Sharing the dividend of growth in Cyprus: reducing taxes or income inequality?

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After a protracted contraction, the Cyprus economy returned to real growth in 2015. This has triggered debates on how the anticipated fruits of growth should be shared. The Minister of Finance announced reductions in taxes whereas the opposition parties favour policies to repair the recession-hit social welfare services and reduce income inequality.

Description

Following a severe economic recession that raised unemployment at unprecedented rates (16.1% in 2014), nowadays the situation in Cyprus has improved and the economy appears to have embarked on a robust growth trajectory. The seasonally adjusted unemployment rate plunged to 12.0% in May, 2016 (Eurostat), albeit part of this decrease might be attributed to migration. Meanwhile the Economics Research Centre of the University of Cyprus forecasts real Gross Domestic Product to grow by 2.4% in 2016.

Following these positive developments, in May 2016, the Minister of Finance, Mr Harris Georgiades of the centre-right Democratic Rally party, announced that the so called "special contribution", a tax levied on the gross monthly emoluments of all employees, self-employed and pensioners in the private and public sector, will be abolished in 2017. This tax was introduced in 2011 and it is estimated to yield around €80 million annual tax revenue. It has a progressive structure: 0% for income up to €1500, 2.5% for income between €1501 and €2500, 3% for income between €2501 and €3500 and 3.5% for income above €3500. Furthermore, an extra 0.5% is added to the contribution rate of highly ranked public officials.

The Minister has also portrayed the intentions of the government on how the dividends of growth shall be shared in statements such as "in the future we will be in a position to propose further reductions in taxes so that the citizen, the employee and the tax payer would start to enjoy the fruits of economic recovery" and "taxes are reduced and at the same time public expenses are rising but in a rational manner, without in any case risking the target of a balanced budget" (Minister's statements in the media).

This one-sided emphasis placed on tax reductions has sparked a public debate, with the left-wing opposition parties suggesting that the dividends of growth should be invested in social policy (for example, increasing child benefits); while the right and centre-right political parties defend the government position, using the argument that the poor will benefit from tax reductions through increasing investment and employment.

Outlook & Commentary

The abolition of the special contribution will exert an inequality-increasing effect on income distribution, because it will mostly benefit high earners in the labour market and the better-off pensioners. Furthermore, this will come on top of the relatively high levels of inequality that already exist in Cyprus.

Before 2010 Cyprus could, indeed, boast

for its relatively moderate income inequality: in 2009 its Gini index was 29.5%, whereas the EU27 average was 30.6% [the Gini varies between 0% (perfect equality, i.e. income is equally divided between all persons) and 100% (perfect inequality, i.e. one person owns all income)]. Nevertheless, the recession has led the country to having one of the highest inequality levels in Europe. According to the latest data, the Gini index in Cyprus was 34.8% in 2014, which is the highest among the austerity-stricken countries (Spain 34.7%, Greece 34.5%, Portugal 34.5%, Ireland 30.8%); and the fifth highest in EU-28, just behind Bulgaria and the three Baltic states. (Eurostat figures)

In the context described above, one could argue that the government should fend off measures retrenching progressive taxation, as these will widen further the already high income inequality. On the other hand, the Eurostat data show that there is a strong link between unemployment and inequality in Cyprus: in 2008, when the unemployment rate was only 3.7%, the Gini index was 29.0%. Therefore, to the extent that they can boost employment (through increasing consumption and investment) reductions in taxation could, in the case of Cyprus, be argued to be a measure combating inequality. Of course, one should add here that a statistical relationship does not establish causality; and, on its own, growth (even when accompanied by increase in employment) does not necessarily result in lower income inequality.

In effect, the current debate about how the dividend of growth should be allocated essentially boils down to the long-standing dilemma of whether the allocation of resources should be managed by the state or left to be decided by market forces. While few would recommend following only one of these two approaches, the right state-market mix remains an elusive solution. In our opinion, the current emphasis placed by the government on tax cuts is rather unbalanced, insofar as no new economic resources appear to be earmarked for policies intended to repair of the recession-hit welfare services. In particular, gaps in the field of publicly provided healthcare services do exist and cause distress among the less well-off who cannot afford expensive medical services from the private sector (Cylus et al, 2013); while the provision of long-term care and child care is fragmented and insufficient (Pashardes and Koutsampelas, 2015). The government could also consider increasing child benefits, as these are found to contribute significantly in containing child poverty, (Koutsampelas, Polycarpou and Pashardes, 2013).

Further reading

Cylus J., I. Papanicolas, E. Constantinou and M. Theodorou, (2013). Moving forward: Lessons for Cyprus as it implements its health insurance scheme. Health Policy, 110, pp. 1-5.

Economics Research Centre, (2016). Economic Bulletin "Economic Outlook", Issue 16/2, April 2016.

Koutsampelas, C., Polycarpou, A. and P. Pashardes (2013). Child Poverty, Family Policies and the Effect of Economic Crisis. Economic Analysis Papers, No. 10-13.

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