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The Distributional Consequences of the Cypriot Crisis

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Abstract

The economic crisis affecting Cyprus is likely to have considerable impact on the income distribution. Our analysis provides an early assessment of the potential distributional shifts. Using microsimulation techniques we take into account austerity measures that affect wages, taxes, social benefits and contribution rates. The analysis also accommodates for the impact of unemployment rise on the income distribution. We focus on policy changes introduced over the period 2009-2012 and we extend the analysis further in 2013 and 2014, thus taking into account a number of measures that have been announced in the framework of the Memorandum of Understanding agreement. Our aim is to obtain the ceteris paribus impact of the crisis on inequality and poverty, as well as to estimate how the burden of austerity has been shared across certain population groups.

Keywords: Austerity, income distribution, Cyprus.

1. Introduction

Since the outbreak of the European debt crisis, many countries embarked on strict austerity programs. Austerity resulted to a reduction in state budget deficits (according to Eurostat average government deficit in the EU27 reduced from -6.5 per cent in 2010 to -4.4 per cent in 2011), but it also generated social tension, high unemployment and further economic slowdown. As the recession in Europe's periphery is deepening and gradually threatens the core of Europe, the strategy of debt reduction through severe austerity measures is increasingly questioned by many politicians and economists alike. At the same time the need to assess the wider impact of these programs is as strong as ever. Cyprus is the newest EU member to enter the unenviable group of program countries, in March 2013, when an economic rescue was rendered absolutely unavoidable.

The paper is a first attempt to gauge the income effects of the Cypriot crisis. The analysis adopts a distributional perspective in the sense that we are interested to quantify the relative losses of the various population groups and test whether the profile of aggregate inequality and poverty changes. Our focus is consciously placed on relative incomes. Since the

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'economic pie' is inevitably going to shrink, what really matters in terms of social fairness is to assess how it is shared. By focusing on distributional changes, we provide a mapping of how upcoming policy choices in Cyprus should be designed in order to align with fairness. Issues of economic efficiency are out of the scope of the analysis, thus very lightly discussed, however we note that there is always a degree of interconnection between equity and efficiency which should not be ignored.

During the last years, similar analyses have mushroomed in the academic community. These studies are relevant to the academic discourse and have a certain value in informing the ongoing national and pan-European political debates. Callan et al (2010) assess the distributional impact of the government's policy response in Ireland with respect to direct tax, social welfare and public sector pay using the Irish SWITCH tax-benefit model. Callan et al. (2011) and Avram et al. (2012) employ the EUROMOD model and proceed to comparisons of six and nine EU countries, respectively, regarding the effects of austerity on income distribution. Matsaganis (2011, 2012) provides an analysis of the impact of the crisis on the labour market and the distribution of income and evaluates the capacity of the Greek welfare state in dealing with the effects of the crisis. Matsaganis and Leventi (2013) provide an assessment of the effects of crisis in Greece using the EUROMOD model. Besides computing the direct impact of austerity policies on inequality, they attempt to estimate the distributional impact of the rise in unemployment by adjusting the model's input dataset using the most recent Labour Force Survey data. These studies share commonalities. Firstly, their empirical analysis is based on cross-sectional microdata. Secondly, they emphasize on the relative impact of measures both at the aggregate level (changes in overall poverty and inequality) and the micro-level (i.e. they measure how the relative income position of various socioeconomic groups changes). That way, the heterogeneity of economic agents is taken into account. Finally, they overcome the important problem of lagged income data by applying microsimulation techniques. Our study follows this stream of the literature and shares these common traits.

We acknowledge, however, that the prognosis of the impending distributional changes is a difficult errand, since economic inequality is the outcome of complex income-generating or income-depleting processes. Recession is linked with increased economic suffering that affects everyone, but at different rates. Soaring unemployment is likely to have a harsher effect on low-income households, than on better-off households. Top incomes are also affected though, because capital income is severely reduced during an economic downfall. The profile of intergenerational allocation is shifting; youth unemployment is extraordinarily high while pensioners are less affected since their income is relatively inelastic to the effects of the crisis. Yet, austerity measures may target them at a rate that depends on the propensity of politicians to redistribute income across generations. Welfare state acts as a Keynesian automatic stabilizer, partly absorbing the shocks of the crisis and simultaneously providing income support to the poor thus ameliorating the most malicious effects of the recession. At the same time, the behavioral responses of individuals to structural changes and economic (dis)incentives should not be underestimated. Parameters that describe preferences, political attitudes, propensity to (save or consume), intensity of labor effort and tax compliance are unlikely to remain stable. No economic model can provide answers to all these questions. However, it is possible, under certain conditions and assumptions, to seek answers to specific empirical questions.

Our aim is to assess the distributional effects of the crisis in Cyprus during the 2012-2013 period (this time span includes the pre-bailout period as well as the post-bailout period which is marked by the terms of the Memorandum of Understanding agreement). Results are preliminary in the sense that the precise size of the distributional consequences of the crisis cannot be accurately assessed until more recent income data become available. Given the slow pace of the collection and processing of household data in Cyprus, the microsimulation approach used in our analysis offers a compromise between not being able to assess the distributional impact of the austerity measures at all and assessing this impact with a statistically high degree of precision. The structure of the paper is the following: section 2 presents briefly the methods followed for deriving the results, section 3 is devoted to empirical analysis. Section 4 hosts a discussion of the results in juxtaposition with the political and economic developments of the period and a compact epilogue closes the paper.

2. Methods and data

The analysis marries microsimulation techniques with standard income distribution analysis. Our model simulates a variety of instruments (contributory and non-contributory benefits, social assistance, social insurance contributions and direct taxes). The informational base of the model consists of the policy rules and the underlying micro-dataset. Our analysis is based on the 2009 Cypriot Household Budget Survey microdata provided by the Statistical Service of Cyprus. The dataset provides information about the demographic and socioeconomic characteristics of the households as well as their reported incomes earned in 2009. Using old data to assess current distributional changes is undoubtedly a drawback. To overcome it, the model follows two steps; firstly the tax and benefit rules are updated to correspond with 2012 and secondly every income component is updated using appropriate uprate factors. Moreover important shifts have taken place in the labor market since 2009. Most importantly, unemployment increased from 5.4% in 2009 to 11.9% in 2012. Therefore we had to factor in unemployment rise in order to synthesize more realistic income distributions. In doing so, we used external statistics about employment disaggregated by gender, age and sector of employment for the years 2009 and 2012. The decrease of the total employment rate between 2009 and 2012 is used to determine the number of employed individuals in the sample who should be moved from employment to unemployment while the disaggregated data are used to determine which individuals in the sample have the higher risk to move from employment to unemployment. In particular, for each group of individuals, we created an index indicating the probability to move from employment to unemployment. Then using this index, we assigned the unemployment status to a number of individuals following a random process. Additionally, we adjusted private wages downwardly adopting as yardstick the most recent forecasts on the GDP growth of the economy. Specifically we assume a 2.5 and 4.0 per cent fall in private wages in 2013 and 2014, respectively.

Having adjusted nominal incomes, the analysis moved to the computation of equivalized disposable income, which serves as proxy of the unobservable welfare of the household. Our definition of income includes all monetary income components (wages, income from self-employment, passive income, pensions and cash transfers) except of non-cash incomes for which information is unavailable. The unit of analysis is the individual in the context of the household. The household is treated as a single spending unit and all incomes are added up to form total household income. To render disposable income comparable among heterogeneous households, we used the 'modified OECD equivalence scales' that assign weights of 1.00 to the household head, 0.50 to each of the remaining adults in the household and 0.30 to each child (person aged below 14) in the household.

Relative inequality is estimated using the Gini index and the parametric family of Atkinson indices, Atkinson (1970). Both indices satisfy the basic axioms of inequality measurement (symmetry, mean independence, population invariance and principle transfers). The Atkinson index is explicitly based on a social welfare function. Its welfare interpretation is simple; the index measures the proportion of total income that could be redistributed with no loss of social welfare, if the remaining income were to be equally distributed. By setting arbitrary values at the inequality aversion parameter that characterizes the index, the analysis can capture a wide range of distributional preferences (for the purposes of the study, the parameter is set at 0.5 and 1.5). Poverty line, following the approach of Eurostat, is set at 60 per cent of the median of the distribution. The poverty indices selected for measuring relative poverty belong to the parametric family of the so called FGT index, Foster et al. (1984). Poverty aversion parameter is set at 0, 1 and 2 successively.

2.1 Measures simulated

Our microsimulation model offers the potential to simulate a wide range of reforms (including tax hikes, wage cuts and social benefits reforms). However there are policies that cannot be simulated, such as reforms of non-simulated policy instruments or other measures that do not affect the income distribution directly (i.e. rationalization of health care costs). The analysis focuses on 2012, 2013 and 2014 and takes into account the following measures.

Year 2012:

• A permanent contribution of 3% on pensionable earnings of state employees to the Public Employees' Pension Plan; 6.8% on pensionable earnings by state officials who are not covered by the government pension scheme or any other similar plan but are entitled to a pension and gratuity.

• An increase in the contribution of state employees to the Widows and Orphans Fund from 0.75% to 2% of pensionable earnings.

• Scale reduction in emoluments of public and broader public sector pensioners and employees from 1 December 2012 until 31 December 2013: 6.5% for €1,001-€1,500; 8.5% for €1,501-€2,000; 9.5% for €2,001-€3,000; 11.5% for €3,001-€4,000; and 12.5% for above €4,001 per month.

• Suspension of COLA for public and broader public sector until the end of the first quarter of 2016.

• Freeze of increments and general wage increase in public and broader public sector until 31 December 2016.

• Temporary contributions in the public, broader public and private sector on gross monthly earnings and pensions until 31 December 2014 at the following rates (levied on gross wages and pensions): 0% for 0-€2,500; 2.5% for €2,500-€3,500; 3% for €3,501-€4,501; and 3.5% above €4,500.

• Child benefit reform. Change in the definition of child and exclusion of one-child families having gross annual income higher than €49,000 and further reduction of the benefit as follows: 10% reduction for €39,000-€49,000 gross annual family income; 20% for €49,000-€59,000; 30% for €59,000-€69,000; 40% for €69,000-€79,000; and 50% for family income €79,000-€89,000.

• Student grant reform. The amount of the grant was reduced by: 7.5% for families with income between €30,000 and €40,000, 15% for income between €40,000-€50,000, 22.5% for income between €50,000-€60,000, 30% for income between €60,000-€70,000, 40% for income between €70,000-€80,000, 50% for income between €80,000-€90,000. PhD students are not eligible for the benefit, while Master students are, if their family income stands below €30,000.

• Public assistance reform. The list of incomes which are excluded from the calculation of the family income was shortened. At the same time, mono-parental families were excluded from the scheme.

• Single parent benefit. A new benefit was introduced in 2012 targeting mono-parental families. Lone parents with income up to €39,000 receive a monthly benefit of €200 for each child, which is decreased in a progressive manner; by 10% for families with income between €39,000-€49,000, 20% for income between €49,000-€59,000, 30% for income between €59,000- €69,000, 40% for income between €69,000-€79,000, and 50% for income between €79,000-€89,000.

Year 2013:

• Freeze of public sector pensions

• Pension entitlements that will accrue after 1 January 2013 are considered as personal income, thus becoming fully taxable.

• Introduce a compulsory health care contribution for public servants and public servant pensioners of 1.5% of gross salaries and pensions.

• Streamline the Easter allowance to pensioners by limiting the benefit to pensioners with a monthly per capita pension of at most €500.

• Implement a scaled reduction in emoluments of public and broader public sector pensioners and employees as follows: 0.8% for 0–€2,000; 1.0% for €2,001-€3,000; 1.5% for €3,001-€4,000; and 2.0% for above €4,001.

• Increase the tax rate on interest income to 30%.

Year 2014:

• Implement a further reduction in emoluments of public and broader public sector employees and pensioners by a flat rate reduction of 3% on all wages.

• Extent the temporary contributions in the public, broader public and private sector on gross earnings and pensions until 31 December 2016, (2.5% for €1,501-€2,500; 3.0%, for €2,501-€3,501; and 3.5%, for income above €3,501).

• Increase the contributions, as of 1 January 2014, of salaried employees and employers to the GSIS by an additional 1 p.p. on pensionable earnings, i.e. 0.5 p.p. from employees, 0.5 p.p. from employers and 1 p.p. from self-employed persons.

Finally, it should be noted that the Memorandum requires the reduction of social transfers by at least 113 million in 2013 and 28.5 million in 2014. These cutbacks are expected to have a regressive impact on the income distribution since social transfers are distributed more equally than disposable income. However, since these measures have not been finalized, we cannot quantify their distributional impact.

3. Empirical analysis

The next two tables provide a panoramic view of the likely distributional changes. In Table 1 the population is separated into ten income groups of equal size (each individual is ranked by her equivalized household disposable income). For each group, we calculate the corresponding income share (that is the total income accrued to the individuals who belong to that group divided by the total income of the entire population). The first column stands for the 2009 distribution which serves as the point of departure. The following columns describe the situation in 2012, 2013 and 2014, respectively.

Although the observed distributional shifts are riddled with irregularities, certain distributional patterns emerge. It appears that the income shares of the poorest deciles have increased during the examined period. For example, in 2009 the poorest 10 per cent of the population enjoyed the 3.77 per cent of the economic pie. This share increased to 3.99 in 2012 and is going to increase further, according to our estimates, to 4.09 in 2014.

TABLE 1

Income shares by deciles

Decile	2009	2012	2013	2014
1st (poorest)	3.77	3.99	3.93	4.09
2	5.28	5.45	5.51	5.63
3	6.32	6.44	6.45	6.49
4	7.37	7.34	7.36	7.44
5	8.43	8.40	8.42	8.49
6	9.46	9.42	9.50	9.47
7	10.61	10.68	10.65	10.72
8	12.48	12.36	12.37	12.24
9	14.75	14.71	14.61	14.39
10th (richest)	21.54	21.22	21.20	21.04

Sources: X2009 HBS, own estimations.

At this point, it should be underscored that after 2012 the nominal income of almost all household is reduced. It is the relative share of income that changes. Having said that, we note that the shares of middle income deciles remain more or less stable, while the rich deciles appear to lose ground. Overall, the comparison of the 2009 distribution with the 2014 distribution yields a reduction of relative income disparities between households, albeit the change is not dramatic. Table 2 proceeds to map these shifts into proportional changes in inequality and poverty indices. Each column of the table displays the percentage year-to-year change in the corresponding index. Year 2009 serves as starting point and thus the column illustrates the absolute values of the indices in that year. An important analytic concern regards the choice of the poverty line. Normally, a dynamic poverty line (i.e. calculated as a proportion of the median of the corresponding income distribution) is the proper choice for poverty analysis. The rationale of relative poverty lines is that poverty should be interpreted in terms of how well-off are the poor relative to general economic prosperity of the society. The ethical roots of this idea go back to Adam Smith and have been reformulated in modern era by Amartya Sen, [see for example, Sen (1976)]. Thus as average income increases (decreases) the cost of maintaining a minimum acceptable level of well-being increases (decreases). This, in our context, means that the poverty line should be reduced as the economy sinks to recession. However, the experience of other program countries shows that internal devaluation implies a slow, painful and, most importantly, asymmetrical adjustment of wages and cost of living in the sense that commodity prices fall at a considerably slower pace than wages. If the latter is true, then a dynamic poverty line is hardly realistic. Following this line of reasoning, we decided to anchor poverty line in 2012 (i.e. the analysis uses the same poverty line for 2012, 2013 and 2014).

TABLE 2

Indicators of Inequality and Poverty (% changes)

Decile	2009	2012	2013	2014
Gini	0,274	-2,7	-0,3	-2,5
Atkinson0.5	0,061	-5,1	-0,1	-4,5
Atkinson1.5	0,171	-4,8	0,8	-5,3
FGT0	0,154	-7,2	13,1	1,3
FGT1	0,033	-16,1	23,1	-1,2
FGT2	0,010	-16,1	32,9	-5,9

Sources: 2009 HBS, own estimations.

Commenting on the results, the estimators show a decline in inequality between 2009 and 2012. Relative inequality keeps falling, however marginally, in 2013, and 2014. The magnitude of the change depends on the index used, with Atkinson (1.5) displaying the largest proportional reduction. Poverty, according to all indices, falls between 2009 and 2012. However, it increases considerably in 2013 (13.1%-32.9%) and thereafter it stabilizes at rather high levels. These results merit a careful interpretation. Firstly, they are partly driven by our methodological choice of setting a static poverty. This choice assumes that inflation will remain either positive or stable. In the long-run such premise is implausible, for prices will ultimately fall. In the short-run, however, we expect a rather 'sticky' price level. Therefore, it is likely for the poor to experience an acute fall of their material well-being, but as product markets approach the equilibrium level their real purchasing power may strengthen.

Overall, the first-round distributional shifts are the outcome of unemployment rise, falling wages and austerity. Unemployment places a heavy toll mostly on low-income households. On the contrary, austerity is progressively designed, targeting mostly middle and high income households. Thus, the final distributional outcome is the combined effect of two counteracting forces: unemployment which tends to increase poverty and inequality; and progressive taxation and/or cutbacks which tend to reduce relative differences between the poor and the rich. Of course, these two factors are interconnected. Austerity is responsible, at least partly, for the unemployment rise (for it hampers economic activity). Nonetheless, our model does not allow for disentangling between the indirect and direct effects of fiscal consolidation.

Up to this point, the analysis aims to give a sketchy outline of the overall distributional shifts. However, it is interesting to investigate who (and to what extent) are mostly affected by the crisis. This entails separating the population into different groups, demarcated by socioeconomic criteria, and computing their relative income position for each year. The relative income position is defined as the ratio of the average income of a group to the national average (multiplied by 100). This exercise is done in Table 3. Among many plausible categorization criteria of the population, we focus on age, gender, geographical area, education and occupation in public/private sector. This classification corresponds largely to the ongoing public debate on the "who pays for the crisis" theme.

The first rows of the column show that the relative income position of the young deteriorates over time (from 102.4 in 2009 to 99.4 in 2014). The position of the middle aged remains stable, while the relative status of the elderly in the distribution of income is improved. Gender and spatial variables do not play an important role in explaining the income effects of the crisis. But this is not so for education. The relative income position of highly educated persons reduces steadily during the examined period and exactly the opposite occurs for low educated persons. A likely explanation of this pattern is that austerity measures affect heavily highly educated well-paid employees. The last partition of the population (between public sector and private sector employees) reveals an interesting development. The situation of public servants has deteriorated between 2009 and 2012 and is expected to deteriorate further. However, even so, they stand considerably better than private sector employees. Public sector wages are administratively determined while private sector wages are vastly affected by market forces. In our analysis we have attempted to simulate these market forces (by assuming that private wages fall at certain rates), however such estimates are tentative and cannot be conclusive before we know the exact magnitude of the recession. Social fairness demands that the cost of the recession should be equally allocated across socioeconomic groups. Thus, the extant disparities between public and private sector should not widen and insofar they shorten, both macro-efficiency and fairness are promoted.

TABLE 3

Relative income position of population groups

Decile	2009	2012	2013	2014
Age				
18-29	102,4	100,4	99,8	99,4
30-64	107,9	107,6	107,4	106,9
over 65	75,3	79,0	81,0	81,8
Gender				
Male	101,4	101,1	101,0	101,1
Female	98,6	98,9	99,0	99,0
Area				
Urban	105,3	105,0	105,0	104,8
Rural	86,9	87,7	87,7	88,2
Education				
Low	84,7	86,0	86,4	87,1
Medium	99,9	99,1	98,7	98,6
High	142,2	140,3	139,9	138,0
Sector				
Public	135,4	131,5	130,0	127,6
Private	105,6	105,5	105,5	104,9

Sources: 2009 HBS, own estimations.

4. Discussion

On 16, March 2013 Eurozone, after dense negotiations, was able to reach an agreement with the government of Cyprus on the terms of a financial rescue. Part of the agreement was a controversial deposit levy which made headlines across the word. The drama reached its apogee few days later when the Cyprus House of Representatives rejected the levy, throwing EU rescue efforts into disarray. However, the combination of ECB threats to end the emergency liquidity assistance (ELA) and the futile efforts of an alternative financial agreement with Russia, forced Cyprus to succumb to the EU bailout conditions. Nowadays, there is wide consensus that the hypertrophic banking sector is at the heart of the economic misfortunes of the country. The regulatory void in conjunction with the typical moral hazard problem in finance (i.e. systemic banks expect to be 'bailed –out' by taxpayers' money) encouraged inordinate risk-taking that lead to the collapse of the Cypriot banking industry. Yet the huge responsibilities of financiers and regulators should not obfuscate the fact that the economy suffers from other structural weaknesses which have been pointed out in the past by several economists, yet remained largely unaddressed. Pashardes (2011) and Clerides (2012) argued that large fiscal imbalances, low competitiveness and an unbalanced allocation of human capital between the various sectors of the economy pose threats to the economy. Pashardes and Polycarpou (2008) measured tax evasion, highlighted the magnitude of the problem and suggested measures to combat it. Simone (2011) suggested that the pension system should be reformed in order to preserve its sustainability. The bottom line is that the economic problems of the country extend far beyond the banking sector and call for a comprehensive set of reforms to address them.

Our analysis concentrates on issues of equity by providing a prognosis of the possible changes in the income distribution caused by the current crisis. We show that the economic slowdown affects everyone albeit through different channels and at a different rate. Unemployment affects mostly those at the middle or low part of the distribution while austerity measures are progressively designed (in most cases) and harm disproportionately those at the middle and upper part of the income distribution. Nonetheless, with the country struggling to implement much needed large-scale economic reforms, the negative effects and indirect consequences on the social economy should not be underestimated. What social strategies should be adopted so as to face the above challenges?

In general, the transition from passive social policy to a more active welfare state should be accelerated. This path entails a policy reorientation in favor of social services and labour market protection while the coverage and generosity of income transfers should be treated with caution and, in some cases, rationalized. On top of the traditional workings of the welfare state (namely redistribution, poverty alleviation and standard social protection), new objectives should be assigned in social policy. More specifically:

Firstly, labour markets are becoming increasingly dualized. Insiders enjoy canonical career trajectories and ample social protection while an increasing number of young people is exposed to high levels of economic uncertainty. This mere fact was reflected on our analysis as we find that the relative income position of young people is going to deteriorate in the upcoming future. Job insecurity is mirrored on time-limited contracts, part-time contracts and contracts for young workers that entail low levels of provisions. Atypical employment may satisfy employer's need for flexibility, and yield short-term economic benefits, but the asymmetric distribution of social protection between occupational groups marginalizes a large part of the working force and is likely to threaten the stability of the political system. Strong family ties may act as an intermediate cushion, but admittedly this is a patchy solution. The role of social policy in that respect should be to provide more protection for non-standard workers while the allocation of economic uncertainty across social groups should become fairer.

Secondly, in view of the challenges attached to population ageing and high elderly poverty in Cyprus, the provision of services to older people gains impetus. Long-term care is a policy area not well developed in Cyprus. On the contrary, informal care fed by strong intergenerational ties is very strong. However, the combination of values changes and the increasing share of elderly in the population require a more systematic treatment of these services. Health care in Cyprus is also characterized by inefficiencies that question the fiscal sustainability of the system and cause discomfort to patients, especially to those with chronic illnesses or/and the elderly. Both areas, long-term and health care, need to be upgraded.

Thirdly, over the last years considerable progress has been achieved as far as the reconciliation of work and family life is considered. These efforts should be strengthened to fend off the threats of the current crisis to cancel the progress been made in combating gender inequalities. The resurgence of the 'male breadwinner' model should not be ruled out, for falling wages and atypical employment may render the home production of services such as child care and elderly care more attractive to females. Measures such as the subsidized care for dependent members or new regulations that provide flexibility to parents of small children are potential antidotes.

Finally, the major repercussion of the severe recession, across all Europe, appears to be unemployment. Especially disquieting is the surge in youth unemployment observed in many economies of the periphery. Youth economic inactivity is caused by factors such as rigid labour markets, low labour demand and a mismatch between education and work. To address these fundamental problems of the economy, the governments must push for a whole set of macroeconomic and structural reforms. Social policy can contribute both actively, in terms of programmes that invest in human capital through lifelong learning and vocational training, and, passively, through providing income protection to the working poor and the unemployed.

Epilogue

The waves of liquidity of the halcyon years battered the reflex of the market economy and gradually led Cyprus astray from the path of sound economics and fiscally responsible governance. Today, the financial crisis has brought Cyprus to new crossroads. The coming years will differ markedly from the recent past of illusory economic abundance. Our tentative empirical analysis shows that income distribution is on the epicenter of strong centrifugal economic forces. The rise of unemployment and falling wages tend to increase income disparities. Low income families face the danger to bear the brunt of economic slowdown. On the other hand, austerity measures are progressively designed and therefore affect mostly middle- and high-income households, albeit certain low-income groups are harmed, too.

In contradiction to textbook microeconomic theory, our contention is that issues of equity and efficiency are intertwined. There are first-best policies that promote economic efficiency, yet they might be difficult to implement due to their short-term social costs. Destabilizing the political system may entail greater costs than adopting policies which minimize equity losses while promoting efficiency. It is possible that policies oriented exclusively to promote efficiency, albeit optimal in strict economic sense, to impact on future political equilibria, in a manner that would endanger the economic benefits, Acemoglou and Robinson (2013). Embracing a pragmatic perspective, policymakers should seek for a golden ratio between satisfying the prerequisites of international lenders, promoting competitiveness and safeguarding the social fabric. This is not going to be an easy errand as long as the economic and political situation in Cyprus and other EU countries remains highly uncertain. To avoid such pitfalls, policies should be keen on preserving redistributive fairness both in static terms (rich vis-à-vis poor) and dynamic terms (current generation vis-à-vis future generation, elderly vis-à-vis young). At the end, one can only hope that the litany of past policy failures will give turn to more prudent, fair and far-sighted governance.

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