Proper Taxation Policy for Enhanced Competitiveness: The Case of a Micro Economy

Rekabet Edebilirliği Artırmak için Uygun Vergi Politikaları: Mikro Ekonomi Örneği

Mustafa Besim

Abstract

This paper evaluates Turkish Cypriot taxation policies and structure using a comprehensive approach, with a view to identifying problems and recommending changes to the tax structure that will improve the competitiveness of the economy. The analysis both at the macro as well as micro level proves that there is a need for fundamental changes to the system. The primary data gathered by both households and businesses surveys about taxation clearly indicate that the perception of tax payers call for reforms in taxation policies. Based on the findings from the analysis and keeping the principles identified in the literature review, the study puts forward set of policy measures that can be practically implemented and that will increase the certainty and simplicity of the system for businesses. This paper also argues that proposed tax policy reforms will lead to significant improvement in growth, productivity and overall competitiveness of the economy.

Keywords: *Taxation, productivity, competitiveness*

JEL Classification: H21, H30

Özet

Bu çalışmada Kuzey Kıbrıs'ta uygulanan vergi politikaları ve yapısı rekabet edebilirlik açısından kapsamlı bir yaklaşım izlenerek değerlendirilmiş, sorunlar tespit edilerek çözüm önerileri bir bütünlük içerisinde sunulmuştur. Gerek makro, gerekse mikro temelli analiz yöntem sonuçları vergi sisteminde yapısal değişikliğe gidilmesi gerekliliğini göstermektedir. Hane halkı ve işletmelere yönelik gerçekleştirilen anketlerden elde edilen birincil veriler, ülkede vergi politikalarında reforma gidilmesi yönünde talebin yüksek olduğunu ortaya koymuştur. Yapılan tespitler ışığında, literatürden de yararlanılarak vergi sisteminin işletmeler ve bireyler için daha anlaşılır, basit ve çalışır kılacak pratikte kolay uygulanabilecek reform önerileri sunulmuştur. Çalışmada ayrıca, yapılan politika önerilerinin ekonomik büyüme, verimlilik ve ekonominin genel rekabet edebilirliğinin iyileşmesine de önemli derecede katkı sağlayacağı savunulmaktadır.

Anahtar Kelimeler: *Vergi, verimlilik, rekabet edebilirlik*

JEL Sınıflandırması: H21, H3

Introduction

The objective of this paper is to evaluate Turkish Cypriot (T/C) taxation policies and structure. It will use a comprehensive approach, with a view to identifying problems and recommending changes to the tax structure and development process that will improve the competitiveness of the T/C economy.

In today's globalized world, when economic development policies are being planned, one has to look at each economy's competitiveness though the lens of the global marketplace. The recent Competitiveness Report on the T/C economy 2012-13 prepared by the Turkish Cypriot Chamber of Commerce (TCCC, 2013) using World Economic Forum (WEF) methodology indicates that the T/C economy is faced with many problems and ranks quite low among the 130 economies listed by the WEF. According to the report, many factors and constraints led to low productivity and weak performance. Among them are: small market size, access to financing, inefficient public sector, inappropriate tax policies and labor market problems. Based on the findings of the Competitiveness Report, this research intends to look into the role of tax policy (tax rates and regulations) in relation to the competitiveness of T/C economy.

The paper will commence by outlining the importance of taxation policy in economic development. The study will then summarize the literature on taxation in relation to competitiveness. Based on the main findings, the paper will analyze the T/C taxation system both at the macro and micro level, with the objective of identifying the main problems. This will be followed by an evaluation of the survey on taxation that has been carried out among households and businesses. Based on the analysis made, a set of policy measures will be outlined which it is believed will improve the quality of taxation and ultimately contribute to the competitiveness of the T/C economy.

Importance of Taxation Policies

In very general terms, the objective of tax policy is to create a tax system that is capable of financing the necessary level of public spending in the most efficient and equitable way possible. According to Tanzi and Zee (2000), especially in developing economies aiming to become part of the international economy, tax policy must play a sensitive role. In this respect, tax system should:

1. Raise enough revenues to finance essential expenditures without recourse to excess public sector borrowing;
2. Raise the revenues in ways that are equitable and that minimize its disincentive effects on economic activities; and,
3. Not deviate a great deal from international norms.

It is essential that the tax system is attractive to competitive national and international businesses. This can only be achieved if the present and the future demands of society, and more specifically businesses, are comprehensively taken into consideration.

In the context of global competition, this means that taxation policies should discourage businesses from undertaking economic activity at home, rather than abroad; they should encourage companies to raise productivity and therefore relative competitiveness by reinvesting profits; and they should encourage the right mix of debt and equity financing so as not to create distortions. Tax policies should promote entrepreneurial activity (the creation of new businesses and risk-taking for reward) and encourage individuals, especially women, to enter and stay in the labor force. As regards the future demands of society, the taxation system should also encourage individuals to save in order to address the future demographic challenges of an ageing population.

In principle, the tax system should be fair, simple and transparent. The criteria of simplicity and transparency entail that the system must reduce the number of different types of tax and simplify the structure of the types of tax. This in return will help both natural as well as legal persons to comprehend the regime more easily. Furthermore, the cost of declaring taxes will be reduced and the efficiency of administration will improve. Eventually this will mean a lower tax burden both on the individual as well as businesses.

Literature Review on Taxation Policy for Enhanced Competitiveness

According to economic theory, taxation affects the rational decisions made by both individuals and corporations, which in turn determines the impact of any individual form of tax on economic performance. At the enterprise level taxation affects decisions about investment, which in turn affects productivity. It also affects decisions about employment levels. At the personal level, taxation affects decisions about savings and expenditure, as well as the decision to participate in the labor force. All of these determine how effective taxation policy is in raising competitiveness. The study shall now review some of the literature in order to answer the following questions:

- What taxation policy would best to contribute to the competitiveness of the economy?
- What taxation policies can best support corporations and encourage them to be more productive?
- What taxation policies would support employment and also increase the per capita production of the economy in general?

The main theoretical model for the impact of taxation on decisions by economic agents was developed from Tobin's q investment theory (Tobin, 1969), in which investment decisions are affected by the market value of investment (V) and the replacement cost of that investment (K). If the market value exceeds the replacement cost, then it is rational to invest (Talpos, 2009). A development of this theory focus on the marginal q: that "a firm will purchase new capital when the marginal benefit exceeds the marginal cost" (Myles 2009: 31). Since corporate taxation affects the marginal benefit of investment, it will also affect the decision to invest. This theory is borne out by recent empirical evidence, in which it was found that corporate taxes reduce investment by increasing the use of cost of capital. Taxation will also have an impact on whether firms choose debt or equity for financing (Vartia, 2008).

In the context of T/C economy, it is also worth mentioning the theory on tax evasion. As stated by Gutmann "higher and higher taxes drive more and more of the economy underground, beyond the reach of the tax collector." (1977: 5). Later studies found that high corporate tax evasion can be linked with high personal tax evasion (Goerke, 2006).

The abovementioned study by Vartia also analyzed the impact of various forms of taxation on total factor productivity (TFP), which in turn affects relative competitiveness. Vartia's paper found new evidence that both personal and corporate income tax have a negative effect on productivity. The negative impact of statutory corporate tax rate on TFP was bigger in industries that are characterized by high profitability.

The same study found that high top personal income tax rates had a negative impact on TFP "working through the channel of entrepreneurial activity (as measured by firm entry rates)" by reducing the incentives for entrepreneurial activity. This was particularly true in industries where there is already a high level of entrepreneurial activity. Vartia (2008) also noted that the impact of top marginal tax rates was higher in countries with a heavy regulatory burden. This could be relevant for the T/C economy as it gradually harmonizes regulations with those of the EU.

Vartia (2008) found a modest positive impact of tax incentives for research and development on long-run productivity. She also found that social security contributions also have a negative effect on total factor productivity, especially for labor-intensive industries. A significant proportion of the literature on the impact of taxation relates to the relationship between taxation policies and economic growth. Since economic growth has a positive effect both on macroeconomic stability and market size—two of World Economic Forum (WEF) criteria for measuring competitiveness—and since the WEF defines competitiveness as "the ability of the country to achieve sustained high rates of growth in GDP per capita", it is worth examining some of the main empirical findings of recent taxation and growth literature. One of the most important recent findings was Arnold (2008: 6), who found that a "stronger reliance on incomes taxes seems to be associated with significantly lower levels of GDP per capita than the use of taxes on consumption and property" and that "within income taxes, those on corporate income seem to be associated with lower levels of GDP per capita than personal income taxes". Property taxes, particularly recurrent taxes on immovable property, appeared to be associated with the highest levels of GDP per capita. This ranking of growth friendliness was robust to a number of sensitivity checks. There was also evidence that the progressivity of personal income tax was negatively related to growth. These findings were supported by Myles (2009), who also found that labor supply is sensitive to taxation, especially for women with young children. There is also some evidence that corporate tax needs to be below the "Laffer curve", the optimal rate for revenue maximization, in order to stimulate growth (Mintz, 2007). Finally, there is evidence to suggest that the level of taxation has a stronger impact on lower and middle income countries than higher income countries (Talpos, 2009), a factor which will be important in assessing the best policy mix for the T/C economy. Given the above findings, as well as the need for a simple tax system and the need to compete globally, a thorough review of T/C taxation policy is needed in order to best position the economy for growth and economic competitiveness.

Taxation System in the T/C Economy: Analysis for Competitiveness

Macro Level Tax Analysis for Competitiveness

Analyzing taxation at the macro level is essential for understanding both the sources of revenues and the dynamics of taxation in factor and product markets. The latter is more relevant for the focus of this paper as it has a direct link with competitiveness. Governments' taxation policies influence the behavior of owners of factors of production in the markets to a great extent. Taxes on labor, capital and other resources play a significant role in determining allocation and how effective these resources are used. Since the degree of effectiveness and efficiency in the use of resources determines productivity in economies, taxation has a direct effect on productivity, which in turn constitutes the foundation of competitiveness.

There is therefore a need to analyze taxation at the macro level in order to determine whether the taxation policies of the T/C economy support effective resource allocation and productivity. This part of the paper overviews taxation at the macro level to determine whether or not current taxation policies contribute to the competitiveness.

Overview of the Taxation System in the Turkish Cypriot Economy

In terms of income tax mix, Personal Income Tax (PIT) for individuals and Corporate Income Tax (CIT) for companies constitute most of the direct taxation in the T/C economy. The CIT is partially integrated with PIT system. There is also a withholding tax on rental incomes. In addition, at both the individual and the firm level, there are social security contributions that are quite substantial. Indirect taxes such as Value Added Tax (VAT) were introduced in 1996. A range of excise taxes, defined by law as the "price stability fund", continues to be an important source of revenue.

Table 1 shows revenues by type of tax from 2006 to 2011, revenues as a share of total revenues and as a share of GNP in 2011. The numbers indicate that the T/C economy rises as much as 31 per cent of GNP in public revenues. Out of this 31 per cent, 22 per cent constitutes both direct and indirect taxation, 6 percent fund revenues and the remaining 3 per cent other revenues. At first sight, a revenue ratio of 22 per cent of GNP, in other words a 22 per cent tax burden on the Turkish Cypriots, may look low. However, when we include "fund revenues", which are technically applied like excise taxes mainly levied on petroleum, motor vehicles and tobacco etc., the burden rises and reaches 31 per cent.

This level is arguably a reasonable tax burden for an economy that has around 13,000US$ per capita income according to official statistics (SPO, 2012). It should also be noted that the social security contributions and provident fund contribution (not stated in Table 1), which are paid especially by the private sector employees, increase this burden to 35 per cent and makes the T/C economy one of the higher-taxed developing economies.

PIT and CIT constitute most of the direct taxation and account for 35 per cent of the total revenues. At the same time, indirect taxation together with fund revenues (arguably an indirect tax) makes up 61 per cent of revenues. This fact shows that T/C public finances are more dependent on indirect taxation than direct taxation. This imbalance obviously has some fiscal risks for the budget and negative implications for resource allocation in the market.

Economies that depend more on indirect taxation for financing their expenditures are liable to face immediate liquidity problems during an economic downturn. Reduction in demand leads to immediate contraction in tax revenues such as VAT and fund revenues that have been defined as excise tax. As Table 1 shows, there has been a decline both in VAT and fund revenues in 2008 and 2009 (especially when numbers are considered in real terms), in parallel with the contraction of real GNP growth of 2,9 per cent and 5,5 per cent respectively in those years. Yet in same years PIT and CIT indicated a more stable trend. This indicates that the T/C Administration should improve direct taxation in order to minimize the liquidity risk that arises during downturns. The share of indirect taxation and direct taxation should be close to each other, each being 50 per cent of total tax revenues (excluding social security contributions). In the EU-27, for example, the share of indirection taxation, direct taxation and social security contributions is 37.6 per cent 32,4 per cent and 30.2 per cent, respectively (Eurostat, 2010).

Although empirical research suggests that too high a level of direct taxation can also be harmful, it is clear that there is scope in the T/C economy for widening the tax base considerably. Different studies indicate that in the T/C economy there are deficiencies not only in the administration of taxation but also with the rates and the tax structures. For example, the findings of Besim and Jenkins (2006) and Besim (2000) confirm that there is a significant amount of income that is not taxed. The same papers indicate that the total untaxed income is above 50 per cent of GNP. This huge amount of tax evasion is not only the result of bad tax administration and problems with the enforcement of laws but also due to high statutory tax rates for income. A report prepared by the World Bank experts states that "personal income tax rates are very high" (The World Bank Report, 2006: 21). As studied in more detail in the section about the personal income tax, high tax rates drive most of the private sector to evade or avoid paying these high taxes. According to tax officials, out of nearly 30,000 registered companies, only 4,000-5,000 companies filed for tax in 2010. This creates unfair competition in the market. Those registered and declaring their incomes properly will have a higher unit cost of production than those who do not declare or who under-declare with unregistered employees. Because of this, competition is not protected in the market and resources are not allocated effectively.

Budget Balance and Competitiveness

Competitiveness is a phenomenon that also indicates how well resources are used. The degree of effectiveness and efficiency in the utilization of resources very much depends on market conditions. If the main institutions of an economy function well, resource allocation will be more effective and productivity will be higher.

In addition to domestic tax revenues of over 30 per cent of GNP, aid and grants from Turkey for infrastructural projects raise the revenues to 35-40 per cent of GNP for the years 2003-2011 (Table 1). Although there is a significant amount of tax evasion, with the transfers from Turkey, T/C public finances generate revenues that are similar to a middle-income developing country. For example, the EU27 average total tax burden, including social security contributions, was 39.3 per cent of GDP in 2008 (Eurostat, 2010). Considering the fact that there exists a significant amount of unrecorded income, one argument would be that if the authorities succeed in getting the unrecorded activities in to the system, the T/C economy would be tax buoyant[1]. Taxing incomes that are not taxed and registering labor in the system would enhance both budgetary balances as well as contribute to the elimination of social deficit.

Table 1. Composition of Revenue, 2006-2011 (Million, TRL)

	2006	2007	2008	2009	2010	2011	% of Total Revenues	% of GNP
TOTAL REVENUES	1,215.6	1,628.5	1,635.0	1,577.8	1791.2	1,952.1	100%	31%
1. Tax Revenues	765.4	954.2	1153.9	1145.2	1272.0	1380.4	71%	22%
Total Direct Taxes	323.6	392.1	489.5	554.0	584.1	597.9	31%	9%
Total Indirect Taxes	441.8	562.0	664.4	591.2	687.9	782.5	40%	12%
2. Fund Revenues	256.7	449.0	318.5	283.7	348.7	406.1	21%	6%
3. Other Revenues	193.56	225.36	162.61	148.87	170.3	165.50	8%	3%
GNP (Millions, TRL)	4,101.3	4,671.2	5,128.3	5,191.5	5649.5	6,374.0		
GNP Growth	12.7	2.8	-2.9	-5.5	3.6	3.8		

Source: SPO (2012), Tax Office (2012)

Note: 2009 GNP value is provisional

Since budget expenditures are as much as 48 per cent of GNP on the average for 2003-2011 (Fig. 1), which exceed revenues of 38 per cent of GNP, the T/C budget faces high deficits, at an average rate of 9 per cent for the years 2003-2011. It is clear that the T/C economy has problems both on the expenditure as well as the revenue side of the budget. Figure 1 also indicates that the public sector dominates the T/C economy. High public sector wage and salary bills with growing social transfers lead to a budgetary structure with inelastic expenditures. This in turn limits the maneuver of the authorities to develop policies that could improve the business environment. Limited resources used by the public sector to finance current budget expenditures reduces what is available to improve the capacity of human capital, research and development, innovation and use of technology, which are the main sources of productivity growth.

In addition, high budget deficits force the administration to levy taxes that are not economically viable and create negative effects on resource use in the overall economy. A study prepared by the TCCC in 2009 outlines a number of taxes, particularly VAT and "stopaj", whose application weaken the competitiveness of the private sector (TCCC, 2009). "Stopaj", introduced in 2007, is a 4 percent withholding tax on income for importers at customs, which is payable when they actually import the goods. This taxation has not only made imported products more expensive, it has also created an additional financing cost for importers. Since this tax is a pre-paid tax, businesses accept it as non-tariff and reflect it in their costs and pricing. As this increases the unit cost production, it has negative implications for productivity. Such a tax not only has a negative effect on importers' productivity it also weakens the competitiveness of the economy as imports represent over 40 per cent of GNP.

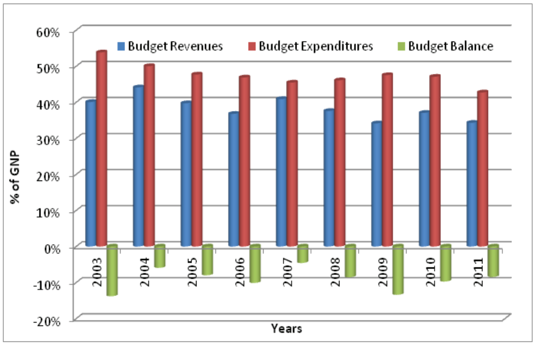

Figure 1. Budget Balance (2003-2011, % of GNP)

Micro Level Tax Analysis for Competitiveness

In order to be able to able to understand the taxation in T/C and its implication for competitiveness, there is a need to look in more depth at the main sources of tax revenues, namely taxes on wages and salaries, capital and consumption.

Personal Income Tax and Marginal Income Taxes

PIT is the second biggest source of revenue after VAT. The personal income tax is levied at statutory rates ranging from 10 per cent to 37 per cent (Table 2). The system carries a number of tax deductions and allowances, which makes it complicated to apply. These deductions, which also include social security and provident fund contributions, bring the top marginal rate of PIT down to approximately 30 per cent.

However, an individual employed in the private sector has to pay this high marginal rate when his or her income reaches only 23,650 TRL. This is approximately 14,094 US$ at 2011 exchange rates . Jenkins (2001) argues that such an escalating rate structure is way out of line compared with other developing or developed economies such as Malaysia, New Zealand and the southern part of Cyprus where the top rate of personal income tax at 30 per cent is paid above incomes of 36,301 EUR and the bottom rate of 20 per cent is only paid on incomes in excess of 19,500 EUR. The same paper states that such rates are applied when the income levels are several times higher in other countries.

As was stated in the section about macro level analysis, the tax net is very narrow and the administration is not able to capture most of the income created in the private sector. Analysis of the PIT explains the main cause of significant size of tax evasion. It is practically impossible for the tax administration to effectively administer an income tax system with such an escalating rate structure and high overall "theoretical" tax burdens. This structure forces private sector employers and their employees to report income equal to minimum salary, which is tax exempt for social security and tax purposes. Then the rest of the income is paid in cash.

Considering especially the unit cost of production for businesses, the situation is made worse when the social security and provident funds are included. For social security the employee pays 8 per cent and employer 10 percent and for the provident funds both employee and employer pays 5 per cent each. These payments amount to additional tax burden of 28 per cent of gross income.

As well as the absolute tax rate, the marginal tax rate is also important. A high marginal personal income tax rate reduces the attractiveness of an additional hour of work relative to leisure activities. There is empirical evidence to suggest that a higher marginal rate of corporate income tax has a stronger effect on investment decisions than a higher average rate of corporate income tax (Talpos, 2009). As for personal taxation, a high marginal personal tax rate discourages entrepreneurship, therefore innovation that can also raise competitiveness.

Taxing Capital: The Corporate Income Tax and Effective Corporate Tax levels

Taxing corporations is very much related to capital investments, investments in innovation and technology and also R&D. In order to be able to compete with the growing competition and expand market share, the abovementioned investments are a must. Investments by corporations lead to more jobs, economic growth and better living standards. Therefore, a corporate tax structure should be competitive so that it helps provide a fertile business environment for domestic as well as foreign investments.

A competitive corporate tax structure affects capital allocation in economies. Especially in open economies, when capital is mobile, firms very much consider the cost of the tax they pay for capital. Chen and Mintz (2010) argue that "… in the end, it is not companies that bear the cost of the taxes they pay but less mobile consumers, in the form of higher prices on goods, and workers, in the form of lower real wages. A competitive business tax system, therefore, means both lower prices for consumer goods and higher compensation for workers, which contribute directly to higher living" (2010: 3). The same paper also concludes that the structure of the CIT can be the most distortionary taxes relative to PIT, consumption tax and property taxes, in terms of impact on long-run gross per capita income.

Table 2. Personal Income Tax Brackets (2011, TRL)

Income Brackets	Cum. Bracket	Rate	Tax	Cum. Tax
3.000	3.000	%10	300	300
3.000	6.000	%20	600	900
7.600	13.600	%25	1.900	2.800
10.050	23.650	%30	3.015	5.815
23.650,01	and above	%37		

Source: Tax Office, 2012

Corporations are taxed at two stages in the T/C economy. In the first stage, corporations are taxed at 10 per cent. There is a separate corporate income tax that is levied on the remaining 90 per cent of the taxable income. Overall, these two stage taxation equals 23.5 per cent of taxable income.

According to The World Bank (2006: 22-23):

> *"In fact, the statutory corporate tax rate of 23.5 percent in the northern part of Cyprus is almost exactly that of the average effective corporate tax rate of 23.6 percent for the 36 countries for which data are available. But effective tax rates in the northern part of Cyprus must be much lower for many businesses and investments, since some businesses and investments receive substantial incentives in the form of investment allowances and soft loans".*

This finding suggests that T/C economy's corporate tax structure is competitive. However, this was based on the situation in 2005. When the updated effective and marginal corporate tax is studied for other countries in the last 5 years, a number of changes can be noted. According to Chen and Mintz (2010), the marginal effective tax rate on capital investment has been declining since 2005. The same economists find that the rate has declined in 30 OECD countries from 23 per cent in 2005 to 19.5 by 2009 and that the statutory corporate tax rate on investment is on average 26,5 per cent.

This finding indicates that countries have chosen to reduce the burden on the capital investment. It is interesting to note that despite the general reduction in rates, the same countries have managed to raise the share of corporate tax revenues (Johansson et al., 2008). This is argued to be the result in part of corporate tax reform that combined rate reduction and base broadening. In terms of the T/C economy, the narrow tax net for corporations has to be considered in parallel with PIT. As noted in section 4.2, high marginal personal income tax rates force companies also to under declare their sales and thus not to reflect their true corporate tax liability. This results in a narrow corporate tax net. So, though the corporate tax rates themselves are at reasonable rates, the problem with high rates of PIT prevents a broadening of the corporate tax base.

Taxing Consumption: Value Added Tax

The VAT system succeeded the sales tax in 1996. It is very comprehensive and covers all the businesses without any threshold. VAT is the biggest source of tax revenues, representing 23 per cent of total revenues or 7 per cent of GNP. From 1st January 2011, the tax office has made some adjustments, eliminating the reduced rate for local producers and also cut the number of rates from six to five: 0, 5, 10, 16 and 20, where 16 per cent is the standard rate (Official Gazette, no: 784/2010).

A number of problems in the implementation of the VAT create significant additional costs to businesses. VAT is collected at the customs when goods are imported. Therefore, it creates an additional financing need for importers to pre-pay the VAT for the goods, which they have not yet sold. Similar to the "stopaj" explained in Section about budget balance and competitiveness, businesses perceive this just like a non-tariff and reflect that in their costs and ultimately in prices. Especially in the case of T/C economy, where access to finance is limited, and the cost of available funding is higher than neighboring economies, it has a significant negative impact on the competitiveness of goods markets.

The other problem of VAT was noted by the World Bank Report (2006). It was argued that the application of VAT is more like a turnover tax as it has a "cascading" or "tax on tax" problem[4], because businesses cannot get VAT refunds unless they export. Thus, there are quite a number of businesses who purchase inputs, pay the VAT and at certain periods have excess tax credits. Under such circumstances, according to normal VAT principles, businesses should be refunded. However they are not.

These two basic problems outlined for VAT show that businesses face problems even with consumption taxes. In normal conditions, businesses should act like agents of tax offices for tax collection. However in the case of the T/C economy, the problems create extra financing burdens, making their unit cost of production increase which leads to productivity problems. In addition, such applications also affect the market conditions by the cascading effect, eroding the purchasing power of consumers.

Remarks on T/C Taxation System Analysis

The analysis of the taxation system at both the macro and micro level has shown that T/C economy has not been successful in developing a well functioning taxation system that can fund its expenditures in a viable and efficient way. The macro level analysis has clearly shown that the system has not only led to huge deficits, it has also led the administration to apply tax policies that distort market conditions, causing misallocation and inefficiencies in the use of resources. The analysis has also indicated that taxation policies in place have caused huge tax evasion, which creates unfairness in the economy. It has also been noted that there is an imbalance with the share of indirect taxes relative to direct taxes. This should be corrected as relying on indirect taxes not only entails fiscal risks in downturns but given the manner in which indirect taxes are applied in the T/C economy, they also create additional costs for businesses.

The dominance of the public sector in the economy also indicates that the system has not provided the means for the private sector to grow through strengthening their capital structure and making more investment in human capital and R&D. The tax system does not encourage private companies to innovate, compete and increase overall unit productivity, which would strengthen the competitiveness of the economy.

At the micro level, the analysis has shown that marginal tax rates of PIT are very high and are out of line compared with other developing economies. The situation is made worse when the social security and the provident funds are added. The burden created by the PIT and other social costs raises costs and prevents successful unit per labor production. The high marginal rate of PIT has an impact on corporate tax, as most companies choose not to declare their true incomes. This also forces the businesses to underdeclare their sales. Overall the tax net base is very narrow and continues to be distorted with these tax policies. The cascading effect created by the existing tax structure adds more burdens to businesses and negatively affects their competitiveness.

In all, the analysis has shown that the existing taxation policies are neither successful in raising sufficient revenues for the budget nor suitable for businesses. This calls for a reform in taxation policies especially with PIT and VAT. A tax structure that broadens the tax base should be the objective. This approach in turn would help reduce the burden on registered and labor in general. The enhanced system would also contribute to the effective allocation of resources in the economy by both factor and goods markets.

Surveys on Taxation in T/C Economy: Perceptions

In this part of the paper, results of a survey that has been carried on taxation in the T/C economy will be analyzed. This paper argues that in addition to the assessment made by using secondary data (published statistics), a complementary approach such as a survey supports and enriches the analysis since observations of actual taxpayers are also taken into account in the analysis. No surveys on taxation have been undertaken for T/C economy before, yet the perceptions of individuals on tax systems are very important and are related to tax compliance. A well functioning taxing system will only be successful if it is perceived as fair by its citizens, transparent, accountable and proper for the economic situation. In economies where these are not achieved, the system is considered to face compliance problems and distortion of resources used.

Being the first of its kind in T/C economy, the survey has been carried out both for households and businesses[5]. The first is expected to gather perceptions more on labor income and consumption taxation in general. The second is more focused on capital taxation and how businesses perceive the taxation in T/C economy.

Household Tax Survey

As the methodology and sample, a telephone survey of 100 households was conducted and data collected based on structured questions. A pilot study was also carried out before the survey to test the questionnaire. The sample of 100 was randomly selected based on the general population. The age range of the sample was 18 to 55+, of which nearly 70 per cent were 25-54. The household survey covered a sample from a wide range of occupations: from professionals such as doctors, lawyers and engineers to supervisors, technicians, teachers, farmers and business owners. Overall, 32 per cent of the sample was from Nicosia 25 per cent, Famagusta, 10 per cent Kyrenia and 11 per cent form İskele. Most of the questions in the survey were closed ended where the participants were given scales from one to five. In the structured questionnaire, there was also number of questions which were open ended where participants' direct views were asked. The survey questionnaire was structured to find out the following:

- Household perceptions about taxation policy and the taxation system overall
- How important taxation is for households
- Quality of the service provided by tax office
- Household perceptions of PIT
- Household perceptions of VAT
- Views on tax administration and tax filing
- Who actually pays taxes?
- Significance of tax evasion

Perception of Households about Taxation

According to 61 per cent of the households that participated in the survey, the administration does not have a clear and defined taxation policy. In the same part of the survey, 65 per cent think that the existing taxation system is not appropriate for the T/C economy. These two findings indicate that there are perceived to be serious problems in with the taxation system. Another finding was that over 71 per cent of households think that the government does not spend and allocate the collected taxes according to the development needs of the T/C economy. The other parallel view is that the system does not support investment.

The general perceptions not being positive do have certain implications. The direct effect is on the compliance. The same survey finds that 80 percent of the household thinks that there is significant tax evasion and it is as high as 70 percent. As it was stated in Section 4, one of the main causes of the evasion is high tax-rates. It is interesting to observe that more that 50 per cent of households agree that taxes are high and only 19 per cent think they are not. The rest are not sure. This finding very much supports the analysis of Section 4, namely that there is a problem with PIT and reforms are needed to be made more acceptable to the tax payers. In the same section of the survey, nearly 50 per cent of the households believe that if the rates are lowered, government tax revenues will rise.

In the second part of the survey, it was found that over 83 per cent of the households that pay tax find the taxation policy and tax system to be an important issue. The survey results also indicate that rate of compliance is as high as 86 per cent among households. Those who use the tax office find that office employees behave well and 39 per cent think that service provided by the office is sufficient. The other 28 per cent find the services not to be sufficient while 11 per cent thinks they are very bad. These finding indicate that there needs to be improvement in the administration as well.

On the third part of the survey where more specific questions about PIT and VAT were asked, some interesting findings have been observed. On the PIT front, 41 per cent of households find the PIT rates to be high and 14 per cent to be very high. In total 55 per cent of households think that the statutory PIT rates are high. The remaining 36 per cent think that the rates are appropriate and 8 per cent think they are low. When the households were asked about their opinion on the rate, 42 per cent wanted flat rates of 20 or 25 per cent. At the same time 14 per cent wanted two rates at 20 and 30 percent. The remaining 38 per cent wanted the existing structure to continue and 5 per cent of the households wanted 5 per cent lower rates. These findings on the PIT support the argument made in section about the macro level analysis, namely those escalating rates distort the system and rates as high as 37 per cent are not acceptable. A total of 56 per cent wanted the rates to be lower than 30 per cent with a single or a maximum of two rates.

It is also interesting to observe that 43 per cent of the households find the VAT rates to be high and 18 per cent think the rates are very high, even though the top rate of 16 per cent is close to the lowest standard EU rate. This may be explained by the cascading problem discussed in Section 4, which pushes up prices. The fact that the neighboring Greek Cypriot economy has the lowest standard VAT rate of 15 per cent could psychologically make households think that the local VAT rate is high. In the same part of the survey, nearly 50 percent of the household demanded VAT system with two or maximum three rates.

Among those households who do not think that the existing tax regime is working well, 78 per cent think that the biggest problem with the regime is tax rates and regulations as well as the tax administration. Households expressed their views to the open-ended question for solving the abovementioned problem as follows:

- 33 per cent fair taxation
- 22 per cent effective inspections and audits
- 17 per cent minimizing political intervention
- 17 per cent lower customs and related port charges
- 6 per cent having world class tax system
- 5 per cent employing those who are capable of administering better.

When the households were asked to express their views on who actually pays taxes, 65 percent of them think that high-income people pay the lowest taxes in the T/C economy. In a separate question regarding SMEs and sole proprietorship (mainly craftsmen), 43 per cent and 56 per cent respectively of the same sample think that they also pay too much tax. In the same part of the survey, 64 per cent of the households think that low-income individuals pay too much tax. These findings indicate and support the view that taxpayers do not perceive the tax system to be fair and they perceive much of the tax burden to be on low-income groups.

Regarding the issue of tax evasion, 80 per cent believe that it exists and 69 per cent of the households think it is common and happens frequently. They identified the causes of evasion were as follows[6]:

- 68 per cent - insufficient inspection and audit
- 44 per cent - lack of deterrent tax penalties
- 37 per cent - high tax rates
- 10 percent – not satisfied with public services

The household survey overall has shown that households are not very happy with the existing consumption and income taxes. Households do not find the government taxation policy clear or, more importantly, appropriate for the T/C economy. They expressed their view in the direction that the existing system of taxation does not foster development of the economy. The results also indicate that there are problems not only with the rates and regulation but also the administration of tax. Households have also stated that the taxation system is not fair and burden is more on the low income and SMEs. In addition, households confirmed that there exists a significant amount of tax evasion in T/C economy.

Business Tax Survey

The method for the business survey was similar to that of households. A sample of 100 businesses was randomly selected based on the database of the Turkish Cypriot Chamber of Commerce and Turkish Cypriot Chamber of Industry. In terms of the sample, 47 per cent of the businesses that participated in the survey employ 1-5 employees, 19 per cent 6-10, 15 per cent 11-20 and the rest 21 and above. The sectors range from construction to cleaning, tourism to electronics and house wares, etc. The selection was based on the share of each sector in the economy of T/C. Among 100 businesses, 55 per cent were from Nicosia, 16 from Famagusta, 23 from Kyrenia, 3 from Güzelyurt and the rest from İskele.

Most of the questions in the survey were closed ended where the participants were given scales from one to five. In the structured questionnaire, there was also number of questions which were open ended where participants' direct views were asked. The survey questionnaire for businesses was structured to find out the following:

- Household perceptions on taxation policy and the taxation system overall
- How important taxation is for businesses?
- Quality of the service provided by tax office
- Business perception on income taxes, both PIT and CIT
- Business perceptions on VAT
- Views on tax administration and tax filing
- Who actually pays taxes?
- Significance of tax evasion
- Perception of the Businesses about Taxation

As stated in earlier sections, taxation is an important factor in business investment decisions, which in turn affects productivity. In this respect the perceptions of businesses play an important role in designing a proper taxing system. As regards the first part of the survey, the businesses seem to have parallel views with the households about the appropriateness of the present taxation system. More then 70 per cent of the businesses participated in the surveys are not happy with existing taxation. They also do not find the taxation policies of the government to be clearly defined (59 per cent). This is also supported by the perception that governments do not allocate the collected taxes in a way that helps the economy to develop. This answer was represented by the 77 per cent of the participants, which is very high. Over 78 per cent did not find the existing system investment-oriented. This finding confirms the analysis made in section about macro level is under corporate taxation. It was agued that taxing undistributed incomes (dividends) would not support investment, as the marginal cost of the investment may be higher than the benefit. Businesses also find the tax collection system neither transparent (55 per cent) nor fair (65 per cent).

Parallel with the households, businesses also find the overall tax rates to be high (51 per cent). The survey on business shows that enterprises find the overall tax rates to be high. In what may be classified as a biased question towards businesses, 60 per cent of the businesses think that companies pay more tax than individuals. Comparing this perception with the statistics of the tax office where only about quarter of the registered companies file for tax, the answer to this question may be evaluated as biased. Businesses also think that government should try to tax consumption more than income. Most of the businesses know the tax rate they have to pay and 70 per cent believe that administration would be able to collect more taxes if the rates were reduced.

Businesses responses to questions related with quality of the services provided by the tax administration is skewed towards the negative, with 34 per cent finding the service provided by the employees of the tax office not to be fair at all. They also think that the tax offices are very poor as regards use of technology, which affects the efficiency and creates additional cost for firms. The survey also identified one of the problems raised in section about macro level analysis related to refunds: 39 per cent of the respondents think that it is impossible to get refunds from the tax office. In addition 18 per cent perceive the refund system as bad.

On the PIT front, 65 per cent of businesses think that the rates levied on labor are too high. Out of 100 businesses 27 of them think that a single flat rate at 20 or 30 per cent is the most appropriate for T/C economy. Another 23 per cent think two rates, 20 and 30 per cent, are better.

Regarding the CIT, 78 per cent of the businesses are happy with the 10 per cent rate but they want the undistributed profits (income) not to be taxed. Even though businesses think that taxing consumption is better than income, 63 per cent of the respondents find the existing VAT rates to be high. This is due to the fact that the VAT is not being applied properly, creating cascading effect that raises the costs to firms. In the survey, 37 percent wants the existing rates to be continued to be used whereas 30 per cent support just 2 rates (8 and 16) and 18 per cent of the respondents think single rate at 16 per cent is most appropriate.

Overall the taxation regime is not perceived to be good, with 50 per cent thinking that it is bad a regime. The businesses think that the cause of this lies both on the rates-regulations as well as tax administration. In order for these problems to be overcome, businesses answered as follows:

- 31 per cent chose fair taxation
- 20 per cent asked for business environment to be improved
- 17 per cent chose lower rates
- 7 per cent chose discussion of the draft tax law by stakeholders before implication
- 3 per cent wanted the SMEs to be supported
- 3 per cent demanded that VAT not to be collected at ports but when the goods are sold
- And the rest asked for simpler and more transparent taxation.

In the section where the participants were asked to state their perception about who pays the tax, 56 per cent believe that SMEs pay too much tax. In parallel with these, 60 per cent believe that craftsmen pay too much tax as well. It is also interesting to note that 66 per cent of businesses think that low-income people are taxed highly in north Cyprus. Confirming this, 73 per cent of businesses think that high-income people pay little tax.

Businesses also agree that tax evasion is a serious problem in the economy; 80 per cent believe that it exists and 69 per cent think it is a common thing and happens frequently. Businesses identified the causes of evasion as follows[7]:

- 65 per cent - insufficient inspection and audit
- 40 per cent - high tax rates
- 33 per cent - lack of deterrent tax penalties
- 27 percent – not satisfied with public services

It is interesting to observe that businesses are also complaining about tax inspections. This shows that unfair competition in the markets between those who are registered and those who are not registered has become a serious problem for businesses.

Remark on the Survey

The findings of both of the surveys confirm to a great extent the problems, which were identified and raised in Section 4 on the taxation system. The perception of the tax payers clearly indicate that significant changes are needed. In a society where the citizens do not perceive the rates and the regulations to be appropriate and fair, it will be very difficult to broaden the tax base and generate tax revenues. Moreover, businesses will not be very willing to make investments. Even if a certain amount of revenue generation is achieved, this will be at the expense of misallocation of resources in the economy with lower TFP, leading to weaker competitiveness.

The survey also identifies deficiencies in the tax administration as one of the cause of the problems with taxation. The high prevalence of tax evasion has also been perceived to be a big problem, confirming some of the studies carried out before. It is also interesting to note that the problem with the evasion is so bad that even businesses are complaining about it. This is due to the unfair competition created by unregistered companies and labor. In both of the surveys carried out, the findings underlines that those on lower income pay much higher taxes relative to high income people. This is another indication that the taxation is not fair in the T/C economy.

Policy Measures for Enhanced Competitiveness

This paper has demonstrated that the T/C tax system has not served the economy well in many respects over the past few decades. The analysis both at the macro as well as micro level proves that there is a need for fundamental changes to the system that would lead to significant improvement in growth, productivity and overall competitiveness of the economy. The primary data gathered by both households and businesses surveys about taxation clearly indicate that the perception of tax payers call for reforms in both taxation policies and as well as tax administration.

Changes in tax policy can create the conditions for more robust job creation in the private sector, stronger capital formation, higher exports and increased investments. Conversely, uncertainty and excessive taxation will continue to restrict our ability to innovate and compete. Rules should therefore aim to create a level playing field for domestic business activity carried out by foreign and T/C businesses while ensuring T/C-sourced income is properly measured and taxed.

For taxpayers, certainty and simplicity in tax legislation and its administration are important. As Johansson et al. (2008) argue, corporate taxation should avoid discouraging efficiency improvements and aim at ensuring neutrality and consistency. This means that certain investments or companies should not be favored at the expense of other potentially more productive investments. This would imply a reasonably low corporate tax rate with few exemptions. It should also be borne in mind that business investments are long term and sudden changes in tax policy without adequate transition cause significant disruption.

In the context of T/C economy, reforms should be made bearing in mind the current and potential future competition from the southern part of Cyprus as well as gradual harmonization of the economy with EU norms. Recent evidence demonstrates that economies grow faster and are more productive when taxation is shifted from corporate and personal income tax to property and consumption taxes. With these principles in mind, below are a number of proposed changes that can be practically implemented and that will increase the certainty and simplicity of T/C's system of businesses.

1.Simplify personal income tax by reducing the number of personal tax rates from five to two. This will also reduce the negative impact of marginal tax rates, which also has a negative impact on corporations' willingness to declare income.

2.Retain the single flat corporate tax rate at 10 per cent and abolish the 15 per cent tax on undistributed profits (retained earnings), in order to encourage firms, which face difficulties accessing debt financing, to increase their equity. Such a move would help improve the financial strength and capital structure of companies and make them more institutionalized.

3.Simplify and broaden the corporate tax base by withdrawing the range of special incentives. Empirical evidence has shown that a simple, low corporate tax rate is more effective in encouraging investment and maintaining revenue than multiple tax incentives, which raise transaction costs.

4.Reduce the top rate of marginal personal income tax gradually from 37.5% to 30%. In an economy that suffers from a crowding out by the public sector, a lower top rate of marginal income tax will increase the relative attractiveness of entrepreneurial activity and should also encourage reporting by companies.

5.Abolish the highly distortionary "stopaj" tax on imported goods, which raise the costs of goods sold relative to the southern part of the island.

6.Implement proper VAT system, whereby businesses can get VAT refunds for their expenditure on goods and services as inputs. This will eliminate the existing tax cascading problem and help reduce the cost of goods and services purchased by businesses.

7.Upgrade the tax administration both physically as well as technologically to minimize the cost of tax filing and other transactions costs.

8.Consider a tax amnesty, followed by higher penalties for tax avoidance and evasion thereafter, in order to reduce the very large size of the tax evasion, estimated at 60% of GDP.

9.Improve inspection and audit capacity to help minimize tax evasion.

10.Upgrade customs physically to be more efficient and effective so to minimize customs burden on imports.

11.Eliminate the "price stability fund" and reallocate taxation of these goods under excise tax.

This helps simplifying indirect taxation and also will be an important step forward for EU harmonization.

Acknowledgements

The author would like to thank USAID for financial support of this research. Special thanks go to Turkish Cypriot Tax Office who provided taxation data used in the analysis and also Fiona Mullen who helped to edit the text.

Notes

1. *Author's Article* has estimated that income that is not recorded in the national income statistics is as much as 30 per cent of the official GNP.
2. A marginal tax rate is the rate that applies to the last TRL income of the tax base (taxable income) and is often applied to the change in one's tax obligation as income rises.
3. 1,67 TRL for a US$ has been used as the exchange rate from Central Bank statistics, Quarterly Bulletins, Vol. 2010-1
4. More detailed work can be found in The World Bank Report, "Sustainability and Sources of Economic Growth in the Northern Part of Cyprus, Volume II: Technical Papers, 2006, p.21.
5. Household Tax Survey Questionnaire and Business Tax Survey Questionnaire can be obtained from the Author by request.
6. Participants were given the option to choose more than one cause.
7. Participants were given the option to choose more than one cause.

References

Arnold, J. (2008). *Do Tax Structures Affect Aggregate Economic Growth?* Empirical Evidence From a Panel of OECD Countries', Economics Department Working Paper No. 643, ECO/WKP (2008) 51, OECD.

Besim, M. and G. P. Jenkins (2005). *Tax Compliance: when do employees behave like the self-employed?'* Applied Economic, Vol. 37, No: 10 June pp.1201-1208.

Besim, M. (2000). *The Size of Unrecorded Economy in the Turkish Republic of Northern Cyprus: A Monetary Approach.* Muhasebe Finansman Dergisi, Marmara University, Vol. 13, Issue 9.

Duanjie, C. and Jack, M. (2010). *Canada's Tax Competitiveness after a Decade of Reforms*. SPP Briefing Papers, School of Public Policy, University of Calgary, Vol. 3 Issue 5.

Eurostat (2010). Taxation Trends in the European Union. European Commission.

Goerke, L. (2006). *Corporate and Personal Income Tax Declarations*. CESifo Working Paper, No. 1781.

Gutmann, P. M. (1977). *Subterranean Economy*. Financial Analyst Journal, (November/December), pp. 26-34.

Jenkins, P. Glenn (2001). *Diagnostic and Proposals for the Reform of the Personal Income Tax System in the TRNC*. Review of Social, Economic & Business Studies, Vol.1, No.1, pp. 64-95.

Johansson, A., Heady C., Arnold J., Brys B., and Vartia L. (2008). *Tax and Economic Growth*. Economics Department Working Paper, No. 620, ECO/WKP(2008)28.

Mayor's Task Force on Tax policy & Competitiveness in Philadelphia (2009). Thinking Beyond Today: a Path to Prosperity, USA.

Mintz, J.M. (2006). *Tax Competitiveness Report: Proposals for Pro-Growth Tax Reform*. C.D. Howe Institute Commentary, No. 239.

Mintz, J.M. (2007). *Tax Competitiveness Report: A Call For Comprehensive Tax Reform*. C.D. Howe Institute Commentary, No. 254.

Myles, G. (2009) *Economic Growth and the Role of Taxation - Disaggregate Data*. Economics Department Working Paper, No. 715, ECO/WKP(2009)56, OECD.

North Cyprus Tax Office (2010). Personal Income Tax Brackets for 2009, Nicosia, North Cyprus.

OECD (1997). *Economic/Fiscal Instruments: Competitiveness Issues Related to Carbon/Energy Taxa-*

tion', Annex I, Expert Group on the United Nations Framework Convention on Climate Change, Working Paper, No. 14, OCDE/GD (97)190.

Official Gazette, no: 784, December 2010.

State Planning Organization (2012). Economics and Social Indicators. Nicosia, North Cyprus.

Talpos, I. and Vancu, I. (2009) *Corporate Income Taxation Effects on Investment Decisions in the European Union'*, Anales Universitatis Apulsensis Series Oeconomica, 11(1).

Tanzi, V. and Zee, H. (2000). T*ax Policy for Emerging Markets - Developing Countries*. IMF Working Papers 00/35, International Monetary Fund.

Tobin, J. (1969) *A General Equilibrium Approach to Monetary Theory*. Journal of Money Credit and Banking, 1, 15-29.

Turkish Republic of Northern Cyprus Central Bank (2010). *Quarterly Bulletins*, Vol.1, Nicosia, North Cyprus, 2010.

Turkish Cypriot Chamber of Commerce, 2009, 2010, 2011,2012,2013 Competitiveness Reports, Nicosia, North Cyprus.

Turkish Cypriot Chamber of Commerce (2009). Özel Sektörün Rekabet Gücünü Olumsuz Etkileyen Kamu Kaynaklı Yükler. Nicosia, North Cyprus.

Vartia, L. (2008) *How Do Taxes Affect Investment and Productivity? An Industry Level Analysis of OECD Countries*. Economics Department Working Paper, No. 656, ECO/WKP(2008)64), OECD.

The World Bank (2006). *Sustainability and Sources of Economic Growth in the Northern Part of Cyprus' Volume I: Economic Assessment, Volume II: Technical Papers*. Poverty Reduction and Economic Management Unit, Europe and Central Asia Region.

Biographical Sketch

Dr. Mustafa Besim has been a Faculty member of Eastern Mediterranean University since 1998. He has lectured economics, public finance, international finance, corporate finance, and project finance and appraisal courses. His field of specialisations are public finance, economic development and investment appraisal. Dr. Besim was assigned to work in the Technical Committee on Economic and Financial Aspects of Cyprus Talks in 2003-4, 2008-2011. Besim has number of publications on Turkish Cypriot economy with topics from underground economies, tax compliance, productivity, future of Turkish Cypriot economy to recent global financial crises. He has presented papers at conferences, mainly on taxation, sustainability of the Turkish Cypriot economy, significance of state budget and underground economy, and fiscal federalism. He has obtained his Ph.D. in Economics of Public Policy from The University of Birmingham. He is also alumni of both the program on Tax Analysis and Revenue Forecasting Program of DCID, Duke University and Investment Appraisal and Risk Analysis of Queen's University.

Otobiyografik Öz

Doç. Dr. Mustafa Besim, Doğu Akdeniz Üniversitesi'nde İşletme lisans ve Ekonomi yüksek lisans derecelerini aldı. Ekonomi ve Kamu Politikaları alanındaki Doktorasını 2004 yılında Birmingham Üniversitesinde tamamladı. Birleşmiş Milletler gözetiminde başlatılan Kıbrıs Görüşmelerinde 2003-2004 ve 2008-2011 yıllarında uzman olarak Ekonomi komitelerinde görev aldı. Doğu Akdeniz Üniversitesi İşletme ve Ekonomi Fakültesi'nde ders vermekte olan Mustafa Besim 2010 yılında ekonomi dalında doçentlik unvanını aldı. Besim'in kamu maliyesi, ekonomik kalkınma, rekabet edebilirlik, uluslararası finans, proje değerlendirme ve finansmanı konularındaki çalışmaları yanında kayıtdışı ekonomi, vergilendirme, verimlilik ve ekonomik kriz konularında da akademik yayınları bulunmaktadır. Besim, Duke Üniversitesi Vergi Analizi ve Gelir Tahminleri programı ile Queen's Üniversitesi Proje Değerlendirme ve Risk Analizi Programlarının da mezunlarındandır.