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THE MAIN IMPACTS OF TAX CHANGES ON HOUSEHOLDS AND PUBLIC BUDGETS

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1. Introduction

We present a concise version of the main results of our 24 February study "How Would Tax Changes Impact Households and Public Budgets." The study estimates the expected impacts of the government's current tax reform proposal and of the original proposal of the National Economic Council (NERV). This material presents the main long-term impacts of the reforms; detailed results, short-term impacts, and our methodology are available in the Czech version.

Our results are based on an analysis of the Czech Statistical Office's data from the Household Budget Survey, which provides a detailed log of approximately 300 income and expenses items for 3000 households. For every household in the sample we calculated the change in living costs, incomes, taxes and insurance caused by these tax changes, using standard theoretical assumptions about the incidence of the tax changes on prices and wages. Consequently, we can assess the *differences* in impacts of the tax changes on different households. The estimates of impacts on the public budgets take into account a wide range of channels whereby tax changes will influence the incomes and expenses of these budgets (they will for instance also influence the individual and corporate income taxes or the public sector's expenditures on employees' wages.

2. The Government's Proposal (unifying VAT at 20%, decreasing social insurance paid by employer by 1.8%)

On February 18 the coalition ministers presented a draft of the pension reform which included unifying the VAT rates at 20% for almost all products, and decreasing social insurance paid by employer by 1.8 percent with the possibility of transferring 3% of salaries into a pension fund.

Impacts on households:

For average households the real income will decrease by 1%, or 289 CZK per month (see Table 1). For the poorest tenth the decrease is 2.01% (307 CZK), for the richest tenth 0.87% (461).

Retirees will not be affected by the tax changes in the long run because the compulsory indexation of pensions fully compensates them for the increase in their living costs (see Table 2).

The real incomes of wage earners and entrepreneurs households will drop by approximately 1.5% (410 CZK), for households of the unemployed the figure is 2.1% (294 CZK). Among these households, real incomes will decrease by 2.5% (408-498 CZK) for the poorest fifth and by 1% (343-463 CZK) for the riches fifth, as shown in Table 3.

The structure of the results stems, among other factors, from the fact that the differences between low-income and high-income households in the shares of expenditures on the goods and services taxed at the reduced VAT rate are not dramatic (for the poorest fifth the share of expenditures on goods and services in the lower rate is by 8% higher than for the richest fifth). The contributing factor is the fact that the lower VAT rate currently applies to several goods and services on which the rich spend a higher percentage of their incomes than the poor (for instance new apartments, labor services associated with apartment and house renovation, culture events or ski-lifts).

The decrease of social insurance deepens income inequalities because economically active households benefit from it, especially those with higher incomes. The impacts of unifying the VAT alone would be spread out more equally across income groups.

The impact on total real incomes of households grows with the number of children (see Table 4).

The exceptions proposed by the government – which would keep a lower 10% VAT for several items (bread, fish, etc.) – decrease the impact of the VAT hike on an average household by 0.26% (60 CZK per month) only.

It is necessary for a possible indexation of social benefits to target the poorest households – an across-the-board indexation would help a broad spectrum of households and only a small part of the money would help those who really need it.

Short-term impacts on households (within one year from implementing the tax changes) are worse than long-term impacts. An average household's real income would decrease by 2.33% (505 CZK).

Impacts on public budgets

The public budgets deficit will decrease by 30 billion CZK. Additional revenue of 47 billion CZK is generated by the VAT hike (after factoring in the compulsory indexation of pensions and a growth in the prices of government purchases); further 2 billion comes through other effects including savings on wages of public sector employees. The deficit grows by 19 billion CZK due to lower insurance revenue (see Table 5).

Because of the partial opt-out of pension insurance into pensions funds, the potential pension reforms will generate transition costs of about 18 billion CZK and most likely even less (under the assumption that 50% of people will use the opportunity to transfer 3% of their earnings into pension funds, which probably exaggerates the real extent of the opt-out). Hence, the net revenues from the tax changes outweigh the expected transition costs of the pension reform by at least 12 billion CZK.

These transition costs could for instance be sufficiently covered by unifying VAT at 18.4% or increasing the lower VAT rate to 16.6% (without exceptions for selected foodstuffs, with a parallel decrease of social insurance by 1.8%).

Pensions will have to be indexed by 2.54%, which increases the public expenditures by 9 billion CZK.

Tax changes will also lead to a redistribution of resources within the public sector; approximately 13 billion CZK will shift from the state budget to other parts of the public sector, especially municipalities and regions. A fixed share of the additional VAT revenue will be automatically shifted to the budgets of municipalities and regions, whereas the drop in insurance revenues is borne entirely by the state's budget.

3. NERV's Proposal (unifying VAT at 19 and decreasing insurance paid by employer by 5%)

The original proposal of the Bezděk commission and NERV (unifying VAT at 19% and decreasing insurance for employers by 5%) would have a nearly neutral impact on the real income of an average household. However, compared to the government's current proposal, its impacts would be unequally distributed. The richer households would benefit (the richest 10% would benefit by 1.7%, that is 414 CZK) and the poorer ones would lose (the poorest tenth's real income would drop by 1.49 percent, that is 206 CZK). The public budgets deficit would grow by 5.5 billion (the proposal would be budget-neutral if the social insurance were reduced by 4.4% only).

Appendix: Long-term impacts of the government's proposal (unifying VAT at 20%, decreasing social insurance paid by employer by 1.8%)

Table 1
Impacts on real incomes of households according to their income decile

	% of expenses	CZK/month
Average	-1.03	-289
0-10% (poorest)	-2.01	-307
10%-20%	-0.98	-226
20%-30%	-0.68	-166
30%-40%	-0.72	-207
40%-50%	-0.56	-208
50%-60%	-1.10	-286
60%-70%	-1.21	-359
70%-80%	-1.12	-329
80%-90%	-1.08	-339
90%-100% (richest)	-0.87	-461

Table 2
Impacts on real incomes of households according to their economic activity

	% of expenses	CZK/month
Employees with lower education	-1.56	-387
Employees with higher education	-1.38	-428
Self-employed	-1.89	-568
Households of inactive people with economically active members	-0.39	-139
Retirees (non-working) without economically active members	0.24	27
Unemployed	-2.05	-294
Other households without economically active members	-2.09	-245

Table 3
Impacts on real incomes of households other than retirees, according to their income

	% of expenses	CZK/month
Average	-1.52	-410
0-10% (poorest)	-2.59	-408
10%-20%	-2.42	-498
20%-30%	-1.95	-439
30%-40%	-1.69	-435
40%-50%	-1.68	-468
50%-60%	-1.52	-379
60%-70%	-1.38	-403
70%-80%	-1.22	-355
80%-90%	-1.09	-343
90%-100% (richest)	-0.87	-463

Table 4

Impacts on real incomes of households according to the number of children

	% of expenses	CZK/month
0	-0.58	-138
1	-1.65	-456
2	-1.95	-629
3	-2.22	-665
4	-2.14	-769

Table 5

Long-term impacts on the public and state budgets deficits (in CZK million)

	Public budgets	State budget
VAT revenue – lower rate	65,804	45,852
VAT revenue – higher rate	0	0
Social insurance revenue – employees	-17,321	-17,321
Social insurance revenue – self-employed	-1,433	-1,433
Income tax revenue - employees	-1,039	-724
Income tax revenue – self employed	-3	-1
Corporate income tax revenue	1,006	701
Expenditure on goods and services	-9,773	-1,495
Expenditure on salaries and social insurance of employees	1,760	868
Pensions expenditures (indexation)	-9,024	-9,024
Total	**29,977**	**17,423**

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