

# TAX RELIEFS OF INDIVIDUALS AND THEIR USE IN THE CZECH REPUBLIC

Daňové úlevy fyzických osob a jejich využívání v ČR

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**Abstract:** The paper focuses on tax relief individuals that are used to support other desirable public policies. They may represent hidden subsidies in the tax system, reducing tax revenue and complications in the administration. Analysis of tax reliefs is complicated because their uniform definition does not exist. They can mean deductions from the tax base (tax allowances), the tax relief or the tax credit which reduce the actual tax liability. The aim of this paper is to evaluate the scope of use of tax reliefs, which are granted to individuals in the Czech Republic, in the form of non-taxable portion of the tax. Methodically, the research relies on the evaluation of secondary statistical data of the Czech Republic Financial Management and is based on aggregated data from tax returns filed for the years 2005 - 2014, which are statistically processed further.

**Abstrakt:** Příspěvek je zaměřen na daňové úlevy fyzických osob, zavedených za účelem podpory jiných žádoucích veřejných politik. Ty mohou představovat skryté dotace v daňovém systému, snižování daňového výnosu a komplikace ve spravování. Analýza daňových úlev je složitá především z důvodů neexistence jejich jednotné definice, neboť mohou znamenat různé slevy a osvobození, které snižují výslednou daňovou povinnost. Cílem příspěvku je vyhodnotit rozsah využívání daňových úlev, které jsou poskytovány fyzickým osobám v České republice ve formě nezdanitelné části daně. Metodicky se výzkum opírá o vyhodnocení sekundárních statických dat Finanční správy ČR a vychází z agregovaných údajů podaných daňových příznání za období let 2005 – 2014, která jsou dále statisticky zpracovaná.

**Keywords:** individuals, tax, tax allowances, tax reliefs

**Klíčová slova:** daň, daňové úlevy, fyzické osoby, nezdanitelné části základu daně

**JEL classification:** D14, E62, H2

## Introduction

Tax relief is one of the fiscal instruments of the state, through which needed public policies are supported. The purpose of the tax relief is to allow benefit for taxpayers under certain conditions. It is benefit from lower tax payments. At the same time tax credits are intended to influence the manner of the taxpayer in the desired direction (Kubátová, 2011). Related to this is the fact that the tax reduction means lower tax revenues of the state, it may constitute hidden subsidies in the tax system and are also generated higher administrative costs (Pechman, 2001). For these reasons, it is necessary to devote attention to tax breaks and do their analysis. This follows a request from the European Commission (Directive 2011/85 / EU) with the intention subsequent fiscal policy recommendations as well.

Analysis of tax reliefs is complicated due to the absence of their uniform definition. Tax reliefs include tax credits, deductions from the tax base and tax exemptions (Janoušková, 2012). Tax reliefs in world literatures are generally hidden under terms tax credits, tax reliefs, tax expenditures, tax allowances, deductible items and their definition not unified. Fookes (2009) considers as tax reliefs those which have a higher goal than the filling of the state budget. James and Nobes (1999) specify the tax reliefs by substitutability of the direct expenditure. Altshuler and Dietz (2006) take into consideration only tax credits which reduce the tax base.

## **1 The aim and methodology**

This paper focuses on tax reliefs of individuals that were in the Law on Income Tax implemented to support other public policies and take the form of a deduction from the tax base and for which are used designation tax allowances in the Czech Republic. For the purposes of this article the general name is tax reliefs. The aim of this paper is to evaluate the extent of the use of tax allowances of taxpayers and assess their impact on the state budget. Methodically research is based on a secondary statistical data from the years 2005 - 2014, provided by the Financial Administration of the Czech Republic, which is prepared on the basis of tax returns. This data will be statistically processed using mean values and by using the synthesis and analogy will be assessed.

## **2 The theoretical basis of tax allowances**

The first definition of the criteria of tax relief did Surrey (1973), which examined their impact on the economy. He defined criteria for identifying tax reliefs and he described a revenue forgone method for their quantification. Existing literature for quantifying uses three basic methods (Poláčková Brixí, 2004). They are the revenue forgone method, the revenue gain method and the outlay equivalent method. In the Czech Republic Jareš (2010) identified tax reliefs and made their classification according to the purpose for which they were introduced. The Ministry of Finance published the first report on tax reliefs with estimates of the total amount for the years 2011 and 2012 in the year 2014.

Tax allowances of individuals reduce the tax base of the taxpayer and thereby the resulting tax liability. These are deductions for the value of donations, the amount of interest paid on housing loans, contributions to life insurance and pension schemes, union dues and deductions for testing of further education under the tax law. They were implemented in the Law on Income Tax to support other public policies.

Deduction of donation from the tax base is one of the fiscal instruments since 1993, and it is intended to promote philanthropy in the Czech Republic. The value of gratuitous transaction (donation) that the taxpayer gave non-profit organizations must exceed 2 % of the tax base or must be at least 1 000 CZK. No more than a total of 15 % of the tax base may be deducted from 2014. It was possible to deduct a maximum of 10 % of the tax base until this year.

Can be deducted from the tax base the amount of interest paid in the taxable period on loan granted in connection with building savings program or with mortgage loan since 1998. It is in the context of housing policy and housing support. The total amount of interest deducted from all loans in one household must not exceed 300 000 CZK.

The purpose of deducting contributions to pension schemes is to be actively involved taxpayers in the creation of own funds for retirement. The amount of pension insurance with government subsidy which is paid by tax payers can be deducted from the tax base since

2000. The amount is to be reduced by 12 000 CZK, and must not exceed the total of 12 000 CZK. Within the pension and social policies can also deduct the amount of insurance since 2001, which is paid by the taxpayer to the private life insurance. The amount must not exceed the total of 12 000 CZK.

Members of trade unions, paying contributions to the trade union, which according to its statutes, defends the economic and social interests of employees may be deducted from the tax base the amount of its members' contributions, up to a maximum of 3 000 CZK. This is to support employment policy since 2004. It is also possible to deduct payment for tests to verify the results of further education up to 10 000 CZK since 2008.

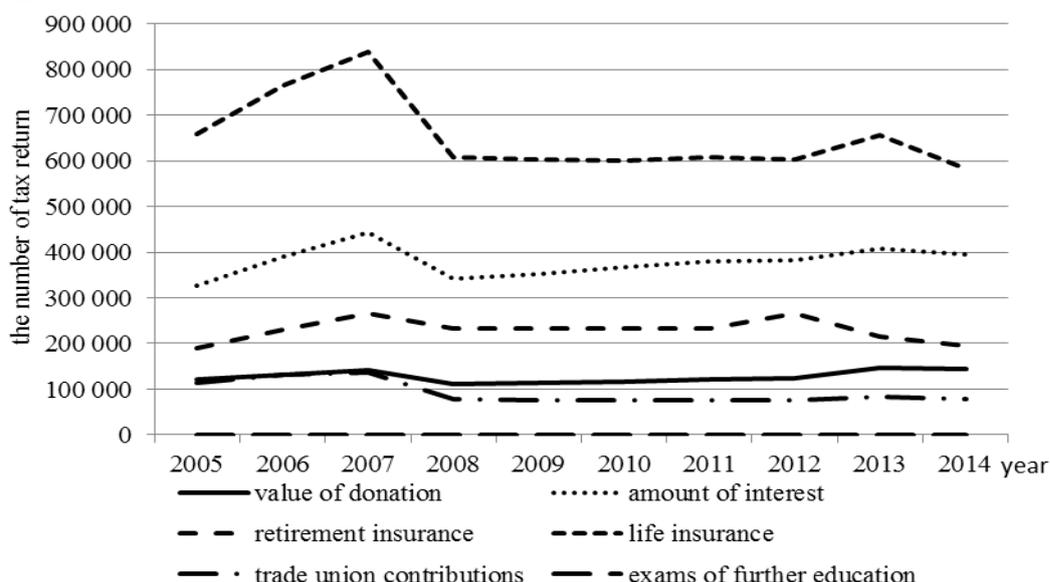
The slid progressive tax rate on personal income has been waived since 2008. The cancellation of tax progression and the introducing of a uniform tax rate of 15 % reduced the effect of deductible items used mainly by middle class.

### 3 Results

The following calculations monitor development tendencies of using tax allowances. They are based on the submitted tax returns of individuals. Due to the fact that employees do not have to submit a tax return and tax allowances may apply in the context of the annual settlement of tax advances from their employers and the tax authority does not have the specific data, calculations have a limited information value. We can however accept the premise that manner between taxpayers who file tax returns and taxpayers who do not give a tax return is the same.

To what extent the tax allowances are use is shown in Figure 1. Most taxpayers reduce their tax base by the amount of premium that is paid to private life insurance.

**Figure 1:** The number of tax return with the claim of tax allowances



Source: Web portal Financial administration of the Czech Republic. [Online] [cit. 14th July 2016]. Available at: <http://www.financnisprava.cz/cs/dane-a-pojistne/analyzy-a-statistiky/udaje-z-danovych-priznani>.

The number of taxpayers who deduct the life insurance had an increasing trend to 2007. Year 2008 was a year of tax reform, which reduced the tax rate and increased significantly tax reliefs. The deduction life insurance used about 229 thousand taxpayers less in this year. This

is a reduction of 27,3 % over the previous year. Another significant decline in the number of taxpayers who take advantage of the deduction for life insurance is in 2014. This reduction could cause a legislative change which adjusts the conditions for tax allowance for life insurance. It is no longer possible to apply the deduction for life insurance contracts, which allow you to select the saved money earlier than in 60 years of the taxpayer.

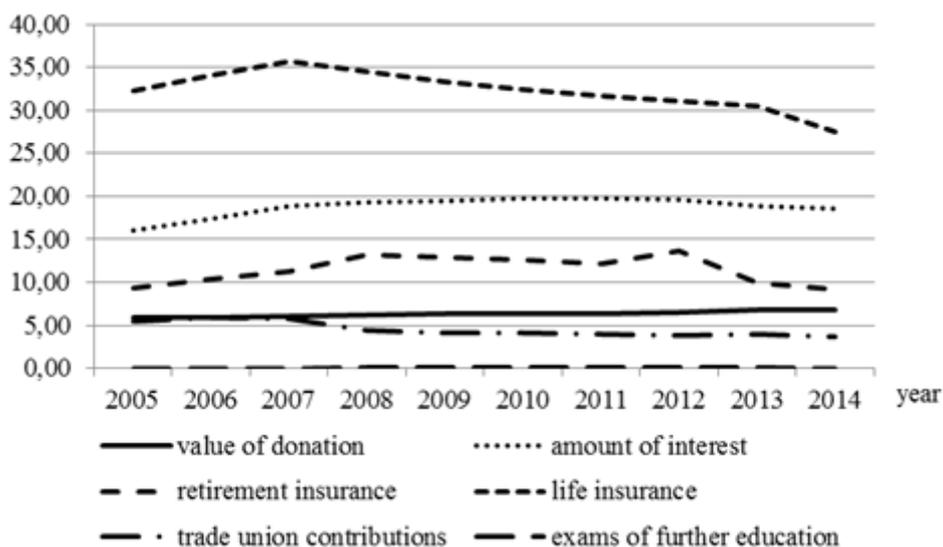
Interest deductions are the second most used tax allowances. Even in this case the reduction in the number of taxpayers who apply this tax allowances was in 2008. Then their number is gradually increasing. Due to decrease in interest rates during this period can be drawn increased interest in mortgage loans.

The deductions for pension insurance are in the third place in the use of tax allowances. In this case, the number of taxpayers decreased by 12,3 % in 2008. Since 2013, when it was introduced unsuccessful pension reform, the number of taxpayers is decreases further. Only 195 thousand taxpayers from a total of 2 123 thousand filed tax returns used the possibility to deduct the pension insurance in 2014, which is 9,2 %. Figure 2 shows the percentage of utilization of the tax allowances of the total number of tax returns.

The number of taxpayers who can apply the deductions for donations not too high in the Czech Republic and it is around 6 % of the total number of submitted tax returns. But it has a growing trend in the monitored last two years. Almost 145 thousand taxpayers used tax allowances on donations in 2014.

After the drop in 2008, the deductions for contributions paid to trade unions are applied in a stable number of taxpayers throughout next season and they are moving around 4 % of the total number of submitted tax returns. The number of taxpayers who apply for the deductions for further education tests is negligible.

**Figure 2:** Use possibilities of tax credits to the total number of tax returns (%)

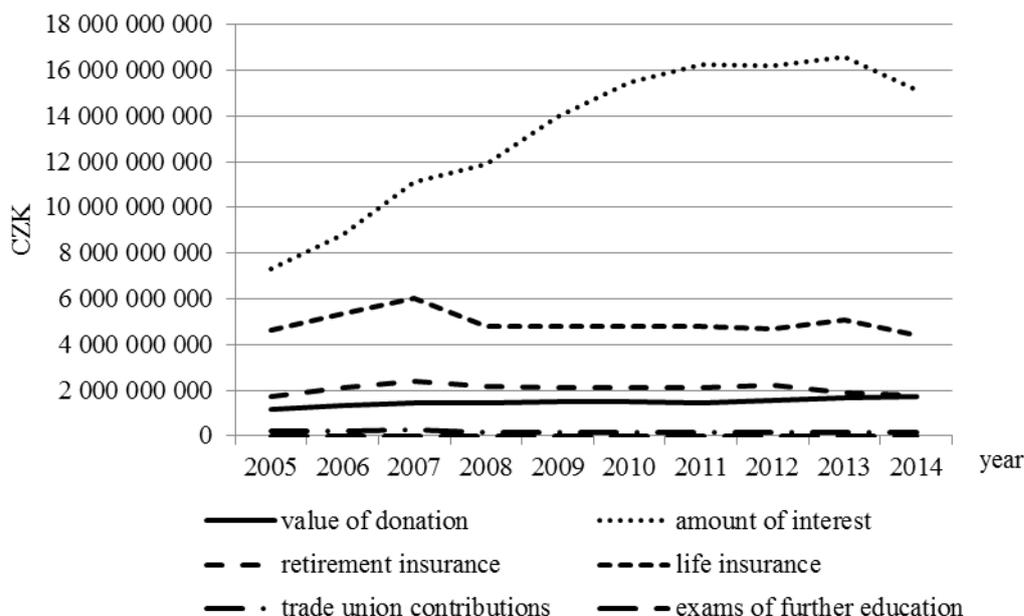


Source: Web portal Financial administration of the Czech Republic. [Online] [cit. 14th July 2016]. Available at: <http://www.financnisprava.cz/cs/dane-a-pojistne/analyzy-a-statistiky/udaje-z-danovych-priznani>. Own calculations

If you compare the total amount of tax allowances of individuals who filed tax returns, as shown in Figure 3, the highest amounts were deducted from the tax base on housing loans.

During the reporting period was the increase of over 100% it is from 7 297 mil. CZK in 2005 to 16 605 mil. CZK in 2013. The most widely used tax allowances from life insurance were deducted for a maximum total amount of 6 022 mil. CZK in 2007. Deductions for pension insurance were the maximum in this year also. It was a total of 2 413 mil. CZK. The highest total amount of donations which taxpayers deducted from tax base in the amount of 1 743 mil. CZK was in 2014. Total deductions for contributions to trade unions are an average of 184 mil. CZK and deductions for further education exams, which were introduced in 2008, are an average of 2 mil. CZK.

**Figure 3:** The total amount of tax allowances



Source: Web portal Financial administration of the Czech Republic. [Online] [cit. 14th July 2016]. Available at: <http://www.financnisprava.cz/cs/dane-a-pojistne/analyzy-a-statistiky/udaje-z-danovych-priznani>. Own calculations.

The average amounts of tax allowances, which were applied by taxpayers, are listed in Table 1. Taxpayers reduce their tax base mostly by interest on loans. The highest average amount of 42 749 CZK in 2011 does not approach the maximum possible amount of deductions for interest, which is 300 000 CZK. Average deductions for pension insurance are rather high and approaching the maximum limit of 12 000 CZK. The pension reform reduced the number of taxpayers who apply the tax allowance for pension insurance after 2013 but taxpayers have increased their contributions. Tax allowances from life insurance are on average decreasing. Individuals donations provide an average of 12 000 CZK.

**Table 1:** The average amount of tax allowances (CZK)

	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014
value of donation	9 813	10 123	10 412	12 884	13 106	12 896	12 085	12 581	11 307	12 028
amount of interest	22 297	22 626	25 118	34 733	39 711	42 352	42 749	42 371	40 784	38 304
retirement insurance	9 057	9 032	9 109	9 302	9 171	9 162	9 128	8 464	8 783	9 183
life insurance	7 042	7 017	7 187	7 894	7 940	7 954	7 906	7 770	7 711	7 596
trade union contributions	1 737	1 832	1 915	2 008	2 023	2 088	2 128	2 169	2 151	2 172
exams of further education	0	0	0	4 347	4 534	4 817	4 326	4 279	4 374	4 477

Source: Own calculations

The total sum of tax allowances, which are deducted on tax returns filed by individuals, are given in Table 2. The highest total amount of 25 387 mil. CZK tax payers subtracted from the tax base in 2013. The impact of this amount on state revenue can be up to 3 808 mil. CZK. Tax by which the total reduction of the tax liability of taxpayers before applying the tax credits is also calculated at the table. Given the complexity of calculation for progressive taxation calculation is performed from 2008. A unified tax rate of 15 % was introduced this year.

**Table 2:** Suma tax allowances by filed tax return and tax (CZK thousand)

	2008	2009	2010	2011	2012	2013	2014
suma tax allowances	20 431 210	22 554 624	24 088 243	24 820 282	24 860 931	25 387 005	23 259 605
tax	3 064 682	3 383 194	3 613 236	3 723 042	3 729 140	3 808 051	3 488 941

Source: Own calculations.

Should it be the assumption that the attitude of all payers of income tax of individuals, including both taxpayers filing tax returns and taxpayers, for which annual tax bill submit employer is similar, can be simply the calculations to estimate the overall impact on public finances according to the following equation:

$$STA = n \cdot TA_i \quad (1)$$

where  $n$  is the total number of income tax payers (ČSÚ) and  $TA_i$  is average tax allowance by taxpayer.

The following Table 3 shows the estimates of individual tax allowances of all income taxes as the above-mentioned condition and total amount of tax allowances in the years 2008 – 2014. There is also calculated with the maximum amount that taxpayers would have to pay in addition to the state budget. It is calculated on the condition that their resulting tax liability was greater than claiming tax credits.

**Table 3:** Suma tax allowances of all income tax payers and tax (CZK thousand)

	2008	2009	2010	2011	2012	2013	2014
value of donation	64 453 689	64 669 606	62 999 141	58 882 261	61 523 749	55 824 037	59 829 248
amount of interest	173 753 564	195 944 148	206 899 992	208 290 686	207 199 404	201 356 254	190 537 376
retirement insurance	46 535 281	45 251 655	44 757 125	44 477 410	41 390 922	43 360 737	45 679 160
life insurance	39 491 577	39 176 693	38 858 377	38 522 673	37 995 643	38 069 312	37 784 042
trade union contributions	10 047 334	9 980 587	10 200 155	10 369 480	10 604 687	10 619 299	10 806 614
exams of further education	21 743 802	22 374 130	23 530 626	21 078 834	20 922 794	21 596 633	22 268 333
SUMA	356 025 248	377 396 820	387 245 415	381 621 345	379 637 200	370 826 272	366 904 772
tax	53 403 787	56 609 523	58 086 812	57 243 202	56 945 580	55 623 941	55 035 716

Source: Own calculations.

But it is not correct to assume that this estimate of the maximum revenue in case of foregone by the repeal of tax allowances could really bring such large sums to public budgets. The calculation cannot take into account possible changes in the attitude of taxpayers who can transfer their activities to other areas.

## Conclusion

The tax allowances in the case of individual taxpayers reduce the tax base and thus lead to lower taxation. At the same time the public budget revenues will decrease, and question is to what degree the reasons for the introduction of tax allowance outweigh these forgone

revenues. However, tax allowances are one of the important tools of tax optimization (Alpanda, Zubairy, 2016).

The effect of tax allowances was significantly reduced by refraining from gliding progressive tax rate on personal income in 2008 when a unified tax rate 15 % was introduced. And decline in the number of taxpayers using tax allowances it documents. If the tax allowances should support the other public policies and the taxpayers' attitude in a desirable direction, reduced taxes significantly lowers their mission. It is achieved a committing taxpayers with higher and premium income. Tax allowances are important to them because then they pay the lowest taxes. In this context, tax allowances reduce the redistributive effect of taxes and this form of tax aid becomes ineffective for taxpayers with low incomes. Additionally, low-income taxpayer has not fiscal space, for example, for saving for pension insurance or providing donations to non-profit organizations.

Also other policy decisions significantly reductions the effect of the tax allowances. An example may be tax allowance for contributions to pension insurance, there is a drop in the number of taxpayers using the deduction for pension insurance after 2013. It can be stated that the new pension reform despite an increase in state contributions to pension insurance, has not brought the desired effect in the greater involvement of taxpayers in their own savings for retirement. The same can by also found for tax allowances on life insurance. Legislative change conditions deductions for life insurance resulted in a drop of the number of taxpayers, who apply tax allowances for life insurance.

The tax allowances usage on donations by individuals is relatively stable. Tax allowances are a positive aspect of tax law, but not bring in themselves more funds to nongovernmental organizations. Despite the increase in the ceiling for the deduction of donations in 2014 they do not have a strong impact on incentives to individual commitment. However, they can affect the amount of donations, especially in case of wealthier individual donors (Janoušková, Kirschnerová, 2016).

Calculation of the loss of state revenues due to tax allowances is complicated by the unavailability of data about employees. Financial management does not have specific tax items, because employers have an obligation to submit only aggregated data about their employees. For this reason only estimation of amounts is possible. However, if this estimate was calculate, the resulting estimated tax covers, for example, paid disability pensions which were amounted to 43 694 812 thousand CZK in the Czech Republic in 2014 or it is many times higher than the expected benefit of 12 000 000 thousand CZK from the introduction of the electronic sale records.

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