:

- in the previous period (at least during the last decade) in the Czech Republic, there has been a strong reduction in the tax burden, especially for higher income groups
- labour costs remain at a very low level in comparison with most of the 'old' EU member countries.

We could note here that, in the Czech Republic, there is a significant difference between the wages, prices and economic level compared to the EU average, which indicates that 'there is something wrong'. The level of wages does not reach 40 % of the EU average, but the price level reaches about two-thirds and the economic level (in terms of GDP per capita in PPP) about 80 % of the EU average.

According to the concepts of so-called liberal and pro-market economists, all the attributes and conditions for ensuring the maximum possible employment and for the reduction of unemployment on the Czech labour market have been met. The developments from about 2000 seem to confirm this, when unemployment in the Czech Republic decreased strongly, although this concept broke down with the crisis in 2008 – as the next graph shows.

Chart 2 – The development of registered unemployment



Source: Ministry of Social Affairs of the Czech Republic.

This made even the analysts of the Ministry of Finance state in the *Report on the tax burden impact on employment* (Ministry of Finance, June 2009) – in contradiction to their rigid ideological-theoretical paradigm quoted at the beginning of this paper – that:

> The question of the impacts of the tax and contribution burden on employment is not easy and its full examination would require research. The business cycle probably plays a bigger role. The proof of this is the last development in 2009, when the tax and contribution burden sank but unemployment grew.

Thus, it can be clearly seen that, for a better analysis of unemployment and the labour market, we need to look more deeply at the micro-structure of the market, especially of Czech industry which forms the backbone of the Czech economy (in terms of exports).

We may accurately state that:

- decreasing taxation for higher income groups and for entrepreneurs has neither shown increased entrepreneurial activity nor supply side stimulation
- on the other hand, the pressure to reduce taxes for the rich, accompanied by the reduction of the overall wage level and of other incomes for the overwhelming part of citizens, has led to the reduction of aggregate demand with fatal impacts for economic growth
- the thesis of a dependency on too-high labour costs and, with that, an insufficient demand for labour has not confirmed itself
- it is unambiguously confirmed that the level of employment is dependent mainly not on reducing labour costs but on the conditions which stimulate economic growth – among these conditions belongs support for aggregate demand in the economy and the support provided for long-term productive investment
- the link between decreasing tax revenues and other social contribution revenues and the reduction of public finance revenues, and thus a dampening of the potential of the state to react adequately in a crisis situation in the economy, is shown quite clearly.

In the end, to show these conclusions more clearly we may quote the following:

> On the other hand, the coming crisis is a global one, across the whole world, a crisis of overproduction which was caused by excessive demand based on speculation on financial markets. The lost of trust in the financial markets and the following break-down of the financial markets has led to a sharp decrease in demand and thus also production. (*Economic Crisis – the Trade Union View* ČMKOS: Prague, 2009)
>
> There is absolutely no evidence that these huge fortunes have been linked to record levels of company or business performance. Top business leaders have grabbed a larger share of the cake themselves. The 'trickle down' effect peters out very quickly as you descend the income ladder. The share of wages and salaries in national income in many countries has fallen sharply in the past 30 years while the already affluent are taking larger shares of the slice that goes to wages and salaries.
>
> Now is the time to expose the titans of the world based in New York, London and other major financial centres, who have patronised us with the message that there is no alternative to a world run by Goldman Sachs and the others. (John Monks, ETUC General Secretary, 'This is the "1979 moment" for casino capitalism' *Financial Times* 3 October 2008)

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