

# Employment, Entrepreneurship, and the "Švarc-system" from the Social Development Point of View

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## Abstract

Economic activity based on producing goods and services is essential for the development of any society. Individuals can carry out this economic activity in dependent activities (employment) or entrepreneurship (self-employment). A third way is the so-called „Švarc-system,” which is not legal in the Czech Republic. It is a situation where persons performing normal activities for the entrepreneur in a dependent relationship are not his employees but formally act as self-employment. There are currently discussions about the legalization of the system among politicians and experts. This article introduces how labor and tax law regulations influence attitudes toward economic activity and development. The research methods to achieve this aim include description, critical analysis, and synthesis. The findings described in this article are that the Švarc-system based on self-employment allows greater freedom for employers and employees and smaller payments to public budgets than forms of dependent activities. A high level of autonomy increases development in various areas and helps social development. The implication falls into practical rather than theoretical fields. Therefore, regulation in this area should be lowered to support further development. This article's originality is that it reflects on the academic impacts of the legalization of the system from legal and economic points of view. These conclusions should help reflect on the regulation of legislation in this field.

Keywords: Employment; self-employment; Švarc-system; personal income tax; development.

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## 1 Introduction

After the coronavirus pandemic's end, society faces new challenges: stabilization of public budgets, development of artificial intelligence, the war in Ukraine, the warming of the planet... However, society must accept these aspects in its further development and try to coexist with them, or better still, use them for its development. However, it is worth pointing out that the obstacles in this regard are very often legal and economic influences, which will have necessary consequences for the functioning of individual states and international relations.

It is indisputable that economic activity leading to the production of goods and services is essential for the development of any society. Individuals can carry out this economic activity either in the form of dependent activities or self-employment. A third way, which is not legal, is the situation where there is employment of self-employment, where persons performing normal activities for the entrepreneur in a dependent relationship are not his employees but formally act as self-employment (the so-called „Švarc-system“). The Švarc-system is named after its „discoverer“ - the entrepreneur Miroslav Švarc, who was the first to use it systematically in the 1990s in

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the Czech Republic. From the labor law perspective, this is illegal employment covering the actual employment relationship with another contract.

The Labour Code regulates and restricts labor relations in many respects, and the related uneven tax burden on work and activities performed is another reason for the significant development of the Švarc-system. On the one hand, the sophistication of the Labour Code, which predefines the rights and obligations of employees and employers, emphasizing protecting employees' rights, is to be appreciated; on the other hand, the Labour Code itself is, in many ways, restrictive. Suppose we add to this the unequal tax burden on work and activities. In that case, this over-regulation encourages the development of the informal economy and generally prevents greater flexibility in business development.

The issue of tax burden relates to the so-called horizontal equity in taxation, whereby according to this theory, two individuals earning the same income level should pay the same level of tax on that income (Finardi & Melicharová, 2021). In the Czech Republic, the personal income tax rate does not differ for each type of income, but the tax base does. The current tax system has a distortionary impact on the labor market. Due to this, individuals are favored over employees, and citizens, aware of this fact, are not willing to share in the solidarity and costs of the social system (Sojtková, 2011). Some authors believe that the introduction of the so-called flat tax in the Czech Republic, but also in Slovakia, has resulted in a distortion of tax neutrality, as the same tax rate gives the higher-income group a tax advantage over the middle-income group (Beblavý & Prousková, 2010). Therefore, the flat tax system has a significantly regressive tax impact (Blechová, 2012).

In the following text, it will be pointed out that the tax implications of work vary according to the form of work performed, and attention will be focused on the legal and economic consequences of a possible loosening of the conditions for choosing to work. The paper aims to detect the legal and financial matters where individuals would be free to decide whether they want to carry out their activity as employees, as self-employment, or through the System, the legalization of which is being discussed among politicians and experts. The research methods to achieve this aim include description, critical analysis, and synthesis.

## 2 Economic activity and sustainable development

*„Sustainable development is a development that meets the needs of the present without compromising the ability of future generations to meet their own needs. It contains within it two key concepts: (1) the concept of 'needs,' in particular the essential needs of the world's poor, to which overriding priority should be given; and (2) the idea of limitations imposed by the state of technology and social organization on the environment's ability to meet present and future needs.“* (see Our Common Future: Report of the World Commission on Environment and Development, 1987, p. 41). Currently, sustainable development can be defined as *„a type of development that also seeks to eliminate or mitigate the adverse effects of the existing pattern of development of human society.“*<sup>2</sup> An integral part of sustainable development is the emphasis on the preservation of natural values, which is directly reflected in the text of the law in the Czech Republic.<sup>3</sup>

Support for research, innovation, and innovative thinking is essential to ensure sustainable development. One of the obstacles in this respect in the Czech Republic is the rigidity of the working environment, where natural persons are limited in their ability to exercise their activities by labour law.

It is worth noting that a large part of development and innovation is carried out by research teams, where standard employment relations are the usual solution to the relationship between specific researchers and the entity in question.

In addition to this, however, a segment of start-ups based on the idea of usually one visionary, who then develops his argument and tries to achieve the desired goal, is gradually growing significantly. Such start-ups are emerging in a wide variety of fields, and this is where the needs of development and labour relations clash.

It is advisable to provide visionaries with freedom in their activities to develop innovations. Still, at the same time, the Labour Code in the Czech Republic significantly restricts them by not allowing contractual freedom to establish cooperation with other entities. A fundamental problem here is sanctioning illegal employment as a factual employment relationship disguised by another contract. (Radvan, Mrkývka & et al., 2016)

Illegal work is dependent work a natural person performs outside the employment relationship. The Labour Code then defines dependent work as work performed in connection with the employer's superiority and subordination of the employee, on behalf of the employer, under the employer's instructions, and performed by the employee personally for the employer. Dependent work must be completed for wages, salary, or remuneration, at

<sup>2</sup> Udržitelný rozvoj. Online. Ministerstvo životního prostředí. [https://www.mzp.cz/cz/udrzitelny\\_rozvoj](https://www.mzp.cz/cz/udrzitelny_rozvoj)

<sup>3</sup> § 6 of Act No. 17/1992 Coll., on the Environment: *„Sustainable development of society is such development that preserves the possibility for current and future generations to satisfy their basic life needs while not reducing the diversity of nature and preserving the natural functions of ecosystems“*

the employer's expense and responsibility, during working hours at the employer's place of work, or at another agreed location.<sup>4</sup>

Dependent work is assessed according to objective circumstances, which include, but are not limited to, personal performance of the activity, subordination and integration into the organizational structure, regular remuneration for work, consistency of performance, nature of the action performed, location of the action, material facilities, exclusivity of service, and the provision of compensatory employment benefits (see Liška, 2016 or Šubrt, Trezziová, 2011).

Simultaneously, dependent work may be performed exclusively in the essential employment relationship, which is the employment relationship and legal relationships based on work agreements performed outside the employment relationship (agreement on work performance and understanding of work activity).<sup>5</sup> It means that, although it is possible to validly conclude contracts between a natural person and another entity under civil law, this is only on condition that no work fulfilling the characteristics and requirements of dependent work is performed based on these contracts.<sup>6</sup>

### 3 Tax differences

The tax burden is the most common reason to be self-employed instead of an employee. The same activity is taxed differently only based on the form of the mutual legal relationship. This is why repeated economic opinions advocate this system's admission (Kerlinová, 2014).

Taxation of work in the Czech Republic is burdened by personal income tax and compulsory insurance premiums for public health insurance and social insurance. The employer bears the administration of all tax obligations (i.e., insurance premiums), and also pays (as an obligation) the personal income tax from dependent activities. This tax is directly linked to the employee's salary. The employer thus includes it in the wage bill, as it is a mandatory payment related to the employee's salary.

We show the model example of an employee with a gross salary of CZK 74 738; the employer must spend CZK 100 000 on wage costs. Of this amount, the public budget receives CZK 42 135,<sup>7</sup> and the employee gets a net salary of CZK 57 866.

In the case of self-employed persons, taxation and the determination of the tax base and insurance premiums are determined differently. Income taxation of natural persons allows the deduction from income the costs reasonably incurred to achieve, secure, and maintain revenue or to use lump-sum expenses, which automatically (without the need for any documentation) reduce the tax base - for trades, lump-sum expenses are 40% of income.

<sup>8</sup> In the case of insurance premiums, they are deducted from half of the assessment base, which is the tax base reduced (as above).

Thus, if self-employment received CZK 100 000 (identical to the employer's wage costs in the previous example), the tax base would be CZK 60 000, the public budgets would receive CZK 32 050, and the net income after taxation would be CZK 67 950.<sup>9</sup>

From this simplest model example<sup>10</sup>, a significant difference in the tax impact on the activity of a particular person is evident, which, in practice, is often exploited by purposeful actions to tax-dependent work as a natural person's business.

However, it is worth pointing out that in some cases, case law has allowed for the freedom to decide whether an individual will carry out their activity as self-employed or as an employee - an example being the performance of a professional sportsman/woman. (Radvan & Neckář, 2016). However, this is an exception.

<sup>4</sup> § 2 of Act No. 262/2006 Coll., the Labour Code.

<sup>5</sup> § 3 of Act No. 262/2006 Coll., the Labour Code.

<sup>6</sup> Ministry of Labour and Social Affairs: Stanovisko k nové definici nelegální práce. Ministerstvo práce a sociálních věcí. <https://www.mpsv.cz/svarcsystem>

<sup>7</sup> Public budgets receive 13.5% of the gross wage in health insurance (4.5% paid by the employee and 9% by the employer), 31.3% of the gross wage in social insurance (of which 6.5% is paid by the employee and 24.8% by the employer) and income tax is 15% of the gross wage; The difference is due to the correction elements of taxation..

<sup>8</sup> § 7 (4) of Act No. 586/1992 Coll., on Income Taxes. The law regulates the limits of use, with the maximum amount of such costs per calendar year being CZK 800 000.

<sup>9</sup> Public budgets for self-employed persons receive 13.5% of health insurance, social insurance 29.2% and income tax is 15%, but all from the assessment base, which is 60% of income.

<sup>10</sup> The aim of this article is not to point out all the possibilities of reducing the tax burden, so the authors only add, for the sake of completeness, that there are other forms of taxation, which lead to even greater differences in net income.

#### 4 Tax revenue

Personal income tax and social security contributions represent a significant source of revenue for public budgets. In 2022, personal income tax and social security contributions accounted for 7.6% and 39.3% of the total state budget revenue of the Czech Republic of CZK, which was 1 624.4 billion.

Table 1. The structure of total revenues of the state budget in 2022.<sup>11</sup>

| Revenue                                         |         |
|-------------------------------------------------|---------|
| Social security                                 | 39.30 % |
| EU incomes                                      | 7.2 %   |
| Other non-tax incomes                           | 4.90 %  |
| Special taxes and charges on goods and services | 9.40 %  |
| VAT                                             | 21.30 % |
| Personal income tax                             | 7.60 %  |
| Corporate income tax                            | 9.30 %  |
| Other tax revenues                              | 1 %     |

However, a closer look at the structure of personal income tax and social insurance receipts shows a significant disproportion between the amount of funds paid by employers for employees and the self-employed.

The state budget revenue from personal income tax paid by employers on behalf of their employees amounted to CZK 94.1 billion in 2022, while for persons filing tax returns,<sup>12</sup> it amounted to only CZK 9 billion; the additional revenue of CZK 20.6 billion represents withholding tax revenue in the case of taxation of interest, dividends and possibly other income taxed at a special tax rate.

In 2022, employers paid CZK 477.9 billion in compulsory social security contributions, employees CZK 125.2 billion, and self-employed persons CZK 34.0 billion. Thus, out of the total premium income of CZK 637.7 billion, payments by the self-employed account for only 5.3%. The disproportion in the volume of premiums paid is evident over the long term.<sup>13</sup>

From an economic perspective, it is evident that public budgets benefit more from the performance of dependent work in employment relationships. On the other hand, increasing the level of taxation to the level of employees would not correspond to the different aspects that entrepreneurship entails - self-employed persons do not have paid holidays, they may lose customers (and therefore their jobs) from one day to the next, they have to administer their activities, including tax returns, keeping mandatory records, any damage is limited to 4.5 times the average wage, etc.

An utterly indisputable aspect in favor of employee relations is the administration of taxes and insurance premiums. In the case of employees, the obligations are delegated to the employer, who usually has sufficient resources to ensure that the payment and registration obligations are correctly fulfilled. At the same time, one entity collectively fulfills this obligation on behalf of all employees. This means that potential controls are carried out on a significantly smaller number of entities, which puts less strain on the entire tax and insurance administration system.

However, from the perspective of societal development, it is appropriate to promote the freedom of individuals in their economic/work/creative activities, as this will allow society to prosper from innovation.

If the inadmissibility of the System, i.e., the de facto employment of self-employment, is abandoned, then this would allow greater freedom for both “employers”<sup>14</sup> and “employees.” With this freedom, it is reasonable to expect development in various areas, with innovators free to pursue their visions in development and new ideas in general.

<sup>11</sup> Ministry of Finance of the Czech Republic. Návrh státního závěrečného účtu České republiky za rok 2022. Sešit C. Zpráva o výsledcích hospodaření státního rozpočtu Ministerstvo financí. <https://www.mfcr.cz/cs/rozpocetova-politika/statni-rozpocet/plneni-statniho-rozpocetu/2022/statni-zaverecny-ucet-za-rok-2022-51132>. p.12.

<sup>12</sup> Income for returnees represents the total tax paid on the basis of the declarations filed, not only for self-employed persons, but de facto everything outside employment. These include, among other things, income from capital assets, rental income, etc. This amount also includes tax settlement in the event of concurrence of employment and other gainful activity (typically an employee who simultaneously carries out business as a self-employed person). See Návrh státního závěrečného účtu České republiky za rok 2022. Sešit C. Zpráva o výsledcích hospodaření státního rozpočtu Ministerstvo financí. <https://www.mfcr.cz/cs/rozpocetova-politika/statni-rozpocet/plneni-statniho-rozpocetu/2022/statni-zaverecny-ucet-za-rok-2022-51132>. p.14.

<sup>13</sup> Detailed graph is in Svoboda, J. OSVČ daly loni na penzi víc, stále ale jen zlomek toho, co zaměstnanci. online. novinky.cz. <https://www.novinky.cz/clanek/ekonomika-osvc-daly-loni-na-penzi-vic-stale-ale-jen-zlomek-toho-co-zamestnanci-40424321>

<sup>14</sup> An important element is the employer's limited possibilities to terminate the employment relationship; In the case of non-employment relationships, the terms of cooperation are a matter of the will of the parties.

## 5 Law and economic impacts of the legalization of the Švarc-system

From a legal point of view, the System's admission would constitute minimal interference in the legal order if only the legislator would choose the form of activity, i.e., whether the person would perform their action as an employee or a self-employed person. It is up to each person's free will to decide whether they prefer a higher level of protection of their rights as an employee or a higher level of autonomy and economic benefit.

If we hypothetically assume acceptance of the Švarc-system, then its economic impact can be divided into several categories. Primarily, they can be divided into two or three categories: the impact on individuals, public finances, or the economy as a whole. It is also possible to consider how economic impacts have changed over time. In this modeling, the situation where only the legalization of the Švarc-system occurs without any change in any other laws that also affect the behavior of individuals is taken into account.

Individuals would generate several benefits by accepting the System. First, expenses (whether natural or flat-rate) could be claimed, reducing the tax base and overall tax liability. It would also be possible to consider tax losses and thus reduce the tax liability in future years. Similarly, it would be possible to reduce the assessment base for social security contributions, which are 50 % of the partial tax base for self-employment. Many existing employees and employers would see these benefits as substantial and would, therefore, be expected to prefer this system.

There will likely be a significant business expansion in the short term. This tax optimization would mean that individuals would receive a larger share of the funds, the use of which they would decide for themselves. As empirical research has shown, part of these funds would be used for immediate consumption, while the rest would be retained as savings. The amount used for direct consumption would vary depending on the size of this saving, the socio-economic situation of the individual, and needs and preferences. Even the prediction of this amount is difficult to quantify. Increased business development would impact the growing demand for economic, accounting, and tax advisers, as not all new entrepreneurs would want to solve this area themselves. Acceptance of the System could also help increase economic activity in this area.

In a longer time, such new entrepreneurs are expected to think more about the relative benefits of economic activity and the opportunities to use their leisure time. They aim to set their optimal boundary for the time spent on profitable economic activity. In the long run, it can be expected that many entrepreneurs would start to ask about health insurance or retirement pensions and how to secure them, and ultimately, to a greater degree of preference for freedom of decision, responsibility, and overall liberalism.

Acceptance of the System would, of course, significantly impact public finances. Although higher economic activity could be expected in this context, it is clear that this tax optimization will automatically mean lower overall tax revenues for some time for social security and health care contributions. In particular, the shortfall in social and health security would be significant, and it is questionable how it would be addressed. Again, there are several options, but if we are to stick to the brief and assume that there is no legislative change that would result in a change in individual decision-making and behavior, then there is no option but to divert the missing funds from other tax revenues, make significant cuts in public spending or deepen the national debt.

The public finances would see a reduction of funds within the entire budget system, as the income from personal income tax from dependent activities is a revenue of the state budget and the budgets of regions and municipalities. This shortfall could be partly covered by higher VAT revenue; as already indicated above, it can be predicted that individuals would use part of the funds raised by tax optimization to increase consumption. However, it cannot be assumed that the total amount would be recovered, so in the long run, there would have to be savings in public spending or increased pressure to raise general revenue. In addition, if there were no change in the budget allocation of taxes, the budgets of municipalities, which have a 1.5% higher share of personal income tax from dependent activities compared to personal income tax from self-employment or VAT under the Budget Allocation of Taxes Act, would lose the most from accepting the Švarc-system, see Table 2.

Table 2. Budgetary allocation of taxes in the Czech Republic in 2023<sup>15</sup>

| Taxes                                         | State budget | Budgets of regions | Budgets of municipalities |
|-----------------------------------------------|--------------|--------------------|---------------------------|
| Personal income tax from dependent activities | 62.88 %      | 9.78 %             | 25.84 % + 1.5 %           |
| Personal income tax on self-employment        | 64.38 %      | 9.78 %             | 25.84 %                   |
| VAT                                           | 64.38 %      | 9.78 %             | 25.84 %                   |

<sup>15</sup> Act No. 243/2000 Coll., on Budgetary Determination of Revenue

It is expected that acceptance of the Švarc-system would increase economic activity. Increased economic activity would entail a higher administrative burden for the public administration, which would be related both to the registration of new entrepreneurs and to the control activities to ascertain whether all the obligations laid down are fulfilled. By its very nature, checking compliance with statutory obligations by an entrepreneur with many employees is more accessible than checking compliance with many small entrepreneurs. In this context, there would have to be an increase in the number of staff in the public administration in the longer term and, therefore, pressure on public expenditure growth, or there would be increased pressure to implement effective digitization. In the second case, if the pressure to implement effective digitization increases, this could positively impact other areas of public administration and lead to a reduction in public spending or a less significant impulse to increase public spending.

Acceptance of the System would also have implications for the economy as a whole. Regarding the impact on the economy, it is difficult to assess these impacts in the short term, as no significant changes can be expected in the short term beyond the increase above in demand for the services of economic, accounting, and tax advisors. In a long time, there could be more pressure for innovation and its implementation (in particular due to a preference for leisure time) and, consequently, an increase in labor efficiency.

To summarise the above impacts, it can be concluded that the acceptance of the System would imply significant changes in people's attitudes toward work, and it can be assumed that there would be a gradual shift from paternalism to liberalism.

## 6 Conclusion

Economic activity will always have an impact on the development of society. It would be advisable for the legal sphere to restrict this economic activity as little as possible and encourage economic subjects and individuals to continue their activities. Therefore, there is a solid demand to minimize regulation in labor relations and establish a tax system that is as fair as possible and has a minimum distortionary impact. On the other hand, however, it is understandable that it is in the interest of public finances to have sufficient stable revenue available each year, and it seems most appropriate to tax those economic activities where there is a minimum amount of tax evasion. The tax system in the Czech Republic has defined employment as the type of income that is the most burdened compared to business income due to the fixed tax base. However, there is little doubt that this type of income is associated with minimal tax evasion. Economic practice has found a way of circumventing the State's levies using the Švarc-system. Thus, although the System is illegal, it can be commonly encountered in practice. It is still more profitable for economic subjects to take the detection risk than to behave according to the established laws.

The question remains: how can this problem be solved effectively? One of the options is to increase the levies of self-employment.<sup>16</sup> This can be done by increasing the tax rate on this income, changing the tax base, or increasing social security and health insurance contributions for self-employment. This last option (i.e., an increase in the levy at self-employment) is now relevant as the documents are currently in the legislative process. Even the experts have differing views on the most appropriate form. According to them, the government's current proposal for adjusting the levies of self-employment will mainly burden low-income self-employed people with high costs. They will be most affected by the increase in minimum levies. The proposal needs to address the benefits for high-income self-employment with low prices - and the motivation for the system. The real reform should, therefore, consist of a revision of flat rates and a reassessment of the flat tax.<sup>17</sup>

However, it should still be considered whether the tax system should not be simplified and the levies in the employment relationship reduced so that the Švarc-system ceases to be lucrative. On the one hand, this would temporarily reduce public budget revenues. Still, on the other hand, it could lead to the development of society as a whole, both through increased innovation and a change in the mindset of individuals to want to and be able to look after themselves, which seems to the authors of this paper to be far more responsible and meaningful.

Simultaneously, it is necessary to perceive that due to the inadmissibility, part of the work performed is entirely paid without taxation. Therefore, if people were left free to set up their business relationships, there might be little tax evasion.<sup>18</sup>

<sup>16</sup> From January 2024, there is an increase in the tax base for the self-employed and insurance premiums, but there is still an inequality against the tax and insurance burden on employees.

<sup>17</sup> Czech Academy of Sciences. *Reforma sociálních odvodů OSVČ: studie PAQ research a IDEA při CERGE-EI*, 2023. <https://www.avcr.cz/cs/pro-media/tiskove-zpravy/Reforma-socialnich-odvodu-OSVC-studie-PAQ-research-a-IDEA-pri-CERGE-EI/>

<sup>18</sup> See European Union. *Undeclared Work in the European Union. Report*. European Union online <https://europa.eu/eurobarometer/api/deliverable/download/file?deliverableId=72319>. See also the factsheets for each EU country <https://europa.eu/eurobarometer/surveys/detail/2250>, for example European Union. *Undeclared work in the European Union - Factsheets (national language) Czechia – cs*. European Union online <https://europa.eu/eurobarometer/api/deliverable/download/file?deliverableId=72205>

To substantiate these assumptions with data, we intend to conduct research focused on determining the advantages and disadvantages of legalizing the system in the Czech Republic, which will consist of two phases. Primarily, we want to compare the current situation in the social, economic, and legislative fields in the Czech Republic with developed countries whose social security contributions are meager. According to the OECD, social security contributions in the Czech Republic are 16.449% of GDP, making them one of the countries with the highest contributions. We have detected two countries, Denmark (0.062% of GDP) and New Zealand (0% of GDP).<sup>19</sup> This research aims to see the different factors that cause the different approaches to social policy in social security payments. Next, the aim is to ensure whether there are barriers to the implementation of these differences. Based on the findings of the first phase of the research, we will move on to the second phase. In a selected sample of respondents (hi-tech companies), we want to use a questionnaire survey to determine attitudes and approaches to the possible legalization of the system. We want to have interviews with the management of hi-tech companies and with employees of hi-tech companies. If, thanks to the legalization of Švarc-system, the management of hi-tech companies used the saved money for science, research, and innovation, and employees used them for investments from which they could then finance their retirement, we would obtain essential data for a society-wide debate on changing the current approach and possibly legalizing Švarc-system.

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<sup>19</sup> OECD (2023), Social security contributions (indicator). doi: 10.1787/3ebfe901-en (Accessed on 28 November 2023)