THE PROPOSED REFORMS OF THE CYPRUS TAX STRUCTURE: WHO REALLY BENEFITS?

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Abstract

This paper intends to highlight the main features of the revised Cyprus tax law and to provide some food for thought regarding its effects on households, businesses and society in general. The new tax laws will reduce the average tax rate of middle-income and upper-income earners. The low-income earners' average tax rate remains unchanged at zero per cent. The increase in the personal allowance will make income tax Jess progressive. The extent to which the increases in VAT and other indirect taxes will shift the burden of taxation from the better off to those worse off depends on the size of the benefits the government will give to low-income earners, the extent to which higher indirect taxes are passed on to consumers in the form of higher priced goods and services, as well as the price-elasticity of demand for both low- and high-income earners.

Introduction

The need for reform of the Cyprus tax system has been acknowledged for quite some time now. The new tax law aims to harmonise the tax system with the EU Code of Conduct, adopt the OECD regulations against harmful tax competition and discriminating practices, promote economic growth by reducing the tax burden on businesses, improve the government's finances, reduce tax evasion and promote social justice.

The government wants to make the tax system more efficient by making it more transparent and easier to administer. The new tax law reduces income tax and broadens the tax base while also abolishing exemptions, deductions, allowances and special rates as well as taxes not found in other OECD countries.[1]

At the same time the new tax law gradually increases VAT to at least 15% to satisfy the Sixth Community Directive of the EU (Source: Report from European Commission). The Cyprus government has promised it will do this by 1 January 2003 *(Phile/eftheros,* 11 November 2001).[2] Cyprus' preferential tax treatment of foreign companies (offshore businesses) will also end as the government has proposed to increase their corporate tax rates and introduce a common corporate tax rate for local and international businesses.

Most of the government's initial proposals were in line with the recommendations made by Professor Wolfgang Gassner of the Department of Austrian and International Tax Law of the Vienna University of Economics. Gassner headed a research team that conducted a study on the Cyprus tax structure on behalf of Deloitte & Touche (Cyprus) for the Cyprus government. The results were present at the conference, "Tax Aspects of Cyprus' Accession to the European Union", Nicosia, 20 June 2001.

This paper will consider whether or not the tax law will help to achieve the aforementioned objectives and to what extent. The first part will outline the recommendations made by Gassner. The second part will describe in detail the proposed tax reforms. The third part will consist of a series of questions the answers to which will suggest who will benefit the most from the proposed changes and who the least. Various examples of tax liabilities for various income level earners before and after the proposed tax reforms are calculated to show the decrease in progressivity. Other macroeconomic effects are also discussed.

The Proposals of the Vienna University of Economics

Wolfgang Gassner explained the aforementioned need for a substantial tax reform. The study proposes to abolish the defence contribution, eliminate stamp duties and to investigate the efficiency of municipal taxes. It suggests that a 40% reduction of the effective income tax burden on individuals would be possible. The personal allowance should be increased from 6000CYP to 12000CYP. The first 12000CYP of taxable income (12000-24000) should be taxed at 12% and all taxable income above 24000CYP should be taxed at 20%. All or almost all personal allowances should be eliminated. Grants should be given to families for their children. Withholding taxes should be introduced and strengthened to secure revenues from interest and royalties. A new single corporation tax rate should be introduced. The corporation tax plus withholding tax on dividends should add up to the equivalent of the maximum income tax rate. Withholding taxes on interest with a rate equal to the marginal income tax rate should be introduced. Regional incentives could be given to areas suffering from the Turkish invasion. Foreign companies should be exempt from withholding taxes on dividends, interest and royalties.

The Proposed Tax Reforms

The general theme of the new tax law is the reduction in direct taxes such as income tax and the increase in indirect taxes such as VAT. More specifically, the level of non-taxable income increasesfrom 6000 CYP to 9000 CYP; the first 3000 CYP of taxable income will be taxed at a marginal tax rate of 20%; the next 3000 CYP of taxable incomeat a basic rate of 30%; and the remaining income at a higher rate of 40%. (See Table 1.)

Table 1 The Current and New Personal Income Tax Brackets

THE CURRENT TAX BRACKETS		THE NEW TAX BRACKETS	
INCOME RANGE (CYP)	**TAX RATE**	**INCOME RANGE (CYP)**	**TAX RATE**
0-6000	**0%**	**0-9000**	**0%**
6001 - 9000	**20%**	**9001 -12000**	**20%**
9001 -12000	**30%**	**12001 - 15000**	**30%**
12001 and above	**40%**	**15000 and above**	**40%**

Tax Exemptions and Allowances

In its attempt to broaden the tax base and make the tax system more efficient, the new law abolishes most of the existing tax exemptions and allowances. More specifically, all of the following have been eliminated: tax exemptions and allowances for interest on mortgages (500CYP) and other purpose loans (100CYP); spouse (500CYP); rent for residence (300CYP); acquisition of first issue company shares; displaced persons (300 CYP); transport fare of rural buses; elderly people and children. The only allowances that will not be scrapped for the time being are pension, provident, health, social security and life insurance contributions as well as deposits at the Housing Finance Corporation.

Interest Income and the Defence Levy

A withholding tax for revenues from interest and royalties has been introduced to broaden the tax base. The defence levy on interest income rises from 3% to 10% and will be taxed at source. The Minister of Finance believes this measure will help reduce tax evasion since there is interest income not declared and which the Inland Revenue cannot find under the current laws.

The defence levy on all other forms of income will gradually be phased out as VAT increases. For instance, the temporary defence contribution of 2% levied on salaries currently paid by employees and pensioners will be scrapped starting 1 January 2003 but will remain in effect for the self employed and corporations at least for the near future. The 3% defence levy on rent and dividends will be abolished in 2003.

Corporate Taxation

Currently corporate tax rates levied on local businesses are 20% on the first 40000CYP of taxable income and 25% on taxable income *above* 40000CYP International companies (offshore companies) face a preferential rate of 4.25%. A new flat 10% corporate rate will be introduced for all companies. However, a withholding tax rate on dividends will also be levied. The government proposed a 15% rate to start but most opposition parties want it to be 20%. Employers' national insurance contributions will increase and the government's own contribution to the Social Security fund will decrease from 4% to 2%, i.e. become equal to that paid by employees.

As far as corporation taxes are concerned, foreign shareholders will be exempted from withholding tax on dividends. This change was one of the recommendations made by Wolfgang Gassner, who headed a team from the Vienna University of Economics which prepared a report on the "Tax Aspects of Cyprus' Accession to the European Union.[3]

Moreover, the government asked for, and has been partially granted, a grandfather clause exemption for its offshore companies. A grandfather clause allows countries to retain existing laws until they expire. Cyprus' offshore laws expire 2011. The EU recently informed George Vassiliou (the chief negotiator for the EU accession negotiations) and Finance Minister Takis Klerides that it will allow existing offshore companies to retain their preferential corporate tax rate of 4.25% until 2005. The government had asked for a nine-year grace period, i.e. until the current laws expired in 2011 but was granted only a three-year grace period.

Indirect Taxes

VAT which is currently 10% will be increased initially to 13% (as of 1 July 2002): and then to 15% as of 1 January 2003. However, the EU has accepted the government's request to allow basic necessities such as most types of food, certain types of medicine and medical tools to maintain their zero-rate until *five* years after Cyprus becomes a full member of the EU. The EU has also allowed VAT on restaurants to be taxed at the reduced rate of 5%. The government hopes that the EU will allow children's clothes and shoes to remain zero-rated. Certain transactions such as banking and insurance contributions are exempt from VAT. The basic difference between the zero rate and exemption is that firms that sell only exempt goods or services have no right to register for VAT and are not eligible to recover the tax paid on their purchases; firms that provide zero-rated goods an services are eligible to *recover* the tax paid by them.

Cyprus' VAT rates compare favourably with the rates of EU countries. (See Table 2.) Out of the 15 member countries, only Luxembourg has a normal rate of 15%. All other members have higher normal rates. Sweden and Denmark have the highest normal rate at 25%. Furthermore, only Portugal and the UK have a reduced rate of 5%. Out of all the EU countries only Ireland and the UK have a zero rate on most foodstuffs, children's clothes and shoes and medicine.

Other Indirect Taxes

The new tax law increases consumer and luxury taxes. Duty free exemptions will be abolished. Road tax and registration fees for some types of vehicles will increase. Tax on petrol will increase from 12.Scent/litre to 16.6cent/litre and 14.Scent/litre to 19.5cent/litre. Tax on diesel (oil) will increase from 2cent/litre to 14.2cent/litre to increase it to EU levels in order to raise the price of diesel to that of petrol. Tax on alcoholic drinks will increase from 1.19CYP/litre to 3.20CYP/litre. Taxes on tobacco will rise up to 57% of the retail selling price. Consumer tax on terrain vehicles will rise from 60% to 70% and on double cabin pickups from 10% to 20%. Van cars that are now exempt will be charged 10% and consumption tax on saloon cars will be reduced to a flat rate of 80% (now ranging 80-100%) on models up to 2000cc. Owners of vans, terrain vehicles and double-cabin pickups who essentially use these vehicles as saloons will face higher taxes. This will help reduce the unfair treatment of saloon car owners who have traditionally paid higher taxes.

Table 2 VAT RATES APPLIED IN THE EU STATES (Situation at 1 May 2002)

Member States	Super Reduced Rate	Reduced Rate	Standard Rate	Parking Rate
Belgium	-	6	21	12
Denmark	-	-	25	-
Germany	-	7	16	-
Greece	4	8	18	-
Spain	4	7	16	-
France	2.1	5.5	19.6	-
Ireland	4.3	12.5	21	12.5
Italy	4	10	20	-
Luxembourg	3	6	15	12
Netherlands	-	6	19	-
Austria	-	10 / 12	20	-
Portugal	-	5 / 12	17	-
Finland	-	8 / 17	22	-
Sweden	-	6 / 12	25	-
UK	-	5	17.5	-

Source: European Comm., Taxation & Customs Policy (freddy.de-buysscher@cec.eu.int)

Higher VAT revenues will be used to finance the reduction in taxes on income and eliminate taxes not found in other OECD countries such as the defence contribution. They will to provide more social benefits. The government will increase basic pensions and public benefits. It will also increa child benefits. The proposed annual payments to households for child support are as follows: 200CYP for one child; 500CYP for two children; 1200CYP for three children and an additional 400CYP for each additional child. The government intends to plough back 88mln CYP in social benefits (Klerides, 2001).

The Effects of the Proposed Reforms

Who will benefit the most and who the least from the reforms? Does the government's tax reform package favour the more affluent? Will the tax reforms lead to a fairer distribution of the tax burden? Will the tax package reduce administration costs and tax evasion and thus increase efficiency? Should tax allowances and exemptions be eliminated? How will the decrease in corporate tax rates affect local businesses? Will the increased corporate tax rate on offshore companies seriously reduce Cyprus' attractiveness as a centre to do business?

The Effects on Tax Progressiveness

Let us begin by looking at the changes in the personal income tax rates. The current marginal income tax rates of 20% (the lower rate) on the first 3000CYP of taxable income (6001-9000CYP), 30% (basic rate) on the next 3000CYP (9001- 12000CYP) and 40% on the remaining income (>12001GYP), with the first 6000CYP earned not taxable, make income tax progressive. A progressive tax system is one in which the proportion of one's income paid in tax rises as income rises. In other words, high-income earners pay a greater proportion of their income in taxes than do low income earners. This is in congruence with one of the fo canons of taxation that Adam Smith had presented in his book *An Enquiry into the Nature and Causes of the Wealth of Nations,* published in 1776, which states that taxes should be levied according to the ability to pay of the individual taxpayer. The greater the marginal tax rates at higher income levels, the more progressive the tax.[4]

The government's proposal aims to increase the level of personal allowance from 6000CYP to 9000CYP while maintaining the existing marginal tax rates although it initially stated that it wished to reduce the basic rate from 30% to 25% and the higher rate from 40% to 28%. This means that the first 9000CYP of income will not be taxed, and income earned above this level will be taxed at lower margin tax rates.[5] Hence, the first conclusion that can be made is that the income tax system will become less progressive.

Who will benefit from the reduced progressivity? About 25% of the employees (salary- and wage-earners combined) earn more than 12000CYP per annum. This group of employees is mainly comprised of legislators, managers, professionals and technicians (Labour Statistics, 2001). These high-income earners will benefit in two main ways. First, an additional 3000CYP of their income will not be taxed due to the increase in the personal allowance. Second, income between 9001CYP and 12000CYP will be taxed at a rate of 20% not 30% and income between 12001CYP and 15000CYP will be taxed at a rate of 30% not 40%.

About 39% of the employees earn between 6000CYP and 10000CYP.[6] These individuals will also benefit because their tax liability will dramatically fall. For many employees in this income range, the tax liability will become zero.

The Average Tax Rate

One may think that the increase in the level of personal allowance will help low income earners by reducing their tax liability. However, this is erroneous since individuals whose total incomes minus allowances is 6000CYP or less, currently do not pay taxes under the existing tax structure since their income does not exceed the tax threshold.[7] If one excludes the defence levy and professional tax, the average tax rate that they face is zero per cent.[8] The increase in the personal allowances to 9000CYP does not reduce their income tax liability and the average tax rate for these low-income earners remains at zero per cent. This is true even after accounting for the proposed elimination of most of the allowances that currently exist.

This point can be shown by calculating the tax liability of households before and after the proposed reforms. Let us consider a few examples.

Example No.1

Assume an unmarried individual earns a salary of 6500CYP.[9] Most females who hold clerical, service, agricultural, craft and unskilled jobs earn average salaries close to this level of income (Labour Statistics, 2001). This individual rents an apartment for 350CYP/month and pays over 100CYP in interest charges on personal loans. Her income level allows her a donations allowance of 60CYP. Assume she also has to pay a professional tax of 60CYP as well as the following: 360CYP life assurance premiums; S00CYP Provident Fund (5%); 150CYP Health; 410CYP Social Insurance. This individual's chargeable income is 4983CYP.[10] (Refer to Table 3.)

Under the current tax system, since the first 6000CYP of chargeable income is not taxed, the tax liability is zero. Of course, the individual pays 130CYP as a defence contribution (2% of 6500CYP) and professional tax of 60CYP. The average tax rate for this individual is 2.9% (or zero if the defence levy and professional tax are not counted).[11] Under the new tax law, this person would save 130CYP (or 190CYP if the professional tax is also abolished) and the average tax rate would fall to 2% (or zero). However, this person will face higher VAT, luxury taxes and petrol prices. Unlike the pensioner whose pension is index linked and whose main purchase items will remain zero-rated, this individual **may** become worse off.

Whether or not she will be worse off depends on the quantity and type of goods she consumes. Individuals earning 500CYP/month would fall into the third lowest income decile. Their mean annual consumption expenditure on services such as transport, hotels, cafes and restaurants, tobacco, alcoholic beverages, household appliances, and other luxury goods such as jewellery, package holidays, video recorders, concerts, etc., is about 25% (Family Budget Survey 1996/1997). The cost of tobacco, alcoholic beverages and transportation will increase due to the higher excise duties and VAT. So will she be worse off?

One must take into consideration that her nominal income will increase due the increase in COLA. Not everyone who earns 500CYP/month has the same consumption preferences. For instance, different age groups have different consumption patterns (FBS 1996/1997). If the CPI rises by less than the increase in the average cost of the basket of goods and services that the individual consumes, the rise in COLA will not fully compensate for the increases in indirect taxes. Furthermore, some individuals who are self-employed may not be able to increase their remuneration in line with the cost of living because the demand for the goods and services they sell is price inelastic hence discouraging them from increasing their prices by the full increase in costs of production that they will face.

Table 3 Unmarried Individual Earnings: 6500CYP/year

	CYP
Income	6500
Less: Rent	300
Interest on loans	100
Donations	60
Professional Tax	60
Life Assurance Premiums	360
Provident Fund	500
Social Insurance Contributions	450
Health Fund	150

Table 4 Unmarried Individual Earnings: 10000CYP/year

	CYP
Income	10000
Less: Rent	300
Interest	100
Donations	100
Professional Tax	100
Life Assurance Premiums	360
Provident Fund	500
Social Insurance Contributions	630
Health Fund	150

The total allowance permitted for contributions to the medical, pension, provident and social insurance fund plus the life assurance premium cannot exceed one sixth of the income after the other allowances have been deducted. In Table 3, only 997CYP [i.e. one sixth of (6500CYP-520CYP)] will be deducted from (6500CYP-520CYP) resulting in a chargeable income of 4983CYP.

Example No. 2 (Refer to Table 4.)

Now consider an unmarried individual who earns a salary of 10000CYP (about 769CYP per month). She also rents an apartment for 400CYP; pays a higher professional tax and is permitted an allowance of 100CYP for donations. She also pays more social insurance due to her higher income. Her permitted allowances are 600CYP plus one sixth of (10000CYP-600CYP). This equals 2167CYP resulting in a taxable income of 7833CYP. Subtracting the personal allowance of 6000CYP, results in 1833CYP being taxed at 20% yielding a tax liability of 366.60CYP. Adding the defence contribution of 200CYP (2% of 10000CYP) and the 100CYP professional tax results in a total tax liability of 667CYP and an average tax rate of 6.67%.

Under the new tax law this individual would not pay tax.[12] Her average tax rate would be zero per cent. Her net gain will be 566.60CYP (plus 100CYP if professional taxes are abolished) that must be compared against the increase in VAT, luxury taxes and petrol prices.

Example No. 3

In this example, a married person whose spouse does not work and has two children, earns 10O00CYP per year and owns a house with interest charges of 1200CYP on the mortgage. Assume all other contributions and allowances are the same as in Example No.2. In this case, there will be an additional allowance of 500CYP for the spouse, 1000CYP for the two children (500CYP each), and 500CYP for interest paid on the mortgage. After subtracting all permitted allowances, chargeable income is calculated to be 6417CYP. Subtracting the 6000CYP personal allowance yields 417CYP that would be taxed at 20%. The income tax liability would be 83CYP. The average tax rate without considering the defence levy and professional tax would be 0.83%. If they are considered, the average tax rate would be 3.83%. Under the proposed reforms, this person would not pay any tax and the average tax rate would fall to zero per cent.[13] There would be a nominal net gain for this household of 283CYP.

Similar calculations for households in which both spouses work and earn even larger gross incomes reveals that the progressivity of the income tax system will decrease.

Efficiency

Whereas the increase in the personal allowance helps to reduce the tax burden for middle- and high-income earners, the elimination of most allowances and exemptions tends to mitigate this beneficial impact. However, the latter will make the tax system more efficient by reducing administrative costs. In general, the reduction of direct taxes and the increase in indirect taxes will help to make the tax system more efficient. This is because direct taxes are easier to evade and more costly to administer. Indirect taxes are collected by the businesses for the government and are therefore less costly to administer and collect.

Another measure that the government proposes in its attempt to decrease administration costs and increase efficiency is the elimination of all income tax return statements of public sector workers with income below a certain level and at a later stage of all workers. This will allow the Internal Revenue Department to use less resources, equipment and space, and pay less wages and salaries. The savings are estimated to be up to 40% of existing expenses.

Interest Income

The government's reforms with respect to interest income will have a mix effect. On the one hand, the defence levy on all forms of income except interest and royalties will be gradually phased out. This means that employees, pensioners and eventually employers will not have to pay the 2% levy. Theoretically, this should have a positive effect on spending and employment. However, the defence levy on interest income will rise from 3% to 10%. This will discourage savings. It will also affect pensioners who have saved money during their whole lives for thei, retirement. This may be considered unfair. To reduce these negative effects the government could allow a certain level of interest income, for instance, 1000-2000CYP to be tax exempt. A mechanism will need to be introduced to exempt from the 10% defence levy, interest income that is less than the non-taxable level.

What is the EU practice on interest income? In Sweden, the banks and Securities Register Centre withhold and deliver preliminary tax to the tax authorities. In Ireland, interest earned on sight or term deposits is deducted source at a rate of 20%. Taxpayers may opt to include interest earned from sight or term deposits in their taxable income which would be taxed according to ti individual's income band.[14] In such cases, the tax deducted at source is credited against the final amount of tax due, and any overpayments are reimbursed. In the UK, interest from investment in individual savings accounts, the National Savings Certificates, and the first GBP 70 interest on ordinary accounts with the Natior Savings Bank are exempt from taxation.

The Inflationary Effects

In the meantime, higher VAT and excise duties will eventually lead to higher price levels (Pechman, 1985). Lower income groups will have to pay higher indirect taxes. This is true even when basic necessities remain zero-rated. For instance, higher taxes on petrol and diesel will result in higher transportation costs. Low- income earners will have to spend a greater proportion of their income on commuting to work and travelling in general. They may also have to face higher prices for other goods and services as firms pass on the higher transportation costs to the consumers in the form of higher prices. As prices rise, COLA will rise contributing even further to higher labour costs which may result in a wage-price spiral.

In 1979 the UK government increased VAT from 8% to 15%. This 7% increase in VAT contributed to an estimated 5% increase in the RPI (Anderton, 1995). In Cyprus, VAT of 5% was introduced on 1 July 1992. Inflation in 1992 was 6.5% compared to 5% in 1991. The rise in inflation was the result of three factors: strong demand fuelled by an accommodating monetary policy, food shortages due to adverse weather conditions and the introduction of VAT *(Economic Review,* Popular Bank, 1992). In October 1993, VAT was increased from 5% to 8%. This increase contributed to the inflation rates of 4.9% in 1993 and 4.7% in 1994 (Bulletin, Bank of Cyprus, 1994).

In the second half of 1999, excise duties were increased on a number of items. From 1 July 2000, the VAT rate was also increased from 8% to 10%. These changes contributed to the upward pressures on prices during 2000 that led to an inflation rate of 4.1% compared to 1.7% in 1999. However, at that time there were also sharp rises in the prices of energy imports (mainly oil), persistent drought conditions and an appreciation of the US Dollar and the Pound Sterling against the Cyprus Pound. All these factors also had inflationary effects. Wage inflation in 2000 was about 7%. This was partly a result of higher excise duties in 1999 as well as higher VAT in 2000 although the main causes were the higher prices of oil, agricultural products and utility bills which resulted in higher wage demands and a higher COLA (Central Bank of Cyprus, Annual Report, 2000).

Similarly, the proposed higher taxes on alcohol and tobacco will increase the retail prices of these goods. Low-income earners, including pensioners, whose price elasticity of demand for such products is low due to addiction, will pay a greater proportion of their income on consumption of these goods after the increases in tax. These examples show that the main effect of the increase in indirect taxes will be to make the tax system more regressive for low-income earners given that they will not be able to benefit from the increase in the level of personal allowance. A regressive tax system is one in which the proportion of income paid in taxes rises as income falls. In other words, low-income earners a greater proportion of their income in taxes than do high-income earners. Moreover, even those individuals who currently earn incomes slightly above the tax threshold and will benefit from the increase in personal allowance to 9000CYP eventually will have to pay income taxes as the increase in VAT will increase the general level of prices (i.e. inflation) and the Cost Of Living Allowance (COLA) which will lead to higher nominal wages and salaries. I believe that one of the reasons that the personal allowance will be increased to 10000CYP starting 1 January 2004 is to offset this effect.

Indirect Taxes and Distributional Effects

So is the tax package socially unfair? Does it give generously to the high-income earners in the form of tax breaks but impose a greater burden on low-income earners and pensioners? The perception that VAT is regressive has been questioned by researchers who have conducted tax incidence analyses using a consumption measure to proxy for lifetime income (e.g. Poterba, 1989, 1991; and Metcalf, 1994). They have found considerably less regressivity of consumption taxes. Caspersen and Metcalf have found "that over the life cycle, a VAT looks substantially less regressive than when viewed in the context of a single year. In contrast, when current consumption is used as a proxy for lifetime income, the tax is by definition proportional. When food, housing, and medical expenditures are zero rated, the VAT looks somewhat less regressive in the lifetime income analysis. If current consumption is used to measure economic welfare, the VAT now looks mildly progressive" (Caspersen and Metcalf, 1994). This is partly why the Minister of Finance is arguing that the increase in VAT is progressive because goods that form a large part of low-income earners' budgets, such as food and medicine, are zero-rated. The extent to which this argument holds depends, in part, on how much the government will increase pensions and other grants such as the annual payments to households for child support. Of course, low-income earners who are not pensioners or who do not have children will not benefit unless the government makes a cash payment directly to those who are below the minimum tax bracket. However, as mentioned earlier the regressive effects of the tax changes will come about by the increase in excise duties on the one hand and the cost-push inflation effect of both higher VAT and excise duties on the other. Assuming that the aforementioned progressive effect of the zero-rated VAT system is outweighed by the above regressive effects, one may argue that the lower direct taxes will benefit mainly higher income groups (such as individuals who earn about 800CYP/month and the higher indirect taxes will hit more the low income groups, thus redistributing income and wealth from the poor to the rich!

In the UK, the regressivity of VAT, excise duties and other indirect taxes is revealed by the fact that the bottom fifth of households paid 30% of their income in indirect taxes compared to only 16% for the top fifth of households in 1994-1995, 1995-1996, and 1996-1997 (Social Trends, 1997-1999, Office for National Statistics, UK).

Another distributional effect arises from tax evasion. High-income earners have a greater incentive to evade taxes than lower income earners because they face higher marginal tax rates on income. To the degree to which high income earners do evade taxes proportionately more than low-income earners, the latter subsidise the more affluent. One way of reducing this injustice is to levy more indirect taxes that are more difficult to evade and reduce direct taxes.

In Cyprus, this injustice is not likely to be that large because a considerable proportion of high-income earners (e.g. doctors and teachers) work in the public sector and their income tax is collected via the PAYE system thus reducing considerably the amount of tax evasion. In this way, high-income public sector workers subsidise the high income earning self-employed.

Effects on Aggregate Demand and Aggregate Supply

However, there are potentially beneficial effects from the above changes. For instance, a higher personal allowance will increase household's disposable income and hence its purchasing power.[15] This in turn will help increase aggregate consumption and aggregate demand. Higher aggregate demand will in turn lead to greater output, more employment, more national income which in turn will create a multiplier effect leading to more consumption and demand. The increased consumption will encourage businesses to invest and produce more. Investment and business activity will also increase because of the reduction in the corporate tax rate from 20% and 25% to 10%. Higher profits due to greater sales and lower corporate taxation will allow businesses to retain more profits for reinvestment and to modernise production methods to prepare for the increased competitive environment that they will face as Cyprus joins the EU. Higher levels of investment will lead to an increase in aggregate supply in the long run, expanding the country's productive potential and economic growth. Higher profits may also result in higher dividends and increased share prices on the CSE.

On the other hand, higher National Insurance contributions by employers will increase the cost to firms of employing workers. This will have a negative effect on businesses' profits and perhaps employment. Furthermore, although the new corporate tax rate will be 10%, the effective corporation tax rate will be higher because of the withholding tax on dividends.

The government's original proposal was to lower the tax rate to 10% with 70% the remaining profits deemed for dividends and charged at a tax rate of 15%. For instance, if a company makes profits of 50000CYP it will have to pay 10% of this (i.e. 5000CYP) in corporate taxes. Seventy per cent of the remaining profits (i.e. 70% of 45000CYP) will be deemed for dividend and charged at a rate of 15%. The firm will have to pay an additional tax of 4725CYP (i.e.15% of 31500CYP). The total tax paid would be 9725CYP resulting in an effective corporate tax rate of 19.45%. If the deemed dividend rate were 20%, the effective corporate tax rate would be 22.6%. It is clear that the extent to which there will be beneficial effects for businesses, their shareholders and the economy depends on the deemed dividend rate that will be set. If there is to be any real boost to firms and the economy the reduced corporate tax rate of 10% should not be mitigated by a deemed dividend of over 13%.

The corporate tax rate of 10% will negatively affect offshore businesses. Their profits will be reduced and even though a 10% corporate tax rate is relatively low, nevertheless, some international businesses may relocate their businesses to other countries which may *levy* slightly higher corporate tax rates but offer other advantages such as closer proximity to markets, lower transportation costs and less political uncertainty. One study estimates that capital flows in Cyprus associated with Russian offshore companies will decrease by about 40%.

Effects on Incentives to Work

One of the arguments against high levels of income taxes is that they act as a disincentive to work. Lower marginal tax rates on income, make work more attractive by increasing the opportunity cost of leisure. Hence, individuals choose to substitute work for leisure. Lower marginal tax rates may encourage workers to work more hours per day or week. They may also encourage older workers to postpone retirement and other people (such as housekeepers) to enter the workforce. This should increase the supply of labour and help firms to fill their job vacancies.[16]

Critics of this view (e.g. Owens, 1988; and Dilnot and Kell, 1988) argue that the impact of a tax cut on incentives is small and of uncertain direction. Studies show that decreases in tax rates lead some people to work more but others to work less. Those who work more do so because the opportunity cost of leisure increases. Those who work less do so because the higher after-tax pay increases their ability to satisfy their wants even though they work fewer hours.

"A number of studies have been completed discussing the link between income tax cuts and incentives to work. For instance, Brown and Dawson (1969) surveyed all the studies published between 1947 and 1968 in the UK and USA making links between tax rates and hours worked. They found that high taxation acted as a disincentive to working longer hours (income < substitution effect) for between 5 and 15% of the population. These workers were mainly people who could choose to vary their hours of work relatively easily - the wealthy, rural workers, the middle aged and those without families. On the other hand, a smaller group of people tended to increase their hours of work when taxes were higher. These were typically part of large families, young, less well-off urban dwellers. For over 70%, higher taxes had no effect on work incentives.

In a 1988 study (Brown, 1988) it was found that the substantial increases in tax allowances in the 1988 UK Budget only increased the number of hours worked in the economy by 0.5%. The cut in the basic rate of tax had no effect at all on hours worked whilst the massive cut in the top rate of tax from 60% to 40% only had a small effect in stimulating extra hours of work by the rich" (Anderton, 1995).

Thus from the above we can say that the originally proposed cuts in the marginal income tax rates would have a positive effect on work if the positive substitution effect of the tax cuts outweighed the negative income effect. Individuals would choose to work more if the additional real disposable income from the tax cuts were less than the increase in the cost of living resulting from the higher VAT and excise duties.

I believe that the government and political parties will be making a big mistake if they do not reduce the basic and higher marginal income tax rates as was originally stated and also recommended by Wolfgang Gassner. The increased disposable income would have generated additional consumption expenditure which in turn would increase the government's revenues from indirect taxes (offsetting the loss in income tax due to the lower marginal tax rates) as well as create more demand for goods and services and therefore labour. This in turn would increase employment and hours of work, which in turn would increase the government's revenues from income taxes. The government would also collect more corporate taxes as firms sold more goods, and earned more revenues and profits.

Environmental Effects

The price of leaded petrol and diesel will rise due to the higher duties levied on them. This will create an incentive over time for people to switch to cars that run on unleaded petrol. This will help reduce the consumption of leaded petrol and diesel and thus the negative effects on the environment. Negative externalities will be partly internalised thus reducing the inefficiency caused by spill-over effects. However, the demand for petrol is price inelastic particularly in the short run so it will take some time for these effects to set in. Finally, these effects must be compared to the distortions created in other areas of the economy due to higher indirect taxes, transportation costs and prices.

Conclusion

The new tax law will benefit the rich and middle class more than the low-income earners. *Overall,* the tax reform is a large step in the right direction. This is because the tax system will become simpler and more efficient. Tax evasion will decrease. Businesses will benefit from the lower corporation taxes. People may have a greater incentive to work. Economic growth should be stimulated. On the other hand, the tax system will become less progressive. Poor people will be negatively affected. Their standard of living will depend on the size of the social benefits provided by the government. Finally, whether the personal allowance should rise to 10000CYP and not 9000CYP does not have to be an issue. In the UK, every March, which is the Budget month, the Chancellor announces changes in the personal allowances as well as the marginal tax rates. Although the UK governments have a majority in Parliament which allows them to easily make changes every year, the time has come where annual alterations to direct taxes should be implemented when economic and demographic conditions change. In this way, taxation policy can be further used as a discretionary fiscal tool. Up to now the Ministry of Finance has rarely altered direct taxes and mainly changes indirect taxes to accompany its discretionary government spending policy. In essence, ti direct taxes act mainly as automatic stabilisers. This reduces the potential for more effective discretionary fiscal policy.

Notes

1. In the government's initial tax reform proposals, the marginal tax rates on income were to be reduced; from 40% to 28% and from 30% to 25%.

2. The 2003 deadline was reiterated by the Minister of Finance, Mr Takis Klerides, at a daily conference (on the new tax law) organised by the Association of Certified Accountants the Inland Revenue Authorities and the Cyprus Chamber of Commerce and Trade.

3. The research was done on behalf of Deloitte & Touche in Cyprus for the Cyprus government and the findings were presented at a conference in Nicosia, 20 June 2001.

4. Whether one agrees or not with this canon of taxation largely depends on his income level. This is a normative issue. Poor people and low-income earners support this view. On

the other hand, many high-income earners feel that it is unfair that they bear such a disproportionately larger burden of tax. Their argument is that their hard work and entrepreneurial activities are rewarded by the government with the 'privilege' of supporting: (a) those who are voluntarily unemployed; {b) those who have not taken the risks involved in business ventures; and (c) those who have not spent time and money on education and training to increase their human capital.

5. In reality, the level of non-taxable income is greater than the personal allowance because of other allowances that currently exist for spouse, children, the elderly, rent for residence, deposits at the Housing Finance Corporation, acquisition of first issue company shares, interest on loans for residence and other purposes, displaced persons, transport fare of rural buses, subscriptions, donations, life assurance premiums, pension, provident, health and social insurance contributions.

6. I have chosen the 10000CYP level to account for life assurance premiums, social security contributions and provident fund contributions that reduce an individual's taxable income.

7. The tax threshold is the total value of allowances that one is entitled to. The level of income earned over the tax threshold is called the taxable income.

8. The average tax rate is calculated by dividing the total income tax paid by the income before tax.

9. This assumes that the individual earns 500CYP/month and earns a 13th salary.

10. Chargeable income is calculated by subtracting from Gross Income the rent paid (maximum 300CYP); interest paid on loans (maximum 100CYP for non residence loans); 60CYP paid for subscriptions (the allowance for income levels between 5001 and 7500CYP); 60CYP for Professional Tax as well as the other contributions. However, the total allowance permitted for contributions to the medical, pension, provident and social insurance fund, as well as the annual life assurance premium cannot exceed one sixth of the income after the other allowances have been deducted. In this example, the contributions to the medical, provident and to Social Insurance plus life assurance premiums total 1420CYP but only 997CYP (which is one sixth of 6500-520) will be deducted from the 5980CYP giving us a chargeable income of 4983CYP.

11. The average tax rates calculated throughout this paper do not take into account the levels of tax evasion. If there were no tax evasion and individuals declared all their income for tax purposes, taxable income and tax liabilities would be greater, increasing the average tax rates.

12. Under the tax reform, the only allowances that will not be abolished will be contributions to provident, social insurance, and health funds, life assurance premiums and deposits at the Housing Finance Corporation. Assuming these will still not be allowed to exceed one sixth of income, these allowances will total 1567 for Example 2. Since 8433CYP

is less than the 9000CYP personal allowance that the government is proposing, this individual will not pay income tax.

13. Total permitted allowances would be 3583CYP that is calculated by adding 1283CYP (i.e. one sixth of 10000-2300CYP) to the other allowances (2300CYP). Subtracting this amount from the person's gross income yields 6417CYP that is less than the proposed personal allowance of 9000CYP.

14. Individuals earning up to 4100.12 euros face a marginal tax rate of 12% and those earning between 4100.12 and 6201.42 euros face a marginal tax rate of 14%.

15. The rise in real disposable income will of course depend on how much the CPI will rise due to the higher indirect taxes. If there is no growth in real income, individuals' purchasing power, on average, will not be higher.

16. Older workers and housekeepers who choose to look for work may end up taking jobs that younger workers could have filled. This may increase unemployment amongst people under 25.

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