

The Cyprus Economy: Reform or Shrink†

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Abstract

The structural problems of the Cyprus economy often originate from distorted wages, prices and profits that give rise to inefficient allocation of resources. This note discusses some of these structural problems and argues for the reform of the tax-benefit system and the government payroll.

Keywords: Tax-benefit reform, public sector payroll, Cyprus economy.

1. Introduction

The large fiscal deficit, the rising unemployment and the bleak outlook of the economy have brought to the surface some long forgotten structural problems of the Cyprus economy, such as the size and inefficiency of the public sector, automatic indexation of salaries and other labour market rigidities, tax evasion and the black economy and the lack of an effective regulatory framework for promoting competition.

This note focuses on the tax-benefit system and the government payroll, pointing out reforms that can help towards enhancing the efficiency of the public sector and the economy at large.

2. Tax reform

The tax system of Cyprus was substantially reformed during 2002-2004, in preparation of the country's full European Union (EU) membership. The main features of that reform was the increase of indirect (VAT) and decrease of direct taxation, and the replacement of all personal tax

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discounts and credits with a generous tax allowance. Some of these features have been argued to have a positive effect on economic activity, e.g. the generous tax allowance is found to encourage labour market participation.¹ Nevertheless, the main criterion in the design of the new tax system was to maintain fiscal balance with a fair distribution of the tax burden. Very little attention was paid to the impact of the tax reform on economic growth, except for the tax rate on profits that was kept low to encourage offshore companies to settle in Cyprus.

Recently, the government has introduced a new tax rate of 35% on annual income above 60,000 euros, and additional contributions on public sector salaries. These and other measures taken (or planned) to reduce the fiscal deficit, as in the past, are discussed and rationalised in the public debate on the basis of vague and subjective criteria of fairness, with little attention is paid to their potentially harmful effects on economic activity.

The basic structure of the Cyprus tax system is very simple. Direct tax of 20%, 25%, 30% and 35% is collected from households with income between 19.501–28.000, 28.001–36.300, 36.301–60.000 and above 60.000 euro, respectively; while companies pay tax on all their income at the rate of 10%. Indirect taxes are collected through VAT (currently at 15% standard and 5%-8% reduced rate) and excise duties that are mostly close to the EU minimum. On the basis of these tax rates one cannot complain that households and companies in Cyprus are overtaxed.

The simple structure and low burden are desirable features of the tax system and should be maintained. Nevertheless, there are three aspects of the system that need to be reformed:

- (i) The income tax brackets are too narrow so that individuals with earnings about twice the national average have a marginal income tax rate of 30%. The tax brackets need to be substantially widened so that the higher tax rates do not burden middle to high incomes, where the labour supply curve is still positively sloped.
- (ii) The possession of immovable property and windfall gains from changes in its use should be taxed. Land taxation represents a rare textbook example of state intervention that promotes equity with no negative effect on efficiency. Excluding it from the tax system grossly defies economic and social policy logic.

¹ Pashardes, P. and A. Polycarpou, Tax-free income vs In-work tax allowances: Effects on Labour Market Participation in Cyprus, in H. Sutherland and O. Lelkes (eds), *Tax and Benefit Policies in the Enlarged Europe: Assessing the Impact with Microsimulation Models*, 2009.

- (iii) All kinds of contributions paid by public sector employees should be replaced with equivalent reductions of salaries. This will reduce both government taxation and spending, delivering a positive signal to the credit rating agencies and the markets.

Furthermore, the Cyprus government should seek ways to use the tax system to improve the physical and economic environment. Taxing traffic congestion is a good example, but unlikely to yield immediate results given the considerable investment needed to create the infrastructure required to develop an efficient public transport network.

3. Benefit reform

The benefit system in Cyprus has been recently criticised for being extravagant, in the sense that it pays benefits to families not in need. While this criticism is not entirely unfounded, the debate about reforming the system to reduce social spending fails to recognise the multi-dimensional objectives of some benefits. Furthermore, the debate fails to distinguish between the social insurance and the social assurance role of the benefit system. I shall briefly discuss these issues in turn.

The argument that all benefits should be means tested is mainly affecting child and student support. Child benefit in Cyprus is generous to large families, a feature contributing to low child poverty.² Means-testing can reduce child poverty even more; however, this will happen at the expense of other objectives served by the same benefit. In particular, child benefit is thought to operate as a vehicle for transferring family income from periods without, to periods with, children. These intertemporal transfers help households adjust income to their needs, thereby 'smoothing' lifetime consumption. The same can be said about student grants.

It follows from the discussion above that subjecting child and student support to means-testing can reduce inequality between households at a given point in time, but increase inequality faced by the same household at different points in its lifecycle. To alleviate the latter effect households with children and students should be offered low-cost loan facilities.

Finally, child support is often part of policies to encourage mothers to participate in the labour market and/or increase fertility. This objective of the child benefit can be served by increasing access to affordable child-care facilities and by introducing in-work benefits for single parents.

² Pashardes P., Why Child Poverty in Cyprus is so Low, Cyprus Economic Policy Review, 1, 3-16, 2007.

Another issue discussed in relation to the need for fiscal consolidation is the economic viability of the state pension system. No matter how described, the state pension system in Cyprus is based on the pay-as-you-go principle: the contributions to the state pension fund are not invested with a view to raise income to pay future pensions but 'borrowed' by the government to cover current spending needs. The government has to come out clean about this and stop acting as if it is an assurance agency. This means recognising as loans the contributions paid to the state pension fund so far and pay back the beneficiaries accordingly. Furthermore, the government should confine its role to the basic part of state pension and stop collecting contributions for the 'funded' part; and reduce future state pensions accordingly. Individuals wishing to have high income when they retire can do so by making their own investment arrangements.

4. Public sector payroll

Table 1 shows the ratio of the average salary of employees in public sector to the corresponding salary in the private sector by occupation for the years 1996, 2003 and 2009.³

The figures reported in the table suggest that while on average, salaries in the public sector are 1.5 times higher than those in the private sector (and have been so since 1996) there substantial discrepancies between occupations. The most striking is the large decrease in the public/private salary ratio among 'Managers, Senior Administrators' and 'Qualified personnel'; and a large increase among 'Teachers'. The public/private salary ratio has also decreased substantially among 'Unskilled laborers'.

The explanation behind the above changes in the public/private salary ratios can be traced to the rigidity of salary parity between occupations in the public sector; in turn, attributed to the automatic indexation and annual salary increments. For instance, between 1996 and 2009 the change in average real salary for 'Teachers' and 'Managers, Senior Administrators' were +30% and +40% in the public and -21% and +140% in the private sector, respectively.

The figures above suggest that the salaries of some occupations in the public sector are too high and need to be reduced. While more analysis may be needed to conclude about the size of this reduction, it appears that the emphasis placed by the government on reducing the salaries of high-paid employees in the public sector is misguided.

³ The figures in Table 1 are exclude part-timers, but include bonuses and supplements paid as part of the employee's remuneration package.

TABLE 1
The public to private sector salary by occupation

Occupation category:	1996	2003	2009
Managers, Senior Administrators	1.52	1.32	0.82
Teachers	1.28	1.68	2.28
Qualified personnel (except teachers)	1.46	1.22	1.06
Technicians, Assistants, Designers	1.33	1.40	1.28
Secretaries, Typists, Cashiers	1.50	1.30	1.31
Clerks and Salespersons	1.43	1.36	1.38
Skilled laborers	1.22	1.48	1.25
Unskilled laborers	1.28	1.64	1.66
All occupations	1.51	1.54	1.46

Source: Calculations based on data drawn from the 1996, 2003 and 2009 Family Expenditure Surveys, Statistical Office.

5. Conclusion

The Cyprus economy is marred with imbalances both between and within the public and private sectors that have been accumulated over many years of mismanagement. Addressing these imbalances requires drastic reforms to create an incentives structure capable to sustain efficient allocation of resources through encouraging rational economic behavior among individuals and firms.

Reform of the tax and benefit systems can help in this direction by introducing incentives to increase employment and investment. Reforming the government payroll to align pay in the public with the private sector efficiency can encourage efficiency in the allocation of resources between the two sectors. Government inefficiency can also be combated by replacing the current rigid remuneration system, based on automatic indexation and universal salary increments, with a flexible system based on productivity.