



COMMENTARY

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Measures for Combating Economic Crisis

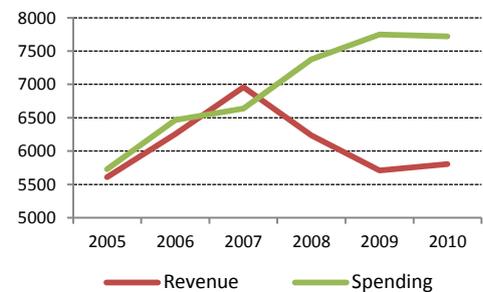
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1. Introduction

Figure 1 shows government revenue and expenditure for the period 2005–2010. Until 2007, both these variables increased at almost the same rate. After 2007, and until 2009, expenditure continued to increase but revenue started to fall. Over the period (2007–2010), public expenditure increased by 16%, while government revenues decreased by 17%. As a result, the government finances have become grossly unbalanced.

Figure 1: Average wage (euro, 2009)



What are the driving forces behind this budgetary shift? To what extent can the proposed austerity measures be appropriate for addressing the fiscal imbalance? What kind of measures and approaches should be put in place so as to avoid harming the economy or, even better, boost economic growth?

This commentary, based on statistical data provided by governmental agencies, tries to answer these questions with the aim to reach policy recommendations for the design of a comprehensive reform that can contribute to combating the current economic crisis.

Abstract

Austerity measures should not target only the wages of public sector employees but also other expenditures. In order to avoid economic downturn, growth-oriented rather than tax revenue measures should be adopted. If a government revenue increase is unavoidable, this should come from taxes on property and, to a lesser extent, VAT. Public sector wages should reflect productivity and state benefits should be given only to those in need. The free provision of public goods is sub-optimal when abused (e.g. by tax evaders and those taking them up not in need but because they are free) or reproduce inequalities. The government needs to combat the abuse of the political system and block narrow interest groups from interfering with the design of national economic policy. Reducing bureaucracy and other institutional reforms to create incentives for higher productivity is a prerequisite for increasing competitiveness. Unless action along these lines is urgently taken the Cyprus society will sooner or later suffer worse consequences than those facing now because of failure to take similar action in the past.



* The results reported in this Commentary are based on quantitative analysis carried out at the Centre of Economic Research by Adamos Andreou and Alexandros Polycarpou.

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2. Public expenditure

Table 1 shows a breakdown of the percentage change in government expenditure (column a) and the proportional contribution of each item to the increase in total public expenditure over 2007–2010.

The largest increase (50%) was for government expenditure on infrastructure and investments, followed by pensions (36%), social benefits (36%) and operating costs (23%). During the same period, wages increased relatively less (20%), but their contribution to total expenditure increase was the largest (30%), because of their large share in total government spending. The contribution of social benefits was also considerable (29%).

The conclusions derived from the figures of Table 1 are:

- one should examine whether large increases of expenditures on social benefits, operating costs and public investment were justified on grounds of efficiency, and;
- austerity measures should target the aforementioned items, since they appear to be responsible for the derailment of public finances.

3. Public revenue

Table 2 reports the percentage change in government revenue by source (column a) and its contribution, in percentage terms, to the change in total revenue (column b) that occurred during the period 2007–2010.

Except for financial revenue, the largest decrease in government revenue came from ‘other direct taxes’ (–41%) and ‘other indirect taxes’ (–27%), which consist of taxes on capital gains, dividends and other property taxes, as well as property title deeds, excise duties and vehicle taxes. These two items contributed the most to the reduction in total revenue that occurred during the period under examination (38% and 14%, relatively). Corporate income taxes were also considerably reduced (–11%); while income taxes increased by 24%.

From the figures of Table 2 one can infer that the slowdown of the economy is responsible for the rising public deficit. As a consequence,

- tax increases on company profits and wages (such as the announced tax rate increase from 30% to 35% for incomes higher than 60.000 euro) may not be fruitful because they will result to further economic downturn and, consequently, reduction of the tax base and government revenue;
- the second austerity package should place emphasis on
 - (α) economic growth through privatisation, outsourcing of public services to the private sector, reduction of tax on undistributed profits and other measures stimulating growth of the private sector, and
 - (β) increasing property tax, as this can raise revenue without increasing inequality and distorting economic incentives.

Expenditures	(a)	(b)
Wages	20%	30%
Pensions	36%	12%
Operating costs	23%	18%
Social benefits	36%	29%
Other transfers	9%	9%
Debt repayment	–30%	–18%
Debt	0%	0%
Infrastructure/Invest.	50%	20%
Total	16%	100%

Revenue source	(a)	(b)
Personal Income Taxes	24%	–10%
Corporate Income Tax	–11%	7%
Other Direct Taxes	–41%	38%
VAT	–1%	1%
Consumption taxes	–3%	2%
Other Indirect Taxes	–27%	14%
Financial Revenues	–73%	68%
Other Revenues	37%	–20%
Total	–17%	100%

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4. Salaries in the public sector

Table 3 compares average wages in the public and private sector by occupational category. It is generally accepted that private sector wages are determined by labour demand and supply. Thus, they reflect more accurately labour productivity than their public sector counterparts, as the latter are not determined by market forces. On that basis the most overpaid occupation in the public sector are teachers. This may be attributed to economic reasons (older age and qualifications of teachers in the public sector¹); but can also be due to the power of the teachers' trade union. The wages of technicians, clerks, assistants and other low-paid public sector employees are generally higher than those in the private sector. In contrast, managers και other professionals employed in the public sector are not overpaid.

The analysis above suggests that:

- Measures to reform the government payroll should not only target the level but also the distribution of wages. A mixture of vertical and horizontal wage adjustments are required to minimize government pay inefficiencies.

5. Value added tax

Table 4 shows the distributional effect of the proposed increase in VAT (from 15% to 17%), as defined by the effect on the consumption of low-income (poorest 25%), medium-income (25%–75%) and high-income (richer 25%) households. Due to the fact that VAT is not levied on all commodities, households' purchasing power is reduced, on average, by only 0.8%. Furthermore, the prices of necessities (e.g. food) will not be affected by the proposed VAT increase. As a result the tax burden will be disproportionately, albeit slightly, larger for the better off households.

In conclusion:

- the proposed VAT increase can yield considerable government revenue without increasing inequality and without distorting economic incentives by as much as other taxes.

6. Wage indexation

In a previous commentary, we argued that automatic wage indexation is unnecessary (if not harmful) for protecting the standard of living of workers in a competitive economy². Therefore,

- automatic wage indexation should be applied only to pensions and social benefits. This indexation scheme should be constructed to reflect price increases that represent the basket of goods purchased by pensioners and social benefit recipients; wage increases in the public sector should be linked to the productivity of employees.

Table 3: Average wage per occupation category

Occupational category	Sector		Pub./Priv.
	Private	Public	
Managers	4809	4832	1.0
Teachers	1218	3037	2.5
Other professionals	2328	2595	1.1
Technicians, assistants	1851	2430	1.3
Clerks	1302	1744	1.3
Service and sale workers	1221	1741	1.4
Skilled workers	1476	1908	1.3
Unskilled workers	812	1340	1.7
Total	1457	2233	1.5

Table 4: Distributional effects of a VAT increase

Income groups	Average	VAT increase	
	consumption	Euro	%
Low (poorest 25%)	19617	139	0.71%
Medium (25%–75%)	38565	304	0.79%
High (richest 25%)	57346	488	0.85%
Total	38518	308	0.80%

¹ Average age of education staff in the private sector is 33 years while in the public sector is 41 years.

² 'Μερικές Αλήθειες για την ΑΤΑ', Commentary Economic Policy, No. 18, Economics Research Centre, University of Cyprus, July 2008: www.ucy.ac.cy/data/ecorece/ATA_%2028-05-08.pdf.



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7. Policy recommendations

The recent sharp rise of fiscal deficit and public debt is the outcome of economic crisis. The adoption of inappropriate fiscal consolidation measures, however, can trap the economy in a vicious cycle. In the light of empirical evidence presented in this Commentary, one can draw the following policy conclusions:

- Austerity measures should target public sector wages and salaries but should not be confined to horizontal cuts. For, not all professions in the public sector are overpaid. Also, the pursuit of public sector efficiency dictates that the practice of automatic wage increases (cost of living allowance, age-based pay/promotion schemes etc) should be replaced with wage setting mechanisms that reflect employee productivity (e.g. quantitative targets, external and internal evaluation, comparisons with private sector and with other countries) and the state of the economy (e.g. GDP growth).
- The government measures should not focus only on public sector wages but also on containing public spending on social benefits and operational costs that have increased substantially during the last few years. For example, it could introduce means-testing for universal benefits (child benefit and student grant) so as to exclude high-income beneficiaries. The free provision of private goods and services should also be reconsidered, as universal unpaid access to these goods and services may give rise to abuse, e.g. students unnecessarily prolonging the duration of their studies and patients over-consuming health care services and pharmaceuticals.
- During periods of economic recession, tax increases are, in general, not recommended. Instead measures relying on private effort/initiative such as privatisations, outsourcing of public services to the private sector and tax reductions on employment and profits are preferable. If tax increases are unavoidable, then it is better to increase property taxes and – to a lesser extent – VAT, because these taxes are relatively less distortive. Also excise duties can be raised in order to reduce negative externalities on the physical and economic environment.

8. Conclusion

The government needs to show the determination required to combat the abuse of the institutional/political system and block narrow interest groups from interfering with the design of national economic policy. Unsocial behavior, such as tax evasion and actions taken for the benefit of political party-based clienteles should not be tolerated. Reducing bureaucracy and undertaking other institutional reforms to create incentives for higher productivity should be considered a prerequisite for increasing the competitiveness and growth potential of the economy. Finally, the government should take action to restore confidence in the economy. Unless economic reform along these lines is urgently implemented the Cyprus society will sooner or later suffer consequences that are likely to be worse than those it is facing now because of failure to take similar action in the past.

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