Efficient tax policies following Cyprus economic downturn

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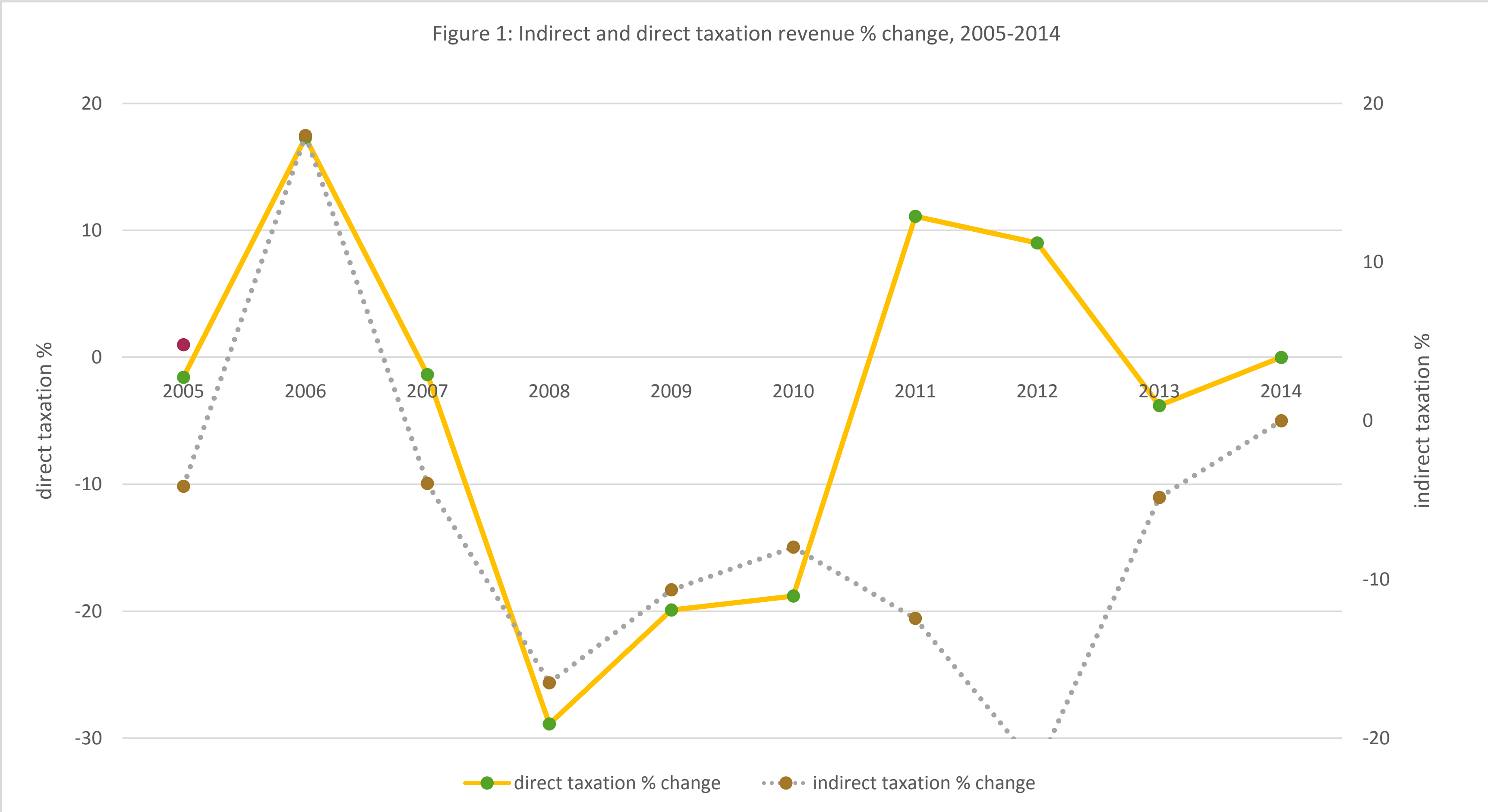
Introductory remarks

- ✓ Tax adjustments after lasting economic downturn are necessary to combat rising income gaps and bring the economy back to steady equilibrium.
- ✓ The safest way to achieve this is to pursue tax optimization rules ensuring efficiency and social cohesion on an individual and social level.
- ✓ The best optimization rule can be formed through optimal tax rates combining efficiency with social cohesion so as (dis)incentives on labour and capital remain consistent.
- ✓ The abovementioned lead to the efficiency–equity trade off highly associated with the informal economy and the existence of tax evasion of which Cyprus suffers.

Impact of economic fluctuations on tax revenue



Impact of economic fluctuations on tax revenue

- ✓ Factually, lower economic activity leads to reduction of tax revenues through reduced indirect and direct tax revenue collections.
- ✓ In figure 1, for 2011-2014, it is shown that direct taxation revenues follow the income path whereas the indirect taxation revenues follow the consumption path.
- ✓ It seems that tax revenues are highly correlated with the business cycle with some time lag as depicted in figure 2.
- ✓ For years prior to 2007, Cyprus has been enjoying high tax revenues associated with even higher growth rates due to some exogenous factors such as the tax reform of 2002/2003 and the tax amnesty law of 2007 that gave strong incentives to investors and depositors to repatriate their funds back to the economy.
- ✓ Tax revenues were also affected by an overheating economy fuelled by a rapid credit expansion, lower interest rates and a resulting housing bubble.

Impact of economic fluctuations on tax revenue

Impact of economic fluctuations on tax revenue

- ✓ The correlation for Cyprus between GDP growth and tax revenue seems to be high enough explaining the closed correlation between GDP growth-tax revenue-fiscal deficit.
- ✓ The determination coefficient (R^2) of GDP is relatively significant at 0.7583.
- ✓ The correlation coefficient is positive at 0.8 meaning that tax revenues are statistically significant with GDP growth.
- ✓ Thus, during booms (slumps) tax revenues increase (decrease) depending on the economic activity path.

	TAX	GDP
TAX	1	0.8
GDP	0.8	1

Tax optimization rule under linear income taxation

- ✓ An important issue for effective tax collection is the issue of tax evasion, which is a drawback in Mediterranean Eurozone economies.
- ✓ If part of tax revenue is lost due to tax evasion, then the income transfer is reduced and redistributive targets may not be met causing suboptimal effects on social policy targets (R. Canbur, et al, 2015).
- ✓ As a result, the tax evasion effect increases the cost of raising taxes offsetting an important fiscal policy tool.
- ✓ Moreover, informal economy could maintain and even extend inequality, if not properly addressed leading to challenging social cohesion conditions.

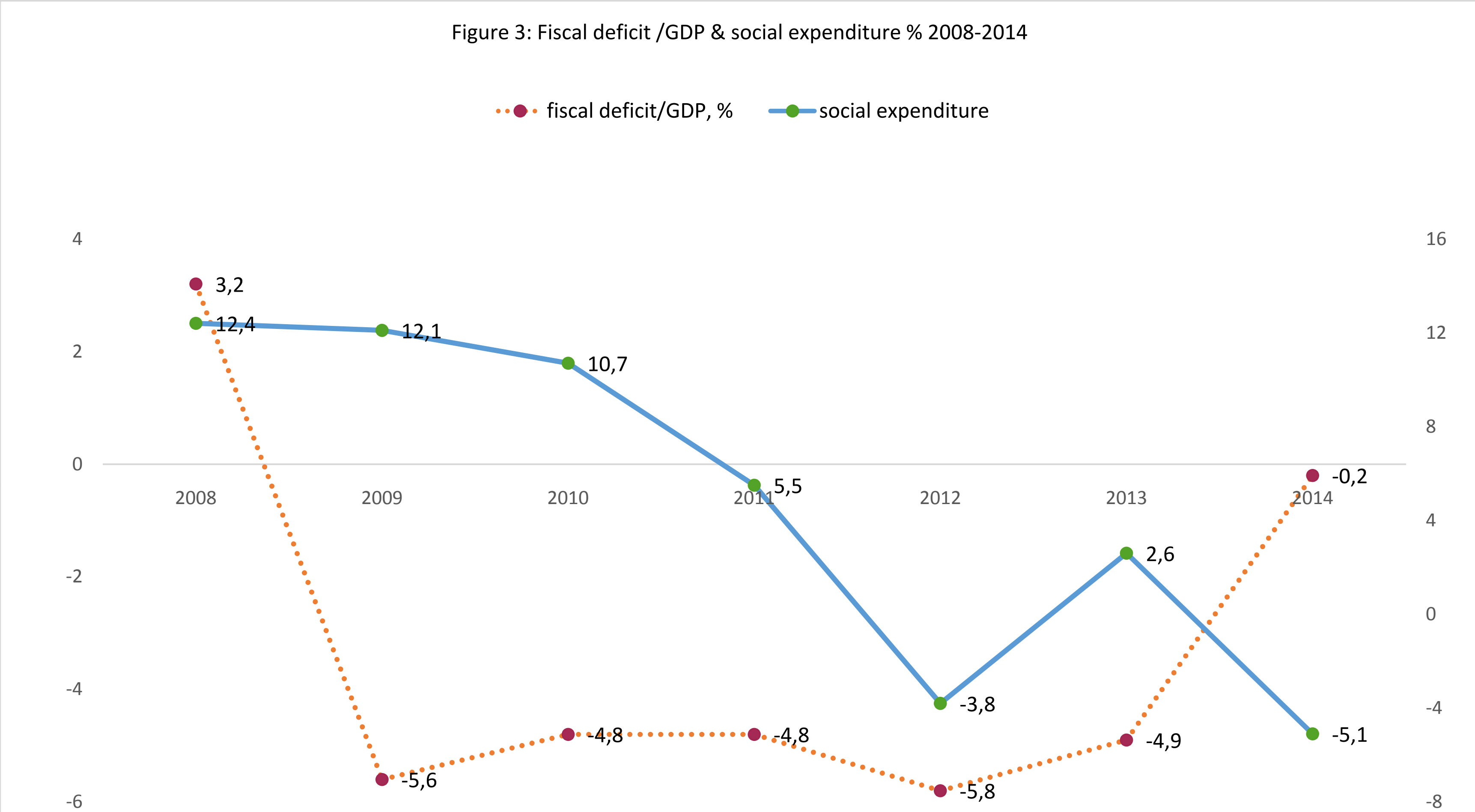
Tax optimization rule under linear income taxation

- ✓ On income tax, if normative reasons lead to progressive taxation, it then depends upon the scale of progressivity to achieve more equal income distribution without at the same time deteriorating economic efficiency.
- ✓ On commodity taxation, what matters to achieve tax optimization is the tax effects on substitute goods causing higher indirect taxation on price inelastic commodities to minimize the substitution effect (P. Pashardes, 2003).
- ✓ The efficiency of the tax system could lead to more favorable effects on tax revenue, better public goods provision and ultimately, faster poverty reduction and embedded robust social cohesion.

Tax optimization rule under linear income taxation

- The upswing of fiscal deficit following the downturn unavoidably is leading to reduced outlays inter alia in social expenditure as depicted in figure 3.
- The reduction in social expenditure follows the increase of fiscal deficit.
- From literature, it seems that a flat tax, with a universal lump-sum transfer, could be close to the optimal rule and optimal taxes should depend on personal characteristics, as well as, income.
- Maintaining fiscal deficit on a downward path presupposes that social expenditure follows a reasonable downward path too.
- The correlation coefficient of fiscal balance with social expenditure is estimated at 0.313 exhibiting the correlation of the two.

Tax optimization rule under linear income taxation



Efficient tax policy mix fostering growth & social cohesion

- ✓ Tax evasion distorts the tax collection system increasing economic inefficiency, raising the fiscal deficit and lowering prospects of poverty reduction.
- ✓ The relationship between the fiscal deficit to GDP with poverty or social exclusion explaining that higher fiscal deficit reduces relative poverty due to lower social expenditure, and vice versa.
- ✓ It was estimated that the correlation coefficient between the fiscal balance and poverty equals -0.26 meaning that expansionary fiscal policy could lower poverty or social exclusion through possibly higher social protection expenditure improving social cohesion conditions.

Conclusions

- ✓ Tax policy can reverse some of the negative economic impact following a significant economic downturn similar to the one that Cyprus experienced recently.
- ✓ After Cyprus experienced a downswing in economic activity, tax containment on business activity and employment could enhance labour growth amid economic upturn and facilitate faster and robust recovery.
- ✓ Policy measures to ease tax burden on labour could also mitigate overall taxation on employment and expand labour demand necessary for a sustainably sound growth.
- ✓ Extend the network of tax treaties for the avoidance of double taxation with countries that Cyprus maintains significant financial and trade relations.
- ✓ Policies to combat tax evasion could also reduce poverty once more public revenue could finance social protection expenditure to alleviate poverty.

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