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Assessing the Distributional and Fiscal Impacts of Cyprus's Personal Income Tax Reform

Aris Avgousti

Charalambos Michael

Georgiana Photiadou

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Address
80 Kennedy Avenue
CY-1076 Nicosia, Cyprus

Postal Address
P. O. Box 25529
CY-1395 Nicosia, Cyprus

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Assessing the Distributional and Fiscal Impacts of Cyprus's 2026 Personal Income Tax Reform **

Aris Avgousti * Charalambos Michael § Georgiana Photiadou *

Central Bank of Cyprus

June 2026

Abstract

This paper assesses the distributional and fiscal implications of Cyprus's 2026 personal income tax (PIT) reform. The analysis is motivated by the fact that major tax reforms can reallocate disposable income across households with heterogeneous consumption and saving behavior, and different balance-sheet characteristics. From a central bank perspective, such distributional shifts are relevant because they can influence the strength and composition of monetary policy transmission (cash-flow versus financial channels) and may interact with household leverage, with potential implications for financial stability. Using tax-benefit microsimulations combined with confidential household microdata, the effect of PIT bracket amendments and two income-dependent tax allowances (for dependent children and university students and for mortgage interest or rental expenses) is evaluated. The results indicate uneven gains across the income distribution. Given that a large share of taxpayers is below the pre-reform tax-free threshold (€19,500), simulated gains for the bottom income groups are minimal. The largest gains accrue to upper-middle-income and high-income households, while lower-middle-income and mid-middle-income households experience relatively modest benefits. The estimated fiscal cost of the PIT measures included in the analysis is around €240 million. Alternative configurations of the upper PIT brackets could have reduced gains at the top of the income distribution and preserved fiscal space for other policy priorities.

Keywords: Cyprus; personal income tax reform; distributional impact; fiscal impact; microsimulation; EUROMOD

JEL classification: H24, H22, D31

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*Research and Policy Centre, Central Bank of Cyprus.

§Economic Analysis and Monetary Policy Section, Central Bank of Cyprus.

Executive summary

This paper assesses the distributional and fiscal implications of Cyprus's 2026 tax reform, focusing on changes to personal income taxation (PIT). The analysis is motivated by the fact that significant tax reforms can reallocate disposable income across households with different marginal propensities to consume, saving behavior, and balance-sheet characteristics. From a central bank perspective, such distributional shifts matter because they can affect the strength and composition of monetary policy transmission (e.g. through cash-flow versus asset-price channels), influence aggregate demand, and interact with household leverage that may contribute to financial vulnerabilities. Therefore, although tax policy lies outside the remit of the central bank, understanding the distributional patterns of the tax reform can provide a useful input for assessing potential implications for monetary policy transmission and financial stability.

The analysis uses EUROMOD tax-benefit microsimulations combined with confidential household survey microdata (EU-SILC and the Household Budget Survey). It covers the most significant PIT measures: (i) amendments to income tax brackets, (ii) the introduction of an income-dependent tax allowance for dependent children and university students, and (iii) an income-dependent tax allowance for mortgage interest or rental expenses related to primary residence. The tax incentive for green capital expenditures is excluded due to data limitations.

The results indicate that a substantial share of taxpayers will not receive any direct benefit from the PIT reform. In 2022, 43 percent of taxpayers reported taxable income below the pre-reform tax-free threshold of €19,500. Consistent with this, the simulations show that gains in the bottom income deciles are minimal. Overall, the largest gains accrue to upper-middle-income and high-income households, while lower-middle-income and mid-middle-income households (approximately those in the 3rd to 7th deciles of the equivalized disposable income distribution) experience relatively modest benefits. The estimated average gains range from €5 per year in the bottom decile to €1,057 per year in the top decile. As a percentage of baseline disposable income, gains rise across most of the distribution and peak in the 9th decile (+2.9 percent), while the top decile records a slightly lower proportional gain (+2 percent). The reform is also expected to reduce the number of taxpayers with positive PIT liabilities by around 22 percent, narrowing the direct tax base. Overall, the reform slightly weakens redistribution, while social welfare indices rise, reflecting higher average disposable income.

From a fiscal perspective, the estimated revenue cost of the PIT measures included in this analysis is around €240 million per year, broadly in line with official projections. While this cost is manageable in the current fiscal environment, the adopted configuration entails an opportunity cost. Illustrative alternative scenarios with a narrower expansion of upper tax brackets reduce gains at the top of the distribution and lower the fiscal cost. The macroeconomic implications of the 2026 tax reform lie outside the scope of this paper. Nevertheless, under stylized assumptions, the reform is likely to support private consumption and generate modest increases in consumption tax revenues, implying a positive but limited impact on GDP, considering the high import content of private consumption.

Beyond distributional effects, the findings contribute to the public debate on the use of fiscal space in Cyprus. During a period of sustained budget surpluses, the allocation of additional fiscal resources matters for long-term growth and social cohesion. In this context, fiscal space could be directed toward productivity-enhancing investment and the improved provision of public goods, while ensur-

ing that public spending remains aligned with the dual strategic objectives of the green and digital transition.

Overall, the reform reduces PIT liabilities and increases average disposable income. However, it delivers uneven gains across the distribution and appears only weakly aligned with the stated objective of a fairer distribution of national income.

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1 Introduction

On 22 December 2025, the House of Representatives of the Republic of Cyprus approved a legislative package implementing a comprehensive tax reform, effective from the start of 2026. The package was based on work commissioned by the Ministry of Finance, which contracted the University of Cyprus Economic Research Centre (ERC) to prepare a tax reform proposal. The ERC presented its proposal on 26 February 2025, after 18 months of consultations and research. The proposal covered personal income and corporate taxation while excluding indirect taxes such as value added tax (VAT). On 18 July 2025, the Ministry of Finance published six draft legislative bills for public consultation, which lasted until 10 September 2025 and largely reflected the ERC recommendations. The final legislative package incorporated amendments introduced during its consideration by the House of Representatives.

The stated objective of the tax reform is to promote a tax system that supports economic growth, employment, and the competitiveness of the Cypriot economy, while ensuring fiscal sustainability and a fairer distribution of national income, in line with Cyprus's Long-Term Strategy for Sustainable Development[1].

This paper evaluates the fiscal and distributional implications of the Cyprus tax reform, focusing on the personal income tax (PIT) component. From a central bank perspective, reforms that affect the distribution of disposable income are relevant because they reallocate resources across households with different marginal propensities to consume, saving behavior and exposure to interest-rate movements. High-income households typically display lower marginal propensities to consume, hold a larger share of financial assets, and face greater exposure to interest-rate fluctuations. As a result, increases in income inequality may weaken monetary policy transmission through cash-flow effects while strengthening it through asset-price and balance-sheet effects (Kaplan et al., 2018). This pattern implies that monetary transmission becomes increasingly reliant on financial channels (Ampudia et al., 2024).

Related research links distributional shifts to broader macro-financial dynamics. Higher saving by high-income households can put downward pressure on equilibrium real interest rates ("saving glut"), supporting asset price growth and raising collateral values. Lower rates may also encourage greater borrowing by lower- and middle-income households, enabling them to smooth consumption in the short term and, in some cases, reinforcing rising consumption norms ("expenditure cascades"). This mechanism may lead to increases in debt-to-income ratios among these groups (Mian et al., 2021).

While changes in the distribution of income can influence aggregate demand and the monetary policy stance (Mian et al., 2021; Auclert, 2019), the parallel build-up of household leverage can increase financial vulnerabilities. Over time, rising indebtedness may weaken balance-sheet resilience, heighten sensitivity to adverse shocks, and raise the risk of disorderly deleveraging or financial stress episodes (Kumhof et al., 2015). Against this background, the distributional effects of the PIT reform warrant attention from a monetary and financial stability perspective. Although the design of tax policy lies outside the remit of the central bank, such reforms could constitute a structural shock to household income and balance-sheet positions, with potential implications for inflation dynamics, monetary policy transmission, and financial vulnerabilities. This motivates an assessment of the distributional characteristics of the Cyprus PIT reform, which can serve as a basis for subsequent

[1]More information on the strategy can be found on the website of the Cyprus Economy and Competitiveness Council: https://www.gov.cy/ecompet/en/documents/.

analysis of the channels through which it may interact with the macro-financial environment.

Our analysis employs the EUROMOD tax-benefit microsimulation model and confidential household-level survey data – EU statistics on income and living conditions (EU-SILC) and the Household Budget Survey (HBS) – to quantify the heterogeneous effects of the PIT changes across the income distribution and to estimate the short-run aggregate impact on disposable income and PIT revenue. This assessment covers: (i) the amendments to PIT brackets, (ii) the means-tested tax allowance for dependent children and university students, and (iii) the means-tested tax allowance for mortgage interest or rental expenses related to a primary residence. The PIT reform also introduces a tax incentive for capital expenditures on green measures, which is not included in the assessment due to limited data availability on eligible expenditures and to avoid imposing additional modeling assumptions. This measure is expected to be relatively limited in fiscal magnitude. The reform also includes corporate tax adjustments, changes to capital gains taxation, and amendments to other personal taxes and stamp duties, which fall outside the scope of this analysis and could be addressed in future work.

The remainder of the paper is organized as follows. Section 2 provides a brief overview of the related literature. Section 3 summarizes the PIT measures included in the legislative package and presents mechanical calculations of gains from the changes in PIT brackets across taxable income levels. Section 4 outlines the methodology and data sources, and introduces the income group definitions used in the analysis. Section 5 presents the microsimulation results, including the distributional impacts and aggregate fiscal effects. Section 6 concludes and discusses broader considerations for the PIT system.

2 Related Literature

In November 2025, before the amendments introduced during consideration by the House of Representatives, the ERC published its final report on the proposed tax reform (Economics Research Centre, 2025), assessing its potential impacts on competitiveness, income inequality, and the transition to a green and digital economy[2]. With respect to inequality, the ERC analysis is limited to six illustrative household types. This paper complements that work by assessing the distributional impact of the PIT reform across the full income distribution.

The distributional implications of the tax system design, including tax brackets, exemptions, credits and deductions, are well documented in the literature. Avram et al. (2014) show that redistribution depends not only on statutory tax rates but also on how the tax base is defined and how different income components and household structures are treated. Using EUROMOD, they find that deductions and allowances can significantly affect the vertical redistribution by shifting tax liabilities across the income range. Similarly, cross-country microsimulation evidence for EU Member States, indicates that variation in direct taxes – particularly, the interaction between household characteristics and tax schedules – are important drivers of differences in disposable income inequality across countries (Immervoll et al., 2006). These studies highlight that reforms that reduce taxable income through targeted deductions can decrease direct tax revenue while, at the same time, reshaping distributional outcomes.

[2]The final report has been published on 18 November 2025 and revised on 29 January 2026. More information on the ERC relevant work can be found on its website: https://www.ucy.ac.cy/erc/taxreform/?lang=en.

IMF staff research (Coady and Le, 2020) argues that progressive tax financing, together with expanding transfer coverage, can strengthen fiscal redistribution and support equity objectives. The authors note that expanding the coverage of social transfers that are financed through progressive taxation can help mitigate these costs and improve the overall equity and effectiveness of fiscal redistribution systems. In this sense, tax deductions for dependent children, students, or housing costs can be viewed as hybrid instruments; although implemented through the tax system, they may function similarly to family- or employment-related transfers by increasing the disposable income of eligible households.

The literature also emphasizes the importance of PIT design features. Figari and Paulus (2013) show that deductions, tax credits, and in-kind components can substantially affect measured redistribution, in some cases to an extent comparable to changes in statutory tax rates. When taxable income is reduced through allowances linked to family composition or essential expenses (such as housing costs), the effective tax burden may shift in ways that standard pre- and post-tax income comparisons understate unless these instruments are explicitly modeled.

Related work has also explored the macroeconomic effects of tax reforms by integrating microsimulation with macroeconomic models. Barrios et al. (2019, 2022) combine EUROMOD with DSGE and VAR-based frameworks, respectively, and find that behavioral and macroeconomic feedbacks are relevant for policy evaluation, although for PIT reforms second-round effects tend to be limited relative to first-round effects.

On the other hand, several studies highlight that tax expenditures can make the tax system more complex, less transparent and produce adverse distributional impacts (Turrini et al., 2024; OECD, 2010). World Bank staff further note that targeted direct transfers are a more efficient way to support low-income households than broad tax relief measures, mainly due to their clear distributional targeting (Wai-Poi et al., 2025). The OECD (2025) and the World Bank (2024) underline that tax expenditures tend to be less transparent than direct spending, complicating fiscal oversight.

At the same time, the expansion of tax-free limits and tax deductions can remove large segments of the population from the tax base. Bakija (2024) notes that such features are often politically popular, particularly when targeted at households with children or lower incomes, and tend to become entrenched, making it difficult to broaden the base again later. Related political economy work suggests that narrowing the tax base can be persistent. Hope and Limberg (2022) document long-term trends in advanced economies highlighting a substantial decline in effective taxation of high-income groups over the last 50 years. They argue that tax reforms often reduce effective taxation of high-income groups by narrowing the top tax base through exemptions and preferential treatments. Finally, Decoster et al. (2010) find that shifts from direct to indirect taxation – often justified as enhancing efficiency – tend to reduce overall tax progressivity, unless offset by targeted transfers or stronger progressivity in direct taxation. Taken together, the literature suggests that reforms that narrow the progressive tax base or rely more heavily on indirect taxation risk entrenching a less progressive fiscal structure that is difficult to reverse.

3 Policy changes: PIT brackets and new tax allowances

The approved legislative package introduces a set of changes to the personal income tax brackets, including an upward shift in threshold levels and a widening of selected brackets (see Table 1). The

objective of these amendments is to reduce the tax burden on earned income and improve incentives for work and productivity. A notable feature is the widening of the fourth bracket from €36,301 – €60,000 (a range of €23,700) to €42,001 – €72,000 (a range of €30,000). In the initial draft bill, this bracket was proposed at an even wider range, €40,000 – €80,000.

Table 1: Amendments in income tax brackets

	Taxable income (€)		Tax rate	Change in the bracket range (€)
	Before (up to 2025)	Tax reform (2026 onwards)		
1	0 – 19,500	0 – 22,000	0%	2,500
2	19,501 – 28,000	22,001 – 32,000	20%	1,500
3	28,001 – 36,300	32,001 – 42,000	25%	1,700
4	36,301 – 60,000	42,001 – 72,000	30%	6,300
5	> 60,000	> 72,000	35%	–

Source: Income Tax (Amendment) (No. 2) Law of 2025 (in Greek).

According to Tax Department data for the 2022 tax year, 43 percent of taxpayers reported taxable income below the pre-reform tax-free threshold of €19,500. This suggests that a substantial share of low-income households are not directly affected by the PIT changes. At the upper end of the distribution, only around 4 percent of taxpayers declared taxable income exceeding €60,000 (Table 2). Therefore, the widening of the fourth PIT bracket suggests that, all else equal, the revision of the brackets provides larger mechanical gains to high-income taxpayers[3].

Table 2: Percentage of taxpayers by taxable income, 2022 tax year

	Taxable income (€)	Taxpayers (number and percentage)	
1	0 – 19,500	129,580	43%
2	19,501 – 28,000	73,172	24%
3	28,001 – 36,300	42,464	14%
4	36,301 – 60,000	43,254	14%
5	> 60,000	10,951	4%
	TOTAL	**299,421**	**100%**

Source: Tax Department (Statistics).

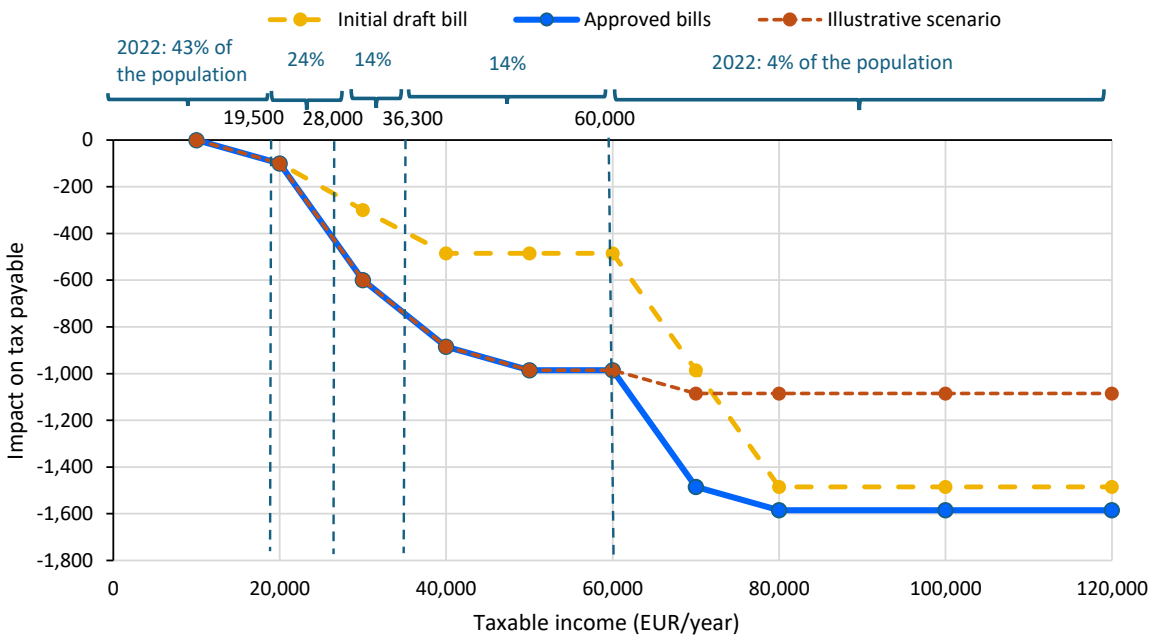
The upward shift in the bracket thresholds generates reductions in tax payable that vary by taxable income. A mechanical calculation of gains, while abstracting from other elements of the reform package such as tax allowances, supports this interpretation. As illustrated in Figure 1, the largest gains accrue to individuals in the top bracket; that is, those with taxable income above €60,000, corresponding to the 96th percentile in the 2024 taxable income distribution of the EU-SILC data (and the 95th percentile when uprated to 2026 income levels).

The bracket amendments introduced during consideration by the House of Representatives, relative to the initial draft bills, moderate the gains for high-income taxpayers, particularly due to the smaller increase in the range of the fourth bracket (Figure 1, blue solid versus yellow dashed line). A narrower fourth bracket – for example €42,001 – €62,000 (a range of €20,000) – would further reduce mechanical gains for high-income taxpayers (Figure 1, orange dotted line), and lower the fiscal cost of the bracket amendments. This would have preserved additional fiscal space for other public policy priorities, including spending to support social cohesion or productivity-enhancing investments.

[3]The initial draft bills were even more favorable to high-income earners, as they included an even larger widening of the fourth tax bracket, to a span of €40,000, implying an increase of €16,300 in this bracket's range.

Figure 1: Change in tax payable, for various income levels

(€/year)



Source: Own calculations, Tax Department (Statistics).

In addition to the shift in tax brackets, the reform introduces three means-tested tax allowances that are fully phased out for households above specified income thresholds. The thresholds are set at €100,000 for families with up to two children, €150,000 for families with three or four children, and €200,000 for families with more than four children. The threshold for single-person households is €40,000. The tax allowances, applicable only if household income is below the relevant threshold, are as follows:

1. **Dependent children and university students allowance:** A tax allowance of €1,000 per parent for the first dependent child or university student, €1,250 for the second, and €1,500 for the third and each subsequent dependent child or university student. For single-parent households or cases in which one parent has full custody, the tax allowance is doubled.

2. **Housing costs allowance:** A tax allowance of up to €2,000 for each spouse, partner, or single individual in respect of either (i) interest expenses paid on a performing loan or (ii) rental expenses, where in both cases the expense must relate to a primary residence.

3. **Green measures allowance:** A tax allowance of up to €1,000 for each spouse, partner, or single individual for eligible capital expenditure on "green measures," such as energy efficiency improvements to a primary residence, installation of renewable energy systems and electricity-storage batteries, and purchase of electric vehicles. This allowance can be claimed over five years, subject to the €1,000 annual cap and a total limit such that cumulative deductions granted to both spouses or partners do not exceed the total amount of eligible expenditure.

The analysis incorporates the bracket reform and the first two tax allowances, which are expected to account for the largest fiscal effects. The green measures allowance is excluded, as reliable data on eligible green expenditures are not available and incorporating it would require additional

assumptions.

The introduction of household-level, means-tested tax allowances represents a shift in design, as their eligibility depends on family income rather than individual conditions. While this approach may enhance the targeting of support, it also adds some complexity as it is expected to increase the administrative effort required to verify household eligibility. The literature generally finds that similar outcomes can be achieved more transparently through direct social transfers, which are typically easier to administer and target.

4 Data and methodology

This section describes the data and methodological framework used to assess the distributional and fiscal impacts of the PIT reform. First, it outlines the model, simulation approach and the household microdata used in the analysis. Then, it presents the income group definitions based on the concept of equivalized disposable income.

4.1 EUROMOD and microdata

The analysis uses EUROMOD, an open-source tax-benefit microsimulation model for EU member states[4]. EUROMOD translates the direct taxes and benefits rules for each member state into a set of policy codes, which can be applied to micro-level survey data to simulate tax liabilities and benefit entitlements at the individual and household levels[5]. This structure allows the model to capture interactions within the tax-benefit system and to compare a baseline policy regime with counterfactual scenarios, such as the PIT reform examined in this paper.

EUROMOD is a static microsimulation model; that is, it delivers the first-round effects of policy changes, abstracting from behavioral responses and general equilibrium mechanisms. Nevertheless, these first-round effects are informative for assessing distributional and immediate fiscal implications.

EUROMOD relies on EU-SILC microdata, which include detailed information on household income components, individuals' demographic and socio-economic characteristics, and household structure. Our baseline simulations use the 2022 EU-SILC dataset (2021 income reference period)[6] and the 2024 EUROMOD policy system[7], the latest available as of January 2026. Since the survey income reference period (2021) lags the policy year (2024), the model applies a set of uprating indices to the relevant monetary variables in the microdata so that they are expressed in values consistent with the policy year under analysis.

The PIT measures are introduced sequentially into the model, allowing their separate as well as combined effects to be assessed. The measures are simulated for 2024 income levels and extended to 2025–2026 by uprating income and pension variables using the Central Bank of Cyprus (CBC)

[4]Detailed information about EUROMOD can be found at: https://euromod-web.jrc.ec.europa.eu/.

[5]Sutherland and Figari (2013) provide the core methodological reference for EUROMOD, describing the model's structure, underlying microdata, and its use for simulating the distributional and fiscal effects of tax-benefit reforms across EU Member States.

[6]This paper is based on data from Eurostat, specifically the EUROMOD input dataset; that is, EU-SILC microdata that have been harmonized and calibrated by Eurostat and the Joint Research Centre (JRC). The responsibility for all conclusions drawn from the data lies entirely with the authors. More information on the EU-SILC survey can be found at: https://ec.europa.eu/eurostat/web/microdata/european-union-statistics-on-income-and-living-conditions.

[7]For more information about Cyprus's tax-benefit policies simulated in EUROMOD, see the latest EUROMOD Country Report: https://euromod-web.jrc.ec.europa.eu/resources/country-reports.

December 2025 projections. The mapping between EUROMOD variables and projection variables is reported in Appendix B.

In addition, our analysis uses the EUROMOD Consumption Tax (CT) add-ons to simulate the short-run impact on consumption taxes following the positive disposable income shock resulting from the PIT reform. The CT tool combines EU-SILC data with imputed household expenditure information from the Household Budget Survey (HBS) across a detailed set of commodity categories[8] to estimate VAT and other indirect taxes under three stylized behavioral assumptions.

4.2 Income group definition and equivalized disposable income

To analyze the distribution of household income, income levels need to be comparable across households of different sizes. This motivates the use of equivalized disposable income. Equivalized disposable income refers to household disposable income adjusted for household size, thereby allowing meaningful comparisons of living standards across households[9].

Income groups are typically defined on the basis of equivalized disposable income. According to 2024 data from the Cyprus Statistical Service (CyStat), the "middle-income class" in Cyprus comprises individuals living in households with equivalized disposable income between €15,501 and €41,333[10], corresponding broadly to the 3rd to 9th deciles of the EU-SILC equivalized disposable income distribution. Within this middle-income range, three sub-groups are distinguished:

- **Lower-middle-income class:** €15,501 – €20,666 (approximately the 3rd–5th deciles)
- **Mid-middle-income class:** €20,667 – €30,999 (approximately the 6th–8th deciles)
- **Upper-middle-income class:** €31,000 – €41,333 (approximately the 9th decile)

Individuals living in households with equivalized disposable income above €41,333 are classified as upper-income, while those below €15,501 are classified as lower-income.

5 Microsimulation results

This section presents the microsimulation results. It begins by examining the distributional effects of the PIT reform on household disposable income, followed by additional distributional results on the reduction in the number of taxpayers and changes in the tax burden. Next, it provides aggregate estimates for PIT revenue, disposable income, and consumption taxes. Finally, it examines the sensitivity of the results to income uprating for 2025–2026.

5.1 Distributional impact on disposable income

Figure 2 presents EUROMOD simulation results on the distributional impact of the PIT changes, applied to 2024 incomes[11]. The three measures assessed are introduced sequentially in EUROMOD:

[8] The EUROMOD input dataset includes this detailed information. More information on the HBS can be found at: https://ec.europa.eu/eurostat/web/microdata/household-budget-survey.

[9] Scale of adjustment used by the OECD and Eurostat: 1 for the first adult of the household, 0.5 for each additional adult (aged 14 or older), and 0.3 for each child under 14 years old.

[10] The income class definitions are based on the OECD recommended definitions. More information can be found on the website of CyStat: https://www.gov.cy/en/economy-and-finance/population-by-income-class-2/.

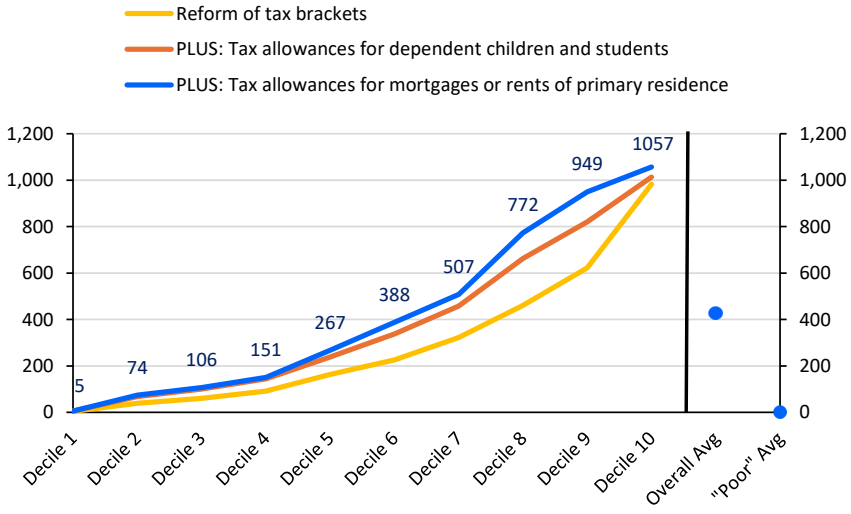
[11] To assess the sensitivity of the results, the distributional impact of the PIT reform is simulated for subsequent income years, that is, 2025-2026. Prior to running these simulations, EUROMOD income and pension variables are uprated using the CBC December 2025 projection exercise, as described in Appendix B.

(i) the bracket reform (yellow line), (ii) the introduction of tax allowance for dependent children and university students (orange line), and (iii) the inclusion of tax allowance for mortgage interest or rental expenses related to a primary residence. Therefore, the blue line in Figure 2 represents the combined effect of the measures included in the assessment.

Considering the tax bracket reform alone (yellow line), the simulations indicate that, holding other reform elements constant, the larger gains accrue to households in the upper part of the income distribution (measured in terms of equivalized disposable income). Households in the bottom 40 percent of the distribution receive minimal benefits, as their incomes already imply little or no PIT liability. Households in the 5th to 7th deciles of the distribution experience modest gains, ranging from an average of €163 per year in the 5th decile (+0.9 percent of baseline disposable income) to €322 per year in the 7th decile (+1.4 percent). Benefits are higher for the 8th and 9th deciles, with average gains of €460 per year (+1.7 percent) and €622 per year (1.9 percent), respectively. Upper-income households receive average gains of €982 per year (+1.9 percent).

Figure 2: Distributional impact of income tax reform components

(a) Absolute effect
(€/year)



(b) Relative effect
(% of baseline income)

Decile	Tax reform
1st	0.06%
2nd	0.63%
3rd	0.77%
4th	0.95%
5th	1.47%
6th	1.88%
7th	2.17%
8th	2.88%
9th	2.93%
10th	2.00%
Overall	1.91%
"Poor"	0.00%

Source: EUROMOD simulations using EU-SILC data.
Notes: (1) The left–hand panel (panel (a)) reports the absolute change in equivalized disposable income. The right–hand panel (panel (b)) reports the corresponding relative effect of the combined PIT measures as a percentage of baseline equivalized disposable income. (2) Equivalized disposable income is household disposable income adjusted by the household (equivalized) size (scale: 1 for the first adult, 0.5 for each additional adult (aged 14 or older), 0.3 for each child under 14 years old). (3) The 2024 top cut-off points for deciles 1–9 of equivalized disposable income are €11,086, €13,628, €15,922, €18,097, €20,666, €23,473, €26,469, €30,602, €38,053, respectively. (4) "Poor" refers to households whose equivalized disposable income falls below the poverty threshold. This threshold is country-specific and defined as 60 percent of the national median equivalized disposable income. For Cyprus, the threshold was estimated at €12,400 in 2024. Further information on the relevant Eurostat definition can be found at: https://ec.europa.eu/eurostat/statistics-explained/index.php?title=Glossary:At-risk-of-poverty_rate. The Cyprus-specific poverty threshold can be found at: https://www.gov.cy/en/economy-and-finance/survey-on-income-and-living-conditions-of-the-households-risk-of-poverty-2024/.

Adding the tax allowance for dependent children and university students on top of the bracket reform increases gains mainly for households in the 5th to 9th deciles, as reflected in the gap between the yellow and orange lines in Figure 2. Gains for the 2nd to 4th deciles remain modest, while those for the 1st and 10th deciles are minimal. Incorporating the tax allowance for housing costs generates additional gains for middle-income groups (difference between the blue and orange lines), particularly

for households in the 8th and 9th deciles, and, to a lesser extent, for households in the 6th and 7th deciles. These gains are smaller than those associated with the tax allowance for children and university students.

Considering the combined effect of the three measures (blue line in Figure 2), the largest absolute gains accrue to the top income decile, averaging €1,057 per year, while the smallest gains accrue to the bottom decile, averaging €5 per year. Expressed as a percentage of baseline equivalized disposable income, the bottom decile records the lowest gain (+0.06 percent), followed by the 2nd to 4th deciles (0.6-1 percent). Gains for the 5th to 7th deciles range between 1.5 percent and 2.2 percent, while the 8th and 9th deciles experience increases of 2.9 percent. The 10th decile records a slightly lower proportional increase of 2 percent.

As expected, the estimated impact on standard inequality and poverty indices is minimal (Table 3). Overall, the reform slightly weakens redistribution, not by making the tax system less progressive, but by shrinking its overall size. This leads to a marginal increase in disposable income inequality. Despite the slightly higher inequality, the social welfare index increases, driven by higher average disposable incomes that make society better off overall.

Table 3: Inequality, poverty and social welfare indices

	Income tax reform		
	Base	Simulated	Impact
Gini index, original income	0.437	0.437	–
Gini index, disposable income	0.287	0.291	0.004
At-risk-of-poverty rate	14.7%	14.5%	-0.2%
Redistribution index = Gini original income − Gini disposable income = (Kakwani index × Net average tax rate) − Re-ranking effect	0.149	0.146	-0.004
Social welfare index = mean eq. disp. income × (1 − Gini disposable income)	1332	1351	18
Income quantile share ratio (S80/S20)	4.12	4.16	0.04

Source: EUROMOD simulations using EU-SILC data.
Note: The S80/S20 indicator is the ratio of total income received by the richest 20 percent of the population (top quantile; S80) to total income received by the poorest 20 percent of the population (bottom quantile; S20). The Gini coefficient accounts for all parts of the income distribution, though it is less intuitive – it is noted that the index for Cyprus is very close to the EA average, in particular after 2016. The "at-risk-of-poverty" indicator is the share of people whose (equivalized) disposable income is below 60 percent of the national median (€961).

Figure 3 depicts two illustrative alternative scenarios that incorporate the approved tax reform components, with the following modifications to the upper part of the PIT schedule:

- **Illustrative scenario 1:** The threshold of the fourth tax bracket is set at €62,000 instead of the approved €72,000.
- **Illustrative scenario 2:** The upper threshold of the fourth tax bracket is set at €62,000 instead of the approved €72,000,
  AND
  the fifth bracket is defined at €62,001–€82,000 with a 35 percent tax rate,
  AND
  a sixth bracket is introduced for taxable income above €82,000 with a 40 percent rate.

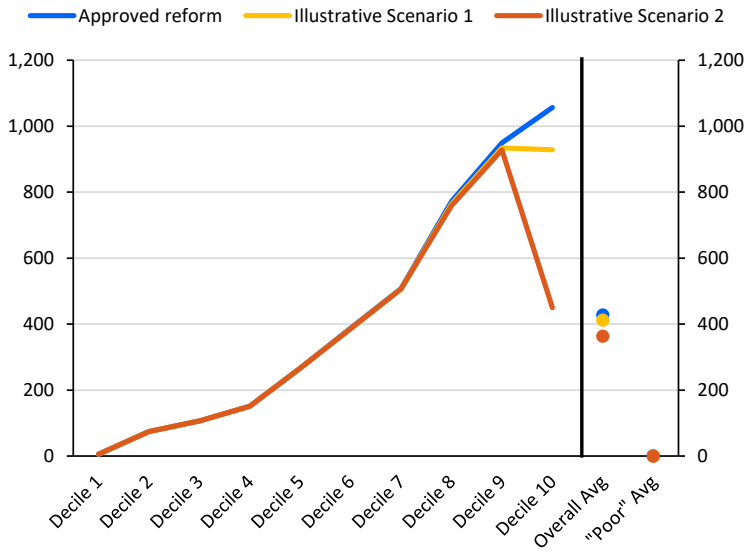
Under Illustrative Scenario 1, households in the top-income decile experience smaller gains compared to the approved reform: €929 per year versus €1,057 per year (1.8 percent versus 2 percent of

baseline disposable income). In Figure 3, this is reflected in the yellow line lying below the blue line (approved reform) for the top-income decile. The yellow line also flattens between the 9th and 10th deciles, indicating broadly similar absolute gains for these two groups.

Under Illustrative Scenario 2, gains for households in the top-income decile are even smaller: €450 per year versus €1,057 per year under the approved reform (0.9 percent versus 2 percent of baseline disposable income). This is reflected in the orange line lying well below the blue line for the top-income decile in Figure 3. Correspondingly, the fiscal cost is lower: by approximately €9 million under Illustrative Scenario 1 and €37 million under Illustrative Scenario 2.

Figure 3: Illustrative scenarios compared to the approved tax reform

(a) Absolute effect (€/year)



(b) Difference from approved reform (pp of baseline income)

Decile	Illustr. Scen.1	Illustr. Scen.2
1st	0.00pp	0.00pp
2nd	0.00pp	0.00pp
3rd	0.00pp	0.00pp
4th	0.00pp	0.00pp
5th	0.00pp	0.00pp
6th	-0.01pp	-0.01pp
7th	0.00pp	0.00pp
8th	-0.03pp	-0.05pp
9th	-0.05pp	-0.07pp
10th	-0.24pp	-1.15pp
Overall	-0.07pp	-0.29pp
"Poor"	0.00pp	0.00pp

Source: EUROMOD simulations using EU-SILC data.
Notes: (1) The left–hand panel (panel (a)) reports the absolute change in equivalized disposable income under the approved reform and the illustrative scenarios. The right–hand panel (panel (b)) reports the difference between each illustrative scenario and the approved reform, expressed in percentage points of baseline equivalized disposable income. (2) Equivalized disposable income is household disposable income adjusted by the household (equivalized) size (scale: 1 for the first adult, 0.5 for each additional adult (aged 14 or older), 0.3 for each child under 14 years old). (3) "Poor" refers to households whose equivalized disposable income falls below the poverty threshold. This threshold is country-specific and defined as 60 percent of the national median equivalized disposable income. For Cyprus, the threshold was estimated at €12,400 in 2024.

5.2 Impact on the PIT tax base and average tax burden

This subsection complements the preceding results by examining the effects of the PIT reform on the number of taxpayers with positive PIT liabilities and on the average tax burden across the income distribution.

The simulations indicate that the PIT reform is expected to reduce the number of taxpayers with positive PIT liabilities by around 22 percent (Table 4). As discussed in the literature, once narrowed, a tax base can become politically difficult to broaden again.

For households, the tax burden is defined as the ratio of total taxes and social insurance contributions to the sum of original income and benefits received. The reform is estimated to reduce the average tax burden by 1.5 percentage points, from 17.4 percent to 15.9 percent. The largest reductions are observed in the 8th and 9th income deciles (2.2–2.3 percentage points), followed by the 5th, 6th,

Table 4: Number of earners and taxpayers

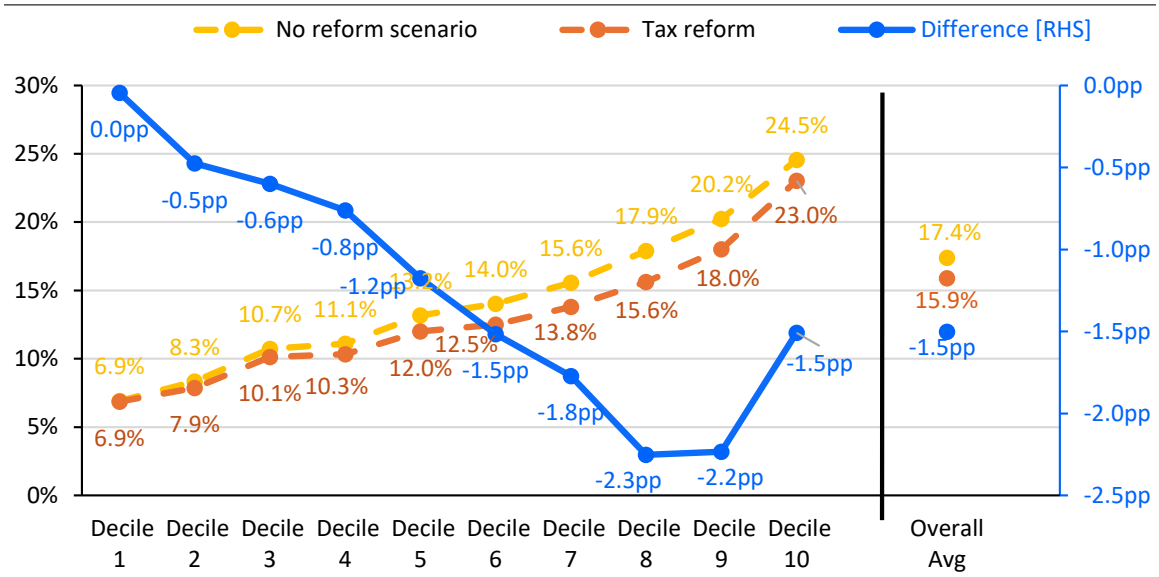
	No reform scenario	Tax reform	Difference (number)	Difference (% of baseline)
Earners	485,397	485,397	0	0.0%
Taxpayers, personal income tax > 0				
Simulations using 2024 incomes	245,199	190,631	-54,568	-22.3%
Simulations using 2026 incomes	265,780	208,357	-57,423	-21.6%

Source: EUROMOD simulations using EU-SILC data.

7th, and 10th deciles (1.2–1.8 percentage points). In contrast, the reductions for the 2nd, 3rd, and 4th deciles are smaller, ranging between 0.5 and 0.8 percentage points. Figure 4 illustrates these estimated changes in the average tax burden across income deciles.

Figure 4: Average tax burden

(%)



Source: EUROMOD simulations using EU-SILC data.
Notes: The tax burden is defined as the ratio of total taxes and social insurance contributions to the sum of original income and any benefits received.

Additional results on the share of households with positive disposable-income gains and on selected household types are reported in Appendix A.

5.3 Aggregate impacts on public revenue, disposable income, and consumption taxes

Aggregate estimates should be interpreted with caution, as scaling survey-based microdata to represent the entire population is subject to limitations. With this caveat, the simulations suggest an annual PIT revenue reduction of approximately €240 million, translating into higher household disposable income (Table 5). This estimate is broadly consistent with the figure reported by the ERC (€220 million, excluding the impact of the tax allowance for green measures).

The impact on private consumption depends on households' marginal propensity to consume (MPC). EUROMOD is a static, non-behavioral model and does not estimate MPCs. However, using HBS-

Table 5: Impact on aggregate taxes and total household disposable income

(€ million, annual)

	Tax brackets	PLUS: Tax allowance for children and students		PLUS: Tax allowance for mortgages and rents	
		Combined impact	Marginal impact	Combined impact	Marginal impact
Personal income tax (total)	-174.8	-218.7	-43.9	-242.8	-24.1
Total household disposable income	174.8	218.7	43.9	242.8	24.1

Source: EUROMOD simulations using EU-SILC data.

based expenditure patterns, the consumption tax add-ons can simulate the impact of a positive income shock on consumption under three stylized assumptions regarding *consumption shares*: constant quantities, constant income shares, and constant expenditure shares[12]. The assumptions of constant quantities and constant expenditure shares represent two extreme cases (saving all versus spending all the additional income). The constant income shares assumption is considered more plausible, as it reflects households' survey-based expenditure and savings patterns. Nevertheless, it should be noted that actual MPCs are typically lower than average propensities to consume (expenditure shares), since MPCs reflect marginal rather than average behavior.

Under the constant income shares and constant expenditure shares assumptions, the national accounts-calibrated estimates suggest increases in consumption tax revenues of €39 million and €44 million, respectively. Table 6 presents the short-term impact of the positive income shock on aggregate private consumption, savings, and consumption tax revenues (VAT and other indirect taxes), without applying calibration to national accounts outturn data. These estimates should be interpreted with caution, as EUROMOD does not incorporate actual MPCs, debt-repayment behavior, second-round effects, or general-equilibrium mechanisms.

Table 6: Simulated aggregate (total) impacts from the income tax reform

Change in:	Constant income shares	Constant quantities	Constant expenditure shares
Household expenditures (EUR mn)	222.8	0	242.8
...as % of baseline	1.77%	0%	1.93%
Savings (EUR mn)	20.0	242.8	0
...as % of baseline	2.54%	30.9%	0%
VAT and other consumption taxes, paid by households (EUR mn)	26.6	0	29.5
...as % of baseline	1.76%	0%	1.95%
Post-consumption tax disposable income	216.2	0	213.3
...as % of baseline	1.83%	0%	1.80%

Source: EUROMOD simulations using EU-SILC data, and the Consumption Tax add-ons combined with HBS data imputed to EU-SILC.

[12] **Constant quantities:** Households keep the quantities consumed unchanged; therefore, private consumption does not change, and savings increase by the full amount of the rise in disposable income. **Constant income shares:** Households maintain constant shares of disposable income for each consumption item. In this case, both private consumption and savings increase proportionally to their respective baseline shares in disposable income. A limitation of this (restrictive) assumption is that, in the case of negative savings, savings decline further despite the positive income shock. **Constant expenditure shares:** Households spend their entire additional income while keeping expenditure shares constant; therefore, private consumption increases by the full amount of the rise in disposable income, while savings remain unchanged.

The effect on GDP depends not only on household MPCs, but also on the import content of the additional consumption, debt-repayment behavior, general equilibrium mechanisms (e.g. labor supply responses, price adjustments), and timing issues (e.g. delayed consumption responses). A detailed quantitative evaluation of the macroeconomic implications of the 2026 tax reform lies outside the scope of this paper. Nevertheless, the distributional analysis presented here can serve as a useful input for a follow-up project.

For illustrative purposes, assuming an import content of 40 percent for additional consumption – a stylized approximation intended to reflect Cyprus's high import dependence, rather than a calibrated estimate – the implied impact on nominal GDP under the constant income shares assumption would be around €134 million (approximately 0.4 percent). This estimate is purely indicative, as it abstracts from behavioral responses and general equilibrium effects.

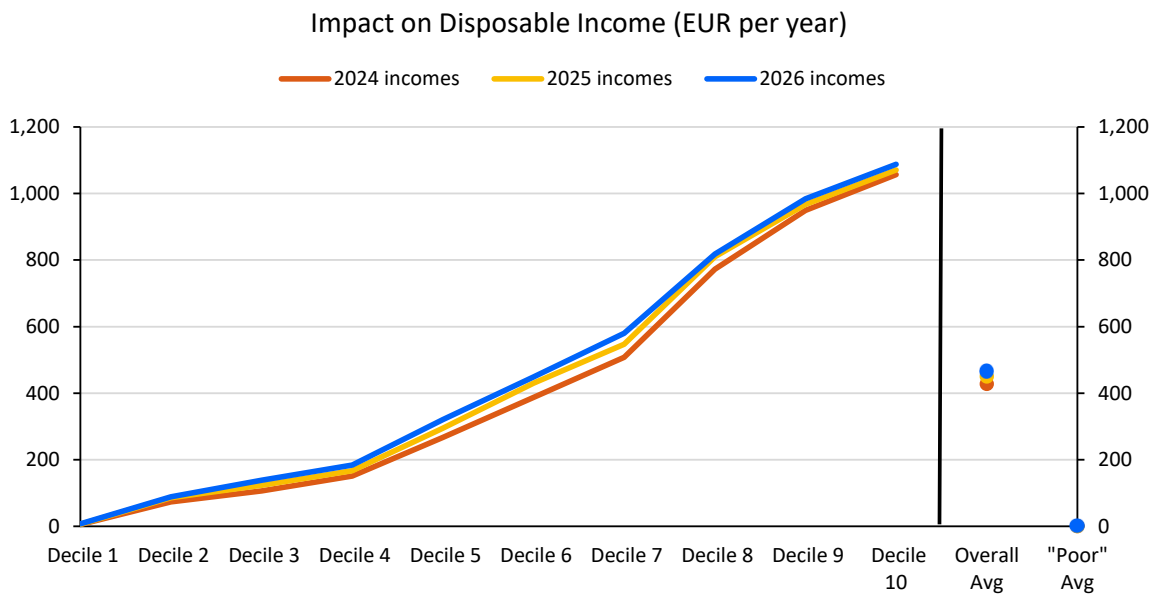
5.4 Sensitivity to income uprating for years 2025-2026

To assess the sensitivity of the results to the income uprating procedure, the distributional impact of the PIT reform is simulated for subsequent income years, that is, 2025-2026. Prior to running these simulations, EUROMOD income and pension variables are uprated using the CBC December 2025 projection exercise, as described in Appendix B.

Figure 5 presents the simulation results for the distributional impact of the PIT reform on simulated incomes for 2025 and 2026. The three lines shown indicate that the main distributional patterns are robust to the uprating of incomes and pensions to reflect expected average levels in subsequent years.

Figure 5: Sensitivity of distributional impact to income uprating

(€/year)



Source: EUROMOD simulations using EU-SILC data.

Notes: (1) Equivalized disposable income is household disposable income adjusted by the household (equivalized) size (scale: 1 for the first adult, 0.5 for each additional adult (aged 14 or older), 0.3 for each child under 14 years old). (2) "Poor" refers to households whose equivalized disposable income falls below the poverty threshold. This threshold is country-specific and defined as 60 percent of the national median equivalized disposable income. For Cyprus, the threshold was estimated at €12,400 in 2024.

6 Conclusion and reflections

This paper evaluates the distributional and fiscal impacts of the 2026 tax reform in Cyprus, focusing on changes to personal income taxation. Given that a large share of taxpayers already falls below the pre-reform tax-free threshold of €19,500, the reform provides limited direct support to low-income households. Using EUROMOD microsimulations and household-level survey data, the analysis shows that the reform delivers uneven gains across the income distribution. The largest gains accrue to upper-middle-income and high-income households, while lower-middle-income and mid-middle-income households, broadly defined as those between the 3rd and 7th deciles of the equivalized disposable income distribution, experience relatively modest benefits. In this respect, the reform appears only weakly aligned with its stated objective of achieving a fairer distribution of national income. Achieving meaningful distributional improvements would likely require strengthening the social safety net and deploying more targeted fiscal support. Nonetheless, overall, society is better off as reflected by the rise in the social welfare index, mirroring higher average disposable incomes associated with a reduced PIT burden.

From a fiscal perspective, the PIT measures entail a non-negligible revenue cost, estimated at around €240 million, broadly in line with official projections. While this cost appears manageable in the context of Cyprus's current fiscal position and may be partly offset by higher revenues from corporate taxation, the adopted configuration of the PIT reform carries an opportunity cost. Alternative configurations, such as a narrower expansion of upper tax brackets, would have reduced windfall gains to high-income earners and lowered the fiscal cost, thereby preserving greater fiscal space for other public policy priorities, including social cohesion and productivity-enhancing public investment.

Although tax policy lies outside the remit of the central bank, the distributional effects of significant tax reforms are relevant from a monetary policy and financial stability perspective. By reallocating disposable income across households with different marginal propensities to consume, different savings behavior, and different exposure to interest rate movements, the reform may influence the strength and composition of monetary policy transmission. Moreover, such reallocation can interact with household balance sheets, leverage dynamics, and housing market pressures, potentially affecting financial vulnerabilities. Therefore, the distributional assessment provided in this paper can serve as a useful input to subsequent analysis on the channels through which the tax reform may interact with the macro-financial environment.

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Appendices

A Additional distributional effects by income decile and household type

This appendix reports additional distributional results, focusing on the share of households with positive disposable-income gains across the income deciles and on selected household-type effects.

With respect to disposable income, the reform generates only non-negative effects. The simulations confirm that no household experiences a decrease in disposable income compared to a no-reform scenario. Approximately 61 percent of households are expected to experience an increase in disposable income ('winners'). Gains are concentrated in the upper part of the income distribution: almost all households in the 8th, 9th, and 10th deciles (over 96 percent in each decile) have direct gains from the reform, while the share of households with positive gains declines in the lower income deciles (Table A.1).

Table A.1: Share of households with positive disposable income changes ('winners') across income deciles

Decile	Share
1st	3.1%
2nd	20.5%
3rd	27.8%
4th	42.5%
5th	59.7%
6th	74.8%
7th	87.7%
8th	96.4%
9th	97.8%
10th	97.2%
All	60.7%

Source: EUROMOD simulations using EU-SILC data.

Table A.2 reports the mean equivalized disposable income for typical household types consisting of two adults with different numbers of children, while Table A.3 reports the corresponding average tax burden. As expected, households with more children experience larger gains, due to the introduction of the child tax allowance.

Table A.2: Mean equivalized disposable income for typical household types

	Difference with baseline	
Household type	(€/year)	(%)
Two adults < 65, no children	373	1.5%
Two adults with one child	514	2.2%
Two adults with two children	586	2.6%
Two adults with three or more children	648	3.1%

Source: EUROMOD simulations using EU-SILC data.

Table A.3: Average tax burden for typical household types

	No reform scenario	Tax reform	Difference
Two adults < 65, no children	18.3%	17.1%	-1.2pp
Two adults with one child	18.5%	16.7%	-1.8pp
Two adults with two children	19.9%	17.8%	-2.1pp
Two adults with three or more children	21.3%	18.9%	-2.4pp

Source: EUROMOD simulations using EU-SILC data.

B Uprating in EUROMOD

While the EUROMOD tax-benefit systems are updated to reflect the latest available policy year (2024 in this analysis), the underlying survey microdata are released with a time lag. As a result, the income reference period of the microdata does not coincide with the policy year being analyzed. In order to ensure consistency of our results and reduce the risk of misinterpretation, monetary variables in the input data are uprated to the policy year. EUROMOD provides a set of uprating indices precisely to correct for such timing inconsistencies. These indices are applied to the relevant monetary variables in the microdata so that they are expressed in values consistent with the policy year under analysis.

The survey data used in this analysis correspond to the 2022 wave, with income information referring to 2021. Therefore, to generate results for 2024 and subsequent simulation years, the embedded EUROMOD uprating indices were applied to income and pension variables. For years beyond 2024, where outturn data for the uprating factors are not available, the indices are extended using projected values. The projected variables presented in Table B.1 are based on the Central Bank of Cyprus (CBC) December 2025 projection exercise.

Table B.1: Forecasted variables used to uprate EUROMOD income and pension variables

EUROMOD uprating index	**CBC variables used (based on the December 2025 projection exercise)**
Basic annual child benefit for one child ($f_ben)	CPI Inflation
Basic amount of a number of benefits ($f_ben)	CPI Inflation
Basic monthly amount of orphan grant ($f_psuor)	CPI Inflation
Single parent benefit ($f_bchlp)	CPI Inflation
Average annual amount of the student grant ($f_studgrant)	Fixed Amount (no change)
Basic amount of military grant ($f_bml)	Fixed Amount (no change)
Monthly guaranteed minimum income benefit amount of head ($f_bsamm)	Fixed Amount (no change)
Basic monthly amount of social pension ($f_poasp)	Pensions (Average pension % change) – Estimated % change in average pension, excluding discretionary decisions
Taxable public pensions ($f_poatx_publ)	Pensions (Average pension % change) – Estimated % change in average pension, excluding discretionary decisions

EUROMOD uprating index	**CBC variables used (based on the December 2025 projection exercise)**
Average pension from SIF ($f_avgpen)	Pensions (Average pension % change) – Estimated % change in average pension, excluding discretionary decisions
Maternity allowance ($f_bma)	Average wage rate, per hour of employment (growth rate)
Average yearly income from employment, previous year ($f_yempv)	Average wage rate, per hour of employment (growth rate)
Average yearly income from employment, lead value ($f_yemdt)	Average wage rate, per hour of employment (growth rate)
Employment income civil servants ($f_EmplInc_Publ)	Average public sector wage, per government employee (growth rate)
Average hourly wage per sector ($f_hourly_wage_lindi_1-12)	Average wage rate, per hour of employment (growth rate)
Average hourly wage, all activity sectors, units of national currency ($f_hourly_wage)	Average wage rate, per hour of employment (growth rate)

Source: EUROMOD, December 2025 CBC macroeconomic projection exercise.