

TURKISH CYPRIOT ECONOMY: NAVIGATING THROUGH CHALLENGING TIMES

Macroeconomic Monitoring Report

SPECIAL ISSUE: DO FISCAL POLICIES HELP REDUCE INCOME
INEQUALITY IN THE TURKISH CYPRIOT ECONOMY?



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TABLE OF CONTENTS

Acknowledgements	v
Abbreviations and Acronyms	vii
Executive Summary	ix
Chapter 1: Recent Economic Developments and the Short-term Outlook	1
1.1 Recovery has gained strength amid new challenges	1
1.2 Rising inflation and inflation persistence raise concerns	6
1.3 Pressures on fiscal and external imbalances remain elevated in 2022	13
1.4 As with other small economies, the Turkish Cypriot economy faces overlapping crises and multiple challenges	15
1.5 The outlook for 2023 is subject to uncertainty and downside risks	18
1.6 In the aftermath of multiple crises, key policy priorities emerge	21
Chapter 2: Special Issue: Do Fiscal Policies Help Reduce Income Inequality in the Turkish Cypriot Economy?	27
2.1 An overview of taxes in the Turkish Cypriot economy	27
1. Direct Taxes	27
2. Indirect Taxes	28
2.2 The impact of fiscal policies on poverty and inequality in the TCc	29
References	36



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ABBREVIATIONS and ACRONYMS

AW	Average Wage
CEQ	Commitment to Equity
CIT	Corporate Income Tax
COVID-19	Coronavirus Disease 2019
DRM	Disaster Risk Management
EMDEs	Emerging Markets and Developing Economies
ERPT	Exchange Rate Pass-Through
EU	European Union
EUR	Euro
FCS	Fragile and Conflict-Affected Situations
FDI	Foreign Direct Investment
GC	Greek Cypriot
GDP	Gross Domestic Product
GL	Green Line
GRADE	Global Rapid Post-Disaster Damage Estimation
IMF	International Monetary Fund
kW	Kilowatt
MW	Megawatt
NPL	Nonperforming Loan
OECD	Organisation for Economic Cooperation and Development
PIT	Personal Income Tax
RE	Renewable Energy
RoC	Republic of Cyprus
SA	Social Assistance
SSC	Social Security Contribution
SDG	Sustainable Development Goal
US\$	United States Dollar
TC	Turkish Cypriot
TCc	Turkish Cypriot Community
TL	Turkish Lira
VAT	Valued-Added Tax
VET	Vocational Education and Training
Yoy	Year-on-year



EXECUTIVE SUMMARY

On February 6, 2023, two powerful earthquakes of 7.8 and 7.5 magnitude struck southeast Türkiye and northwest Syria, with significant socio-economic implications for the Turkish Cypriot community (TCc), through trade and inflation. The earthquakes struck at a time when the Turkish Cypriot (TC) economy was striving to recover from the impact of COVID-19 pandemic, record high inflation and the challenges associated to Russia's invasion of Ukraine. Following a deep recession in 2020—the most severe in Europe—and a very modest rebound in 2021, the TC economy recovered rather more strongly than expected in 2022—albeit a year characterized by multiple crises. While the TC economy was already dealing with high inflation—triggered by the post-COVID-19 recovery and the depreciation of the Turkish lira (TL)—the war in Ukraine in February 2022 added further pressure through supply chain disruptions, increasing prices still further and raising levels of uncertainty. Against this background, the economic implications of the earthquakes in Türkiye for the TC economy are also expected to be significant, mostly through trade and aid channels, and inflation. Increased spending, both to provide immediate emergency support and to strengthen disaster risk management (DRM), will also weigh on the already strained 'public' finances.

Before the earthquakes, the recovery of the TC economy had been characterized by two positive features, helping the TC economy consolidate its recovery from the COVID-19 shock. The year 2022 was a record year for Green Line (GL) crossings, and for GL trade. Like other services-reliant economies in Europe, the TC economy witnessed a convergence to pre-pandemic levels. A strong rebound in the 'export' of both goods and services, and stronger-than-expected domestic demand led the recovery. From the supply side, the services sector contributed to the rebound, supported by strong credit growth to the private sector.

However, the economic recovery was also associated with record high inflation, which peaked at 120.7 percent year-on-year (yoy) in October 2022, with highest impact on the poorest households. Headline inflation surged in 2022—more sharply than in any previous year—as rising commodity prices, particularly for energy and food, and currency depreciation passed through to consumer prices. Inflation has slightly decelerated since its peak in October 2022, reaching 84.9 percent in February 2023, but nonetheless remains elevated. Core inflation has also increased significantly since end-2021, suggesting a persistent inflationary entrenchment and rising expectations. The TC economy has also witnessed a large variation in price changes across products, with food and energy prices leading, especially in the first half of the year. This means that, due not only to the composition of the consumption basket but also to the differentiated price increases across groups, the poorest households have been facing the highest inflation rates.

The twin fiscal and current account deficits also deteriorated because of mounting inflation. In 2022, 'public' spending surpassed TL 20 billion, with more than 40 percent of total expenditures destined to transfers, followed by wages and compensation at almost 40 percent, and capital expenditures declining to about 9 percent. The share of defense spending dropped slightly from 7 percent of total expenditures in 2021 to 5.8 percent in 2022. Meanwhile, revenues excluding grants reached almost TL 18 billion, mostly driven by indirect taxes, which make up about 37 percent of revenues, due to rising prices. Aid received from Türkiye in the form of grants constitutes the most important source of funding in alleviating the large financing gap between revenues and budget expenditures. The current account deficit, excluding grants from Türkiye, is also estimated to remain elevated.



Against this background, the fragile recovery of the TC economy is exposed to high downside risks. Due to the weakening of growth prospects, both in the EU and in Türkiye, and due to further trade disruptions, the key driving sectors for the TC economy, such as ‘exports’ of goods and services, may witness a deceleration in 2023. Agriculture may be further negatively impacted by rising input costs and unfavorable weather conditions. While inflation is expected to decline, it is nevertheless likely to remain among the highest in Europe. This may have further negative consequences for the purchasing power of households, leading to a slowdown in poverty reduction, income convergence, and a reduction in consumption. Risks for the outlook of the TC economy remain skewed to the downside, mostly driven by external factors, above all a more prolonged or increasingly intense war in Ukraine. The TC economy faces risks arising from its high inflation, because of both domestic factors and currency depreciation, exacerbated by loosening monetary and fiscal policies in Türkiye, in response to the earthquakes and ahead of the 2023 general and presidential elections. Substantial inflation and further currency depreciation may weaken both corporate and ‘public’ balance sheets. Already limited fiscal space may be further eroded and debt vulnerabilities amplified.

The TCc ‘administration’ should maintain its focus on providing emergency support to those in need, while reducing vulnerability to future crises and building macroeconomic stability. In the context of high inflation, the empirical association between fiscal policy and developments in inflation should be monitored and fiscal policy deployed to restore price stability and lessen the impact of the cost-of-living crisis. To respond effectively to high inflation, the TCc ‘administration’ should first have a full understanding of how fiscal policy impacts inflation and how households are affected. The distributional impact of fiscal policy should also be understood. In a context of extremely high imbalances, prudent fiscal policies should be pursued aimed at ensuring medium-term debt sustainability, while raising potential growth in a sustainable

manner. In this context, also risks stemming from the financial sector should be closely monitored and acted upon. Only an adequate macroeconomic policy framework can help the TC economy build resilience and should anchor any reform agenda. In the aftermath of multiple crises, five reform priorities emerge:

- Maintain the focus on providing emergency support to the poor and most vulnerable, i.e., those most impacted by the cost-of-living crisis.
- Strengthen energy security, by boosting investment in renewable energy (RE) sources, promoting energy efficiency, and reforming energy tariffs.
- Strengthen resilience to natural disaster- and climate change-related risks. This can be achieved by strengthening financial protection, investing in risk reduction, and improving preparedness.
- Strengthen resilience in the broader sense, through competitiveness-enhancing reforms, thereby building a more competitive private sector
- Enhance human capital and recover from pandemic-induced losses.

Policy inaction and delays in implementing urgently needed structural reforms in the TC economy have also contributed to its vulnerability.

The Special Issue analyzes the impact of taxes and transfers on poverty and inequality in the TCc. It shows that fiscal policy has overall only a limited impact on reducing inequality, but the system is unable to reduce poverty. The Special Issue provides an initial step towards understanding the distributional impact of fiscal policy in the TCc. The Special Issue builds on the first ever Commitment to Equity (CEQ) model developed for the TCc, which analyzes the impact of taxes and transfers on poverty and inequality. Based on the latest announced estimates from 2015 Household Budget Survey, relative poverty is estimated at 22.2 percent. Income inequality is also high based on 2015 HBS, with the Gini coefficient estimated at 34 percent, 3 percentage points above the EU

average. The TC fiscal practices contribute to a moderate reduction only in income inequality. Overall, inequality in the TCc drops from 0.445 to 0.361 after fiscal interventions, a reduction around 0.08 of a Gini point and among the lowest levels observed. When looking at the impact on poverty, while transfers and direct taxes have a redistributive effect, indirect taxes have a significant negative impact on household budgets and lead to an increase in poverty from 21.8 to 25.5 percent. In-kind transfers, such as health and education, have important redistributive effects and lift the

impact of fiscal policy in the bottom half of the distribution. When in-kind transfers are excluded from the analysis, all households beginning in the second decile are net payers to the system, as the share of taxes paid exceeds the cash benefits received for all but the poorest 10 percent of the population. When included, instead, all households in the 1st to 5th decile result net beneficiaries, reporting a positive net fiscal position. Overall, the results point to potential improvements that could be achieved in the TCc through a more effective system of taxes and transfers to reduce the burden on the poor and address inequality.



Chapter 1: Recent Economic Developments and the Short-term Outlook

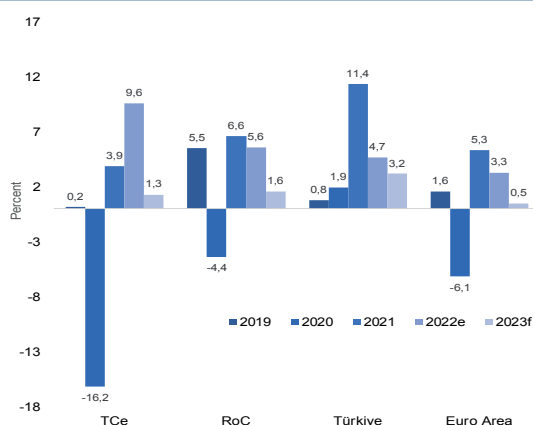
1.1 Recovery has gained strength amid new challenges

Notwithstanding the multiple shocks and persisting structural challenges, during 2022 the TC economy consolidated its recovery from the COVID-19 shock. Following a deep recession in 2020 and a very modest rebound in 2021, the TC economy recovered more strongly than expected in 2022—a year characterized by multiple crises. While the TC economy was already dealing with high inflation, triggered by the post-COVID-19 recovery and Turkish lira depreciation at the end of 2021, the war in Ukraine added further pressure through supply chain disruption, increased prices, and higher uncertainty.

As in most economies across Europe, GDP growth in the TC economy in 2022 was stronger than expected, albeit not fully returning to its pre-pandemic level (Figures 1.1 and 1.2). Growth was revised upward for most European economies in 2022, including the Euro zone, the Republic of Cyprus (RoC), and Türkiye.

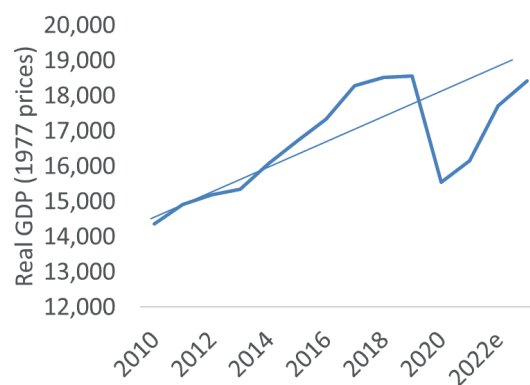
This reflected stronger-than-projected growth in the first half of the year, a quicker-than-expected rebound in international travel as economies reopened, and additional support measures that helped shield households and firms from rising prices. In the RoC, despite rising inflation, private consumption remained robust, supported by increased employment and wages, and underpinned by targeted measures to compensate for high energy prices. In the RoC, tourism also played a role, as arrivals reached 80 percent of the 2019 levels. In addition, exports of business services increased significantly. In Türkiye, 2022 growth exceeded expectations. A tripling of the minimum wage between December 2021 and January 2023, and a rebound in tourism helped support activity and offset drags from multidecade-high inflation, significant currency depreciation, and swelling external liabilities. In this context, the TC economy also consolidated a robust recovery in 2022, with growth estimated at almost 10 percent. However, GDP has not yet returned to its pre-pandemic level.

Figure 1.1 Real GDP annual growth



Source: TCc ‘statistics office’ (‘SO’); World Development Indicators (WDI).

Figure 1.2 Real GDP



Source: World Bank staff estimates; TCc ‘SO’.
Note: Light-blue line for pre-crisis GDP trend.



Two record highs characterized the TC economy’s recovery in 2022:

- Green Line (GL) crossings.¹** In summer 2022, the TC economy recorded the highest number of GL crossings ever. The number of GL crossings, after the lifting of COVID-19 restrictions, jumped and surpassed 700,000 in August 2022, a value exceeding pre-crisis levels (Figure 1.3). The same trend was seen among GL crossings that exclude Turkish Cypriots, surpassing 500,000 in the same month. Overall, almost 6.6 million crossings were recorded in 2022. The lowest numbers of GL crossings were observed in May 2020, with only 1,056 crossings for the whole population and 108 excluding Turkish Cypriots.
- Green Line transactions.** In 2022, GL trade² hit an all-time high of EUR14.8 million (US\$15.6 million), breaking the record set in 2008, with the monthly average for that year surpassing EUR1.2 million (US\$1.3 million) (Figure 1.4). The top-five traded goods include: construction-related materials (61 percent), plastic products (12 percent) and fresh fish (6

percent). Processed foods, including olive oil, jams, and carob syrup, eventually allowed to cross the GL once again in 2022,³ amounted to almost 7 percent of total GL trade. In addition to reported GL trade transactions, intra-island trade also consists of consumer transactions, including fuel purchases, among others, some of them tracked through credit card payments, others in cash. Credit card transactions by Greek Cypriots in the TC economy more than doubled during the first eight months of 2022 compared with the same period in 2019.⁴

The labor market has also recovered to pre-pandemic levels, but not for women. Employment has returned to its 2019 level, while the unemployment rate has decreased, returning to its 2019 rate, at 6.3 percent. But the labor market recovery has not been equal across workers. In particular, women’s employment has remained low, at 34 percent, since the start of the pandemic, while female unemployment has remained above the 2019 level.⁵

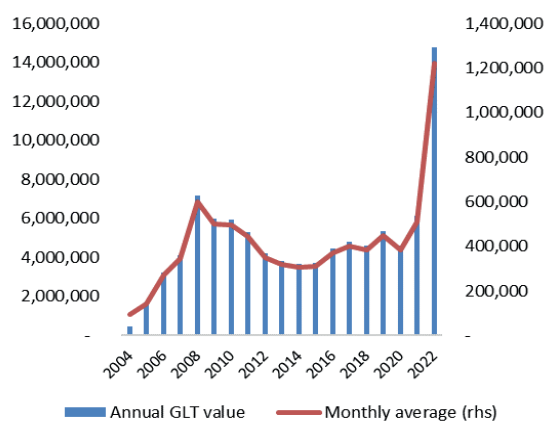
In the first five months of 2022, TC ‘exports’ declined by 3 percent, with Türkiye remaining

Figure 1.3 GL crossings, for the entire population and excluding Turkish Cypriots, 2019–2022



Source: TCc ‘ministry of tourism’.

Figure 1.4 GL trade, annual value and monthly average values in euros, 2004–2022



Source: TC Chamber of Commerce.

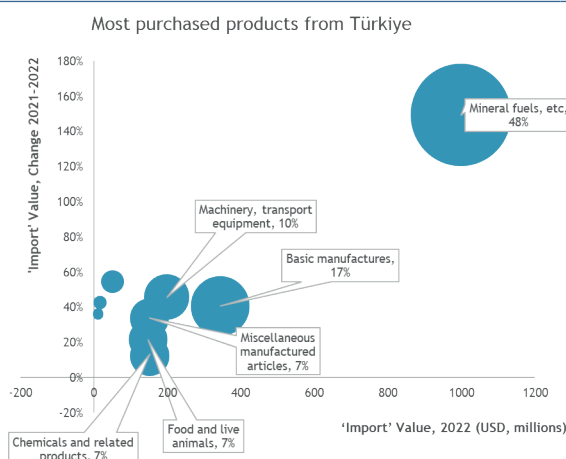
- GL crossings refer to the movement of people across the Green Line.
- GL trade measures the movement of goods from the TC economy to the RoC. In 2021, it amounted for 5 percent of overall ‘exports’ of the TC economy.
- Source: <https://cyprus-mail.com/2022/06/09/olives-carob-syrup-and-grapes-added-to-green-line-regulation/>
- Source: Cyprus News Agency.
- Source: Labor Force Survey, 2022 (TCc ‘SO’)

the main recipient of TC products. As a small, open economy, the TC economy has an unbalanced external trade structure, with a strong reliance on ‘imports’ for both intermediate goods and final consumption, accounting for 43 percent of GDP over the period 2010–2019. Conversely, the average share of ‘exports’ of goods in the same period was small, at just 3 percent of GDP, with Türkiye as the main destination market for TC products, hence further limiting the benefits for TC ‘exports’ arising from currency depreciation.⁶ The three most ‘exported’ goods by the TC in the first five months of 2022 were dairy products, citrus fruit, and scrap materials. Overall goods ‘exported’ to Türkiye in early 2022 hit US\$40.7 million, representing about 60 percent of total goods—an increase of just 3 percent compared with the same period in 2021. The value of ‘exports’ to third countries in early 2022 represents over 40 percent of the total, decreasing by 11 percent compared with the same period in 2021.

The severe compression in ‘exports’ of key agricultural products, in particular potatoes, reflects both the food security crisis and the difficulties facing the agriculture sector in recent years. In 2022, many economies around the world resorted to banning exports

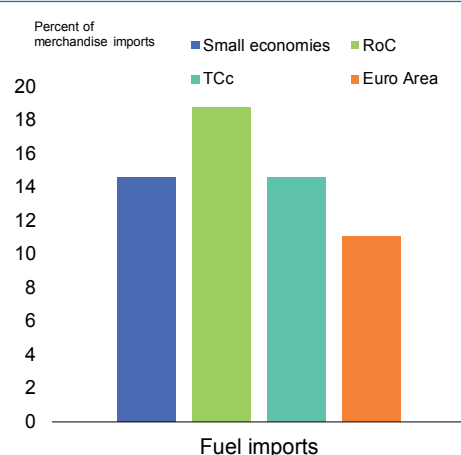
of specific products to cope with supply chain disruptions, rising prices, and to secure food security. Türkiye, for example, banned exports of potatoes and fresh onions in 2022 to a specific set of partner economies, nevertheless the TC economy was exempt from the export ban.⁷ Even though this minimized the implications for the TC economy, the food security crisis adds to the problem that the agriculture sector was already facing due to unfavorable weather conditions, particularly the frosty weather in 2022.⁸ As a result, in the first five months of the year, the ‘export’ of potatoes from the TC economy dropped to zero. Potatoes used to account for about 5 percent of total ‘export’ in 2014/15, but on a declining trend since then. Instead, products have been destined for local consumption and GL trade. This episode follows a series of difficulties facing the agriculture sector for many years. Over several years, a lack of rainfall, high temperatures, and diseases have taken a toll on agricultural production in Cyprus. The production of potatoes in the TC economy decreased by 60 percent in 2018 and subsequent shortages in supply led to soaring prices of potatoes. Similarly, serious shortages in the supply of locally produced potatoes have also affected the RoC economy.⁹

Figure 1.5 Most purchased products from Türkiye



Source: World Bank staff, Turkstat.
Note: Bubble size represents the share in total ‘imports’ from Türkiye in 2022.

Figure 1.6 Fuel ‘imports’ (% merchandise ‘import’)



Source: World Bank, 2023; WDI; TCC ‘trade department’.
Note: Small economies include a sample of 37 economies, among which 28 are small islands.

6 Accounting for high inflation, the nominal depreciation of the Turkish lira resulted in an appreciation of the real effective exchange rate, hence making Turkish exports – and more so, TC ‘exports’ - less competitive.
 7 Source: <https://www.tarimdunyasi.net/2022/11/24/patates-ve-kuru-sogan-ihracatina-kisitlama-getirildi/>
 8 Source: <https://cyprus-mail.com/2022/03/27/potatoes-fall-victim-to-war-and-weather/>
 9 Source: <https://cyprus-mail.com/2018/11/06/potato-crisis-also-seen-in-the-north/>

Stronger-than-expected domestic demand has driven ‘imports’ up, especially for intermediate goods.

In the first five months of 2022, ‘imports’ increased by 39 percent. This may reflect stronger than expected demand, rising prices, as well as households frontloading consumption in a high inflationary environment. The three most purchased goods by the TCc in the first five months of 2022 were fuel, vehicles, and construction iron.¹⁰ However, ‘import’ growth over the same period of 2021–2022 was led primarily by glass (processed glass), generators, and power plant systems, almost all increasing by over 200 percent. Most of the purchased construction materials come from the RoC. However, Türkiye remains the main supplier for the TC economy, especially for intermediate goods (Figure 1.5). In fact, overall goods supplied from Türkiye in early 2022 hit US\$493 million, representing more than 68 percent of total goods, and with an increase of 59 percent compared with the same period in 2021. The value of ‘imports’ from third countries in early 2022 represented over 32 percent of total ‘imports’—an increase of 9 percent compared with the same period in 2021.

The high dependence of the TC economy on ‘imported’ fuels exacerbated the impact of the 2022 energy crisis

(Figure 1.6). Mineral fuels, such as crude oil and natural gas, remain the main products supplied from abroad to the TC economy. In a context of high energy prices and restricted supply since the beginning of the war in Ukraine, this has translated directly into higher energy bills and wider current account deficits in energy-importing economies such as the TC economy. Box 1 discusses the impact of the energy crisis on the TC economy.

Domestic demand was also supported by credit growth to the private sector. As of the end of 2022, the total amount of bank loans

rose, particularly for ‘import’ and ‘export’-related loans, but decreased across other categories. The business loans category remains the predominant category, amounting to almost three-quarters of total loans in 2022. Higher production costs for businesses since 2021 translated into stronger demand for working capital, especially in 2021. Consumer loans remain low at about 20 percent of total loans. Among them, credit card debt remained stable at 3 percent of total loans. Consumer confidence also regained strength, with the deposits-to-loans ratio reaching an historical high at 2.05. The Central Bank of Türkiye lowered its policy rate further to 9 percent in November 2022, driving the Turkish lira to new record lows. Although cuts to the policy interest rate have totaled 1,000 basis points since mid-2021, interest rates on bank loans have risen in the TCc, with interest rates on TL loans about four times the policy rate (as of March 2023).

Since the end of 2021, there has been an inversion in the ratio between the Turkish lira and other currencies for both loans and deposits

(Figures 1.9 and 1.10). While the Turkish lira has predominated since 2009, with the share of Turkish lira loans amounting to an average of 59 percent, after the latest depreciation episode from the end of 2021, the share of Turkish lira loans has declined and stabilized below 40 percent. A similar phenomenon characterizes deposits. While the increase in foreign currency credit—namely, credit denominated in a currency outside the currency area—is an indicator of liquidity in the financial markets, it also carries increased exchange rate risk. De facto, banks transfer currency risks to customers, when customers commit to debt service payments in foreign currency, regardless of the currency denomination of their revenues.

Table 1.1 Interest rates on deposits and loans by private banks, by currency (annual %)

	TL	US\$	EUR	GBP
Deposits	16.5	2.35	1.75	2.6
Loans	36.76	8.76	8.76	8.76

Source: TCc ‘central bank’ and sample of private banks; March 2023.

¹⁰ <https://ticaret.gov.ct.tr/Portals/11/Raporlar/%C4%B0statistik/01%20DT-%C4%B0th-%C4%B0hr-Rapor/01-DT-%C4%B0thalat/%C4%B0thalat-2022/ITHALAT%20OCAK%20-%20MAYIS%202022.pdf?ver=2023-02-20-133544-897>

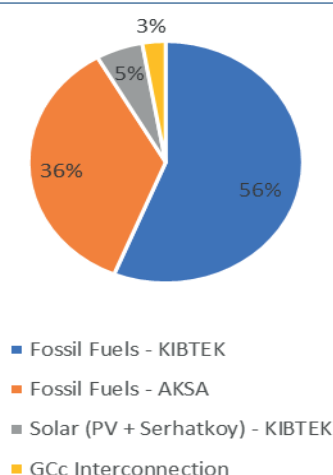


Box 1: The impact of the 2022 energy crisis on the TC economy

The impact of the energy crisis, further exacerbated by the war in Ukraine, has been particularly severe for the TC economy, given its high reliance on ‘imports’. About 60 percent of ‘imported’ fuel is used in electricity generation, while the rest is used in sectors such as transport, industry and agriculture. KIB-TEK, a ‘public’ company, deals with production, transmission, and distribution, while AKSA, a private company, is also involved in energy production. K-PET and ALPET instead deal with the sourcing of fossil fuels for the energy needs in the transport, industry, and agriculture sectors. Other domestic sources include renewable energy (RE),¹¹ such as solar, which amounted to 5.6 percent of total electricity production in 2022. Almost 3 percent was instead transferred from the RoC through the interconnection of the electricity networks (Figure 1.7). Despite the frequency differences between the electricity networks, which generate power outages, the interconnection plays an extremely important role in the security of energy supply.

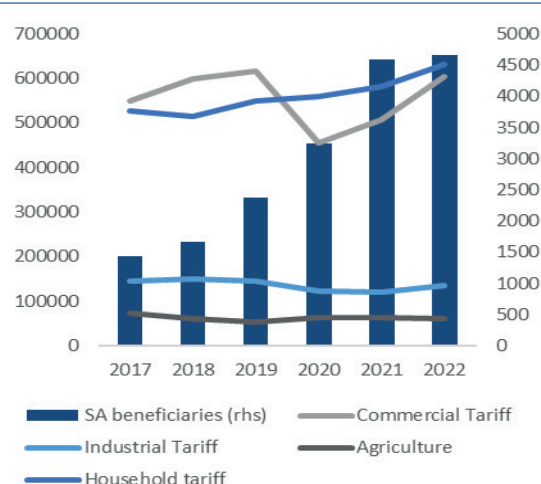
The TCc ‘administration’ has adopted measures to counteract the energy crisis, including expanding the social assistance; going forward, structural reforms to improve energy security will be of vital importance. In 2022, a multiple tariffs system based on the amount of electricity consumption was introduced. In addition, the amount of electricity consumption to qualify for energy subsidies more than tripled (from 1,444 MW in 2018 to 4,657 MW in 2022). Those under the poor-in-need support receive a cheaper tariff for the first 500 Kw utilized, with a tariff of TL 0.3442. For comparison, ordinary households face a tariff of TL 1.6110 for the first 250 Kw, and TL 3.3237 between 250 Kw and 500 Kw. Tariffs increase to TL 3.5737 between 501 Kw and 750 Kw, TL 3,8737 between 751 Kw and 1,000 Kw, and TL 4.5237 above 1,000 Kw. This has allowed for an expansion over time of the coverage of the social assistance (SA) support (Figure 1.8). Going forward, measures to promote energy efficiency and increase RE investments are a top priority to increase energy savings and energy supply, respectively. In addition, strengthening the energy cooperation between the two communities can contribute to overcoming structural problems and boosting the potential for RE across the island.

Figure 1.7 Electricity production in the TC economy (2022)



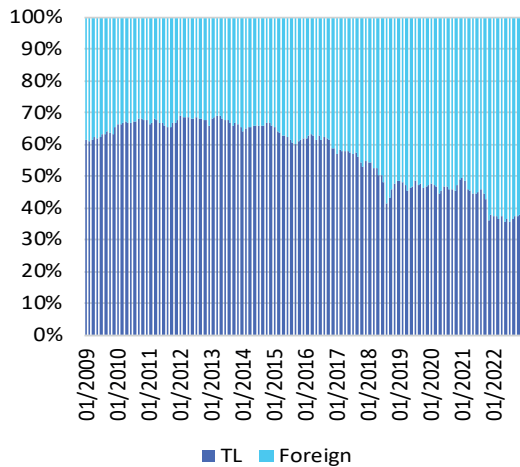
Source: World Bank staff, KIB-TEK.

Figure 1.8 Electricity consumption by consumer type, 2017–2022

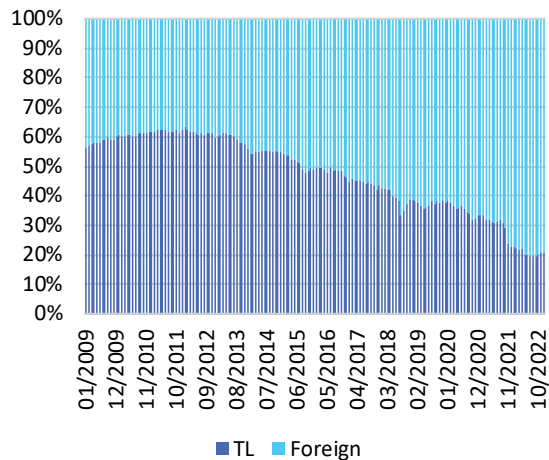


Source: World Bank staff, KIB-TEK.

11 In 2011, the ‘Renewable Energy Law’ (No. 47/2011) introduced the Renewable Energy Board and defined the key principles for RE production. With amendments in 2016, 2017 and 2021, further regulation was introduced with respect to the permits and implementation of the ‘Renewable Energy Law’.

Figure 1.9 Loans, by currency


Source: World Bank staff, TCc 'central bank'.

Figure 1.10 Deposits, by currency


Source: World Bank staff, TCc 'central bank'.

For example, firms that belong to industries that generate more revenues abroad tend to borrow in foreign currency. If customers are not perfectly hedged, a depreciation of the local currency increases the probability that a firm will become past due on its loans.¹² On the other hand, growth of foreign currency deposits reflects higher 'tourism' receipts. However, an increased exposure to foreign currency through deposits may also have negative implications, by increasing the pass-through of exchange rate shocks to domestic inflation.

In this context, risks stemming from the financial sector should be closely monitored and acted upon. As of December 2022, nonperforming loans (NPLs) amounted to almost 4 percent of total loans and reached 8 percent of the total for loans in Turkish lira, decreasing from the peak reached in 2020. Similarly, provisions for NPLs (as a share of NPLs) partially recovered, increasing to 60 percent, but remained still below the pre-pandemic ratio of 68 percent in 2019. The capital adequacy ratio of the sector declined toward the end of the year. Currency mismatch, with almost 80 percent of deposits denominated in foreign currency, while a large share of loans is still denominated in Turkish

lira, may expose the TC banking system to indirect systemic risk. The recent initiatives promoted by the TCc 'central bank' are expected to help reduce NPLs. In this context of elevated price pressures, tightening financial conditions, and exchange rate volatility, the banking system exposures to exchange rate risk and rollover risk need to be monitored carefully and contained through macro- and micro-prudential policies.

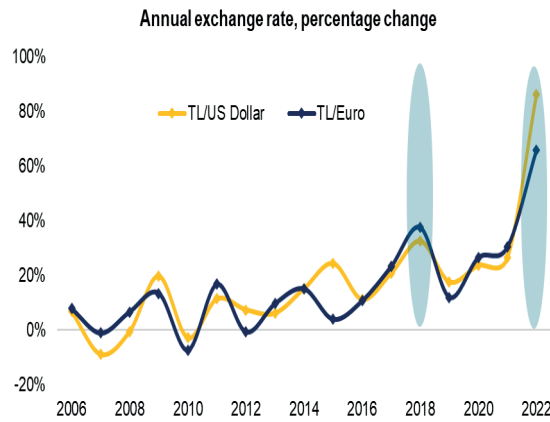
1.2 Rising inflation and inflation persistence raise concerns

A record of 120.7 percent inflation was reached in October 2022 year-on-year (yoy), amid a global surge in commodity prices and driven by the Turkish lira depreciation, which continued throughout 2022 (Figures 1.11 and 1.12). Headline inflation surged in 2022—more sharply than in any previous year—as currency depreciation and rising commodity prices, particularly for energy and food, passed through to consumers. Box 2 discusses the impact of agri-food inflation in the TC economy. Inflation has slightly decelerated since, reaching 84.9 percent in February 2023, but remains elevated. Core inflation, however, has also increased significantly since end-2021.

¹² Niepmann F. and T. Schmidt-Esinlohr (2022). *Foreign currency loans and credit risk: Evidence from U.S. banks*. Journal of International Economics. Vol. 135.

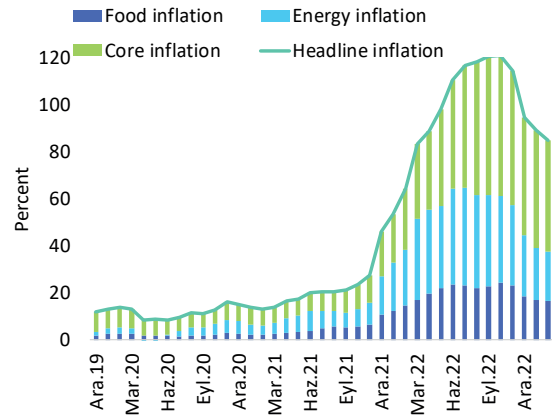


Figure 1.11 Turkish lira annual exchange rate depreciation in the TC economy, percentage change, 2006–2022



Source: World Bank staff, Central Bank of Türkiye.

Figure 1.12 Inflation components (2019.12–2023.02)



Source: World Bank staff, TCc 'statistics office'.

A key transmission channel of the Turkish lira depreciation on the TC economy is through its effect on domestic prices, namely the exchange rate pass-through (ERPT). Consumer prices in the TC economy have historically moved with the exchange rate and exchange rate shocks tend to be far stronger and have a more prolonged impact on inflation in the TC economy than in Türkiye.¹³ The Turkish lira shock has also had a double-sided impact on TC firms. From a cost/supply perspective, the Turkish lira depreciation generates higher inflation for TC firms compared with Turkish firms, putting TC firms at a greater disadvantage. From the demand perspective, since the Turkish market is by far the most important for TC products, TC companies cannot take advantage of the Turkish lira depreciation. Instead, Turkish companies are able to benefit from increased competitiveness of their own products and boost their exports to foreign markets.

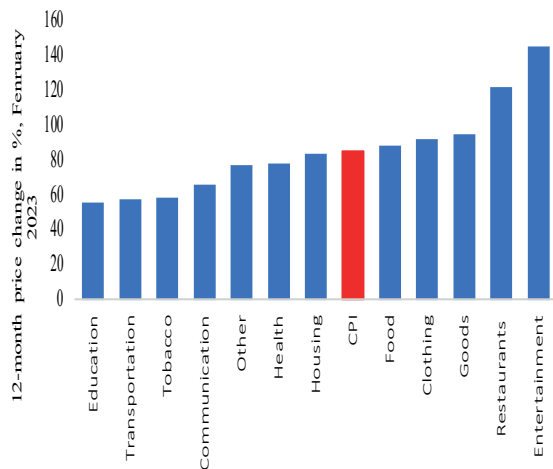
To strengthen the international role of the Turkish lira, Türkiye has promoted, and in some cases mandated, the use of the Turkish lira in commercial transactions with

its partner economies, also including the TC economy. On November 4, 2022, based on the amendment to the Article 9 of the Export Circular of the Central Bank of Türkiye, the use of the Turkish lira became mandatory for export declarations issued as of December 5, 2022, and collections made within this scope, *vis-à-vis* the TC economy.¹⁴ This policy may further weaken the position of TC companies *vis-à-vis* their Turkish peers and render the TC economy increasingly vulnerable to exchange rate shocks.

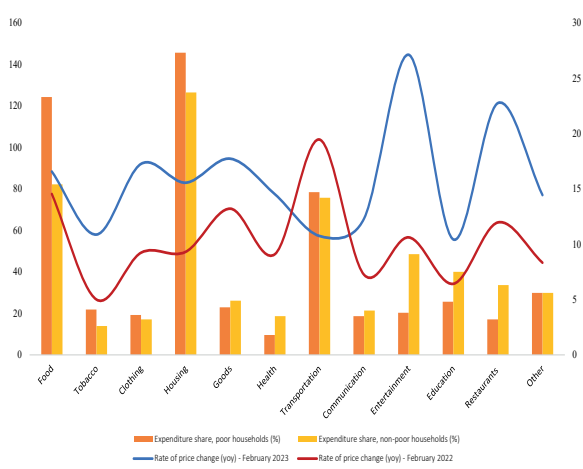
The TC economy shows a large dispersion in price changes across consumption goods, reaching above 80 percentage points in February 2023. The large dispersion in price changes in the TC economy is evident when looking at the price change by consumption group in February 2023 (Figure 1.13). While the 12-month price change was 84.9 percent, the prices of the entertainment and restaurants groups increased both by almost 140 percent in the same period, and the price of the education and transportation groups increased by around 56 percent—a difference between them of up to 84 percentage points.

13 World Bank (2022a) Macroeconomic Monitoring Report. Testing the Resilience of the Turkish Cypriot Economy.

14 Source: <https://www.kizilkaya.com.tr/media/8217/Ihracat%2BGenelgesi.pdf>

Figure 1.13 Twelve-month price change across items, February 2023


Source: World Bank staff, TCc 'statistics office'.

Figure 1.14 Inflation and expenditure share for poor households, by item, February 2023


Source: World Bank staff, TCc 'statistics office'.

The high dispersion across price changes implies that the increase in inflation affects households differently. Throughout Europe, the cost-of-living crisis in the region is so acute that 93 percent of Europeans identify inflation as their most pressing concern and the high inflation of 2022 had a heterogeneous impact on the population.¹⁵ Especially in the first half of 2022, price increases in the TCc were high in food, housing and transportation (Figure 1.14), which constitute about two-thirds of consumption expenditure among poor households. Therefore, due not only to the composition of their consumption basket, but also to the differentiated price increases across groups, in the TCc as well as in almost every economy in Europe, the poorest households were the ones that faced the highest inflation rates. In the second half of 2022, inflation was

instead mostly driven by rapid increases in restaurant (121 percent) and entertainment (145 percent) prices (Figure 1.14). Accounting for the variability of inflation rates across household types is crucial in designing effective strategies to protect vulnerable households and promote economic growth.

As shown in Figure 1.12, core inflation has also increased significantly. Since the 2021 currency depreciation episode, inflation in the TC economy has become more broad-based, with core inflation significantly on the rise. Although inflation is likely to gradually moderate in the short term, underlying inflationary pressures have become more persistent. Rising core inflation reflects in fact inertial inflation, the loosening fiscal and monetary policies, and second-round effects driven by wage and pension indexation.

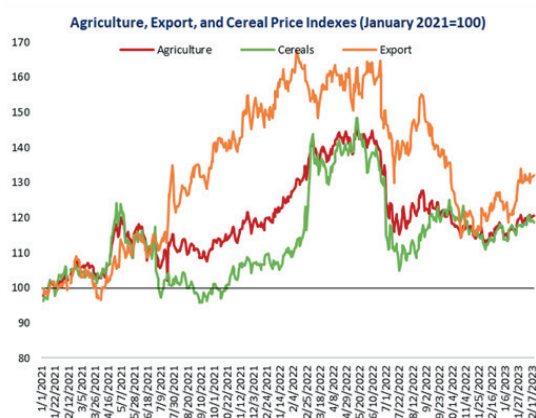
15 World Bank. 2023. Europe and Central Asia Economic Update Spring 2023. *Weak Growth, High Inflation, and a Cost-of-Living Crisis*. World Bank: Washington, DC.



Box 2: The impact of the global food crisis of the TC economy

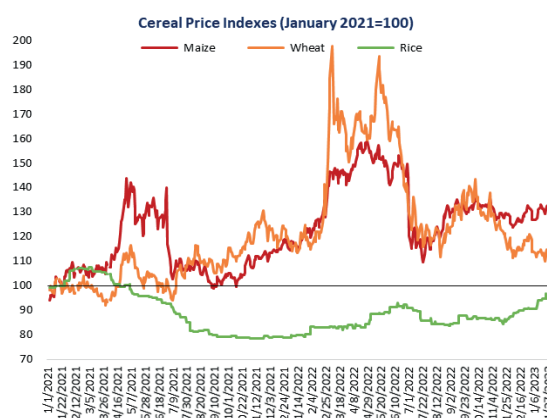
Global food prices, which reached a record high in 2022 caused by the COVID-19 outbreak and amplified by the war of Ukraine, have increased food insecurity and added to the cost-of-living crisis. Agricultural, cereal, and export prices remained relatively stable at the beginning of 2023, after food commodity prices declined in the third quarter of 2022 from their all-time highs in April 2022 (Figures 1.15 and 1.16). Despite a decline in the third quarter of 2022, food price indices remain almost 20 percent higher than one year ago and above historical standards. High food prices have also strained households' budgets, which required policy interventions to fund extra social protection measures for the most vulnerable.

Figure 1.15 Agricultural price trends (nominal indices)



Source: Food Security Update #79. Agriculture and Food Global Practice. World Bank.

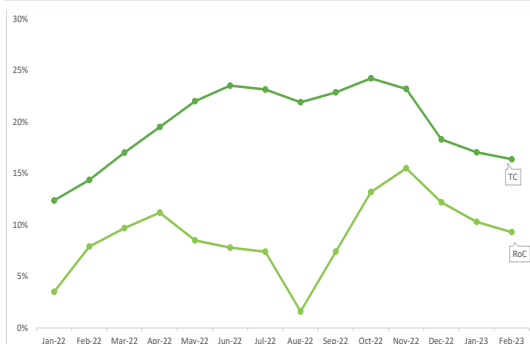
Figure 1.16 Cereal price trends (nominal indices)



Source: Food Security Update #79. Agriculture and Food Global Practice. World Bank.

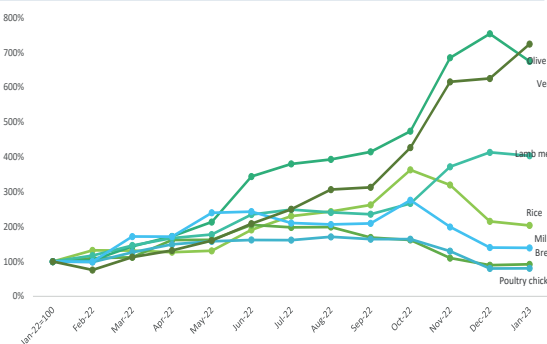
Domestic food price inflation¹⁶ remains high in almost all low- and middle-income economies, including in the GC and TC economies (Figures 1.17 and 1.18). In all, 83.3 percent of low-income economies, 90.2 percent of lower middle-income economies, and 91 percent of upper middle-income economies have seen inflation levels above 5 percent, with many experiencing double-digit inflation. The share of high-income economies with high inflation is also high, with about 85.5 percent experiencing high food price inflation. In the RoC economy, food price inflation reached 10.9 percent in January 2023 compared with the previous year (Figure 1.17), while the TC economy experienced the highest inflation since 1994, and some essential food product (Figure 1.18).

Figure 1.17 Food inflation in the RoC and TCc (% change, yoy)



Source: CYSTAT; TCc 'SO'.

Figure 1.18 Food product inflation in the TCc (% change, yoy)



Source: TCc 'SO'.

16 Domestic food price inflation is measured as year-on-year change in the food component of a country's Consumer Price Index (CPI).

(continued)

A rise in food inflation is the result not only of the pass-through of high global prices to domestic prices, but also of local factors. In a year of average weather conditions, the RoC has a self-sufficiency rate above 75 percent in almost all fresh agricultural products, including citrus, fresh fruits, fresh vegetables and potatoes. The self-sufficiency rate is also above 75 percent in most meat types (except beef and veal), including sheep and goats, pork, and poultry, but is dependent on external factors to feed them. The same applies for eggs and milk, but not for milk products where, apart from halloumi, other types of cheese are mostly imported. A shortage is observed in legumes, where almost 86 percent of local consumption is imported. Feedstuff used in livestock production is mostly imported, reaching 90 percent of the total consumption for barley and wheat, while for soya/oilseeds and corn all the locally consumed quantities are exclusively imported. Rising prices reflect the slowdown in agricultural growth observed more recently, driven by the disruptions of the supply chains triggered by the COVID-19 outbreak and recent drought episodes, but also due to declining productivity and limited resilience to climate shocks. In the TC economy, the high food inflation reflects the exchange rate depreciation and high dependence on ‘imports’ for both agricultural inputs and food products. Finally, the oligopoly of some ‘importers’ and the presence of ‘import’ restrictions¹⁷ have contributed to maintaining prices elevated.

Temporary measures have been introduced to offset rising prices of agricultural inputs and food items. More recently, in January 2023, the TCc ‘administration’ imposed a cap on the LPG price and appointed a working group for quality and price inspections. In the RoC, the first supplementary budget of 2022, passed by parliament in early June, included EUR18 million for the purchase and storage of strategic reserves of grains, plus EUR7.6 million in direct support to goat, cattle and pig farmers, but only to cover higher production costs, not to increase production.

Global and local food prices are projected to stay elevated in 2023 and 2024. The continuation of the war in Ukraine could create an export gap of 35 million tons of grains and oilseeds in the 2022/23 marketing year. The weather phenomenon El Niño could cause droughts in south and southeast Asia and Australia, and floods in Latin America. The International Monetary Fund (IMF) estimates that globally a 1-percent increase in fertilizer and oil prices—which have climbed recently and remain high—boosts food prices by 0.45 and 0.2 percent, respectively. All these risks, coupled with other important factors for the GC and TC economies (see Section 1.6, which discusses the short-term outlook), are expected to put upward pressure on food inflation globally, and in both the GC and TC economies in the foreseeable future.

To address high food price inflation and build food security, four key areas have been identified for further actions.¹⁸ First, it is necessary to continue to provide immediate support to the vulnerable. Second, trade facilitation should be strengthened by removing trade restrictions and adopting inspections and licensing processes that are more flexible to help minimize supply disruptions and lower prices to producers and consumers. Third, increasing transparency and improving the monitoring of trade measures will be critical. Fourth, further investments and targeted support are also needed to encourage farmers to boost sustainable food production and invest in climate-resilient agriculture.

Increasing food prices have negative distributional impacts and should be monitored closely. Rising food prices have a higher burden on the budgets of low-income households and can push households into poverty if their incomes are not rising at the same rate (Laborde et al., 2020; Baez et al., 2021). Rising food prices (and also prices in general) can deepen the extent of deprivation among poor and vulnerable households, and force them to use unsafe coping strategies (i.e., skipping meals, selling assets, etc.), which could have severe and long-lasting consequences. Transfer programs should support low-income families to offset the adverse impacts of rising prices.

17 World Bank (2021). Policy Note on the Impact of Import Restrictions on Goods Accessing the Turkish Cypriot Market. mimeo.

18 <https://www.worldbank.org/en/news/statement/2022/07/15/joint-statement-by-the-heads-of-the-food-and-agriculture-organization-international-monetary-fund-world-bank-group-world>

Box 3: Informality in the TC economy

Informal—or shadow—economies consist of activities that have market value but are not formally registered in national accounts and fiscal balances. Informal economic activity is widespread in emerging markets and developing economies where, on average, it accounts for about one-third of output and more than two-thirds of employment. In general, the informal economy, as a percentage of national income, has been in decline in emerging markets for several decades, a trend attributed in large part to policy reforms. Indeed, between 1990 and 2018, the informal sector’s contributions to national economies, on average, fell by about 7 percentage points of GDP (Ohnsorge and Yu, 2022).

Widespread informal sector activity hampers economic development in a variety of ways and is broadly associated with weaker economic outcomes. Economies with large informal sectors have lower per-capita incomes, greater poverty, more limited financial development, and weaker growth in output, investment, and productivity. Economies with above-average informal activity tend to have one-quarter to one-third the GDP per capita of economies with little informality. Moreover, informal activity strains fiscal revenues, hampering the abilities of governments to provide services, conduct countercyclical policies, service debt, and/or implement crisis-response measures (Ohnsorge and Yu, 2022).

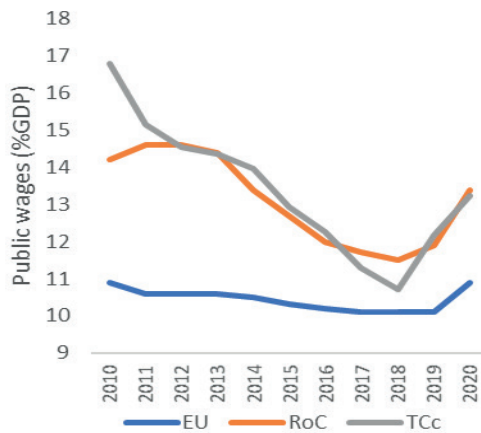
More effort is needed to assess the extent of informality in the TC economy, and to design effective policies to tackle it. Some initial estimates of the size of the informal economy exist (Kıbrıs Türk Ticaret Odası, 2015). More recently, the TCc ‘administration’ has announced renewed efforts with the aim of combating informality. In March 2023, inspections have been announced by the ‘department of labor and social security’ to provide an assessment of the informal economy and to develop measures to reduce it.¹⁹ Overcoming the challenges of informal economic activity requires a combination of policies tailored to economy-specific circumstances, informed by the drivers of—and challenges posed by—informality. Where informality is predominantly a reflection of poor governance, streamlining regulatory and tax frameworks while improving the efficiency of public revenue collection and regulatory enforcement as well as strengthening public service delivery can help bolster tax morale. Complementary measures should be also designed to expand access to finance, markets, and inputs to foster firm productivity and growth; to improve education system to facilitate formal sector employment; and to enhance safety nets to cushion household risks.

The response of wages—both private and ‘public’—and pensions to an increase in inflation is one of the factors leading to second-round effects, hence making the inflationary shock more persistent. Indexation—namely, the practice of adjusting wages (both private and public and including also minimum wages) and pensions (including minimum pensions) based on the changes in another price or composite indicators of prices—broadly aims at preventing purchasing power losses for the recipients. In an inflationary environment, a reduction in purchasing power due to rising prices, with heterogenous impacts across

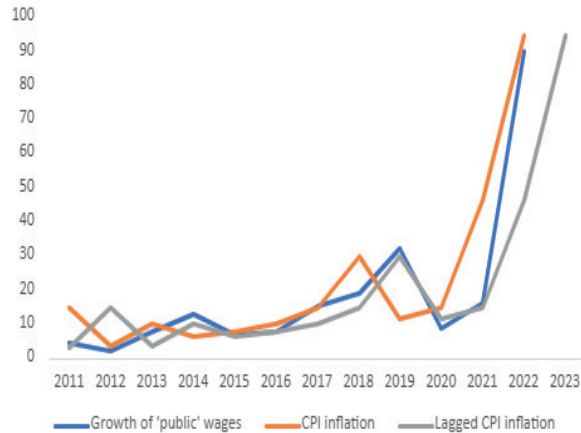
population groups, and the consequent erosion of real incomes, is in fact the single biggest cost of inflation. At the same time, indexation may contribute to making the inflationary shock more persistent, creating a spiral inflation-wage indexation-inflation. When the indexation of wages and pensions to inflation is automatic, the transmission tends to be more likely, particularly in high inflation contexts. While transmission from wages may likely affect both the demand and the production sides, pensions are likely to impact demand through disposable income.²⁰

¹⁹ Source: <https://csgb.gov.ct.tr/HABERLER/kay%c4%b1t-d%c4%b1%59f%4%b1%4%b1k-%c4%b0le-m252cadele-ale-ai%4%b1nd%4%b1>

²⁰ Alvarez et al. (2022) shows that wage-price spiral risks still appear contained. Based on the historical evidence, only a small minority of such episodes were followed by sustained acceleration in wages and prices. Instead, inflation and nominal wage growth tended to stabilize, leaving real wage growth broadly unchanged.

Figure 1.19 ‘Public’ wages spending (% of GDP)


Source: Eurostat; TCc ‘ministry of finance’.

Figure 1.20 ‘Public’ wages growth and inflation in the TC economy


Source: World Bank staff, TCc ‘statistics office’, TCc ‘ministry of finance’.

Similar to other small economies, the TC economy has a large ‘public’ sector, with ‘public’ employment reaching 30 percent of total employment, which is double the EU average. As a share of GDP, the size of ‘public’ administration in small economies tends to be larger than in other emerging economies. This partly reflects the fixed costs of ‘public’ sectors, which are high relative to their small economies and their populations. In the case of the TCc, this is also a reflection of a large informal sector (see Box 3) and a significant wage gap between private and ‘public’ sectors, despite the modest ‘public’ salaries compared with the EU average.

While compensation for employees still accounts for significant budget resources, it has decreased significantly over time, momentarily approaching alignment with the EU average in 2018, before increasing

once again (Figure 1.19). Personnel spending has decreased significantly in the past decade, following a reform of ‘public’ employment, introduced in 2010 (‘Law 47/2010’), which introduced a new salary system for ‘public’ employees.²¹ Earlier, in 2008, a performance-based assessment had been introduced for promotion. Indexation of ‘public’ wages remains de facto fully automatic, with ‘public’ wages growth following closely lagged inflation and current inflation in 2022 (Figure 1.20).²² Similarly, both pensions and minimum pensions can also be considered to be fully indexed to inflation.^{23,24}

Similar to other EU economies, recent events and policy measures have partially reversed this trend. Since 2018, spending on ‘public’ wages has picked up in both the TC and GC economies. Moreover, minimal economic growth in 2019, followed by the deep recession

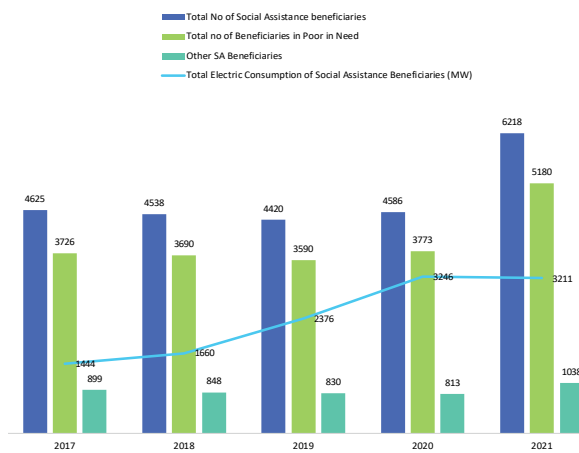
21 Teachers, armed forces personnel, and contract-based ‘public’ servants are paid on a different salary scale.

22 In the EU, (full or partial) price indexation of public wages is relatively limited and applies to about one-fifth of the Euro zone public wage bill. In most economies, public wages are not automatically indexed to inflation, nor does inflation play a formal role in wage setting. Full and partial price indexation is reported in five countries, representing about 20 percent of the euro area public wage bill in 2021. In two of these (Belgium and Luxembourg), public wages are fully automatically indexed to prices (with a backward-looking index, linked to the cost of living); the RoC and Malta have a similar but more restricted indexation scheme categorized as partially automatic. In Italy, expected inflation excluding energy is taken into account during negotiations for contract renewals: if inflation turns out to be higher than the increase in public wages over the three-year contract period, the difference is made up in the following three-year period. Finally, public wages are currently frozen in Greece and France (in the latter, until end-2022; the freeze does not apply to education, health and low wages).

23 See ‘Law 7/79’; ‘Law 82/2009’; and ‘Law 47/2010’.

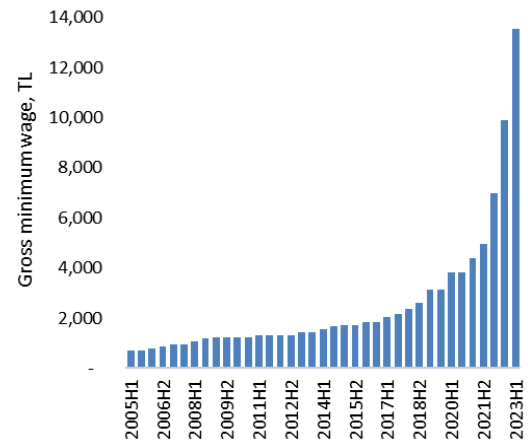
24 In the EU, public pensions are indexed automatically—fully or partially—to prices and wages, mostly in a backward-looking way, in almost all countries. Only Ireland does not apply automatic indexation. Full price indexation of public pensions is applied in six countries (Belgium, Greece, Spain, Italy, Luxembourg and Slovakia); indexation to economy-wide wages and the minimum wage is applied in Germany and the Netherlands; all the remaining countries apply partial automatic price indexation.

Figure 1.21 Number of SA beneficiaries and energy consumption subsidized, 2017–2021²⁵



Source: 'TCc 'department of social services', KIB-TEK.

Figure 1.22 Minimum wage, 2005–2023



Source: www.csgeb.gov.ct.tr

in 2020 and the subdued recovery thereafter, have also contributed to a reversal in the declining trend in the personnel spending-to-GDP ratio in the TC economy, well ahead of what has been observed in other economies.

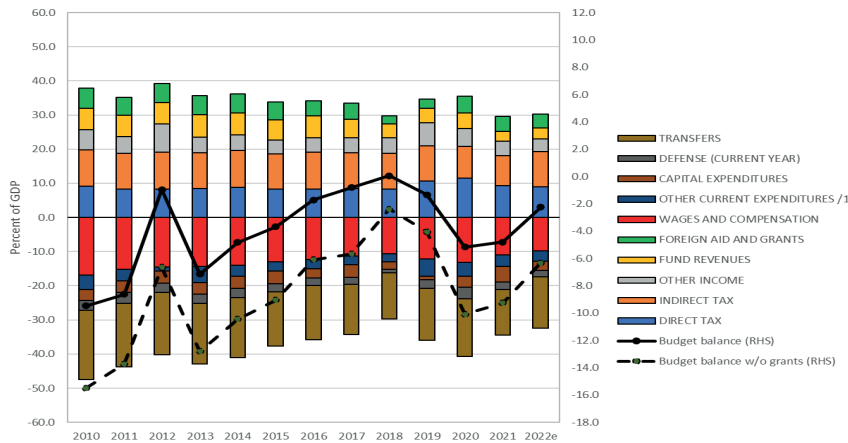
The TCc 'administration' has stepped in to control the wage bill, strengthen social support and promote a fairer system, especially toward low-income households. The TCc 'administration' has introduced measures to reduce the wage gap between people employed in the 'public' sector before and after the 2010 reform.²⁶ In parallel, since 2018, the TCc 'administration' has increased the coverage of social assistance (SA), mostly driven by the expansion of the energy subsidy program in which eligibility is limited only to the social assistance beneficiaries (Figure 1.21; see also Box 1). Finally, the TCc 'administration' has also raised the minimum wage, but its increase since 2019 has been modest, especially if compared with the inflation rate increase (Figure 1.22).

1.3 Pressures on fiscal and external imbalances remain elevated in 2022

The strong recovery and higher revenue collection have led to a reduction in the deficit, despite mounting inflationary pressures (Figure 1.23). In 2022, spending surpassed TL 20 billion, with more than 40 percent of total expenditures destined to transfers, followed by wages and compensation at almost 40 percent and capital expenditures declining to about 9 percent. The share of defense spending dropped slightly from 7 percent of total expenditures in 2021 to 5.8 percent in 2022. Meanwhile, revenues, excluding grants, reached almost TL 18 billion, mostly driven by indirect taxes, which make up about 37 percent of local revenues, due to rising prices. Aid received from Türkiye in the form of grants constitutes the most important source of funding in alleviating the financing gap between revenues and budget expenditures, amounting to TL 2.6 billion, of which almost half was in the form of defense grants (Figure 1.24). Loans from Türkiye amounted to TL 1,191 million. Debt is expected to remain

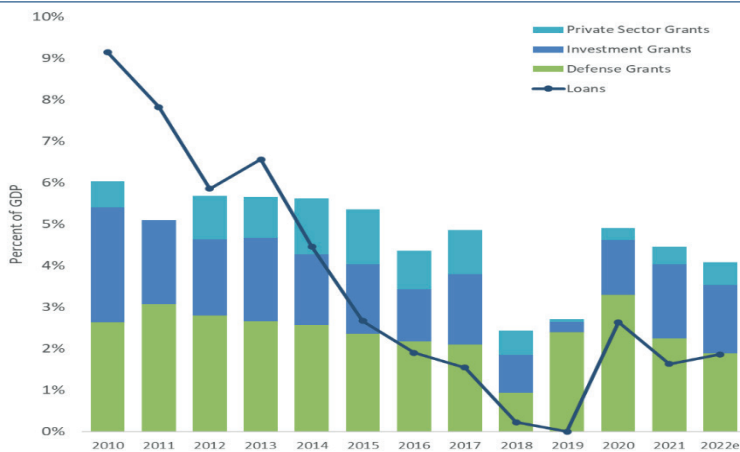
²⁵ The "Others" category includes: disabled veterans; martyrs' families; parents of the martyrs; disabled; foster families; urgent allowances.

²⁶ <http://basbakanlik.gov.ct.tr/BASIN-VE-HALKLA-%C4%B0L%C4%B0C5%9EK%C4%B0LER/BASIN-A%C3%87IKLAMALARI/472010-sayili-yasa-kapsamindak%C4%B0-kamu-199ali%C5%9Fanlarina-maa%C5%9F-arti%C5%9Fi-%C4%B0199%C4%B0n-protokol-%C4%B0mzalandi>

Figure 1.23 Fiscal accounts: revenues, expenditures and balance (% of GDP)


/1 Residual category. Total-wages and compensation-capital expenditures-defense-transfers

Source: World Bank staff, TCc 'ministry of finance'.

Figure 1.24 External financing from Türkiye


Source: World Bank staff, TCc 'ministry of finance'.

high, but the debt-to-GDP ratio should remain below the historical average due to high inflation (Table 1.2). However, while in the short run this may benefit 'public' finances, in the context of high inflation, a negative impact on economic activity from an adverse supply shock may end up outweighing the positive impact of higher inflation on debt ratios.²⁷

The current account deficit, excluding grants from Türkiye, is estimated to remain

elevated. Based on the available data until May 2022, merchandise 'exports' declined by 3 percent, while 'imports' increased by 39 percent compared with the corresponding period in 2021. Despite the expected increase in 'exports' over the course of the year, this may not have been enough to compensate for rising 'imports', and the current account deficit is therefore expected to remain elevated at about 4 percent of GDP (Table 1.2).

27 Bankowski et al. (2023).

Box 4: Key features of small economies

Small economies are a heterogeneous group with diverse economic features, but they share common attributes that make them especially vulnerable to shocks. These include limited connectivity, dependence on imports of essential goods, highly concentrated economic structures, a large public sector, reliance on external financing, and susceptibility to natural disasters and climate change. The TC economy shares most of these characteristics with the other small economies. However, policy inaction and delayed urgently needed structural reforms add to its vulnerability.

Key characteristics. Small economies are defined as economies with populations of 1.5 million or less. As of 2022, none of these economies is classified as low income. They have very high levels of trade openness, importing a large percentage of their food and/or fuel, and are three times more reliant on global shipping than the world average. Their exports are concentrated in tourism and the production of primary commodities, and in most cases not energy, metals, meat, or grain. As a group, small economies tend to run fiscal deficits and depend on a mixture of aid and foreign direct investment (FDI) to finance large current account deficits. On average, small economies have higher public debt levels than other EMDEs. Nearly all small economies have fixed exchange rates. Due to their size and geographic locations, they are also more vulnerable to the effects of climate change. These features, together with other country-specific challenges, make small economies especially vulnerable to shocks.

Categorization into subgroups. The sample of small economies is categorized according to the subgroups: tourism-reliant;²⁸ commodity importers or commodity exporters²⁹; with fixed exchange rates;³⁰ islands or land-locked; remittance-reliant economies;³¹ fragile and conflict-affected situations. The TC economy shares similar economic characteristics with tourism-reliant and commodity-importer island economies.

1.4 As with other small economies, the Turkish Cypriot economy faces overlapping crises and multiple challenges

Small economies suffered disproportionate adverse economic impacts from the COVID-19 pandemic, largely due to prolonged disruptions to global tourism. As a group, they suffered a far more severe recession in 2020 and a much weaker initial rebound than other emerging markets and developing economies (EMDEs) (Figure 1.25).³² Output contracted

by more than 11 percent in small economies, seven times higher than other EMDEs. The recession was even deeper in tourism-reliant small economies, including the TC economy, with GDP contracting by nearly 13 percent and more than 16 percent in the TC economy. In the RoC, a small, open and advanced economy that is also tourism-reliant, the output contraction was also pronounced at 5 percent, albeit much less than in other small economies, but more than the EMDE average, once small economies are excluded. Its openness renders the RoC especially vulnerable to both demand and price shocks in the Euro zone.

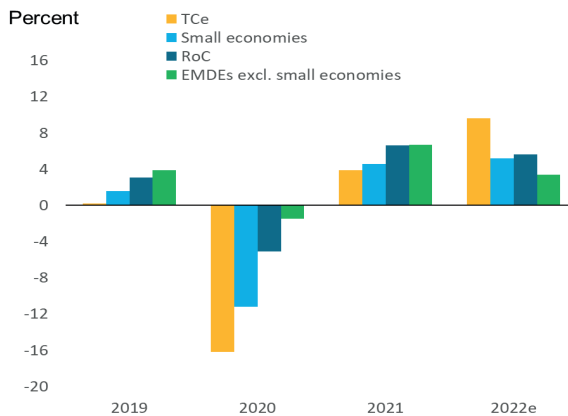
²⁸ Tourism-reliant economies report inbound tourism expenditures as a share of GDP during 2015–19 above the 3rd percentile of the share in all EMDEs, based on UN World Tourism Organization data.

²⁹ Exports of these two types of commodities accounted for 20 percent or more of total exports, on average, in 2017–19. Economies that meet these thresholds as a result of re-exports are excluded.

³⁰ Fixed exchange rates include managed arrangements, pegs within horizontal bands, crawl-like arrangements, crawling pegs, stabilized arrangements, conventional pegs, currency boards, and the absence of a country-issued legal tender.

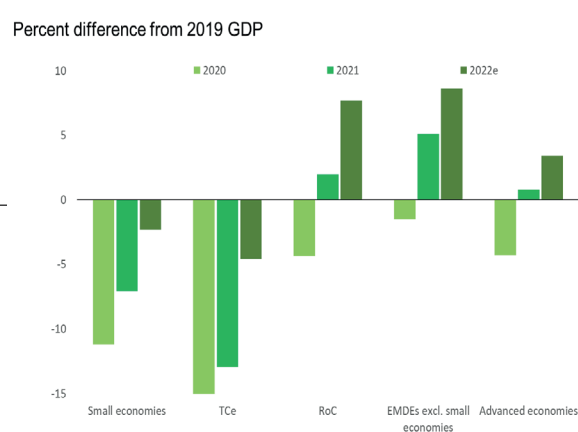
³¹ Remittance inflows as a share of GDP between 2015–20 above the 75th percentile of all EMDEs (i.e., above 8 percent of GDP), based on World Bank data.

³² EMDEs include all those that are not classified as advanced economies and for which a forecast is published for the World Bank (2023) Global Economic Prospect report. Dependent territories are excluded. Advanced economies include the RoC, among others.

Figure 1.25 Real GDP annual growth, 2019–2022


Source: World Bank staff estimates.

Note: EMDEs = emerging market and developing economies; FCS = fragile and conflict-affected situation economies. Country groups are GDP weighted at average 2010–19 prices and market exchange rates. Sample includes 34 EMDE small economies (of which 11 are commodity-exporters, six are FCS, and 22 are tourism-reliant) and 115 EMDEs excluding small economies and Guyana.

Figure 1.26 Real GDP annual variation (%) from 2019 baseline, 2020–2022


Source: World Bank staff estimates.

Note: EMDEs = emerging market and developing economies; FCS = fragile and conflict-affected situation economies. Country groups are GDP weighted at average 2010–19 prices and market exchange rates. Sample includes 34 EMDE small economies (of which 11 are commodity-exporters, six are FCS, and 22 are tourism-reliant) and 115 EMDEs excluding small economies and Guyana.

The typical features of small economies amplified the effects of the 2020 global recession and have slowed their recoveries.

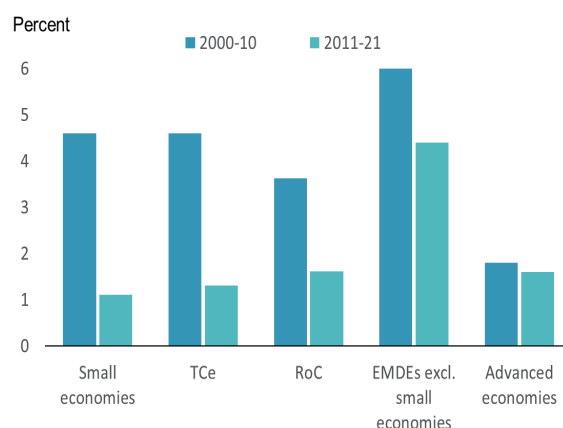
Recoveries remained weak in 2021 and for at least part of 2022, as new COVID-19 variants prolonged travel restrictions. In parallel, soaring global prices and supply chain disruptions resulting from the war in Ukraine and the global monetary tightening cycle, brought into focus the risks of depending on imported essentials. From 2 percent in January 2020, inflation in the median small economy increased to 7.5 percent in September 2022, even as domestic demand remained weak. With debt levels well above the EMDE average, global monetary policy tightening raised debt servicing costs and threatens to further slow small economies' recoveries, with large and possibly permanent losses to their levels of output.

The TC economy had a far more severe recession in 2020, a weaker initial rebound, and a slower recovery than other small economies. In addition to the indicated challenges, the TC economy suffered even more than other small economies (Figures 1.25). The deeper impact of the overlapping crises observed for the TC economy reflects instead not only its economic structure, but

also the byproduct of ineffective policies to build resilience and competitiveness. Small economies, including the TC economy, are not expected to regain their pre-pandemic levels of per capita output until after 2023, and only after other economies recover more fully (Figure 1.26). Conditions in the RoC and other advanced economies have deteriorated sharply since mid-2022 (amid high inflation, rapid monetary tightening, reduced fiscal support, and major energy supply disruptions and price hikes in Europe). In all, growth in advanced economies slowed from 5.3 percent in 2021 to 2.5 percent in 2022 and it is projected to slow to 0.5 percent in 2023, as central banks continue to tighten monetary policy to contain inflationary pressures, labor markets soften, and energy market disruptions in Europe persist.

Small economies are subject to a variety of risks, including dependence on imports of essential goods, highly concentrated economic structures, reliance on external financing, and susceptibility to natural disasters and climate change. Most small economies entered the global tightening cycle with adequate reserve buffers, but an external financing shock could nonetheless create significant financial stress, particularly in small economies with highly

Figure 1.27 Average annual growth, 2000–2010 vs 2011–2021

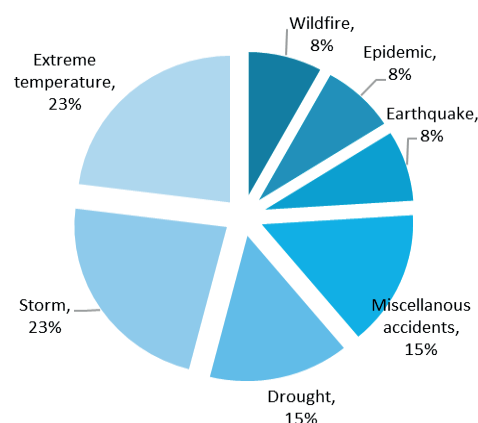


Source: World Bank staff estimates.

Note: EMDEs = emerging market and developing economies; FCS = fragile and conflict-affected situation economies. Country groups are GDP weighted at average 2010–19 prices and market exchange rates.

Sample includes 34 EMDE small economies (of which 11 are commodity-exporters, six are FCS, and 22 are tourism-reliant) and 115 EMDEs excluding small economies and Guyana.

Figure 1.28 Average annual natural hazard occurrence in Cyprus for 1980–2020



Source: World Bank Climate Knowledge Portal

<https://climateknowledgeportal.worldbank.org/country/cyprus/vulnerability>

indebted private sectors. In the long term, small economies, including the TC economy, face adverse structural conditions that have weakened their growth even before the recent succession of shocks (Figure 1.27), and further weaken their prospects. Remoteness, lack of scale, and limited connectivity raise costs and constrain diversification efforts for small economies such as the TC economy. Trade costs are almost one-half higher in EMDEs than in advanced economies. In the TC economy, the average price of goods accessing the TC market is 20.1 percent higher than similar goods accessing regional benchmark economies, rising to 26.6 percent for varieties protected by bans.³³ The RoC has experienced a reduction in its average annual growth from 3.6 to 1.6 percent in the past two decades. However, access to the EU market has partially eased the problems related to remoteness and limited connectivity for the RoC.

Damage from climate and natural disasters, estimated at nearly 5 percent of GDP annually, on average, for small economies, is

increasing. Similar to other small economies, and particularly island economies, the TC economy is susceptible to natural disasters and climate change. The island of Cyprus is vulnerable to earthquakes and floods, with the former posing the greater risk of a high impact and lower probability event. The World Bank disaster risk profile for the island of Cyprus³⁴ shows that: (i) the annual average population affected by flooding in Cyprus is about 400 and the annual average effect to GDP is about US\$4 million; (ii) the annual average population affected by earthquakes in Cyprus is about 5,000 and the annual average effect on GDP is about US\$70 million; (iii) and the annual average fatalities and capital losses due to earthquakes are less than one, and the losses about US\$10 million, respectively. The fatalities and capital losses caused by more intense, less frequent events can be substantially larger than the annual averages. As global temperatures keep rising, extreme temperature and storms—the most common shocks in Cyprus since 1980 (Figure 1.28)—are expected to become even more frequent.

³³ World Bank (2021). Policy Note on the Impact of Import Restrictions on Goods Accessing the Turkish Cypriot Market. mimeo.

³⁴ World Bank (2017). Disaster Risk Profile: Cyprus. <https://www.gfdr.org/en/publication/disaster-risk-profile-cyprus>



1.5 The outlook for 2023 is subject to uncertainty and downside risks

On February 6, 2023, two powerful earthquakes of 7.8 and 7.5 magnitude struck southeast Türkiye and northwest Syria. In Türkiye, the earthquakes resulted in widespread damage across 11 provinces, where around 14.01 million (16.5 percent) of Türkiye's population live, including Adana, Adıyaman, Diyarbakır, Elazığ, Gaziantep, Hatay, Kahramanmaraş, Kilis, Malatya, Osmaniye and Şanlıurfa. More than 55,000 fatalities have been reported overall, of which over 50,000 in Türkiye. Millions have been displaced. Two weeks after the powerful earthquakes, a third 6.3 magnitude earthquake hit southern Türkiye, causing additional deaths and injuries. The earthquakes have caused an estimated US\$34.2 billion in direct physical damage in Türkiye, equivalent to about 4 percent of the country's 2021 GDP. According to the Global Rapid Post-Disaster Damage Estimation (GRADE) Report (World Bank, 2023),³⁵ the recovery and reconstruction costs are expected to be much larger, potentially twice as large, and GDP losses associated to economic disruption will also add to the cost of the earthquakes. The affected region accounts for more than 9 percent of the economy, and 14.3 and 11 percent of agricultural and industrial production, respectively.

Despite a drag on growth in 2023 due to earthquake-related production, export, and consumption disruptions, pre-election spending and earthquake recovery are expected to support growth in Türkiye in 2023. Economic activity is expected to remain solid in H1 2023, supported by a 55 percent net minimum wage increase in January 2023 and expansionary fiscal policies ahead of the 2023 elections set for May 14, which will counteract weakening global demand. Massive reconstruction efforts in the earthquake

zone—with large multiplier effects—will boost growth in late-2023 and beyond. However, pre-election spending and earthquake recovery are expected to further weaken fiscal balances and long-term debt sustainability, as observed after episodes of reconstruction following natural disasters.³⁶

The policy response of the Turkish government to the earthquakes, including further monetary and fiscal expansion, may require budget reallocations and lead to further depreciation, inflation and debt pressures. The Central Bank of Türkiye is expected to cut its policy rate further. It also used reserves to help steady the Turkish lira in the aftermath of the earthquakes, and reserves could remain under pressure in the weeks ahead. The central bank is also reported to have asked banks to take actions to ease pressure on the lira. Lastly, the central bank announced government bonds purchase plans. The earthquakes added pressures to an increasingly fragile macro-financial situation amid a deteriorating external environment and particular domestic policy mix. Despite rapidly rising inflation, the Central Bank of Türkiye continued to cut interest rates by 550 bps from August 2022 to February 2023, while relying on an increasingly complex mix of heterodox macro-prudential regulatory measures to support the Turkish lira, reduce inflation, and control and direct credit growth.

The social implications of the Türkiye and Syria earthquakes for the TCc are significant. The TCc mourns the loss of 49 Turkish Cypriots who died in Türkiye during the earthquakes on February 6. The TCc 'administration' amended the relevant legal text enabling relatives of the earthquake victims to access financial support. Moreover, an estimated 1,000 people among the displaced from Türkiye have applied for humanitarian aid to the TCc 'social services department'. They can apply for 'humanitarian residence permits', which have a validity of six months. However, for them to work, relevant

35 Gunasekera, Rashmin; Ishizawa Escudero, Oscar Anil; Daniell, James Edward; Pomonis, Antonios; Macabuag, Joshua Lee David Clifton; Brand, Johannes; Schaefer, Andreas; Romero, Roberth; Esper, Sarah; Otálora, Samuel González; Khazai, Bijan; Cox, Kerri Dionne. *Global Rapid Post-Disaster Damage Estimation (GRADE) Report: February 6, 2023 Kahramanmaraş Earthquakes - Türkiye Report (English)*. Washington, DC: World Bank Group. <http://documents.worldbank.org/curated/en/099022723021250141/P1788430aeb62f08009b2302bd4074030fb>

36 Fan, R.Y., Lederman, D., Nguyen, H. et al. Calamities, Debt, and Growth in Developing Countries. IMF Econ Rev (2023). <https://doi.org/10.1057/s41308-023-00200-3>

restrictive permits would need to be lifted. Access to health and education systems is free and granted, as no regulatory change was needed.

The economic implications are also expected to be significant, mostly through trade and aid channels, and increased risk of further depreciation and inflation. Both ‘imports’ and ‘exports’ to and from the affected areas are expected to be impacted, not only given existing trade relations, but also due to the disrupted functionality of the İskenderun port. Box 5 provides details on the trade relations between the TC economy and the affected cities, and a comparison with the 1999 earthquake. The TC economy is expected to experience additional supply chain disruptions and price increases. The TC economy faces risks arising from its high inflation, as a consequence of both domestic factors and the currency depreciation, exacerbated by loosening monetary and fiscal policies in Türkiye, in response to the earthquake and ahead of the 2023 presidential elections.

Moreover, aid from Türkiye, expected to be around TL 5.5 billion in the 2023 budget of the TCc ‘administration’, could be significantly downsized due to the need of the Government of Türkiye to repurpose spending toward emerging support and reconstruction. Aid from Türkiye is a critical source of financing for the TCc ‘administration’. It has however contributed to overall procyclicality of fiscal policy. Since the early 2000s, aid from Türkiye has turned from being countercyclical to procyclical—namely, increasing during good times—hence contributing further to the economic volatility of the TC economy. Overall, both revenues and spending have been procyclical in the TC economy since 1977, and procyclicality has increased over time. Among revenues, while the procyclical nature of tax revenues represent a good feature, as they act as automatic stabilizers of the business cycle, procyclicality of aid is detrimental to short-

and long-term growth, as more aid is received when the economic activity is at full potential. On the spending side, all components tend to be highly procyclical, with the only exception being defense spending, which tends to be countercyclical, decreasing in good times. The combination of these factors has resulted in more volatile economic cycles and less fiscal space to counteract them, and in a reduced effectiveness of fiscal policy as a lever to reduce macroeconomic volatility—an essential role in the context of the TC economy.

The TCc ‘administration’ has reacted promptly to provide emergency support, but more action is needed going forward to strengthen preventive and preparedness mechanisms.

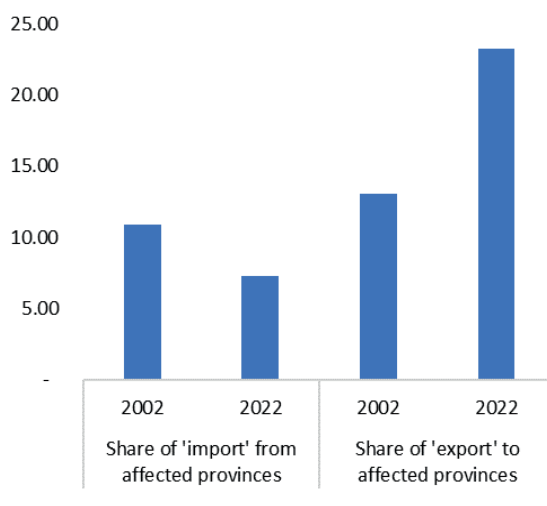
Coordination groups, both at the central and local levels, have been established to deal with emergency and disaster preparedness in the case of a possible earthquake directly affecting the island. The ‘disaster and emergency management committee’ under the ‘prime minister’ was established in 2016. One of the first tasks undertaken in 2023 was a review of the safety of school buildings. Consultations are ongoing for the establishment of an ‘earthquake legal process follow-up committee’ to deal with the reform of earthquake regulations. Efforts are needed to update the existing regulations and to align them with EU and international best practices. On March 2, a ‘communication committee’ was established to prepare for, and ensure, uninterrupted communications in the case of a possible earthquake. A bi-communal initiative has also been initiated to deal with disaster risk management (DRM) from an island-wide perspective. Moreover, the ‘ministry of finance’ has considered a set of measures to deal with increasing financing needs by either cutting spending, including through (voluntary) pay cut or paycheck deductions, a 1 percent deduction on interest rates on TL deposits (2 percent if deposits in other currencies) above 100,000 TL, or by raising revenues.

Box 5: The economic impact of the İzmit earthquake in 1999

The economic impact on the TC economy from the 2023 earthquakes may be mostly felt through ‘exports’, as the affected Turkish provinces account for almost one-quarter of total ‘exports’ to Türkiye (Figure 1.29). The 11 provinces hit by the earthquakes, mostly from the East Anatolia region and two from the Mediterranean region, have become less important over time in terms of supply for the TC economy, but more important as destination markets for TC products.

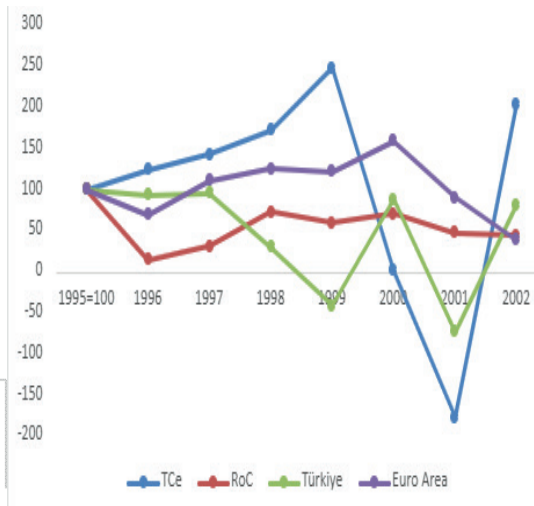
In the past, despite the strong trade linkages with affected areas by similar disasters, the TC economy proved resilient. The İzmit earthquake on August 17, 1999, with a magnitude of 7.4, struck the Anatolian fault system with the epicenter at about 7 miles southeast of İzmit. About 17,000 people lost their lives and some 250,000 people were left homeless. The İzmit earthquake happened in the industrialized and most densely populated urban areas, also including Istanbul. Overall, the nine provinces accounted for one-third of Türkiye’s GDP. The earthquake triggered a recession for the Turkish economy, with GDP dropping by 5.8 percent. Despite of significant trade links, the economic impact in the TC economy was not large, as opposed to the financial crisis that struck just a few years later (Figure 1.30).

Figure 1.29 Trade by provinces of Türkiye, 2002–2022



Source: Turkstat.

Figure 1.30 Real GDP growth pre- and post-1999



Source: WDI; TCc ‘SO’.

Against this background, GDP growth for the TC economy is expected to subside in 2023 at just above 1 percent. The forecast builds on the assumption that the war in Ukraine persists in the near term, with no further escalation in the intensity. The projections also assume that sanctions imposed on Belarus and the Russian Federation remain in place. Energy prices are assumed to moderate from 2022 averages. Türkiye’s growth is expected to remain robust at 3.2 percent, driven by pre-electoral and

reconstruction spending, but with implications for further depreciation and rising inflation. The Euro zone, instead, is expected to grow at 0.5 percent in 2023, and inflation to remain still above policy targets. In this context, the key driving sectors for the TC economy, such as ‘tourism’ and ‘exports’, may witness a deceleration. However, the new supply chain disruptions are expected to further increase the price of intermediate goods. The agriculture sector may also be negatively impacted by the

Turkish lira depreciation and a further increase in input prices, combined with the adverse impact of weather and the drought risks for 2023. While inflation is expected to decline from the all-time peak reached in 2022, it is nevertheless expected to remain high and among the highest in the region, with negative consequences for the purchasing power of households, hence leading to a slowdown in poverty reduction, income convergence, and a reduction in consumption. While the latter, together with a deceleration of energy and commodity prices, may contribute to a reduced growth of 'imports', this may not be enough to compensate for reduced 'exports', hence resulting in increased pressures on external accounts.

Risks for the outlook of the TC economy remain skewed to the downside, mostly driven by external factors. The earthquake hit an already fragile recovery which, despite speeding up in 2022, was facing several uncertainties and downside risks. Above all, these uncertainties could manifest in a more prolonged and increasingly intense war in Ukraine. The TC economy faces risks arising from its high inflation, as a consequence of both domestic factors and Turkish lira depreciation, incremented by loosening monetary and fiscal policies in Türkiye, in response to the earthquake and ahead of the 2023 presidential election. Substantial inflation and continuing depreciation may further weaken both corporate and 'public' balance sheets. The already limited fiscal space may be further eroded and debt vulnerabilities amplified. The TC economy has long been afflicted by low productivity, per capita income growth, and convergence. These trends are set to persist, with elevated prices for essential goods endangering poverty reduction. Economic losses from climate-related and natural disasters add to these challenges.

1.6 In the aftermath of multiple crises, key policy priorities emerge

The TCc 'administration' should maintain its focus on providing emergency support to those in need while reducing vulnerability to future crises and building macroeconomic

stability. In a context of extremely high imbalances, prudent fiscal policies should be pursued, aimed at ensuring medium-term debt sustainability, while raising potential growth in a sustainable manner and addressing the resilience objective. Only an adequate macroeconomic policy framework can help the TC economy restore price stability, lessen the impact of the cost-of-living crisis and anchor any reform agenda. In the aftermath of multiple crises, five reform priorities emerge. First is to maintain the focus on providing emergency support to the poor and most vulnerable, i.e., those most impacted by the cost-of-living crisis. Second is to strengthen energy security, by boosting investment in renewable energy (RE) sources, promoting energy efficiency, and reforming energy tariffs. Third is to strengthen resilience to natural disaster- and climate change-related risks. This can be achieved by strengthening financial protection, investing in risk reduction, and improving preparedness. Fourth is to strengthen resilience in the broader sense, through competitiveness-enhancing reforms, thereby building a more competitive private sector. Fifth is to enhance human capital and to recover from pandemic-induced losses.

Building an adequate macroeconomic framework

An adequate macroeconomic policy framework should anchor any reform agenda. The TC economy is confronted by the challenge of increasing social and fiscal pressures that are exacerbated by its acute vulnerability to external developments. Advancing reforms to create fiscal space, reduce fiscal risks, increase counter-cyclicality, and reduce budgetary rigidities will be key in building resilience and enhancing macro-fiscal stability. Reorienting 'public' finance toward emerging needs and development priorities will be paramount in successfully steering the TC economy toward a new growth model, rather than allowing precious resources to be absorbed by inefficient 'public' spending in non-viable sectors. A gradual shift toward a simpler, more progressive, and more efficient tax system is also needed to increase revenues and reduce distortions. In addition, ensuring strengthened revenue collection for the Local Community Bodies (LCBs),



while enhancing their accountability, will also be key in ensuring the sustainability of local finances. Finally, a counter-cyclical stance, supported by the implementation and monitoring of simple fiscal rules, is crucial in protecting the economy from future shocks.

In the context of high inflation, the empirical association between fiscal policy and developments in inflation should be monitored and fiscal policy deployed to restore price stability and lessen the impact of the cost-of-living crisis. While fiscal policy's impact on inflation has changed over the decades, it remains significant; for a sample of advanced economies since 1985, it is estimated that reducing expenditure by 1 percentage point of GDP lowers inflation by half a percentage point (IMF, 2023). To respond effectively to high inflation, the TCc 'administration' should first have a full understanding of how fiscal policy impacts inflation and how households are affected. The distributional impact of fiscal policy should also be understood. The Special Issue provides an initial step in this direction. Furthermore, the TCc 'administration' should carefully assess the impact of 'public' wage setting during periods of high inflation, including through indexation, on the setting of private wages, the impact of pension indexation, and the potential effects of inflation on the structure of the tax system.

Key short-term and medium-term actions can help improve the macroeconomic policy framework. In the short term, actions include: (i) conducting a fully-fledged 'public' finance review, including tax policy and tax expenditure, 'public' expenditure, fiscal incidence analysis (with the Special Issue laying the basis for it), and the incentive system; (ii) designing and introducing a cyclical-adjusted fiscal rule and fiscal council to help monitor and guarantee fiscal sustainability and macroeconomic management; (iii) enhancing domestic mobilization, including through reforming income tax and broadening the revenue base of the LCBs; (iv) improving 'public' debt, mitigating exchange rate risks and monitoring financial sector risks; and (v) taking stock of arrears and contingent liabilities, and developing a report-

ing and monitoring mechanism to avoid their future build-up. In the medium term, a broader reform of both the revenue and spending frameworks, together with a broader strategy to support private sector development, is needed to achieve a return to growth.

Providing emergency support to the poor and most vulnerable

Transfer programs, such as the "Poor in Need" program, and programs for disability, education, and health care, should continue to support low-income families to offset the adverse impacts of rising prices. In the short term, the system should aim to protect the real value of the SA transfers. Second, the system should aim to provide SA transfers to poor and vulnerable households, by improving its targeting mechanisms, especially given limited resources. For example, the "Poor in Need" program has an age limit. De facto, the TCc does not have a program to support poor people just because they are poor. The eligibility criteria for the "Poor in Need" program could be adjusted to improve the coverage of the program.

Strengthening energy security

To strengthen energy security, the TCc 'administration' could focus on: (i) boosting investment in RE sources, also in a joint effort with the RoC; (ii) promoting energy efficiency; and (iii) reforming the energy tariffs system. While a multi-tariff rising block structure is often motivated by the need to subsidize basic consumption for the poorest, it is important to assess whether the tariff structure is calibrated to ensure that the average tariff equates with cost recovery and that the benefits do not leak to higher income groups, which is especially important at a time of heightened fiscal pressures. Subsidies are also unsustainable because the developments in the energy markets, coupled with the need for significant investment in the sector, suggest that energy costs are going to continue increasing. To avoid passing such an increase through to households would require even greater subsidies. Continuing to shelter consumers through subsidies to the sector might therefore

prove to be unsustainable in the near future.³⁷ Finally, fiscal measures that are not temporary, targeted and tailored to preserving incentives to consume less energy are likely to exacerbate inflationary pressures.³⁸

Strengthening resilience to natural disaster- and climate change-related risks

As the TC economy recovers from the impacts of the pandemic and deals with the socio-economic consequences of the earthquakes, there is an opportunity to become more resilient to natural disaster- and climate change-related shocks. This can be achieved by strengthening financial protection, investing in risk reduction, and improving preparedness, also in coordination with the RoC. Key actions include: (i) enhancing technical and human capabilities in civil defense and DRM to prioritize, design, and implement interventions; (ii) improving the availability of risk information on disaster and climate risks at different scales; and (iii) learning from, and sharing, best practices and knowledge on prevention and preparedness to raise awareness of the importance of investing in prevention and preparedness.³⁹

Strengthening resilience in the broader sense, through competitiveness-enhancing reforms

The TCc ‘administration’ should continue to reduce the administrative burden on businesses and facilitate GL trade, which, despite having increased significantly, remains extremely low. A shift in paradigm is needed through overhauling the current fiscal incentive framework toward a more effective use of resources, including investment in climate-resilient agriculture, quality-enhancing processing technologies, and increased compliance to standards. Building a competitive private sector would require reforming business regulations and procedures that are under the mandate of the TCc ‘administration’ and that should be aligned with international best practices and

the *EU Acquis*. Special attention should continue to be devoted to the regulation concerning ‘imports’ and GL trade. Pre-permits, licenses imposed by the TCc ‘administration’, and bans as well as the lack of risk management practices, on top of regulatory uncertainty and other cumbersome procedures, contribute to increasing prices, penalizing consumers and eroding competitiveness of TC firms *vis-à-vis* their competitors. In addition, addressing risks to the financial sector, stemming from further currency depreciation but also sharp slowdown in economic activity in reference to capital adequacy and NPLs, can help strengthen financial stability and access to finance.

Enhancing human capital

The COVID-19 pandemic caused large losses in working hours, especially for female workers, and extended school closures in the TCc, as in other small economies, which may have left permanent scars. Box 6 provides a preliminary assessment of the impact of the pandemic on health and education in the TCc. Enacting policies that increase access to pre-primary education is crucial to sustaining and strengthening the current and future workforce. Greater access to high-quality childcare and early learning programs will support mothers so that they can work, and this will benefit children, leaving them better prepared for school and the job market later in life. Re-skilling policies should also be introduced, as participating in the labor market may have become more difficult for workers who lost their jobs and may have become low-skilled since. The quality of Vocational Education and Training (VET) and Lifelong Learning programmes should also be improved, thereby enhancing the employability of youth graduating from VET schools and ensuring skills and competences are in line with the needs of the private sector. Investing in human capital should be at the center of any policies aimed at bolstering the economy.

³⁷ See, for example, World Bank (2013).

³⁸ Bankowski et al. (2023).

³⁹ World Bank (2021). Economics for Disaster Prevention and Preparedness Investment in Disaster Risk Management in Europe Makes Economic Sense.

Box 6: The impact of COVID-19 pandemic on human capital in the Turkish Cypriot community

Despite unprecedented human development gains over the past 25 years, serious challenges remain, especially for developing economies. Human capital consists of the knowledge, skills, and health that people invest in and accumulate throughout their lives, enabling them to realize their potential as productive members of society. Investing in people through nutrition, health care, quality education, jobs, and skills improves human capital development—a critical component in ending extreme poverty and creating more inclusive societies. Despite development gains over the past 25 years, gaps in human capital are widening amid rapid global changes in technology, demography, fragility, and climate. Conflict events and pandemics can have a devastating effect on human capital through loss of life, livelihoods, nutrition, and the interruption of essential health and education services. Such impacts reverberate throughout many individuals' lifespan, limiting their total productivity. Despite these known effects, investment in people are relegated to a lower economic priority.⁴⁰

In the TCc, a dramatic reversal of the declining trend of the infant mortality rate points to the need to develop more data to understand the causes and inform needed measures to address them. The infant mortality rate is the number of infants dying before reaching 1 year of age per 1,000 live births in a given year. In addition to providing information regarding maternal and infant health, the rate is a primary indicator of a society's overall health. Ending preventable deaths of newborns and children under 5 years of age is a major priority on the list of the SDGs (Target 3.2). Compared with 1961, the infant mortality rate in all EU member states, including the RoC, has fallen dramatically. Over the past decade alone, the infant mortality rate in the EU fell from 4.0 deaths per 1,000 live births in 2010 to 3.1 deaths per 1,000 live births in 2021 (Figure 1.31). Türkiye has a higher incidence of infant mortality. However, it too has made remarkable progress, halving infant deaths from 15.5 to 7.7 per 1,000 live births in the past decade. Meanwhile, the TCc, which had the lowest infant mortality rates in previous years, shows an alarming reversal in infant mortality reduction. While the infant mortality rate in the TCc remained between 2 and 3 deaths per 1,000 live births, it started increasing after 2016 and surpassed 7 deaths per 1,000 live births in 2021. Possible socio-economic factors driving the recent rise in the indicator could include the indirect effects of the COVID-19 pandemic. The direct impact of COVID-19 on child, adolescent and youth mortality seems to be limited, but there is concern that the indirect effects of the pandemic on mortality in these age groups due to strained health systems, household income loss, and disruptions to care-seeking and preventative interventions, such as vaccinations, may be more substantial.⁴¹ Additional factors contributing to a deterioration in infant health may be related to: (i) the decline in 'public' health expenditure, which declined from 3.6 percent of GNP in 2019 to 3.1 percent, and from 9.9 percent of total spending to 7.6 percent over the same period; (ii) aging health infrastructure and a reduced availability of ventilators during the pandemic, and numbers of physicians/health personnel; and (iii) reduced levels of education of expectant mothers, such as breast-feeding, and also family planning and birth control methods, among other. Other factors could include access to clean drinking water, hygienic conditions, and maternal health.

The COVID-19 pandemic took its toll on education outcomes more severely in the TCc in 2020. The gross enrolment ratio—namely the ratio of total enrolment, regardless of age, to the population of the age group that officially corresponds to the level of education shown⁴²—indicates the capacity of each level of the education system. A high ratio may, however, reflect a substantial number of overage children enrolled in each grade because of repetition or late entry rather than a successful education system.⁴³

40 In 2018, the World Bank launched the Human Capital Index (HCI), which quantifies the contribution of health and education to the productivity of the next generation of workers. The index is a summary measure of the amount of human capital that a child born today can expect to acquire by age 18, given the risks of poor health and poor education that prevail in the country where she lives. The index was updated in 2020 and covers 98 percent of the world's population. Read more at: [https://www.worldbank.org/en/publication/human-capital#:~:text=The%20Human%20Capital%20Index%20\(HCI,the%20next%20generation%20of%20workers](https://www.worldbank.org/en/publication/human-capital#:~:text=The%20Human%20Capital%20Index%20(HCI,the%20next%20generation%20of%20workers).

41 Source: <https://data.unicef.org/topic/child-survival/covid-19/>

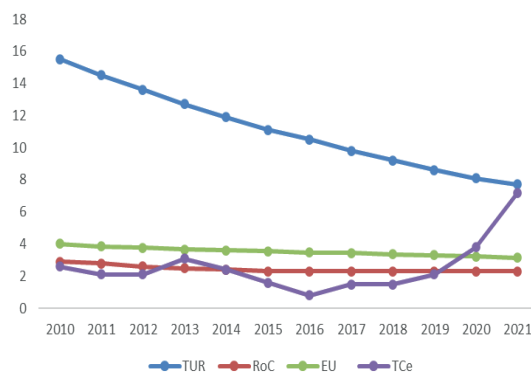
42 UNESCO Institute for Statistics (UIS). UIS.Stat Bulk Data Download Service. Accessed October 24, 2022. <https://apiportal.uis.unesco.org/bdds>.

43 Enrolment indicators are based on annual school surveys, but do not necessarily reflect actual attendance or dropout rates during the year. Also, the length of education differs across countries and can influence enrolment rates, although the International Standard Classification of Education (ISCED) tries to minimize the difference.



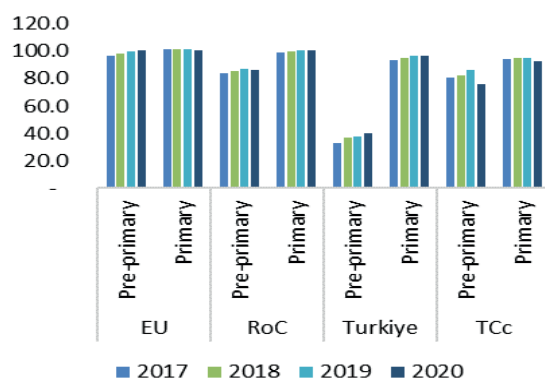
Ensuring, among other things, the completion of equitable and good-quality primary and secondary education to all school-age children is crucial for development and is a major priority on the list of the SDGs (Target 4.1), which call for all children to complete free, equitable and quality primary education, leading to relevant and effective learning outcomes, by 2030. From the late 1990s, the level of primary education in all EU member states has remained high. However, over the past decade, the gross enrolment ratio in primary education in the EU declined from 103.4 percent in 2013 to 100.5 percent in 2020 (Figure 1.32). Türkiye also has a high level of primary education. However, it too has had a reversal in the past decade, when its primary education gross enrolment ratio fell from 107.2 percent in 2013 to 93.2 percent in 2017, after which it started to rise once again and stabilized at 97 percent in 2019. While the RoC showed low levels of education in the 1970s and 1980s, the gross enrolment ratio in primary education jumped from 80.5 percent in 1992 to 101.1 percent in the following year, and since 2005 has maintained a stable rate above 90 percent. The TCc also experienced an increase in the primary enrolment rate⁴⁴ over time. However, the ratio decreased more in 2020, by almost 3 percent, from 95.3 percent in 2019. A similar drop is observed in the pre-primary enrolment rate (Figure 1.32). Despite both ratios recovering in 2021 back to their pre-pandemic levels (not shown in the figures), the relatively sizable drop in 2020 compared with that observed in the EU or the RoC, suggests that long-lasting scars from the pandemic losses may be more severe.

Figure 1.31 Mortality rate, infant (per 1,000 live births)



Source: WDI and TCc Statistical Yearbook 2021.

Figure 1.32 School enrolment, pre-primary and primary (% gross)⁴⁵



Source: WDI and TCc Statistical Yearbook 2021.

Note: For the TC economy, 'primary school includes 'primary and junior high school' (5–14 age group).

Finally, relatively low pre-primary enrolment rates, when compared with the EU average, also reflect low female participation in the labor force both in the TCc and the RoC. Childcare challenges can be a barrier to work, especially for mothers who disproportionately take on unpaid caregiving responsibilities when their family cannot find or afford childcare. Studies show that the universal free pre-primary policy has a positive impact on the labor force participation of mothers with pre-primary school age children.⁴⁶ In some cases, the availability of private preschools instead do not increase work participation of women in the labor market, but instead increases the likelihood of holding a second job. The availability of preschools induces mothers to informal sector occupations that do not require full-time commitments.⁴⁷ The reopening of schools may not be enough to return mothers' labor force participation back to its pre-pandemic levels.⁴⁸ This is particularly relevant for the TC economy, since women made up for 76 percent of job losses in 2020 and only partially returned to work in 2021.⁴⁹

44 Education in TC is compulsory until the age of 15 and the literacy rate is almost 100 percent. Specifically, the education system consists of pre-school education (for children between the ages of four and six), primary education (7–12 age group, it lasts for five years and is free and compulsory), secondary education (13–15 age group, it lasts for three years and is free and compulsory) and higher education (16–18 age group, it lasts for three years).

45 The gross enrolment ratio is the ratio of total enrolment, regardless of age, to the population of the age group that officially corresponds to the level of education shown.

46 See for example, Li (2020) and Ilin et al. (2022).

47 See Halim et al. (2019).

48 <https://www.brookings.edu/research/the-relationship-between-school-closures-and-female-labor-force-participation-during-the-pandemic/>

49 Source: LFS.


Table 1.2 Key economic indicators of the TC economy

	2018	2019	2020	2021	2022e	2023f
Real economy						
Real GDP, % change	1.3	0.2	-16.2	3.9	9.6	1.3
Agriculture, % volume change	2.6	2.7	1.8	-1.5	-6.1	-5.0
Industry, % volume change	-12.4	-14.6	-15	16.8	3.0	-5.0
Services, % volume change	3.2	1.4	-18.4	7.9	12.1	5.1
CPI, period average, % change	23.1	19.5	11.7	21.4	94.5	70
Fiscal accounts						
Revenues, % GDP	29.8	34.6	35.5	29.7	30.2	28.6
Expenditures, % GDP	29.8	35.9	40.6	34.5	32.7	33.8
Fiscal Balance, % GDP	0.1	-1.3	-5.2	-4.8	-2.5	-5.1
<i>excluding aid from Türkiye, % GDP</i>	-2.4	-4	-10.1	-9.2	-6.6	-10.4
Local Balance ^a % GDP	0.9	-0.5	-3.5	-2.5	-1.9	-4.3
'Public' Debt, % GDP	120.1	142.1	168.2	156.3	140.8	126.9
<i>Internal, % GDP</i>	30.0	37.9	44.4	40.5	38.5	33.5
<i>External, % GDP</i>	90.0	104.2	123.8	115.8	102.2	93.4
Balance of Payments						
Current Account Balance, % GDP	5.7	11.8	-8.5	-1.4	-3.9	-6.8
Excl. foreign grants, % GDP	3.3	9.1	-13.5	-5.8	-8.0	-12.0

Source: 'SPO', 'statistics office' and World Bank staff.

Note: e=estimate; f=forecast. Forecast may be subject to revision as data for 2022 become available.

^a Local Balance is computed as the difference between local revenues (total revenues, excluding grants from Türkiye) and local expenditures (total expenditures, excluding the ones financed by Türkiye).

Special Issue: Do Fiscal Policies Help Reduce Income Inequality in the Turkish Cypriot Economy?

Income inequality in the TCc is considerably higher than in most European economies.

Using data from the 2015 Household Budget Survey, the Gini coefficient in the TCc is estimated to be 34.1 percent, 3 points above the EU average of 31 percent. This places the TCc at the higher end of the range of economies for which similar estimates can be derived using Eurostat data, which show this measure varying from 24 percent in Slovakia to 40 percent in Türkiye. Income inequality in the TCc is also much higher than in other small islands such as Malta (28.1 percent), Iceland (24.7 percent), and the RoC (33.6 percent). The relative poverty rate in the TCc - derived following the Eurostat methodology of proportion of households with an equivalized disposable income below 60 percent of the median equivalized disposable income - is estimated at 22.2 percent. This is high compared with the EU average (17 percent) and it is among the highest ones, after Serbia, Romania, Türkiye and Latvia.

This Special Issue assesses the effectiveness of fiscal policies in reducing poverty and income inequality in the TCc. These policies include taxes, fees to collect revenue and transfers to support households, including subsidies, pensions, other direct transfers, as well as education and health. Their distributional impact depends on which households bear the relative burden of taxes and which ones benefit from transfers and social spending. The identification of the distributional effects of existing policies and new reforms can play a key role in redistributing the benefits of economic growth and in enhancing the incomes of poor households. This chapter presents the first attempt to quantify their distributional impacts; in essence, the analysis aims to answer the following three key questions:

1. what is the overall impact of fiscal policy on inequality and poverty?

2. how does TCc compare with other economies in terms of the distributional impact of its fiscal policy?
3. how can the analysis be used to inform policy reform?

2.1 An overview of taxes in the Turkish Cypriot economy

Revenue collection of the TCc 'administration' is relatively low compared with EU economies.

While the EU average for tax-to-GDP⁵⁰ ratio is around 41.7 percent in 2021, it was only 19.7 percent for the TCc 'administration'. As the recovery gains speed, increasing tax revenue mobilization is key to build fiscal space to counteract future shocks. In the TCc, revenue collection is largely implemented at the central level. Total tax revenues constitute 19.7 percent of GDP, according to the most recent information in 2021, of which indirect taxes (value-added tax [VAT], and customs and excise tax) account for 35 percent of all the tax revenues or 7 percent of GDP, while direct taxes (personal income tax [PIT] and corporate income tax [CIT]) constitute 44 percent of all tax revenues or 8.6 percent of GDP in 2021. Overall, around 79 percent of the fiscal revenues in the TCc come from four primary sources (PIT, VAT, CIT and customs and excise duties), and the remaining 21 percent are primarily from other tax revenues (property tax, 4%; duty fees, 7%; vehicle tax, 2%) or non-tax revenues (around 8 percent).

1. Direct Taxes

Personal income tax is the primary source of direct tax collection in the TCc 'administration'. PIT applies progressive taxation to labor income and other sources of individual income. PIT is collected monthly through withholding on labor income and through annual declarations. Personal income tax brackets range from 10 to 37 percent.

⁵⁰ Includes taxes and social contributions

Table 2.1 Key parameters for PIT and allowances (TL, per year)

	2019	2020	2021	2022	2023
Annual personal discount	28,300	36,800	42,000	75,600	150,000
Top of 10% bracket		5,000			15,000
Top of 20% bracket		10,000			30,000
Top of 25% bracket		19,000			57,000
Top of 30% bracket		30,000			90,000
Top of 37% bracket		30,000+			90,000+

Source: TCc 'tax department'. **Note:** There is also a max SSC. In 2023, this amounts to 94,941 TL (per month).

A set of several allowances is used to further inject progressivity into the system. Beyond the personal allowance reported in Table 2.1, there are six more categories of allowances: a special allowance on PIT due on net earnings for employees; an allowance for the dependent spouse; an allowance for dependent children, which varies with the number of children; a disability and old-age allowance; an allowance for social security expenses; and an allowance for expenses for municipal occupation tax and life insurance premiums. Allowances apply to all individuals and reduces the effective tax rate for personal income tax significantly.

Similar to other economies, there is only one Social Security Contribution (SSC) rate, independent of the income level. The contribution rate to the Social Security Fund is applied on the gross wage and amounts to 11 percent for the employer and 9 percent for the employee.⁵¹ The employer's rate is relatively low compared with the OECD/EU economies. The TCc 'administration' contributes 6 percent, bringing the overall SSC rate close to the OECD/EU average.^{52,53,54} Similar to other economies,

the TC system also foresees a minimum and maximum contribution.

Finally, among direct taxes, property-related taxes are paid according to the type of property. Property owners pay property taxes to local administrative units, and it is based on the square meter size of the property. However, the central 'administration' collects VAT from the buyers and income tax from the sellers in case of an exchange of properties.

2. Indirect Taxes

Among the indirect taxes facing households, VAT in the TCc is the major indirect tax revenue⁵⁵ and is characterized by numerous rates and exemptions. In the TC economy, five VAT rates are applied: 0, 5, 10, 16, and 20 percent. The standard VAT rate of 16 percent is below the EU average and applies only to a very limited set of products⁵⁶ due to the long list of reduced rate goods. A few basic goods, such as agricultural raw materials, cereals, and milk, have 0 percent VAT rate. Most intermediary raw products such as flour, honey, cheese, diapers,

⁵¹ From the gross taxable income, 13 percent of the mandatory SSC can be deducted.

⁵² Most OECD economies adopt instead a progressive schedule. Among them, five adopt a minimum threshold for employer SSC, while 13 countries adopt a maximum threshold (which does not necessarily correspond to maximum PIT income threshold), hence de facto setting the maximum SSC rate. Finally, nine countries instead do not apply any income thresholds to SSCs.

⁵³ In the RoC, since January 1, 2019, the employees' own contribution to the state-administered social insurance fund is 8.3 percent of their gross remuneration, with a maximum annual cap on insurable emoluments as of January 1, 2023, of EUR60,060. The rate of 8.3 percent applies for both employee and the employer up to December 31, 2023. Thereafter, the rate will increase every five years by 0.5 percent until it reaches 10.3 percent as of January 1, 2039.

⁵⁴ A similar provision exists in the RoC.

Source: https://ec.europa.eu/employment_social/empl_portal/SSRinEU/Your%20social%20security%20rights%20in%20Cyprus_en.pdf

⁵⁵ Other major indirect taxes are customs taxes and taxes from the vehicles, and additional fees.

⁵⁶ Most services and products not defined by law are subject to 16 percent VAT rate. For specific products, which fall under a reduced rate of 5 percent regime in the EU, namely feminine hygiene products, a high rate of 16 percent is applied. The VAT rate of 20 percent is applied the alcohol, tobacco and luxury items.

property, and related items with construction have 5 percent VAT rate. Fossil fuels, fizzy drinks, all kinds of prefabricated products, wooden or metal materials and similar items are subject to 10 percent VAT. Alcoholic drinks, all kinds of tobacco-related products and all luxury services and products are subject to 20 percent VAT. In addition, tax on ‘customs’ constitute a large share of revenue collection in the TCc (around 25 percent). Tax on motor vehicles, communication tax, electricity ‘municipal’ tax, water ‘municipal’ tax and road tax are also paid by the consumers of these goods and services.

2.2 The impact of fiscal policies on poverty and inequality in the TCc

The distributional impact of fiscal policy in the TCc is assessed through the Commitment to Equity (CEQ) methodology. The CEQ, based on Lustig (2018), is a comprehensive incidence analysis that uses data from household surveys and administrative accounts to assess the impact of taxes and social transfers on household poverty and inequality. Box 1 provides a brief explanation of the methodology and data used. The approach has been applied in over 70 economies.

Box 1: The Commitment to Equity (CEQ) model for the TCc: methodology and data

The method is based on an accounting approach; it adds and subtracts taxes and transfers to household per capita income to measure income before and after each fiscal intervention. The per capita household income after transfers and taxes Y_h for household h is given by

$$Y_h = I_h - \sum_i T_i S_{ih} + \sum_j B_j S_{jh} \quad (1)$$

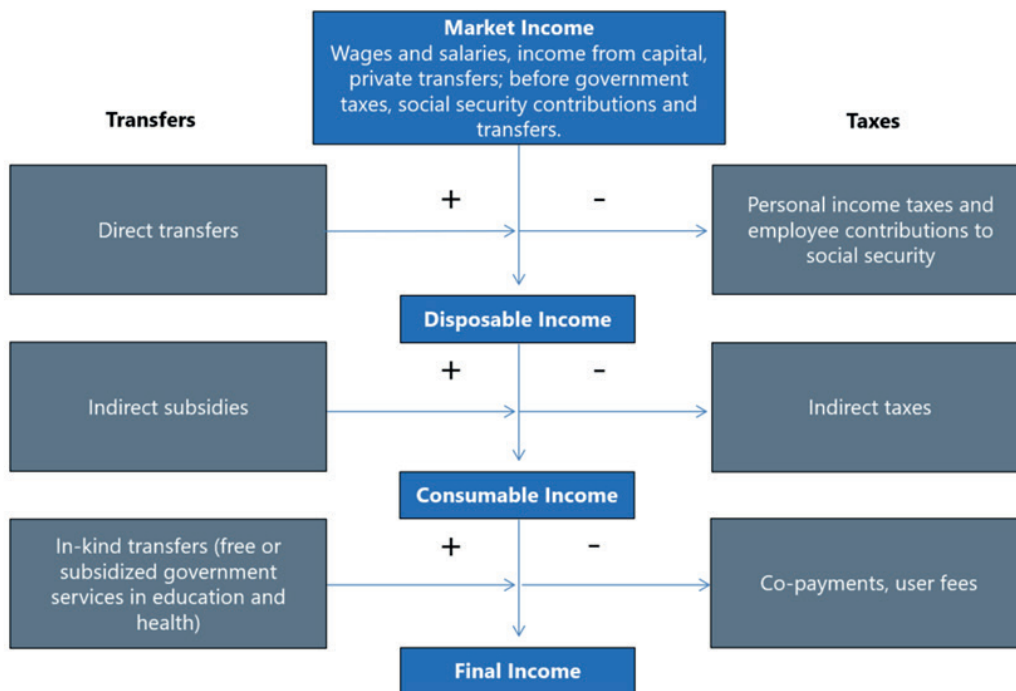
where I_h is the income before taxes and transfers, T_i are the taxes paid by households (i is the range of taxes analyzed), B_j are the transfers received by households (j is the range of transfers studied), and S_{ih} and S_{jh} are the share of tax i and transfer j paid and received by households, respectively.

The CEQ measures the distributional impact of fiscal policy sequentially by defining four income concepts (Figure 2.4). First, market income is the income received by each household before taxes and transfers. It includes wages and salaries, income from capital (e.g., rents, profits, and dividends), private transfers (e.g., remittances), and other income, all before administration taxes, social security contributions, and transfers. Second, disposable income includes the impact of direct cash transfers and subtracts PIT and employee contributions to social security from market income. Third, consumable income subtracts the impact of indirect taxes on consumption (e.g., VAT and excises) and adds indirect subsidies to the disposable income. Lastly, final income adds the social spending on education and health as in-kind public transfers to consumable income.

The main source of information is the 2021 Household Budget Survey, a representative household survey that collects detailed information on consumption, labor income, social assistance, pensions, remittances, financial income, assets, housing characteristics, accessibility to labor and financial market, health services, education opportunities, and individual characteristics such as education, health, and labor market status and experience. The survey has been collected every 6–7 years. The survey interviewed 1,391 households in twelve months and is representative at the administration and urban/rural level. The survey collected data on the most important dimensions of welfare, which is expected to support evidence-based policy making in areas such as education, health, housing, employment, and poverty alleviation. The survey also gathered information on the consumption patterns, income, and expenditures of the households in the TCc, intended to update the Consumption Price Index basket and inform calculations of economic activity.

To measure progressivity, the CEQ follows the standard practice and use the Kakwani index (Kakwani, 1977). A tax (benefit) is progressive whenever its burden (entitlement) rises (decreases) with income. In the case of transfers, the index is defined as the difference between the Gini coefficient of market income plus pensions (when pensions are treated as deferred income) and the concentration coefficient of the transfers. For each tax, the Kakwani index is calculated as the difference between the concentration coefficient of the tax and the Gini coefficient of market income plus pensions. A Kakwani index for taxes will be positive (negative) if a tax is globally progressive (regressive), while a Kakwani index for transfers is positive if a transfer is progressive in relative terms.

Figure 2.1 Income concepts under the CEQ analysis



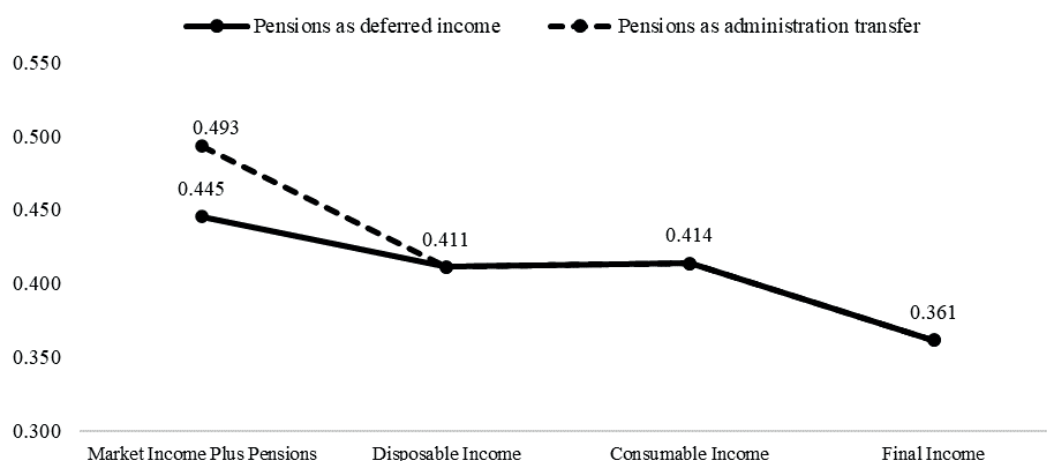
Source: Lustig (2018).

The fiscal system in the TCc contributes to a moderate reduction in income inequality. Figure 2.2 shows how the measurement of inequality changes before and after fiscal policy interventions are accounted for – namely, at market income, disposable income, and consumable income. Before any fiscal policy, described with market income in the analysis, the Gini coefficient is 0.493 and it drops to 0.445 when pensions are added. It is critical whether pensions are treated as

deferred income or transfer.⁵⁷ After direct taxes and transfers are included, the Gini further declines to 0.411 at disposable income. At consumable income, the Gini increases slightly to 0.414 after including indirect taxes. Finally, in-kind education and health spending has the largest equalizing effect, with the Gini dropping to 0.361. Overall, inequality in TCc drops from 0.445 to 0.361 after fiscal interventions, a reduction of around 0.08 of a Gini point (Figures 2.2 and 2.3).

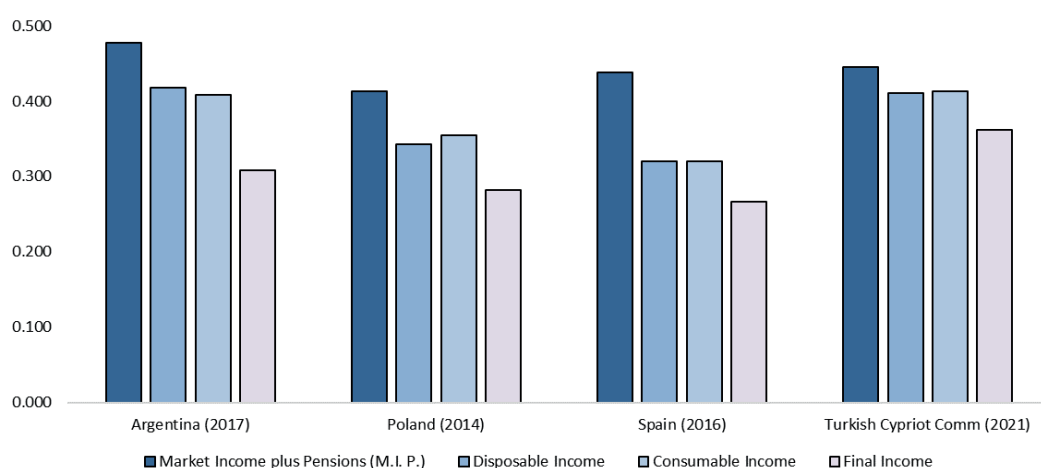
⁵⁷ The CEQ uses two different options to treat pensions. Contributory pensions as pure deferred income refers to the scenario where the workers save a share of their earnings during employment to receive as a pensions when they are retired. Contributory pensions as administration transfer refers to the scenario where the retirement pensions are mainly sponsored by administration budget. When we treat the contributory pensions as deferred income, pensions are included in the market income and excluded the fiscal policy hence the poverty rate is lower compared to pensions as administration transfers scenario (where pensions are excluded from the market income and included in the fiscal policy).

Figure 2.2 Inequality before and after fiscal policy in TCc, 2021



Source: Own estimates based on TCc 2021 HBS. The TCc results are preliminary.
Note: The figure shows the Gini coefficient for each income concept described in Box 1, Figure 2.1. Market Income refers to before and after fiscal interventions; Disposable Income refers to after direct taxes and transfers; Consumable Income refers to after indirect taxes and final income refers to after in-kind (education and health) transfers.

Figure 2.3 Gini coefficient before and after fiscal policy in TCc, 2021



Source: Argentina (Ladronis et al., 2019); Poland (Goraus and Inchauste, 2016); Spain (Bengoechea et al., 2020). The TCc own estimates based on TCc 2021 HBS. The TCc results are preliminary.
Note: Marginal contribution to equality is the difference between the Gini coefficient without the particular fiscal intervention and the Gini coefficient of all income components together.

Fiscal policy in the TCc has significantly smaller contribution to reduction in income inequality. Income inequality generally falls in all economies after taxes and transfers, which implies that there is always some fiscal redistribution. The differences are in the magnitudes. Argentina, Poland and Spain are used as comparator countries in this analysis. These countries are among the ones that achieved the highest redistribution of

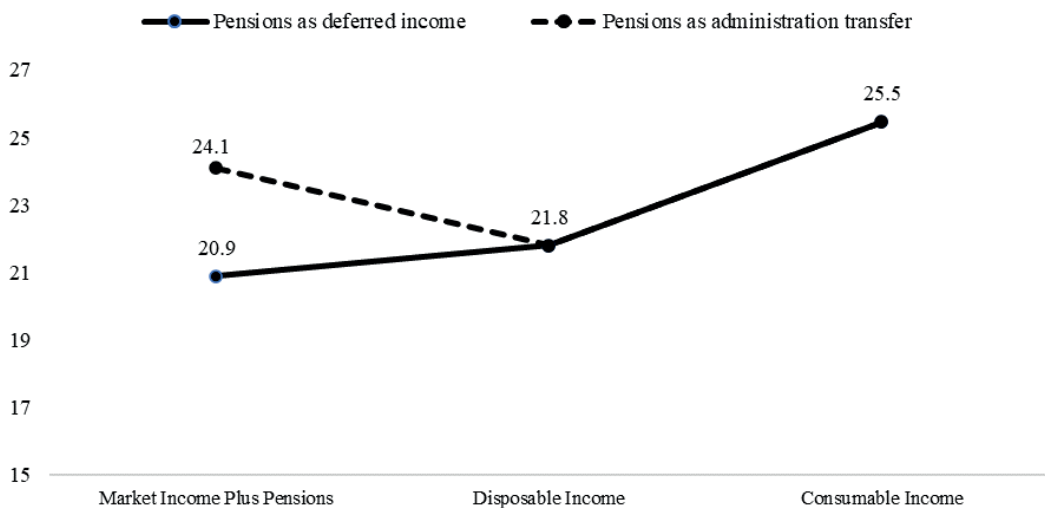
resources in the world (and for which a similar analysis is done). The objective of comparing TCc with the best performers is to understand the potential of fiscal policy to redistribute resources in an economy and promote inclusive growth. Reduction in income inequality can reach up to 0.17 Gini points as in Spain and Argentina and 0.13 Gini points in Poland, while the reduction in income inequality after fiscal policy was only at 0.08 Gini points in the TCc.

TCC's fiscal system is not effective in reducing poverty. Figure 2.4 shows how the measurement of poverty changes before and after fiscal policy interventions are accounted for – namely, at market income, disposable income, and consumable income. If pensions are considered as deferred income, market income (before taxes and transfers) increases, thus poverty measured at market income is lower at 20.9. If pensions are treated as transfers, hence as a fiscal policy item, market income is instead lower, thus poverty higher at 24.1. After taking into account all direct transfers and direct taxes, poverty is estimated at 21.8. However, since indirect taxes are regressive and have a significant impact on household budgets, eventually poverty increases from 21.8 to 25.5 percent.

In-cash transfers only are not sufficient to offset the burden of taxes across all deciles of the distribution but the bottom 10 percent; in-kind transfers, such as education and health, have important redistributive effects.

For a better understanding of the changes in inequality and poverty brought by taxes and transfers, Figure 2.5 looks at the incidence of fiscal interventions across households, as a share of market income plus pensions. When only cash transfers are considered (i.e., excluding in-kind benefits such as health and education), only households in the bottom 10 percent of the income distribution are net beneficiaries of the system and their net cash position is positive (Figure 2.5). In other words, these households receive higher transfers than the taxes they pay. For households in the second decile and above, cash transfers received are not sufficient to offset the burden of taxes. These households are net payers into the system with a negative net cash position. The effects of spending on education and health provide significant positive benefits to all households. These in-kind transfers improve the impact of fiscal policy in the bottom half of the distribution, with all households in the 1st to 5th decile reporting a positive net fiscal position.

Figure 2.4 Poverty before and after fiscal policy in the TCc, 2021



Source: Own estimates based on TCc 2021 HBS. The TCc results are preliminary.

Note: The figure shows the poverty rate for each income concept described in Box 1, Figure 2.1. Market Income refers to before and after fiscal interventions; Disposable income refers to after direct taxes and transfers; Consumable income refers to after indirect taxes and final income refers to after in-kind (education and health) transfers.

Figure 2.5 Net cash position and fiscal position, by decile


Source: Own estimates based on TCc 2021 HBS. The TCc results are preliminary.

Note: The net cash position includes the monetary fiscal policies, taxes, transfers and subsidies. The fiscal position includes the monetary value of education and health spending (computed as total spending on education and health divided by number of beneficiaries, students for education and total population for health spending). Even though education and health spending do not affect the budgets of the households directly, they benefit households.

Direct taxes are progressive in the TCc, but they are relatively low (Figure 2.6). Having a progressive personal income tax bracket and generous allowances for low-income households lead to progressivity of direct transfers. Direct taxes include PIT, interest from bank deposits tax and occupational municipal tax. Those taxes also contribute to reducing inequality in the TCc. The direct tax system has relatively moderate equalizing effect—higher reduction in Gini points (0.015 reduction in Gini), compared with Argentina (0.009) and Poland (0.013), while it is significantly lower than Spain (0.05).

Direct transfers are progressive and contribute to a reduction in inequality (Figure 2.7). Direct transfers are successful to deliver cash transfers to low-income households, as the progressivity of the system is relatively high. The equalizing effect of the direct transfer system, however, is significantly low. While progressivity of the system is comparable to other countries, it is significantly less equalizing than in other economies, Spain (0.089), Poland (0.081), and Argentina (0.055). The TCc allocates a smaller budget to social transfers as a share of GDP and the adequacy levels of cash transfers are relatively low.

Indirect taxes are regressive and lead to

a slight increase in inequality (Figure 2.8). The regressivity of indirect taxes in the TCc is the lowest among all economies. Other economies have more regressive indirect tax systems compared with the TCc, while the un-equalizing effect of indirect taxes on income distribution in TCc is higher than in Argentina and Spain. The un-equalizing effect was higher in Poland as indirect taxes are the main source of revenue collection.

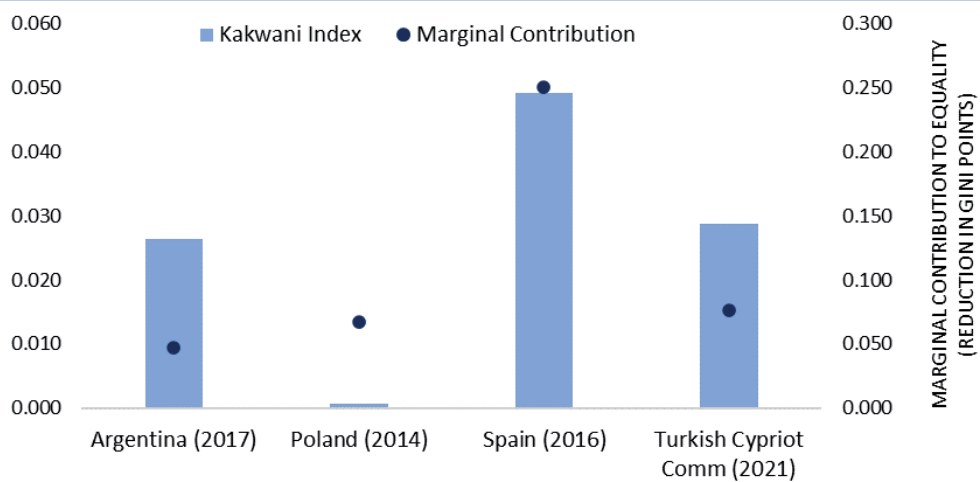
Overall, the inability of the TC system to reduce poverty, and the limited impact on inequality, call for a more effective system to address inequality and reduce poverty.

The direct tax and transfer system of the TCc is redistributive, with progressive and redistributive direct taxes, in line with other economies. However, indirect taxes are regressive and un-equalizing. Although direct transfers are progressive, their impact on reducing inequality and boosting the incomes of low-income households is very limited due to low adequacy. With regards to in-kind transfers, both education and health have important redistributive effects. These results point to potential improvements that could be achieved in the TCc through a more effective system of taxes and transfers to reduce the burden on the poor and to reduce inequality.

First, reallocating resources from subsidies to well-targeted cash transfers can achieve higher reductions in inequality and poverty. Evidence shows that subsidies tend to be regressive and inefficient, with a large share of subsidies going to better-off households (World Bank, 2022b). Well-targeted cash transfers are instead more effective mechanisms to support poor and vulnerable groups. Second, high-return investments in education, research and development, and infrastructure projects

should also be prioritized as means to spur long-term growth and contribute to poverty and inequality reduction. Finally, revenue mobilization should be improved, especially given the low tax revenue collection in the TC economy, while minimizing economic distortions and negative distributional impacts. This can be done by broadening the tax base, reducing regressive tax exemptions, and strengthening tax administration.

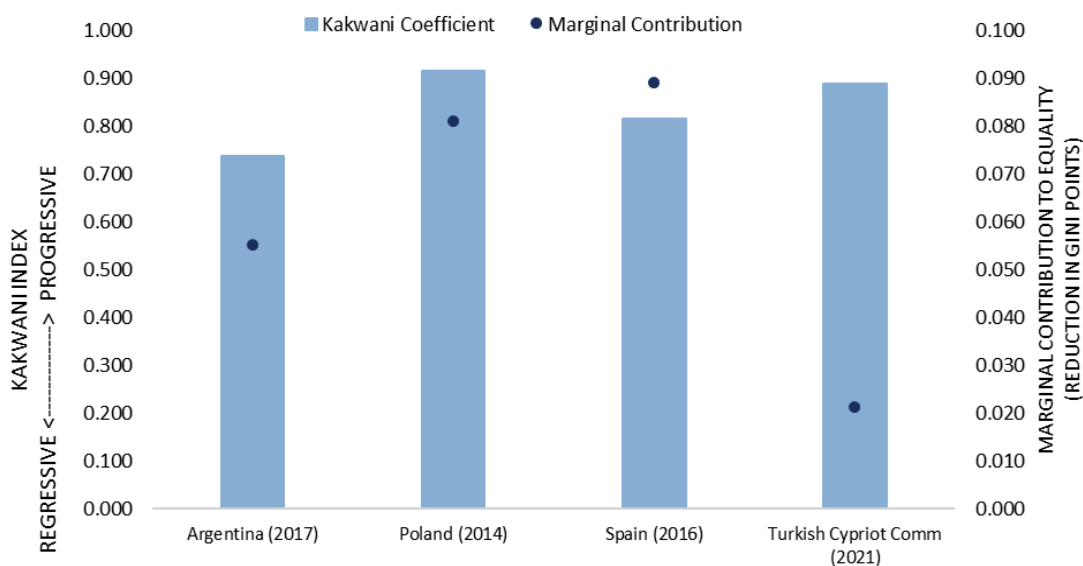
Figure 2.6 Direct taxes



Source: Argentina (Ladronis et al., 2019); Poland (Goraus and Inchauste, 2016); Spain (Bengoechea et al., 2020). The TCc own estimates based on TCc 2021 HBS. The TCc results are preliminary.

Note: Marginal contribution to equality is the difference between the Gini coefficient without the particular fiscal intervention and the Gini coefficient of all income components together.

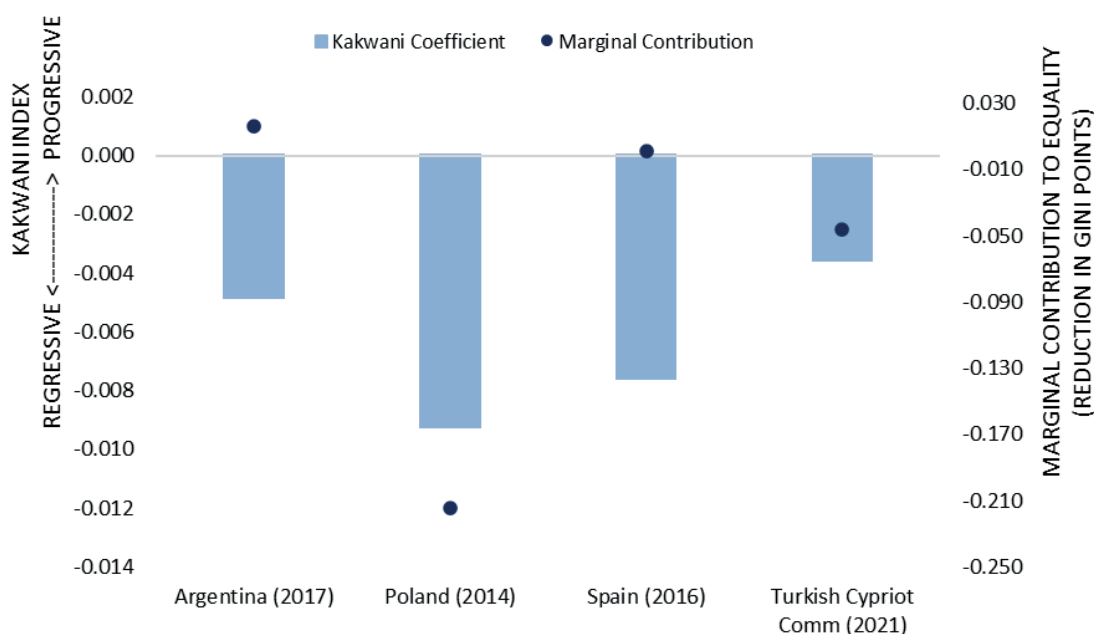
Figure 2.7 Direct transfers



Source: Argentina (Ladronis et al., 2019); Poland (Goraus and Inchauste, 2016); Spain (Bengoechea et al., 2020). The TCc own estimates based on TCc 2021 HBS. The TCc results are preliminary.

Note: Marginal contribution to equality is the difference between the Gini coefficient without the particular fiscal intervention and the Gini coefficient of all income components together.

Figure 2.8 Indirect taxes



Source: Argentina (Ladronis et al., 2019); Poland (Goraus and Inchauste, 2016); Spain (Bengoechea et al., 2020). The TCc own estimates based on TCc 2021 HBS. The TCc results are preliminary.

Note: Marginal contribution to equality is the difference between the Gini coefficient without the particular fiscal intervention and the Gini coefficient of all income components together.

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