Cyprus is a high-taxing country!

Description

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Taxation is perhaps the ultimate political act in a democratic society. It's not just about raising revenue and spending it; it's also about the kind of society we want to be—how inclusive or exclusive—and the spending programs we're going to have and how we're going to fund them. Therefore, taxation is a crucial instrument of public policy, and it shapes society. Well-designed taxes can promote stability, justice, and a nation's prosperity. Poorly designed taxes, however, can distort markets, burden the poor, and hinder economic growth. Taxation's impact can be uniquely pervasive, changing relative prices, behaviours, and ultimately, economic outcomes. In this article we discuss the fundamental principles of taxation that are universal in their meaning and interpretation, and we examine how Cyprus' taxation system fares against them, and how taxation reform should look like!

For Adam Smith, taxation was a moral and economic responsibility—a way for citizens and social stakeholders to contribute to the common good in proportion to their means. In his seminal work, The Wealth of Nations, published in 1776, he laid down his four canons of taxation: Equity, certainty, convenience, and efficiency. Much has changed since then, but these principles still influence modern tax policy discussions. We continue to summarize them under the headings of equity, efficiency, simplicity, and adequacy.

Equity, or fairness, is the cornerstone of a good tax system. Equity encompasses two main dimensions: horizontal and vertical equity. Horizontal equity means that taxpayers in similar financial circumstances are taxed equally. Taxing them differently would undermine public trust and the perception of fairness. Vertical equity is when taxpayers with higher paying abilities contribute more to public revenues. This is progressive taxation, in which marginal tax rates are higher for higher income brackets, resulting in a higher average tax liability as a percentage of income. The opposite is regressive taxation, where the average tax liability falls as income increases. Income and wealth taxes are progressive. However, taxes on production, such as excise taxes and the value-added tax, are regressive.

There is also an element of intergenerational equity. Ideally, each generation’s taxes would cover its own expenses, with allowances for absorbing shocks and undertaking public investments that increase a nation’s productive capacity. With these exceptions, debt accumulation should be kept to a minimum, and deficits and surpluses should be offsetting each other over time.

In the context of a tax system, efficiency is about minimizing the distortions that taxes create in individuals’ and firms’ decisions regarding saving, consumption, work, and investment. Taxes alter relative prices and incentives, which can distort the market outcome and lead to the misallocation of resources. High marginal tax rates on labor income can discourage work. High taxes on capital income can deter investment. An efficient tax system aims to minimize these distortions.

Tax systems must be simple. Tax laws should be clear and easy to understand to reduce compliance costs for taxpayers and administrative costs for the government. Revenue adequacy means generating enough revenue to fund public services and meet societal needs, as well as ensuring long-term fiscal and debt sustainability. But no more.

In practice, a good tax system should be progressive with moderate rates and broad bases. It should have no loopholes and should minimize exemptions and deductions that distort choices and must also reduce poverty. Tax systems must be elastic enough or sufficiently responsive to economic growth as necessary to create sufficient fiscal space to accommodate policy changes and societal pressures, but no more.

Cyprus’s public finances reflect a tax system that is highly responsive to nominal economic expansion and driven by high fiscal drag and low progressivity overall. Spending, on the other hand, is lopsided, leaving many functional areas underspent and others overspent.

From 2002 to 2024, tax revenues rose considerably faster than the economy on average, sharply contrasting with almost all European Union member states. While this was beneficial for public finances, it is important to understand the underlying drivers to manage the potential effects, such as fiscal drag. This high responsiveness to economic expansion was not due to progressive tax structures or improvements in the tax base. Rather, it was mostly driven by large increases in indirect taxes and net social contributions, the regressive parts of the tax system.

Indirect taxes, including value-added taxes, accounted for 31.6% of total revenues in 2024, or 14% of GDP—one of the highest percentages in the European Union. Net social contributions accounted for 30.6% of total revenues in 2024, or 13.5% of GDP. Conversely, income taxes on individuals contributed only 8.6% to total revenues and 3.8% to GDP, which was among the lowest in the European Union despite a perfectly progressive tax structure. In contrast, company taxation presents the opposite result. It contributed 14.4% of total revenues and 6.4% of GDP in 2024, which was one of the highest in the European Union.

A tax system that derives more revenue from its more regressive parts, particularly indirect taxes, than from direct taxes while overall tax revenues rise much faster than economic growth presents a complex picture with several implications. It raises equity concerns. Regressive taxes take a larger percentage of income from lower-income households than from higher-income households. As the economy grows, the tax burden on lower-income households could increase disproportionately. This could exacerbate income inequality even as overall revenues rise. The progressivity or regressivity of the entire tax system requires careful analysis and corrective measures. In such a scenario, the specific design of indirect taxes, such as exemptions or lower rates for essential goods, becomes particularly important.

Fiscal drag occurs when inflation and income growth push taxpayers into higher income tax brackets, leading to an increase in tax revenue without any change in tax rates. This raises the overall tax burden, leaving individuals and households with less disposable income. Fiscal drag can also impact consumers through indirect taxes that are ad valorem, or proportional to price, which rises with inflation. Thus, consumers end up paying more taxes on their purchases, even if their purchasing power hasn’t improved, which reduces their disposable income. Fiscal drag on indirect taxes, such as value-added taxes, can subtly increase the tax burden on consumers, leading to higher living costs. In Cyprus, fiscal drag certainly accounts for a large portion of the high responsiveness of tax revenues to increases in nominal economic growth.

The question of whether a tax system taxes too much, or too little is not about the amount of revenue it raises in absolute terms or in relation to GDP. Rather, it is about the set of normative principles that define the characteristics of a good or efficient tax system, as discussed above. The tax system's high responsiveness to economic expansion, the presence of large amounts of fiscal drag, and sustained large surpluses suggest that it taxes a bit too much. While this served the purpose of reducing the debt ratio from 113% to 65%, likely under 60% by the end of the year, the same pace henceforth is contestable. Sustained large fiscal surpluses are not necessarily a net positive for an economy when they violate intergenerational fairness, as discussed earlier and when the underlying purpose weakens. Unduly burdening current generations for the benefit of future generations is just as unethical as doing the opposite: burdening future generations for the benefit of current ones. The former has surpluses; the latter has deficits. Void of purpose, both states are unfit.

A tax reform should correct these deficiencies in line with well-defined principles of taxation and best practices. However, the proposed reform does not meet these criteria and, in some respects, exacerbates the existing deficiencies. Corporate taxes need not rise for the small and medium sized companies that operate under more restrictive and more competitive conditions than their larger counterparts. Tax brackets for middle incomes remain unfairly narrow, and higher incomes benefit unduly from savings incentives. The new tax allowances as proposed are discriminatory against the principle of horizontal equity, and the poorest in society are totally neglected.

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