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Urgent need to reform Cyprus tax policy

A former finance ministry advisor writes an open letter to Finance Minister Harris Georgiades on the need to reform tax collection and payments so that public services can be improved

Dear Minister of Finance, Harris Georgiades,

The need to provide high quality public services, a characteristic of an advanced European state, and to finance new government programmes and initiatives over the medium-term, are likely to place greater demands on government revenues, and even more burden on the limited resources of the law-abiding tax-payer.

However, with the tax collection system becoming more regressive and the tax base having narrowed, it is highly probable that serious difficulties will be encountered in raising sufficient revenue to meet these expenditure demands. And in this connection raising tax rates for lower and middle income households as well as increased debt financing are not considered feasible options, especially as current tax and debt management policies are exacerbating income, wealth and intergenerational inequalities.

The solution for this government's financing problem lies in making the tax system more progressive and fairer and in broadening the tax base through taxing wealth, especially with an unpopular tax on immovable property[1], and most importantly in taking measures to effectively combat widespread tax evasion.

Government expenditure requirements

There is a need for Cyprus to improve the quality of its public services in line with those of Northern European countries particularly in the provision of certain types of social protection, such as benefits for sickness, healthcare and disability. While this does not necessarily mean that more money should be thrown at solving problems in these areas, it is quite striking that the Cyprus government spends much less on social protection than most Northern European countries of the EU. For example, the Cyprus government's expenditure on sickness, healthcare and disability benefits was equal to 4.4 per cent of GDP in 2016, whereas that of Germany, Belgium and the Netherlands amounted to 9.9 per cent, 10.5 per cent and 12.4 per cent, respectively. The EU average was 10.4 per cent. Furthermore, the government will need to devote more resources to the financing of new programmes such as the debt relief schemes and possibly low-cost housing projects, for new initiatives including revamping tax administration and contributing to the European defence network, and for prospective contingencies including costs associated with asset protection schemes provided for under the sale of the Cooperative Central Bank. It is noted that the level of government expenditure of Euro area members averaged 47 per cent of GDP in 2017 whereas such outlays in Cyprus amounted to a relatively low 37.5 per cent of GDP.

Financing government expenditure requirements

It could be argued that with the government projected to produce relatively large budget surpluses, a considerable portion of these surpluses could be used to finance greater government expenditures. While past and projected surpluses have been excessively high in taking more money out of the domestic economy than necessary, it is my view that primary surpluses of around 4 per cent of GDP should be used mainly to repay debt and lower the loan servicing burdens of future tax payers.

The appropriate way to finance the needed increased expenditures of the Cyprus government would be by raising government revenues to much higher levels through introducing and implementing a more progressive tax system and by broadening the tax base. Countries such as Germany, the Netherlands, and Luxembourg generate government revenue levels of some 44 per cent to 45 per cent of GDP and produce modest surpluses of 1 per cent to 2 per cent of GDP, in the process enabling such countries to provide high quality public services including adequate benefits to more vulnerable persons. In sum there needs to be a balanced upward adjustment of government expenditures and revenues over the medium-term.

Increasing government revenue

In line with the need to reduce income and wealth inequalities it is recommended that the structure of the tax rates on personal incomes be made more progressive in favour of low- and middle-income earners by reducing tax rates for annual incomes below 50,000 euros and raising rates for annual incomes of 50,001 euros or more, with a new top rate of 40 per cent for incomes above 60,000 euros. The average top rate in the euro area was 41.5 per cent in 2017. And as you outlined in your budget speech tax returns should be submitted by all income earners, even if they are below the no-tax threshold of 19,500 euros. These submissions would not only provide information to help combat tax evasion, but would provide a basis for extending tax credits such as for partly covering housing costs for low income recipients. In addition, there seems to be a compelling need to introduce a revenue-rich progressive tax on immovable property to bring Cyprus into line with tax systems of many other Euro area members.

However, for a more progressive and broader tax system to be effective in significantly raising actual tax collections there will have to be a very large reduction in the huge amount of tax evasion taking place by both individuals and business units in Cyprus. Along with Greece, Cyprus is reported to have one of the largest untaxed (shadow) economies in the euro area, the size of which is estimated at around 26 per cent of official GDP[2]. At end-September 2018, tax arrears owed to the Tax Department amounted to just under 2.3 billion euros. But such tax arrears may be only part of the tax evasion-iceberg as many entities such as school teachers giving private lessons do not report all their income, while others do not even submit tax returns even though they earn income considerably above the no-tax threshold.

To combat the widespread tax evasion in Cyprus there needs to be not only a fundamental change in the political willingness to tackle the problem by evenly enforcing tax laws and regulations, but also for a substantial increase in the resources of the Tax Department and in the related facilities of the private sector. A large increase in staff is urgently required for efficiently assessing tax returns and objections as well for on-site inspections of businesses to determine among other things whether proper VAT receipts are being issued. And as stated as well in your budget speech, consideration needs to be given to mandating the use of card readers of electronic payments by product and service providers in efforts to tackle tax evasion[3]. Furthermore, rapid progress in implementing an integrated tax administration system through deploying a new tax IT system needs to be made. Why can't the same tax identification number be used for VAT and income tax payments?

Reducing Inequalities

While the above measures recommended to raise tax revenue should enable the government to better provide public services and to meet other expenditure priorities compatible with an advanced European state they should also help to reduce the relatively high income and wealth inequalities prevailing in Cyprus. The restructuring of personal income tax rates in favour of lower and middle income earners should raise the disposable incomes of lower and middle income households. In addition, greater actual tax collections from high income and wealthier households and businesses should enable the redistribution of funds for protecting the more vulnerable members of society.

The policies of many European countries including Cyprus are failing to address some of the problems associated with intergenerational inequality. The inability of many young persons to obtain jobs and incomes commensurate with their educational qualifications and training together with high housing costs relative to their meagre incomes or unemployment benefits means that they cannot enjoy a standard of living similar to their parents. Not only is the potential of these persons to contribute more to economic growth lost with their underemployment and unemployment, but the resources to afford adequate housing accommodation hardly exist for a large number of younger persons and couples. Government policies which aim at boosting the property market including the golden visa scheme are tending to make housing costs more unaffordable for younger persons as well as for other low income earners. Moreover, government policies that fail to adequately address issues like housing affordability or climate change are only 'kicking the can down the road" and stealing from the next generation who are just going to be left to try and solve these problems.

What is needed is for the government and the private sector to put more resources into constructing and renovating social and more affordable housing accommodation including low cost rental units. But this is very expensive business and how will it be financed? In Cyprus the older generations (40 years above) have and are still benefiting from the very generous tax treatment of immovable property dividing society between rich property owners and poor renters. Indeed, property taxes have been very low and only modestly progressive with the government tax on immovable property being abolished in January 2017. Accordingly, it is recommended that a substantial and progressive property tax be introduced and together with the greater and hopefully more effective taxation of high income earners contribute to the financial resources required to construct more low cost housing. Serious consideration also needs to be given to exempting first time buyers of a primary residence from the 5 per cent VAT and transfer fees. And as indicated above tax credits for housing costs could be extended to low income recipients under a means tested housing programme.

Yours sincerely,

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[1] A new property tax, though the least growth-unfriendly of taxes, will be unpopular, and accordingly if introduced should be at the early stages of the political election cycle.

[2] See Friedrich Schneider, Size and Development of the Shadow Economy of 31 European Countries and Five Other OECD Countries, January 20, 2015.

[3] Studies have shown that countries with a higher share of electronic payments as against cash tend to have smaller shadow economies. See A.T. Kearney and F. Schneider, The Shadow Economy in Europe, 2013.