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COMMISSION STAFF WORKING DOCUMENT

Assessment of the 2012 national reform programme and stability programme for CYPRUS

Accompanying the document

Recommendation for a

COUNCIL RECOMMENDATION

on Cyprus' 2012 national reform programme and delivering a Council opinion on Cyprus' updated stability programme, 2012-2015

CONTENTS

EXECUTIVE SUMMARY

In 2012, Cyprus's economic activity is expected to contract by 0.8% in 2012, before regaining some momentum in 2013 to reach 0.3% of GDP. Unemployment is foreseen to increase further to 9.8% in 2012.

To ensure sound public finances, Cyprus has adopted a series of consolidation measures, committing to the reduction of its fiscal deficit. Legislation has also been put in place to accommodate, via public intervention, risks to the viability of banks or needs for recapitalisation that cannot be met by market operations. As response to the economy's contraction, the government also adopted a wide-ranging package of measure to enhance the country's growth potential, employment, productivity, and competitiveness. Measures were taken to reform the pension system and a social dialogue is currently under way regarding the reform of the wage indexation system.

Despite these efforts, Cyprus is affected by sizeable and persistent current account deficits, large amount of accumulated private sector debt, widening annual deficits of public finances and the large exposure to Greece of the banking sector. Tax collection is marked by inefficiencies that give rise to tax evasion. A comprehensive pension reform is needed to address the inherent sustainability as well as adequacy problems of the system, given the high poverty risk among the elderly. The healthcare system is characterised by inequity and inefficiencies. Unemployment is on the rise, reaching historically high figures, especially for young people and the labour market is characterised by an inadequate supply of skills to match current and future labour demand. Obstacles in the services market and to the provision of professional services remain.

1. INTRODUCTION

In July 2011, the Council of the European Union adopted seven country-specific recommendations[1] (CSRs) for economic and structural reform policies for Cyprus. These recommendations[2] concerned public finances, banking supervision, the pension and healthcare system, the labour market, energy and deregulation.

In November 2011, the Annual Growth Survey for 2012 (AGS 2012) provided the basis for building the necessary common understanding of the priorities for action at national and EU level in 2012[3]. It focused on five priorities — growth-friendly fiscal consolidation, restoring normal lending to the economy, promoting growth and competitiveness, tackling unemployment and social consequences of the crisis, and modernising public administration — and encouraged Member States to implement them in the 2012 European Semester.

Against this background, Cyprus presented updates of its national reform programme and stability programme in May 2012. These programmes give details on progress made since July 2011 and plans for moving forward.

This Staff Working Document assesses the state of implementation of the 2011 CSRs as well as the AGS 2012 in Cyprus, identifies current policy challenges and, in this light, examines the country's latest policy plans.

Overall assessment

Cyprus has implemented the Council recommendations only partially. Cyprus has adopted a series of consolidation measures, committing to the reduction of its fiscal deficit as required under the Excessive Deficit Procedure (and repeated in the CSRs). It has also adopted legislation to allow governmental support to the banking sector, if needed. Notwithstanding these achievements, reform efforts were limited, in particular regarding pensions, wage indexation, energy and regulation. As for healthcare reform, no progress is reported.

Cyprus faces its most pressing challenges in public finances and in the supervision of the banking sector's efforts to meet new capitalisation requirements, while in parallel, it has to address concerns regarding the labour market and education policy, pension and healthcare systems, the energy sector, and remaining regulatory obstacles in the services sector. The government budget deficit has to be reduced to the medium-term objective so as to help boost the confidence of financial markets. The banking sector has made significant effort to meet the strengthened capital requirements; however, close monitoring of developments is required. In the labour market and education policy, the supply of skills needs to be matched with the needs of business modernisation and potential growth areas of the economy. In parallel, the sharp increase in youth unemployment needs to be addressed. Furthermore, the existing system of wage indexation limits the degree to which wages reflect productivity differences across sectors, resulting in undermined flexibility and competitiveness losses. On the pension and healthcare front, ensuring control of relative expenditure and the projected increase in age-related expenditure constitute additional challenges. Regarding the single market, the full implementation of the sectoral legislation in line with the Services Directive is still awaited. In the energy sector, further progress in improving resource efficiency, in particular water efficiency and waste management, is needed.

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1 SEC(2011) 803 final
2 OJ C 210, 16.7.2011, p.12
3 COM(2011) 815 final

The national reform programme and the stability programme submitted by Cyprus respond to last year's recommendations and also have forward-looking elements. While some measures have been adopted to address the challenges at least in the medium-term horizon, in some other areas they do not address the challenges in a comprehensive and permanent way.

2. ECONOMIC DEVELOPMENTS AND CHALLENGES

2.1. Recent economic developments and outlook

Recent economic developments

The Cypriot economy grew by a modest 0.5 % in 2011. After a good first half-year when GDP rose by 1.5 % y-o-y thanks to an exceptionally good tourist season, economic activity was badly affected by the accident in July that destroyed the Vassiliko electricity-producing plant, which accounted for half of the total generating capacity of Cyprus. Moreover, a worsening external environment and tightening financial and fiscal conditions compounded the adverse effect on economic activity.

Domestic demand, traditionally the main driver of growth, shrank in 2011. Tighter bank lending conditions along with a worsening labour market outlook and weaker confidence weighed on private consumption. In addition, weak foreign demand for housing and a restructuring of corporate balance sheets kept investment on a correction path for the third year in a row. On the other hand, the external sector made a positive contribution to growth. Tourist arrivals and revenues posted an increase of 10 % and 13 % respectively. This was due to political instability in competing Mediterranean destinations and an increased flow of arrivals from developing markets such as Russia. Also, import growth decreased, in line with the contraction in domestic demand.

Economic outlook

GDP is projected to contract by 0.8% in 2012 due to a fall in domestic demand and the weaker external environment, notably including persistent financial market uncertainty. Private consumption will be restrained by the squeeze in disposable income, mainly among public sector employees, exerted by the fiscal restriction incorporated in the Budget Law 2012 adopted on 16 December 2011, as well as by the rise in unemployment to unprecedented levels. The large exposure of the financial sector to Greece and the banks' need of recapitalisation will probably raise the cost of financing and limit private-sector access to it. Demand for housing is also expected to remain sluggish, while other construction investment is likely to benefit from reconstruction work in the destroyed Vassilikos power station and from other infrastructure projects. Leading indicators point to weak, albeit improving, consumer and business confidence. This suggests that a recovery should set in during the second half of 2012, with the improvement of the external environment and the resumption of private investment as uncertainty slowly dissipates. The contribution of the external sector to growth is set to remain positive. While slowing global trade and worsening economic prospects in Cyprus' main trading partners are likely to weigh on exports of goods, this should be partly offset by healthy performance of business services and tourism. Imports are set to decline against the backdrop of weak domestic demand, allowing the current-account deficit to narrow further. Economic activity is projected to recover only gradually in 2013, mainly driven by private investment, while domestic consumption will remain constrained by the need for further correction of economic imbalances.

On 7 May 2012, Cyprus submitted its stability programme and, on 10 May 2012 its 2012 national reform programme. They outline in an integrated manner the fiscal consolidation efforts, the key structural reforms and the reforms that underpin macroeconomic stabilisation. The national reform programme evaluates progress towards meeting national targets for employment, R&D, education, energy and climate change and poverty reduction for 2020. These targets set out the longer-term development trajectory to modernise the Cypriot economy and put immediate reform priorities in a broader context. The national reform programme also describes the measures Cyprus plans to take to fulfil its obligations under the Euro Plus Pact.

Prior to adopting the national reform programme, the Cypriot government has held consultations with social partners and political parties on Europe 2020 matters. On the 5th of April 2012 a public consultation was held with all stakeholders (political actors, social partners and civil society), where an outline of the national reform programme was presented.

Both programmes share the same economic outlook, but they do not quantify the impact of the proposed structural reforms on growth. For 2012 the outlook is broadly in line with the most recent Commission forecast. However, for 2013 the Cypriot authorities are more optimistic and anticipate real GDP growth of 0.5%, as well as an additional consolidation effort of 1.8% of GDP.

2.2. Challenges

Cyprus is currently facing multidimensional challenges, with some progress made by the government in a number of areas. The deteriorating outlook for growth, with increasing unemployment, the prevailing high deficit, and the new challenges resulting from the exposure of the financial sector (with its disproportionate size relative to the domestic economy) to the developments in Greece raise the negative risks associated with the short-term prospects, posing more difficulty for Cyprus's economy. The Cypriot sovereign debt is thus being increasingly perceived as risky. As a result, the government and the commercial banks are unable to borrow from international financial markets, to which they have lost access since June 2011. Safeguarding the long-term sustainability of public finances and improving the efficiency of public spending by adhering to a medium-term budgetary framework with a binding statutory basis and corrective mechanism form two additional urgent policy challenges. Progress with the phasing-in of an enforceable multiannual budgetary framework is still slow. Implementation of the growth-enhancing measures put to Parliament for adoption in March 2012 will be welcome. Equally important is the allocation of public expenditure directed towards growth-enhancing items including for the promotion of innovation, R&D, and in the energy sector. As regards the revenue-raising capacity of the government, improving tax administration and compliance, including fighting tax evasion, constitute additional challenges for the authorities, as Cyprus's administrative costs in relation to revenue collection rank highest in the EU.

Cyprus also faces the challenge of strengthening its external competitiveness and fostering growth. The in-depth-review undertaken for Cyprus identified imbalances in persistent current account deficit, loss of external competitiveness, annual deficits in public finances, and the financial sector which require close monitoring and urgent economic policy attention in order to avert any adverse effects.

Appropriate wage and price adjustments are necessary in order to regain and sustain competitiveness. In this context, the uniform application of the wage indexation mechanism (i.e. the cost of living allowance — COLA) introduces an element of wage rigidity, thereby limiting the degree to which wages reflect productivity differences across sectors. The resulting inflationary second-round effects undermine flexibility and erode competitiveness. Currently, unemployment is on the rise (while being still below the EU average), reaching historically high figures, especially for young people. On the other hand, whereas the Cypriot workforce is overall well educated, the labour market is characterised by an inadequate supply of skills to match current and future labour demand. As regards the active inclusion of socially vulnerable population groups, measures to help single parents and public assistance recipients to enter and remain in the labour market are currently not sufficiently developed.

Growing public pension and healthcare expenditure (at the varying respective levels) due to the ageing of the population are further issues that need to be addressed. A comprehensive pension reform to address the inherent sustainability problems of the system is necessary, and this in parallel should be an opportunity to make the system more equitable. In the short to medium-term, adequacy issues are also important given the high poverty risk among the elderly. The expected increases in healthcare expenditure related to population ageing, adoption of new technologies, and the inefficiencies of the healthcare system are not yet properly addressed. The implementation of enacted legislation to move to the National Health Insurance Scheme of universal coverage is being constantly postponed.

In order to boost growth in the services market and to open up the provision of professional services, the implementation of the Service Directive is a key requirement. However, it is not yet achieved in all sectors.

Regarding energy, the recent gas discovery in Cyprus Exclusive Economic Zone is promising for Cyprus's diversification of energy sources and for reduction of its excessive reliance on oil imports. Further progress in improving resource efficiency, in particular water efficiency and waste management, can bring benefits in terms of growth and jobs.

Box 1: Summary of the results of the in-depth review under the macroeconomic imbalances procedure

- **Sizeable and persistent current account deficits have resulted mainly from a deficit in the volume of trade, which is in turn linked to a gradual erosion of price/cost competitiveness.** Indeed, the latter was driven, under the impact of the boom of the early 2000s and domestic labour shortages, by wage growth outpacing productivity gains. The needed correction of the rise in relative unit labour cost should be facilitated by the current slack in overall demand and employment and by wage restraint in the public sector, which serves as a benchmark also for private sector settlements. At the same time, a shift of the supply structure towards goods and services of higher value added would help generate higher export revenues, notably in the tourism industry, which is an important source of revenue for the Cypriot economy. Insofar as the financing of the current account deficit is concerned, Cyprus was able to rely in the past on high external capital inflows from foreign deposits and foreign direct investment (FDI), also including re-invested profits of foreign companies in Cyprus. Such reliance represents a particular vulnerability should confidence in the sovereign and the private economy diminish.

- **The banking sector suffers from a large exposure to Greece, in terms of both the private sector and the sovereign, and needs to raise fresh capital.** The non-performing loans (as a percentage of total loans) of the non-financial corporations increased substantially, and are significantly higher than the percentage of non-performing loans of the whole private sector. Legislation has been put in place to accommodate, via public intervention, any risks to the viability of banks or need for recapitalisation that cannot be met by market operations. The situation in the Cypriot banking sector also threatens the sustainability of the country's position. The composition of the international investment position is a cause for concern, as it is characterized by risky foreign assets and liabilities dominated by foreign-held deposits. Any shock to the banking sector could thus have catastrophic consequences to the economy by compounding the challenges arising from Cyprus' internal imbalances.

- **The large amount of accumulated private sector debt is a source of concern.** Total private sector indebtedness (as a share of GDP) in Cyprus is the second highest in the EU, with the debt of non-financial corporations being particularly outstanding. In addition the net financial position of the non-financial corporate sector is negative. Most non-financial corporations in Cyprus are small enterprises and their main source of funding is loans from banks, in contrast to larger euro-area enterprises, which have access to other sources of funding, such as shares and other equity. Given that external financing is constrained by prohibitively high interest rates, corporate investment relies crucially on the generation of higher private savings. The degree of household indebtedness is also among the highest in the EU. While household loans, most of which were granted for housing purposes, are well collateralised and households are on aggregate net lenders, the servicing costs of the debt absorb a relatively high share of household disposable income, implying an important vulnerability in terms of potential interest rate rises.

- **Domestically, government finances have swung to annual deficits that have widened even as the economy recovered from recession**. The general government deficit, at over 6% of GDP in 2011, exceeds the reference value of the Stability and Growth Pact by a wide margin and recent efforts to correct the excessive deficit, although substantial, may not prove sufficient. Likewise, **public debt has risen above the ceiling of 60% of GDP.** A credible consolidation strategy needs to address the issue of overstaffing, the generosity of social benefits granted independent of private needs, and the system of automatic and frequent salary adjustments. Control over government spending should be effectively reinforced by subjecting annual budgetary planning to a medium-term fiscal framework, which is about to be adopted.

In this context, the national authorities adopted an ambitious expenditure-driven consolidation strategy to correct the excessive fiscal deficit, to stabilise the banking sector, and to strengthen economic growth over the medium term. However, the size and scope of the identified imbalances, as well as their potential negative spill-over effects to other economies in the euro-area call for a comprehensive adjustment and determined policy action on a sustained basis. Beyond the correction of the excessive fiscal deficit, restoring balance in public finances should be supported by tight control over expenditure going forward, the adoption of a medium-term budgetary framework and the establishment of a fiscal Council for the surveillance of budgetary execution, as well as by strengthening tax compliance and the fight against tax evasion. In order to restore external competitiveness, wage dynamics need to be better controlled by means of a thorough reform of the wage indexation system; over the medium term, upgrading the supply structure by a shift towards higher- value-added activities will increase the scope for higher earnings. Policies for the financial sector will need to strengthen regulatory provisions for bank recapitalisation and supervision of the cooperative societies. In order to reduce the indebtedness of the private sector, corporate legislation establishing liability for loan repayments and covering supervision of the granting of corporate loans will both need to be reinforced.

3. ASSESSMENT OF THE POLICY AGENDA

3.1. Fiscal policy and taxation

Budgetary developments and debt dynamics

The main goal of the medium-term budgetary strategy presented in the stability programme for the years 2012 to 2015 consists of reducing the general government deficit to zero in structural in 2013 and nominal terms in 2014. The strategy first envisages a reduction of the general govermnent deficit to below 3% of GDP in 2012, in line with the Council recommendation issued in the context of the Excessive Deficit Proedure (EDP) in July 2010, and then a further reduction in the subsequent years. The programme confirms the previous medium-term objective (MTO) of a balanced budget in structural terms, which adequately reflects the requirements of the Stability and Growth Pact.

In 2011, the general government deficit increased from 5.3% of GDP in 2010 to 6.3% of GDP. This was due to both revenue shortfall and expenditure overruns, especially in wage bill and social transfers. In the previous stability programme the general government deficit was planned to be 4%. The consolidation effort planned in the programme is front-loaded in terms of the headline deficit, primary balance and (recalculated) structural balance, mainly coming from the expenditure side. The consolidation effort planned for 2012 and 2013 is underpinned by measures but not fully. Specifically, under the current programme, the government intends to implement additional consolidation measures of 1.8% of GDP for 2013. This explains the difference between the previous and the current stability programme to deficit targets in the years 2013 to 2015. Box 1 presents the measures already adopted.

In 2012, progress is targeted for the fiscal deficit of an annual effect of 3.5% GDP of the structural balance[4] till the deadline for the correction of the Council by 2012. The Commission, forecasts that the correction will be of 2.9% GDP, under a no-policy-change, which is larger than the 1.5% of GDP annual fiscal effort required by the Council5. In 2013, the targeted progress of 2 pps. of GDP fiscal deficit reduction would lead to the achievement of the MTO. Nevertheless, there are uncertainties surrounding the achievement of the stablitiy programme's targets, which stem from potentially more negative macroeconomic outlook (with more negative growth rate and higher unemployment), measures for 2013 not being fully defined, expenditure projections due to the electoral year and possible financial rescue operations for troubled financial corporations.

In the period 2012-2014, the net government expenditure decreases faster than this benchmark of "Reference rate" for Cyprus[6]. Following an overall assessment of the Cyprus' State’s budgetary developments with the structural balance as a reference, including an analysis of expenditure net of discretionary revenue measures, the adjustment path towards the MTO seems to be appropriate.

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[4] “Cyclically adjusted balance net of one-off and temporary measures, recalculated by the Commission services on the basis of the information provided in the programme, using the commonly agreed methodology.”

[5] http://ec.europa.eu/economy_finance/economic_governance/sgp/pdf/30_edps/104-07_council/2010-07-13_cy_126-7_council_en.pdf

[6] For Cyprus the "Reference value" is 1.51 for each of the years 2012 -2015

In 2013 and 2014, according to the stability programme and the Commission's forecast, plans would ensure sufficient progress towards compliance with the debt criterion[7]. In 2015, according to stability programme, the debt benchmark will be met at the end of the transition period.

Long-term sustainability

The long-term change in age-related expenditure is clearly above the EU average. The initial budgetary position offsets the long-term costs. Under a no-policy-change assumption, debt would increase to 77% of GDP by 2020[8]. Additional fiscal consolidation beyond the forecast horizon would be needed to make progress towards the reference value for government debt beyond the short-term. However, the full implementation of the programme would be enough to put debt on a downward path by 2020. Given the very high projected increase in age-related expenditure, focus should be put on containing long-term public spending trends. Ensuring sufficient primary surpluses over the medium-term, as planned in the programme update and further reforming the Cypriot social security system, in particular reforming the pension system so as to curb the projected substantial increase in age-related expenditure, would improve the sustainability of public finances.

Box 2. Main measures

The consolidation measures are mainly from the expenditure side. The main revenue-supporting measure is the VAT rate rise from 15 % to 17 %. On the expenditure side, the main measure is the targeting of social transfers, which accounts for about 1 % GDP consolidation.

Revenue	Expenditure
2011	
• Full-year impact from the application of the minimum excise duties prescribed by the EU *acquis* on petroleum products (0.1 %) • Increased tobacco products excise duty (0.1 %) • Application of the reduced VAT rate on foodstuffs and pharmaceuticals (0.3 %) • Application of a levy on bank deposits (0.4 %) • Harmonisation of water pricing policy (0.1 %) • Increased tax on interest accrued on deposits of local banks from 10 % to 15 % (0.1 %) • Dividend income from semi-governmental organisations (-0.7 %) • Interest rate swap (-0.2 %)	• Temporary compensating expenditure measures to vulnerable groups adversely affected by the application of the reduced VAT rate on foodstuffs and pharmaceuticals (0.2 %)Targeting social transfers towards low-income households (0.1 %) • Income support provided to Cyprus Airways (0.1 %) • Containment in the rate of growth of current expenditure (0.1 %)
2012	
• Increase of the standard VAT rate from 15 % to 17 %, from 1 March 2012 (0.7 %). • Increase of the tax rate on deemed dividend distribution from 15 % to 20 % (0.1 %). • Revision of scales used for applying the tax coefficients on immovable property, until the re-evaluation of land prices from 1980s prices	• Targeting of all social schemes based mainly on income and economic criteria • (-1.0 %). • Freezing of emoluments, including pensions, in the broader public sector for a period of two years. (-0.7 %) • Containment in the rate of growth of

7 Structural adjustment is larger than the required adjustment (DG ECFIN calculations)

8 These projections do not take into account possible state intervention to financial institutions, therefore these projections are underestimating debt developments (by more than 10 pps. in 2020, given the increase in debt and interest expenditure)

to current prices. (0.1 %). • Increase of tax on interest accrued on deposits of local banks from 10 % to 15 % (0.2 %) • Introduction of a temporary contribution on gross earnings of broader **public** sector employees and pensioners for a period of two years from 0 % to 3.5 % (0.1 %). • Introduction of a temporary contribution on gross earnings of **private** sector employees and pensioners for a period of two years from 0 % to 3.5 % (0.1 %). • Increased contribution of 3 % on gross earnings of broader public sector employees for public pensions (0.2 %). • Contribution on gross earnings of broader **public** sector employees and pensioners for a period of two years from 0 % to 3.5 % (0.1 %). • Increase of the rate of contribution in the Widows and Orphans Fund by 1.25 pp to 2 % on gross earnings (0.1 %). •	current expenditure (-0.3%) • Temporary compensating expenditure measures to vulnerable groups adversely affected by the application of the reduced VAT rate on foodstuffs and pharmaceuticals (-0.2 %) • Abolition of all vacant posts (-0.1 %) • Reduction of call allowances in the broader public sector (-0.1 %). • Reduction of the number of personnel in the broader public sector by 5 000 over the next five years (one recruitment for every four retirees). (-0.1 %). •
2013	
• Increase of the standard VAT rate from 15 % to 17 %, from 1 March 2012 (0.1 %)	• Freezing of emoluments, including pensions, in the broader public sector for a period of two years. (-0.8 %) Abolition of all vacant posts (-0.1 %). • Reduction of the number of personnel in the broader public sector by 5 000 over the next five years (one recruitment for every four retirees). (-0.1 %)
• **2014**	
• Contribution on gross earnings of broader **public** sector employees and pensioners for a period of two years from 0 % to 3.5 %. • Contribution on gross earnings of **private** sector employees and pensioners for a period of two years from 0 % to 3.5 %. • Increase of the tax rate on deemed dividend distribution from 15 % to 17 %.	• Abolition of all vacant posts. • Reduction of the number of personnel in the broader public sector by 5 000 over the next five years (one recruitment for every four retirees).

Note: The budgetary impact in the table (as a percentage of GDP) is the impact reported in the programme (SP), i.e. by the national authorities. A positive sign means that revenue/expenditure increases as a consequence of the measure. The degree of detail reflects the type of information made available in the stability programme and the multi-annual budget.

Fiscal frameworks

In Cyprus, the institutionalization of the medium term budgetary framework into primary law is still pending. The government has recently prepared a draft Bill entitled 'Law on the Medium-Term Budgetary Framework and Fiscal Rules' which secured the legal vetting by the Law Office of the Republic on 4 May 2012, but still requires Ministerial Council approval before being submitted to the Parliament for adoption at the end of May 2012. Enforceable as of the date of adoption, it will be applicable for the compilation of the 2013 Budget Law. The new medium-term budgetary framework will become the only budgetary method for the budget planning as of 2013. The draft medium-term budgetary framework provides for the achievement of the medium-term budgetary objective through the introduction of an expenditure and debt brake rule. To that end, it provides for the introduction of a medium-term budgetary framework which puts in place monitoring and control of expenditure by line ministries, while promoting the reallocation of expenditure in favour of growth-enhancing activities as set out in the national reform programme. In case of departure from the medium-term objective (or as long as the medium-term objective has not been reached), the annual growth rate of expenditure may not exceed a rate below the medium-term potential growth rate of GDP, unless such excess is covered by the generation of new revenues. The 2012 Budget Law adopted on 16 December 2011 reflects the principles of the medium-term budgetary framework. While the 2012 Budget Law warrants systematic monitoring of 2012 budgetary plans, especially on expenditure, it does not envisage a corrective mechanism in case of non-compliance.

Tax system

The Cypriot tax-to-GDP ratio is in line with the EU-27 average. The structure of Cyprus's tax system stands out in several respects. In terms of tax structure, Cyprus relies heavily on consumption taxes, while the tax burden on labour is low. The revenue share from capital taxes is relatively high (fourth highest in the EU-27), while tax rates remain rather low. The share of environmental taxes in relation to total taxes in Cyprus is above the EU-27 average due to its high transport taxes, while there are no pollution and resource taxes.

Cyprus has implemented several tax measures to reduce its budget deficit. These measures are allocated across all tax areas, labour, capital and consumption. As such, the measures correspond only partly to the AGS priority of shifting taxation away from labour. However, Cyprus is among those countries that have a fairly low share of distortionary taxation, i.e. labour and capital taxation. Particularly, increases in social security contributions, the introduction of an additional tax bracket with a top rate of 35 % for incomes over EUR 60 000 in the personal income tax field and the temporary solidarity contribution increase the labour tax burden. Most measures are targeted at high-income individuals and public sector employees. The increased taxation of capital — increasing the defence contribution on interest from 10 % to 15 % and on dividends from 15 % to temporarily 20 %, after which it will be reduced to 17 % in 2014, also aggravates the burden of taxes which are considered as more detrimental to growth. At the same time that taxes considered more detrimental to growth have been increased, i.e. capital and labour taxation, the reliance on consumption taxation, i.e. less distortionary taxation, has risen with the relatively low standard VAT rate (15 %) being increased to 17 %.

The VAT base was broadened in 2011, by making previously exempt food and pharmaceutical products subject to a 5 % VAT rate. However, given the large number of remaining VAT-exempt services and the wide application of reduced VAT rates, there is scope for further measures to fully address the AGS priority of tax base broadening.
Immovable property taxation, and in particular recurrent taxes, is acknowledged to be the least harmful to growth among broad categories of taxes. There is scope to improve and extend the taxation of immovable property in Cyprus, which is low in relation to other EU countries. Taxes on property transactions account for the main part of this revenue. The autumn 2011 consolidation package raised the rates and lowered the tax thresholds of the recurrent property tax. However, there were no changes to the assessment of the tax base, which remains the market value in 1980. A proposal concerning an updated assessment of property values aiming to reflect recent market values was put forward for 2010, but has so far not been implemented. The tax structure of immovable property suggests that a shift from taxing property transactions towards the recurrent tax on immovable property would improve economic efficiency, and also offer scope to

increase property taxes. Revenue from a recurrent property tax would be less cyclical than revenue from a tax on property transfers and lower taxes on property transfers could support the housing market.

Future challenges, which have not been tackled with the recent fiscal consolidation packages or in detail within the recent stability programme and national reform programme, are the AGS priorities of improving tax collection and tackling tax evasion. While increased inspection of companies – as envisaged in the national reform programme – is a step in the right direction, its effectiveness and efficiency to encourage a move away from informal/undeclared work and tackle tax evasion has to be assessed. Furthermore, improving revenue collection systems – by making them more efficient - would also boost the effectiveness of the recently introduced tax measures.

3.2. Financial sector

Financial stability

Cyprus's large banking sector, with assets of more than seven times the economy's annual output, is a pillar of the economy, generating a high share of jobs and income, and indirectly supporting other business services. Following the outbreak of the financial crisis, the Cypriot banking system at first remained resilient, as banks and supervisors took action, with some consolidation of bank balance sheets taking place. Yet, in 2011 banks faced deterioration in the quality of their assets and an increase in credit provisioning, which impacted on their profitability.

Given that Cyprus's banking institutions are widely exposed to the Greek economy (both as holders of Greek government bonds and as lenders for Greek domestic loans), the banks' asset performance, profitability, capital, and liquidity buffers have been negatively affected by the restructuring of the Greek government debt, and by the increasing non-performing loans (NPLs) extended to Greek borrowers. Domestic banks, which have the strongest links to the domestic economy, are also the principal holders of Greek government bonds and providers of loans to Greek and Cypriot borrowers, while other financial institutions (mainly subsidiaries of Greek banks) operating in Cyprus are comparatively less exposed to the Greek sovereign debt and, with limited loans, to the domestic market. The prudential requirement to invest 70 % of the non-resident deposits into liquid assets resulted in the banks' high demand for Greek government bonds, which were considered liquid assets. Total exposure of the consolidated Cypriot banking sector to Greece amounts to around 175 % of GDP (in November 2011).

No Cypriot institution was below the required 5 % core Tier 1 (a key measure of a bank's financial strength) following the July 2011 European Banking Authority (EBA) stress test. However, concerns over the sovereign debt markets and difficulties on the interbank market resulted in a call by the European Council on 27 October 2011 for a temporary increase of banks' capital to a 9 % core Tier 1 capital ratio by mid-2012 (above the threshold laid down as part of the Basel III package); this increase is coordinated by the EBA. In December 2011, the EBA established the need for two institutions[9] to further increase their respective compliance with the capital base requirements, which currently is being pursued. The total capital increase necessary was EUR 3.5 billion.

[9] Laiki Popular Bank and Bank of Cyprus.

To that end, the banks concerned submitted capital strengthening plans on 29 February 2012. Their plans include new equity issuance, conversion of existing hybrid capital to eligible convertible capital, restrictions on profit distributions and bonuses, and the sale of assets such as foreign subsidiaries. Successful implementation of the announced capital strengthening plans is crucial. Anticipating that the Cyprus Popular Bank may fail to achieve its own plan to raise the fresh capital required by mid-June 2012, the government decided to recapitalise the bank and underwrote a rights issue of EUR 1.8 billion on 17 May 2012. In that case, the bank will have to undergo appropriate restructuring and downsizing in line with EU competition law.

In their recent downgrades of Cyprus's sovereign debt, two of the credit rating agencies also downgraded the three main Cypriot banks' ratings to 'non-investment grade', owing to contagion from Greece and the Cypriot sovereign downgrades and under the rationale that finding private capital to cover their new capital needs until June 2012 would be difficult. These downward ratings primarily affected banks' ability to access international markets and caused liquidity constraints in the Cypriot financial system, while the stock prices of the major banks declined.

Furthermore, non-performing loans (NPLs) during 2011 increased, reaching 14.4 % for domestic institutions and 13.2 % for all banks operating in Cyprus. NPLs to non-financial corporations have also been increasing, putting an additional burden on the profitability of Cyprus's banks. Regarding domestic operations, the expected contraction of the economy by 0.5 % in 2012, based on the latest Commission forecast, could exert further pressure on NPLs. On the positive side, the vulnerabilities related to size and concentrations are mitigated by the overall moderate degree of leverage of the banks. The loan to deposit ratio is low, particularly for the domestic Cypriot banks where it is less than 100 % thanks to their strong deposit rates.

As a response to the challenging environment and in line with the CSR of June 2011 on the need for strengthening of the prudential framework for supervision of banks to ensure early detection of risks, the Cyprus Parliament adopted on 14 December 2011 two bills to strengthen the system's resilience against banking crises. The first bill allows the Ministerial Council — in cooperation with the Central Bank of Cyprus — to take, in times of financial crisis, measures to address liquidity/solvency problems and/or to enhance the capital base. Such government support, if given, would first require clearance against EU state aid rules. The second bill provides for the establishment of an independent financial stability fund. These regulatory and legal changes are relevant, addressing the strengthening of the prudential banking framework in an effective manner. However, the supervision of the cooperative credit societies, which hold about 40 % of all domestic deposits, needs strengthening.

Access to finance for SMEs

The government has prepared a financing mechanism to facilitate SME access to finance by providing guarantees to stimulate growth and job creation in Cyprus. This action comes as a response to concerns by Cyprus's entrepreneurs that credit conditions are a major challenge as interest rates are now at nearly 8 % (indicating a sharp tightening of credit standards) and 140 % of collateral is requested by banks. The mechanism will involve the creation of a Holding Fund, managed by the European Investment Fund (EIF), bearing similarities with the JEREMIE initiative (joint European resources for micro and medium enterprises). Regarding the implementation of the JEREMIE instruments, it is expected that the whole amount of EUR 20 million under the 'Funded Risk Sharing Product' will be disbursed to SMEs by mid-2012. Meanwhile, the implementation of the 'First Loss Portfolio Guarantee Product' is proving more problematic, with limited demand due to current economic conditions that are not conducive to business expansion or start-ups.

3.3. Labour market, education and social policies

Labour market policies

The crisis adversely affected the Cypriot labour market, raising the rate of unemployment. The subdued economic activity dampened job creation, causing a large increase in youth unemployment, whereas efforts to further adapt educational outcomes to the labour market needs were not ambitious enough and lacked urgency. Three particular challenges have to be confronted in the Cyprus labour market: (i) ensuring that the system of wage adjustment is conducive to regaining and sustaining competitiveness, (ii) easing the transition from school to work particularly by reinforcing the supply of vocationally oriented skills at secondary, post-secondary and higher education levels, through a combination of classroom education and on-the-job training, (iii) exploiting the growth and job creation potential of high value-added activities through appropriate policy measures including those aimed at boosting the re-skilling and up-skilling opportunities for the workforce (in particular for the low-skilled, older workers and disadvantaged groups). These challenges are referred to in the June 2011 CSRs for Cyprus. Additionally, in a new challenging development, Cyprus experienced one of the highest year-on-year increases in youth unemployment in the EU in 2011.

Wage growth is expected to moderate given unfavourable labour market conditions in tandem with public sector wage restraint linked to the fiscal consolidation effort, expected to spill over to the private sector. In particular, in December 2011, Cyprus adopted a series of measures to contain public sector wages which included a two-year pay freeze in the broader public sector affecting, among other things, the inflation-linked pay rise (cost of living allowance — COLA) and the seniority-based rises. Empirical evidence suggests that a temporary de-activation of the COLA system is occurring also in the private sector, though this is a discretionary decision by each employer. In parallel, the government and social partners agreed to initiate a dialogue with the aim of reviewing the COLA system by the end of June 2012. While the above developments are first steps in the right direction for Cyprus to regain and sustain competitiveness, their relevance and credibility depends crucially on the degree of ambition and enforcement of the final outcome of the social dialogue currently under way regarding the reform of the wage indexation system.

With a view to addressing the policy challenge of further adapting the education and training system to the labour market and skills requirements, a number of positive steps have been taken. Particularly, in September 2011 the gradual introduction of new curricula from primary up to the first year of upper secondary education was launched, focusing on the development of key skills. Moreover, the development phase for the new apprenticeship system is proceeding and the latest commitment of the national authorities is to have the new system operating in October 2012, instead of February 2012 as initially planned. On the other hand, the Council of Ministers approved the planned setting-up of four post-Secondary Institutes for Vocational Education and Training in September 2012. The establishment and operation of the Vocational Qualifications System is proceeding with 67 standards developed so far in priority occupations.

Also, Cyprus continued to implement measures for improving the employability of unemployed and inactive persons, as well as of secondary and tertiary graduates. These measures focus on the provision of training and work experience, offering work placement and training opportunities to secondary and tertiary education graduates, as well as providing incentives to companies for recruiting unemployed and other vulnerable people. Company traineeships are vital to help bridge the gap between the world of education and the world of work. Furthermore, an action plan for the promotion of green skills for both employed and unemployed persons is being carried out. Cyprus is also implementing some schemes to encourage the entrepreneurship of women and young people, and it plans to introduce a new one for combating youth unemployment and long-term unemployment. The above measures are relevant but not ambitious enough, especially when taking into account the growing youth unemployment and structural unemployment associated with the shedding of semi-skilled or low-skilled labour in the sectors of construction and trade. There is a need to expand support measures for young people making full use of the EU structural funds, putting emphasis on the provision of more workplace learning opportunities, teaching of entrepreneurial skills, and promotion of self-employment. Further efforts are also required for enhancing the skills profile of the workforce to facilitate the necessary transitions in the labour market, focusing in particular on those groups with a low participation rate in lifelong learning activities such as the low-skilled, unemployed and older workers. Ensuring the appropriate capacity readiness of public employment services is of paramount relevance to the effective implementation of the above active labour market measures.

In addition to these efforts to improve the supply of skills, it will be necessary to improve the demand side through new business initiatives, innovation and growth. In particular, policy measures aimed at exploiting the growth and job creation potential of high value-added activities (business services, health and social sectors, digital economy, green jobs) should be promoted. This would in turn make vocational education and training more attractive in the sectors where there could potentially be an increasing demand for new skills. Adequate priority should also be given to the anticipation of skills that may be needed for exploitation of recently discovered natural gas resources.

Cyprus has a well above the EU average proportion of older people in employment and this proportion has been steadily growing over the last decade. Women tend to make a much earlier exit from the labour market than men. No active ageing strategy providing incentives or removing disincentives for staying longer in work is in place. The public sector pension scheme allows for early retirement from the age of 55 without any actuarial reduction of benefits.

Social policies

Cyprus faces challenges in ensuring the long-term sustainability of public finances, notably in the pension field, which have been only partially addressed. Even though a series of measures have been adopted to improve the sustainability of the pension system, a comprehensive pension reform has not yet been designed. Cyprus has implemented two important structural measures: the enactment of contributions from public sector employees to their public pensions, and the inclusion in the social security fund of newcomers to the public sector, with the abolition of occupational pensions. While the measures adopted are relevant and credible, the response of Cyprus is not sufficiently ambitious; it is important to explore the scope for more ambitious measures that will secure sustainability and adequacy, and further improve the system's fairness, in the longer term. Cyprus has not increased the retirement age but adopted the aforementioned measures which, according to the Cypriot authorities, have a significant budgetary effect for public finances. Increasing the retirement age and linking it with life expectancy would provide an opportunity to increase fairness notably in terms of aligning the pensionable ages of the public and private sector. Such a change could also be utilised to help address issues of adequacy in the medium to long term.

In terms of poverty among the elderly, Cyprus has partly addressed their high at-risk-of-poverty rate. In 2010, 41.2% of the Cypriot population aged 65 or more was still exposed to the risk of poverty, the highest rate in the EU. In order to address the high at-risk-of-poverty rate of the elderly, the provision of the means-tested grant to low-income pensioner households continues. There are plans to gradually phase out the grant scheme along with the maturation of the pension system. A special grant for low-income pensioner households was also introduced as compensation for the VAT increase on foodstuffs and medicines. The adopted measures are relevant, credible, and in the right direction. However, considering that old-age poverty rates remain high, the challenge of improving the short-term adequacy of income for a large proportion of the elderly population are still to be met. Close monitoring is important for tracking the effectiveness of the adopted measures in reducing old-age poverty.

With regard to the healthcare system, no progress has been observed in the direction of implementing the national health insurance system (apart from some advancement in the operational design in the financing aspect of the new National Health Insurance System), which could help to address major problems of inefficiency and inequity. The provision and funding of healthcare is fragmented between public and — largely unregulated — private providers of healthcare services. The current system has led to the unequal distribution of services and inequities in access to care. Moreover, capacity and care quality are to a large extent unregulated. There is no universal health coverage. Currently around 85 % of the population is eligible for public healthcare that is either free or provided at a reduced cost. However, only 40 % of the population use public healthcare services, mainly due to the inefficiencies and long waiting times. Thus, the majority of the beneficiaries use private healthcare services and bear the total expense. Therefore, around two thirds of the total healthcare cost in Cyprus is covered by the private sector. This is equivalent to 3.4 % of GDP, the second highest share across the EU, after Greece.

In addition, healthcare expenditure is growing rapidly. This is probably because the government exerts little control over the tariffs of healthcare services. The absence of an integrated and homogeneous national healthcare system is wasteful of resources, causes overlaps and irrational distribution of services and healthcare facilities, and leads to low quality of services for citizens. Furthermore, the Directive on the application of patients' rights in cross-border healthcare, which should be transposed into national law by October 2013, requires Member States to improve transparency and to either charge existing public tariffs to patients from other Member States (in a non-discriminatory way) or, in the absence of such official tariffs, put in place an objective, non-discriminatory pricing mechanism for health services. The National Health Insurance System should foster universal coverage, equal treatment, and sustainability. The new system should provide a rational supply of services, which will avoid duplication and waste of resources. No clear timeline for proceeding with the National Health Insurance System has been presented so far, casting doubt on the political will to implement it. In parallel this poses risks to the long-term control and sustainability of public finances.

In the coming years the public healthcare expenditure cost is expected to continue increasing at a higher rate than nominal GDP, making the healthcare reform more urgent, especially when considering that the elderly are at great risk of poverty or exclusion. Meanwhile, policy challenges also exist in respect of the provision and quality standards of long-term care. Consultation on reforming long-term care is on-going.

In a context of increasing unemployment and greater strain on the social protection budget, the population at risk of poverty or exclusion has increased. The government announced its plans to rationalise social benefits by introducing income and wealth criteria. This is expected to improve the targeting of benefits. The laws on child benefit and the student allowance were consequently modified. This is a step in the right direction. Close monitoring is needed to ensure that these measures produce the intended impact. The government is also planning to reform the public assistance law in order to correct the distortions of the current system. At present, there is a lack of proper activation measures for public assistance recipients, who risk getting trapped in the benefit system instead.

In seeking to address the high incidence of poverty among single person households with dependent children, Cyprus has introduced a cash benefit for single parent households, calculated on the basis of income and wealth criteria. However, the cash benefit is not linked with activation measures specifically targeted at unemployed/inactive single parents. Moreover, the proportion of single persons who withdraw from a paid job when children enter the household is far from negligible. This can be linked to the limited availability of flexible forms of employment in Cyprus and to the relatively high cost of childcare.

There is thus scope for introducing or reinforcing activation measures targeted at single parents and public assistance recipients. These need to include personalised psychological support and understanding of labour market conditions. Flexible forms of employment need to be made sufficiently available and more efforts must be made to satisfy the needs in terms of care services for dependents.

3.4. Growth and competitiveness structural measures

Cyprus is a small, open, service-oriented island economy, with micro-services and family-owned enterprises. The small size of the economy limits the range of diversification of production activities and leads to a higher degree of trade specialisation, which in turn increases its exposure to external shocks. Evidently, the adverse external environment coupled with the international financial crisis hit the Cypriot economy (albeit with delayed effect), weighing strongly on growth which during the last two years had contracted, while imbalances built up during the previous years came to the fore.

In an effort to enhance the country's growth potential, employment, productivity and competitiveness, the government prepared a wide-ranging package of measures, adopted by the Council of Ministers, consisting of measures to support employment, institutional arrangements for attracting public and private investments, and measures to enhance the role of Cyprus as an international business and financial centre providing high value added services. The measures are intended to form an immediate response to the economy's contraction at a time when fiscal consolidation measures would be taking full effect.

In terms of its business environment, Cyprus ranked 37th out of 183 economies in 2011.[10] Yet, it performs poorly in a number of sub-areas such as dealing with construction permits (75th position), and registering property (66th position). There are

[10] *Doing Business in a More Transparent World: Cyprus*, The World Bank, 2012.

also severe restrictions in key transport sectors in terms of working hours (e.g. ports, warehouses). The cost of starting a business is relatively high and the process of enforcing contracts should be accelerated.

In regard to the service sector, Cyprus transposed the Services Directive by way of a horizontal law accompanied by a number of sector-specific amending laws and regulations. However, in sectors such as retailing, tourism, and construction services, sector-specific legislation and a firm timetable for adoption are still awaited. Other issues concern regulated professional services where fixed tariffs exist (such as lawyers and architects), which play an important role in a variety of contractual and legal acts for business (and citizens), and improving their quality and reducing their cost can have a multiplier effect on the economy in the medium term. Regarding the requirement whereby the Services Directive leaves it to the Member State to streamline the regulatory environment, quantitative or territorial restrictions exist in the tourism and food and beverages sectors. Also in the education sector, legal form and shareholding requirements have been maintained. Cyprus ranks favourably in relation to the EU average (152 regulated professions) with regard to regulation of professional services. The country has notified to the Commission 90 regulated professions (60 % in the health sector, 15 % in the transport sector, 15 % in construction and industry). Of the 90 regulated professions in Cyprus, only four are in business services.

To enhance the business environment, and in line with the Services Directive, the Point of Single Contact (PSC) was set up through the upgrading and expansion of the One-Stop Shop. The PSC provides a good level of information on procedures and formalities and the portal is well structured. However, it does not score well on online completion of procedures. While it accepts e-IDs from some Member States, the option of using this system is not available for Cypriot nationals as e-IDs are not yet issued in Cyprus. Through the personal space accessible in the PSC Portal, registered service providers for several sectors are able to submit online application forms (direct data entry), attach supporting documents, and e-sign the application package.

In Cyprus, R&D expenditure is 0.5% of GDP, which is in line with its national commitments under the EU 2020 strategy, but is far from the EU average (2.0%). Regarding R&D and innovation policies, the announced new national plan for research and innovation has not materialised yet. The role of the business community in innovation remains marginal, partly because of the structure of the productive sector (small companies in traditional sectors) and partly because of weak consultation processes that hamper the full involvement of businesses in RTDI activities. The Cyprus Ministry of Commerce, Industry and Tourism focuses on defining and promoting a broader research and innovation concept that reaches beyond manufacturing enterprises and includes services, a sector where Cyprus is strong. Emphasis is also placed on fostering cooperation between universities and research centres targeted by innovation policy measures. To date, policy priorities rely on traditional direct funding-type schemes. One such financial tool is under preparation and aims to encourage SMEs (which under-invest in research and innovation) to develop and introduce innovative products and services, either in-house, or by cooperating with research organisations or other companies. The public sector with pre-commercial procurement would be invited to play an active part and lead the development of technologically innovative solutions addressing its specific needs.

The transport infrastructure in Cyprus (road, sea and air) is generally considered to be of relatively good quality. However, the lack of alternatives to private cars for inland transport, together with relatively low fuel taxes, increases the dependency on imported oil products and the sensitivity of the economy to changes in oil prices. It also has a strong impact on congestion and on greenhouse gas emissions. Given that transport accounts for more than half of the total CO_2 emissions from non-ETS activities, reversing the trend in CO_2 emissions from transport is key to enabling Cyprus to meet its 2020 target (i.e. to reduce CO_2 emissions by -5 % by 2020). According to latest data, the environmental performance of transport has not improved in recent years.

Cyprus adopted its Digital Strategy on 8 February 2012, aiming to drive Cyprus into the digital era mainly by achieving full broadband coverage, reducing passive infrastructure network costs, and allocating spectrum for wireless networks that would potentially support high-speed broadband access. While Cyprus has almost reached 100 % broadband coverage and despite a significant increase in broadband speeds, it is still at infant stage regarding the deployment of Next Generation Access networks (only 7.3 % of lines provide 10 Mbps or more). Implementation of its Digital Strategy is still pending, in particular the allocation of sufficient spectrum to wireless electronic communications services and the inducement for electronic communications providers to invest in ultra-high-speed networks. Although the analogue switch-off was completed in July and September 2011, there is no concrete timetable for the release of the digital dividend (1800 MHz band) for wireless broadband.

Cyprus is currently not expected to achieve the climate target based on existing measures. According to the 2011 bi-annual projections based on existing measures submitted by the country, Cyprus is expected to increase emissions by 8.4 % (compared to 2005) by 2020, falling short by 13.4 % (base-year emissions) relative to the target. In order to achieve the target without making use of costly flexibility mechanisms, Cyprus would thus need to adopt and effectively implement these additional policies.
In the CSRs issued in June 2011, emphasis was placed on the need for Cyprus to increase the diversity of its energy mix and to expand its supply and use of renewable energy sources. The recent gas discovery (December 2011) in Cyprus's Exclusive Economic Zone is very promising for the diversification of energy sources, allowing Cyprus to move away from its excessive reliance on oil imports. However, energy efficiency and the use of renewable energy should be important components of the effort to strengthen energy security in Cyprus and progress towards the climate target.

Under the second National Energy Efficiency Action Plan (NEEAP), grants and subsidies are planned for the residential, service, and industrial sectors so as to increase energy efficiency as well as the use of renewable energy sources from 2011 to 2020, but more may be required. It is of concern that, to date, there is no energy service company (ESCO) operating in Cyprus. The second NEEAP emphasises the potential of further energy savings in buildings and it also provides for investments in public transport (on-going) as well as for financial incentives to have more fuel-efficient vehicles (yet to be formally adopted).

Cyprus is late in implementing the Third Energy Package and has yet to notify its national measures to the Commission (two infringement procedures in progress). Although the electricity market is legally open to all non-domestic customers, there are no alternative suppliers beside the incumbent Electricity Authority Cyprus (EAC), a public-law body which enjoys a *de facto* monopoly, although the cost-oriented prices are set by the national energy regulatory authority (CERA). The gas market law currently in force grants DEFA, the new Public Gas Corporation, a legal monopoly for 20 years and allows EAC to own part of its share capital. Such provisions represent a huge obstacle to the development of a competitive energy market, which is particularly important given the prospects of new gas resources for the island.

In compliance with the Water Framework Directive 2000/60/EC, Cyprus adopted its River Management Plan on 9 June 2011. The Plan is currently being assessed by the Commission and may require further follow-up as regards its implementation. It includes water pricing policies as indicated by the Directive, and in line with the Council recommendation. It also comprises measures to increase water efficiency and improve the ecological conditions of aquatic ecosystems that will contribute to achieving resource efficiency goals.

However, Cyprus is not creating opportunities to recycle more and reduce its current 80 % landfilling rate, accounting for the highest amount of landfilled waste per capita in the EU[11]. Increasing waste generation and landfilling drive increasing GHG emission from the waste sector which was responsible for 17.3% of Cyprus GHG emissions[12] in 2011. This is not a resource-efficient approach and it may prevent Cyprus from reaching the EU recycling targets. Current very limited economic instruments, including landfilling fees, pay-as-you-throw and producer responsibility schemes[13] have not proven to be effective as Cyprus still ranks very low in recycling rates. Modelling shows that without any action, the amount of waste generated and landfilled will double[14] by 2025, hindering growth by hampering energy recovery, neglecting potential to reduce GHG emissions and foregoing opportunities for job creation.

3.5. Modernisation of public administration

Cyprus has so far taken significant steps to better serve citizens and to enhance the productivity and effectiveness of public services. Citizens' Service Centres (CSC) are now operating, providing citizens with over 50 services of six government departments. Also, the Companies Registration System (e-filing), allowing for complete online registration of companies, is expected to partly address the cost of setting up a business in Cyprus, which is higher than the EU average. Additionally, the system of 'e-procurement' enables public procurement competitions to be carried out electronically.

Furthermore, Cyprus is committed to reducing by 20% the administrative burden in national legislation by 2012. On ways to achieve this target, a sectoral baseline project was promoted for reducing the administrative burden in all legislation relating to enterprises, based on eight priority areas. A number of relevant proposals have been submitted in each national priority area, on the basis of recommendations made by a consultancy firm and after extensive consultation with government departments and the private sector. It is expected that implementation of all recommendations will bring a total reduction of 22 % in the administrative burden (i.e. EUR 155 407 051).

Regarding e-governance, not all of the most important public services for enterprises are online yet (still 75 %), leading to some inefficiencies, whereas the take-up rate by enterprises has increased to 74 %. On the other hand, both provision (at 42 %) and take-up (at 25 %) for and by citizens are among the lowest. In this respect, a horizontal proposal has also been submitted aimed at promoting the use of existing electronic systems in the Public Service.

[11] http://europa.eu/rapid/pressReleasesAction.do?reference=STAT/12/48&format=HTML&aged=0&language=EN&guiLanguage=en

[12] Cyprus National Reform Programme, 2012.

[13] Use of economic instrument, Annex I, BioIntelligence Service, 2012.

[14] Use of economic instruments, Annex V, BioIntelligence Service, 2012.

Some other challenges need to be addressed. The transposition of the Late Payment Directive is still pending. Also, enforcement of contracts in Cyprus requires twice as much time as the regional average. In response to that, Cyprus is evaluating the establishment of commercial courts to resolve trade disputes.

4. OVERVIEW TABLE

2011 commitments	Summary assessment
Country-specific recommendations (CSRs)	
CSR 1: Adopt the necessary measures of a permanent nature to achieve the budgetary target in 2011 and the correction of the excessive deficit by 2012, in line with the Council recommendations under the EDP. Take measures to keep tight control over expenditure and make use of any better-than-expected budgetary developments for faster deficit and debt reduction. Ensure progress towards the medium-term objective by at least 0.5% of GDP annually and bring the public debt ratio on a downward path. Accelerate the phasing-in of an enforceable multiannual budgetary framework with a binding statutory basis and corrective mechanisms, as from the preparation of the 2012 budget. The programme and performance budgeting should be implemented as soon as possible.	Cyprus has implemented CSR 1 only partially: Effective action has been taken to correct the excessive budget deficit in a timely and sustainable manner, by 2012. However, an enforceable multiannual budgetary framework law has not yet adopted, although the Cypriot authorities committed to adopt it by May 2012.
CSR 2: Strengthen further the prudential framework for supervision of banks and cooperative credit societies to ensure early detection of risks.	Cyprus has implemented CSR 2 only partially: Effective action was taken with the adoption of two legal instruments to strengthen the resilience of the banking system against financial crises (a bill allowing the government to take measures in a period of financial crisis to address liquidity/solvency problems and/or to enhance the capital base; a second bill that provides for the establishment of an independent stability fund).
CSR 3: Improve the long-term sustainability of public finances by implementing reform measures to control pension and healthcare expenditure in order to curb the projected increase in age-related expenditure. For pensions, extend years of contribution, link retirement age with life expectancy or adopt other measures with an equivalent budgetary effect, while taking care to address the high at-risk-of-poverty rate for the elderly. For healthcare, take further steps to accelerate implementation of the national health insurance system.	Cyprus has implemented CSR 3 only partially: On pension system sustainability and poverty risk for the elderly, Cyprus has implemented the recommendation only partially: a series of measures have been taken in the framework of fiscal consolidation to control pension expenditure. However, there is a lack of ambition and long-term vision. Measures addressing the risk of poverty for the elderly need to be monitored. On the health insurance system, Cyprus has not implemented the recommendation: no progress was observed in the direction of implementation of the national health insurance system.
CSR 4: Take steps to reform, in consultation with social partners and in accordance with national practices, the system of wage bargaining and wage indexation to ensure that wage growth better reflects developments in labour productivity and competitiveness.	Cyprus has implemented CSR 4 only partially: On the wage indexation system: In the framework of fiscal consolidation, a two-year freeze of the cost of living allowance (COLA) was decided, also bringing about a downward shift in the public wage bill. A social dialogue is currently under way regarding reform of the wage indexation system. The Cypriot authorities undertook to reach an agreement and reform the COLA by the end of June 2012.

CSR 5: Take further steps, within the reform planned for the vocational education and training system, to match education outcomes to labour market needs better, including setting up post-secondary vocational education and training institutes. Take measures to increase the effectiveness of the vocational training system by increasing the incentives for and improving access to vocational education and training, especially for low-skilled workers, women and older workers.	Cyprus has implemented CSR 5 only partially: A draft policy proposal for setting up Post-Secondary Institutes for Vocational Education and Training has been prepared, pending approval by the Ministerial Council. Following its approval, four Institutes will be running as of September 2012. The gradual introduction of new curricula from primary to the first year of upper secondary education is proceeding, having started in September 2011. There is still a need to strengthen the appropriate re-skilling and up-skilling training schemes targeted at the indicated groups (low-skilled, unemployed, and older workers).
CSR 6: Abolish remaining obstacles to the establishment and free provision of services in sector-specific legislation by December 2011 in order to create more opportunities for growth and jobs in the services sector.	Cyprus has implemented CSR 6 only partially: Cyprus transposed the Services Directive by way of horizontal law. However, in some sectors such as retailing, tourism, and construction services, sector-specific legislation and a firm timetable for adoption are still awaited.
CSR 7: Introduce measures to increase the diversity of the energy mix and the expansion of renewable energy sources. Establish, by 2012, a water management plan and a price-setting scheme reflecting cost efficiency and equity concerns in order to ensure more sustainable management of water resources.	Cyprus has implemented CSR 7 only partially: To date, Cyprus has not submitted its Progress Report due in December 2011 (as required by the Renewable Energy Directive) to allow the Commission to assess and monitor progress in meeting the national target (13 %) of diversifying its energy mix and expanding the use of renewable sources. Cyprus adopted its River Management Plan on 9 June 2011, and it is currently being assessed by the Commission. The Plan also includes water pricing policies as indicated by the Directive, and seems to be in line with the CSR.
Euro Plus Pact (national commitments and progress)	
Fostering employment: • lifelong learning • undeclared work	The commitments for fostering unemployment have only partially been implemented: In February 2012, the government adopted a decision on the establishment of post-secondary vocational education and training institutes (four in total, one in each district in Cyprus). Enrolment of the first students and full operation of these institutes is planned for September 2012. The estimated budget for this action is EUR 4 411 696 (co-financed at 85 % from the ESF). In response to the large inflow of foreign workers and as a result of the economic crisis, over the last two years the government has stepped up the labour inspection process, in order to inspect, at employers' premises, illegal work and unregistered employees, and has reinforced the penalties for illegal employment while putting more stringent conditions on employers to limit undeclared work. A nationwide complaints line has been established to allow citizens to report illegal work.
Competitiveness:	The commitments related to competitiveness

• public sector wage development • wage-setting mechanisms • business environment • education, R&D, and innovation • enhancing the digital economy • improving the competitiveness of enterprises • promoting energy efficiency and use of RES	have been partially implemented. The government has adopted a series of fiscal consolidation measures to address the excessive government deficit, some of which affect public sector wages. A key measure involves the enactment of contributions from public sector employees to their public pensions, and the freezing of emoluments, including pensions, in the broader public sector for two years, bringing about a downward shift in the public wage bill. In addition, the government adopted measures regarding the abolition of all vacant posts in the public sector (exemptions up to 10 %), the reduction of salary scales for new employees in the broader public sector by 10 %, and reduction of the number of personnel in the broader public sector by 5 000 over the next five years (one recruitment for every four retirements). Importantly, there will be no cost-of-living adjustments (COLA) for 2011-2012. A public dialogue for redesigning COLA is currently ongoing with a view to being concluded by end of June 2012. Cyprus intends to maintain the current corporate taxation system, which features low rates and a broad tax base. A state grant scheme being promoted is to be co-financed by Structural Funds (85 %) and the Republic of Cyprus (15 %). It aims to provide financial support to companies in services sectors for upgrading their technology and to promote innovation. Cyprus adopted its National Digital Strategy for 2012-2020 on 8 February 2012. To date, Cyprus has achieved 100 % broadband coverage with at least 2Mbps. Additionally, in all the communities (151 communities) that were not covered by the DSL network in 2009, terrestrial infrastructure (Wi-Fi) and satellite connections have been installed. A scheme has been set up for grants to strengthen the competitiveness of SMEs in the services sector in order to upgrade their technology and to promote innovation. The total budget of the scheme amounts to EUR 23 million for the programming period 2007-2013 (co-financed by Structural Funds). Between 40 and 50 enterprises are expected to be subsidised.
Sustainability of public finances: • align pensions to demography	The commitments related to the sustainability of public finances have been partially implemented: In the context of reforming the public pension

	system, a number of measures have been adopted. These entail the enactment of contributions of 3% on gross earnings of broader public employees against pension entitlements, a temporary contribution on gross earnings of broader public sector employees and pensioners for a period of two years, and an increase in the rate of contribution to the Widows and Orphans Fund by 1.25 pps to 2% on gross earnings of broader public sector employees. In addition, the government has opted for the abolition of occupational pensions for new employees of the broader public sector, with considerable savings over the long term. A draft new budgetary framework is being established. The draft bill is expected to be approved by the Council of Ministers and will then be submitted to the Parliament by the end of May 2012.
Financial stability: • national legislation for banking resolution or other measures	The financial stability commitments have only been partially implemented: On 14 December 2011, the government adopted two legal instruments to strengthen the resilience of the banking system against financial crises (a bill allowing the government to take measures in a period of financial crisis to address liquidity/solvency problems and/or to enhance the capital base; a second bill that provides for the establishment of an independent stability fund).
Europe 2020 (national targets and progress)	
Employment rate: 75% - 77% of the population aged 20–64 should be employed by 2020.	The unemployment rate doubled between 2008 and 2011, from 3.7% to 7.4% (annual average). The overall employment rate continued its declining trend for 2011 and is now standing at 73.8 % compared to 75.7% in 2009. This suggests that the attainment of the lower boundary target will require a more ambitious and consistent policy effort
R&D target: Increase R&D expenditure to 0.5% of GDP by 2020.	R&D intensity for 2010 increased to 0.5 % of GDP (Eurostat provisional data) from 0.43% in 2008 and 0.49% in 2009. Cyprus is on track to meet its national target. The public source of funding for R&D intensity was 69%, the highest percentage in the EU27. Business R&D expenditures (BERD) as a share of GDP were 0.09% in 2010, at the lowest level in EU27.
Greenhouse gas emissions target: Reduction of greenhouse gas emissions in non-ETS sectors by 5% (compared to 2005).	Greenhouse gas emissions in non-ETS sectors were reduced by 7 % (compared to 2005) by 2010 in Cyprus. According to Cyprus' latest projections based on existing measures, emissions are expected to increase by 8.4 % (compared to 2005) by 2020, thereby leading to a shortfall of the target by 13.4 percentage points. This means there is not sufficient progress towards achievement of the target.

Renewable energy target: 13 % of gross final energy consumption from renewable sources.	Starting from 2.9 % in 2005, the share of renewable energy in gross final energy consumption decreased to 2.5 % in 2006, but has been increased to 4.6 % (in 2009) since then. The Eurostat estimation for 2010 is 5.4% which would show that CY is on track to reach its 2020 target (4.92% interim target for 2011/2012). The Commission is waiting for the Progress report (as per requirements of the Renewable Energy Directive) to make a full assessment of the measures in place to follow the indicative trajectory.
Greenhouse gas emissions target: Reduce CO_2 emissions by 5 % by 2020. Increase the proportion of renewable energy by 13 % by 2020. Energy efficiency — reduction of energy consumption in Mtoe from 6.6 % to 14.3 % by 2020. (0.46Mtoe)	Greenhouse gas emissions in non-ETS sectors were reduced by 7 % (compared to 2005) by 2010 in Cyprus. According to Cyprus' latest projections based on existing measures, emissions are expected to increase by 8.4 % (compared to 2005) by 2020, thereby leading to a shortfall of the target by 13.4 percentage points. This means there is not sufficient progress towards achievement of the target. The current level of renewable energy (based on presentation of the Cyprus Planning Bureau, 12/10/2011) is 5.4 %. The current level of energy efficiency: reduction of energy consumption in Mtoe (based on presentation of the Cyprus Planning Bureau, 12/10/2011) is 6.6 %. The method of assessment of national progress in energy efficiency is currently under discussion between the institutions in the context of the proposed Energy Efficiency Directive.
Early school leaving target: Reduce the rate of early school leavers to 10 % by 2020.	According to the Cyprus Planning Bureau, the current early school leavers' rate at national level is 11.2%. Cyprus seems on track to meet its 2020 target on early school leaving.
Tertiary education target: Increase participation in higher education to 46 %.	Cyprus is currently at level of 45.8 % and seems on track to meet its 2020 target on tertiary education.
Target for reducing the population at risk of poverty or social exclusion in number of persons: Reduce the number of people at risk of poverty or social inclusion by 27 000 persons or decrease to 19.3 % of the population.	The number of people at risk of poverty and social exclusion has increased from 22.9% (182 000 persons) in 2009 to 23.6% (188 000 people) in 2010. It is expected that the current context of crisis will intensify the negative effects on certain population groups (unemployed persons, single parents, public benefit recipients, migrants). Sustained policy initiatives will thus have to focus on these groups for the attainment of the target, as well as on the elderly at risk.

5. ANNEX

Table I. Macroeconomic indicators

	1995-1999	2000-2004	2005-2008	2009	2010	2011	2012	2013
Core indicators								
GDP growth rate	4.8	3.5	4.2	-1.9	1.1	0.5	-0.8	0.3
Output gap [1]	-1.3	0.9	1.1	-0.6	-0.9	-0.6	-1.9	-2.0
HICP (annual % change)	2.3	3.1	2.7	0.2	2.6	3.5	3.4	2.5
Domestic demand (annual % change) [2]	4.4	4.5	6.5	-7.0	1.9	-3.3	-2.4	0.3
Unemployment rate (% of labour force) [3]	3.2	4.2	4.4	5.3	6.2	7.8	9.8	9.9
Gross fixed capital formation (% of GDP)	18.8	17.8	21.3	20.5	19.5	16.6	16.5	16.3
Gross national saving (% of GDP)	18.3	14.2	12.0	8.4	10.9	9.4	8.9	9.2
General Government (% of GDP)								
Net lending (+) or net borrowing (-)	**-3.5**	**-3.9**	**0.2**	**-6.1**	**-5.3**	**-6.3**	**-3.4**	**-2.5**
Gross debt	**56.2**	**65.3**	**60.4**	**58.5**	**61.5**	**71.6**	**76.5**	**78.1**
Net financial assets	**-35.9**	**-37.3**	**-34.5**	**-33.9**	**-38.3**	**n.a**	**n.a**	**n.a**
Total revenue	32.2	36.5	42.5	40.1	41.1	41.0	42.6	42.8
Total expenditure	35.7	40.4	42.3	46.2	46.4	47.3	46.0	45.3
of which: Interest	2.6	3.4	3.2	2.6	2.3	2.5	3.2	3.2
Corporations (% of GDP)								
Net lending (+) or net borrowing (-)	**2.9**	**-0.3**	**-5.0**	**-5.5**	**-4.7**	**-1.0**	**-3.2**	**-2.6**
Net financial assets, non-financial corporations	**-78.9**	**-114.5**	**-116.2**	**-145.7**	**-121.9**	**n.a**	**n.a**	**n.a**
Net financial assets, financial corporations	**-59.1**	**10.4**	**12.0**	**55.3**	**83.7**	**n.a**	**n.a**	**n.a**
Gross capital formation	8.6	7.3	8.2	7.3	7.8	7.7	8.5	8.4
Gross operating surplus	26.9	24.6	21.1	21.2	21.6	25.9	25.1	25.7
Households and NPISH (% of GDP)								
Net lending (+) or net borrowing (-)	**-0.6**	**0.8**	**-4.2**	**0.6**	**2.2**	**-0.5**	**-1.2**	**-2.1**
Net financial assets	**107.8**	**122.0**	**160.4**	**142.9**	**134.4**	**n.a**	**n.a**	**n.a**
Gross wages and salaries	39.6	39.1	38.3	39.4	39.5	39.7	38.2	37.4
Net property income	6.1	5.4	5.5	5.6	5.3	-0.5	1.1	1.6
Current transfers received	17.2	20.0	22.2	24.0	28.1	28.4	27.6	27.7
Gross saving	7.0	7.8	5.7	8.5	8.8	4.3	3.1	2.2
Rest of the world (% of GDP)								
Net lending (+) or net borrowing (-)	**-1.2**	**-3.4**	**-9.1**	**-10.9**	**-8.6**	**-7.1**	**-7.8**	**-7.2**
Net financial assets	**67.7**	**20.7**	**-20.2**	**-15.8**	**-54.3**	**n.a**	**n.a**	**n.a**
Net exports of goods and services	-0.8	-0.4	-5.9	-5.7	-6.3	-3.1	-1.9	-1.9
Net primary income from the rest of the world	-0.9	-4.4	-4.0	-4.5	-2.7	-3.4	-7.3	-6.9
Net capital transactions	0.0	0.3	0.2	0.1	0.2	0.2	-0.1	0.0
Tradable sector	44.7	41.9	36.6	35.2	35.3	35.2	n.a	n.a
Non-tradable sector	47.8	49.4	52.5	54.7	54.8	55.3	n.a	n.a
of which: Building and construction sector	9.0	8.7	10.9	9.3	8.2	7.3	n.a	n.a
Real effective exchange rate (index, 2000=100)	106.7	108.3	118.8	121.9	118.0	120.2	116.7	115.6
Terms of trade goods and services (index, 2000=100)	99.4	100.6	102.1	102.0	102.4	100.6	99.7	99.8
Market performance of exports (index, 2000=100)	110.1	96.3	86.6	88.7	88.5	91.9	93.7	93.6

Notes:

[1] The output gap constitutes the gap between the actual and potential gross domestic product at 2000 market prices.

[2] The indicator for domestic demand includes stocks.

[3] Unemployed persons are all persons who were not employed, had actively sought work and were ready to begin working immediately or within two weeks. The labour force is the total number of people employed and unemployed. The unemployment rate covers the age group 15-74.

Source:

Commission spring 2012 forecast

Table II. Comparison of macroeconomic developments and forecasts

	2011		2012		2013		2014	2015
	COM	SP	COM	SP	COM	SP	SP	SP
Real GDP (% change)	0.5	0.5	-0.8	-0.5	0.3	0.5	1.0	1.5
Private consumption (% change)	0.2	0.2	-2.5	-1.3	0.3	1.0	1.5	1.7
Gross fixed capital formation (% change)	-13.8	-13.8	-1.1	5.5	0.8	-1.0	-0.2	1.2
Exports of goods and services (% change)	3.6	3.6	1.4	2.0	2.3	3.0	3.6	4.0
Imports of goods and services (% change)	-5.0	-5.0	-2.2	1.5	2.3	1.5	2.8	3.3
Contributions to real GDP growth:								
- Final domestic demand	-3.5	-3.6	-2.4	-0.7	0.4	-0.2	0.7	1.2
- Change in inventories	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
- Net exports	3.9	4.1	1.6	0.2	0.0	0.7	0.3	0.3
Output gap[1]	-0.6	-0.6	-1.9	-1.8	-2.0	-2.1	-2.1	-1.7
Employment (% change)	0.5	0.6	-1.5	-0.2	0.6	0.2	0.3	0.3
Unemployment rate (%)	7.8	7.7	9.8	9.5	9.9	9.5	9.0	8.5
Labour productivity (% change)	-0.1	-0.1	0.7	-0.3	-0.2	0.3	0.7	1.2
HICP inflation (%)	3.5	3.5	3.4	3.0	2.5	2.2	2.0	2.0
GDP deflator (% change)	2.0	2.0	2.3	3.0	2.0	2.2	2.0	2.0
Comp. of employees (per head, % change)	2.0	2.0	-0.8	1.2	-0.3	1.3	1.2	1.7
Net lending/borrowing vis-à-vis the rest of the world (% of GDP)	-7.1	-10.4	-7.8	-7.5	-7.2	-6.5	-5.5	-5.0

Note:

[1] In percent of potential GDP, with potential GDP growth according to the programme as recalculated by the Commission.

Source :

Commission spring 2012 forecasts (COM); Stability programme (SP).

Table III. Composition of the budgetary adjustment

(% of GDP)	2011	2012		2013		2014	2015	Change: 2011-2015
	COM	COM	SP	COM	SP	SP	SP	SP
Revenue	**41.0**	**42.6**	**42.5**	**42.8**	**42.4**	**42.1**	**42.6**	**1.6**
of which:								
- Taxes on production and imports	14.8	15.1	15.3	15.4	15.4	15.4	15.3	0.5
- Current taxes on income, wealth, etc.	11.9	12.9	13.0	13.3	13.0	12.3	12.7	0.8
- Social contributions	9.5	9.7	9.5	9.9	9.4	10.1	10.0	0.5
- Other (residual)	4.9	4.9	4.7	4.3	4.6	4.3	4.6	-0.3
Expenditure	**47.3**	**46.0**	**45.1**	**45.3**	**43.0**	**42.1**	**42.6**	**-4.7**
of which:								
- Primary expenditure	44.8	42.8	42.1	42.0	39.8	39.0	39.6	-5.2
of which:								
Compensation of employees	15.8	15.4	15.3	15.4	14.6	14.3	13.9	-1.9
Intermediate consumpiton	4.9	4.8	5.0	4.3	4.9	4.9	4.8	-0.1
Social payments	15.3	14.6	15.2	14.7	15.5	15.7	15.8	0.5
Subsidies	0.5	0.9	0.4	0.8	0.3	0.3	0.3	-0.2
Gross fixed capital formation	3.4	3.1	3.1	3.1	2.7	2.7	2.7	-0.7
Other (residual)	4.8	4.0	3.1	3.8	1.8	1.1	2.1	-2.7
- Interest expenditure	2.5	3.2	3.0	3.2	3.2	3.1	3.0	0.5
General government balance (GGB)	**-6.3**	**-3.4**	**-2.6**	**-2.5**	**-0.6**	**0.0**	**0.0**	**6.3**
Primary balance	**-3.8**	**-0.2**	**0.4**	**0.7**	**2.6**	**3.1**	**3.0**	**6.8**
One-off and other temporary measures	-0.5	0.0	0.1	0.0	0.0	0.0	0.0	0.5
GGB excl. one-offs	**-5.8**	**-3.4**	**-2.7**	**-2.5**	**-0.6**	**0.0**	**0.0**	**5.8**
Output gap[2]	-0.6	-1.9	-1.8	-2.0	-2.1	-2.1	-1.7	-1.0
Cyclically-adjusted balance[2]	-6.0	-2.7	-1.9	-1.7	0.2	0.8	0.6	6.7
Structural balance[3]	**-5.5**	**-2.7**	**-2.0**	**-1.7**	**0.2**	**0.8**	**0.6**	**6.2**
Change in structural balance		*2.9*	*3.5*	*1.0*	*2.2*	*0.6*	*-0.2*	
Structural primary balance[3]	-3.1	0.5	1.0	1.6	3.4	3.9	3.6	6.7
Change in structural primary balance		*3.6*	*4.0*	*1.0*	*2.4*	*0.5*	*-0.3*	
Expenditure benchmark								
Public expenditure growth[4] (real)		-7.92	-9.14	-2.18	-5.18	-3.28	2.58	-
Reference rate[5,6]		1.51	1.51	1.51	1.51	*1.51*	*1.51*	-
Lower reference rate[5,7]		0.33	0.33	0.33	0.33	*0.33*	*0.33*	-
Deviation in % GDP from applicable reference rate		-3.74	-4.76	-1.08	-2.30	*-1.88*	*0.41*	-
Two-year average deviation in % GDP from applicable reference rate		n.a.	n.a.	-2.41	-3.53	*-2.09*	*-0.74*	-

Notes*:*

[1]On a no-policy-change basis.

[2]Output gap (in % of potential GDP) and cyclically-adjusted balance according to the programme as recalculated by the Commission on the basis of the information in the programme.

[3]Structural (primary) balance = cyclically-adjusted (primary) balance excluding one-off and other temporary measures.

[4]Modified expenditure aggregate used for the expenditure benchmark, growth rates net of non-discretionary changes in unemployment benefit and of discretionary measures.

[5]The reference rates applicable to 2014 onwards will be available from mid-2012. For illustrative purposes, the current reference rates have also been applied to the years 2014 onwards.

[6]The (standard) reference rate applies starting in the year following which the country has reached its MTO.

[7]The lower reference rate applies as long as the country is adjusting towards its MTO, including the year in which it reaches the

Source :

Stability programme (SP); Commission spring 2012 forecasts (COM); Commission calculations.

Table IV. Debt dynamics

(% of GDP)	average 2006-10	2011	2012		2013		2014	2015
			COM	CP	COM	CP	CP	CP
Gross debt ratio[1]	**58.5**	**71.6**	**76.5**	**72.1**	**78.1**	**70.2**	**67.8**	**65.4**
Change in the ratio	-1.6	10.2	4.9	0.5	1.5	-1.9	-2.4	-2.4
Contributions [2] :								
1. Primary balance	**-1.2**	**3.8**	**0.2**	**-0.4**	**-0.7**	**-2.6**	**-3.1**	**-3.0**
2. "Snow-ball" effect	**-0.3**	**1.0**	**2.2**	**1.2**	**1.5**	**1.3**	**1.1**	**0.7**
Of which:								
Interest expenditure	2.8	2.5	3.2	3.0	3.2	3.2	3.1	3.0
Growth effect	-1.5	-0.3	0.6	0.3	-0.3	-0.4	-0.7	-1.0
Inflation effect	-1.7	-1.2	-1.6	-2.1	-1.5	-1.5	-1.3	-1.3
3. Stock-flow adjustment	**0.0**	**5.3**	**2.5**	**-0.4**	**0.8**	**-0.6**	**-0.4**	**-0.1**
Of which:								
Cash/accruals diff.				0.0		0.0	0.0	0.0
Acc. financial assets				0.5		0.5	0.5	0.5
Privatisation				0.0		0.0	0.0	0.0
Val. effect & residual				0.0		0.0	0.0	0.0
(% of GDP)		2011	2012		2013		2014	2015
			COM/SP[3]	SP[4]	COM/SP[3]	SP[4]	SP[4]	SP[4]
Gap to the debt benchmark[5,6]	-	-	-	-	-	-	-	-
Structural adjustment[7]	-	-	-	-	2.2	2.2	0.6	-0.2
To be compared to:								
Required adjustment[8]	-	-	-	-	0.0	0.1	0.0	0.0

Notes:

[1]End of period.

[2]The snow-ball effect captures the impact of interest expenditure on accumulated debt, as well as the impact of real GDP growth and inflation on the

[3]Assessment of the consolidation path set in the SP assuming growth follows the COM forecasts.

[4]Assessment of the consolidation path set in the SP assuming growth follows the SP projections.

[5] Not relevant during EDP that were ongoing in November 2011 and in the three years following the correction of the excessive deficit.

[6]Shows the difference between the debt-to-GDP ratio and the debt benchmark. If positive, projected gross debt-to-GDP ratio does not comply with the debt reduction benchmark.

[7]Applicable only during the transition period of three years from the correction of the excessive deficit for EDP that were ongoing in November 2011.

[8]Defines the remaining annual structural adjustment over the transition period which ensures that - if followed – Member State will comply with the debt reduction benchmark at the end of the transition period, assuming that COM (SP) budgetary projections are achieved.

Source :

Stability programme (SP); Commission services' spring 2012 forecasts (COM); Commission services' calculations.

Table V. Long term sustainability indicators

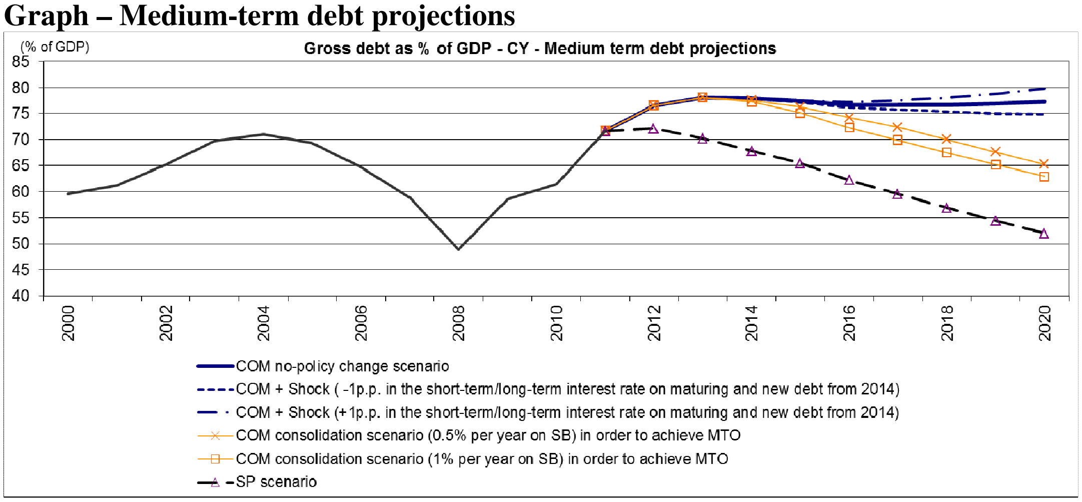
	CY		EU27	
	No-policy change scenario	Stability programme scenario	No-policy change scenario	SCP's scenario
S2	5.5	3.3	2.9	0.7
of which:				
Initial budgetary position (IBP)	-0.2	-2.2	0.7	-1.6
Long-term change in the primary balance (LTC)	5.7	5.5	2.3	2.4
of which:				
pensions	5.8	5.5	1.1	1.2
health care and long-term care	0.3	0.3	1.5	1.5
other	-0.5	-0.3	-0.3	-0.3
S1 (required adjustment)*	2.3	-1.6	2.2	-0.1
Debt, % of GDP (2011)	71.6		82.8	
Age-related expenditure, % of GDP (2011)	17.8		25.8	

Source: Commission, 2012 Stability programme.

Note: The 'no policy change' scenario depicts the sustainability gap under the assumption that the budgetary position evolves according to the spring 2012 forecast until 2013. The 'stability programme' scenario depicts the sustainability gap under the assumption that the budgetary plans in the programme are fully implemented.

* The required adjustment of the primary balance until 2020 to reach a public debt of 60% of GDP by 2030.

Graph – Medium-term debt projections



Source: Commission, 2012 stability and convergence programmes.

Table VI - Taxation indicators — Cyprus

	2001	2005	2007	2008	2009	2010
Total tax revenues (incl. actual compulsory social contributions, % of GDP)	30.7	35.0	40.1	38.6	35.3	35.7
Breakdown by economic function (% of GDP)[1]						
Consumption	11.4	14.6	15.2	15.2	13.5	13.5
of which:						
- VAT	5.7	9.1	10.2	10.6	9.2	9.2
- excise duties on tobacco and alcohol	0.8	1.4	1.3	1.3	1.3	1.3
- energy	1.0	1.9	1.8	1.6	1.6	1.9
- other (residual)	3.9	2.2	1.9	1.8	1.4	1.1
Labour employed	9.8	11.3	10.8	11.0	12.2	12.6
Labour non-employed	0.2	0.1	0.1	0.1	0.1	0.1
Capital and business income	7.4	6.4	10.6	9.7	7.8	7.6
Stocks of capital/wealth	1.8	2.7	3.4	2.6	1.7	1.9
p.m. Environmental taxes[2]	3.0	3.5	3.4	3.2	2.9	2.9
VAT efficiency[3]						
Actual VAT revenues as % of theoretical revenues at standard rate	75.8	82.7	92.1	91.9	79.9	79.2

Note:

1 Tax revenues are broken down by economic function, i.e. according to whether taxes are raised on consumption, labour or capital. See European Commission (2012), Taxation trends in the European Union, for a more detailed explanation.

2 This category comprises taxes on energy, transport and pollution and resources included in taxes on consumption and capital.

3 The VAT efficiency is measured via the VAT revenue ratio. The VAT revenue ratio is defined as the ratio between the actual VAT revenue collected and the revenue that would theoretically be raised if VAT was applied at the standard rate to all final consumption. A low ratio can indicate a reduction of the tax base due to large exemptions or the application of reduced rates to a wide range of goods and services ('policy gap') or a failure to collect all tax due to e.g. fraud ('collection gap'). See European Commission (2011), Tax reforms in EU Member States, European Economy 5/2011, for a more detailed explanation.

Source: Commission

Table VII Selected macro-financial stability indicators

	2007	2008	2009	2010	2011
Total assets of the banking sector (% of GDP)	584.2	688.3	827.1	778.8	747.4
Share of assets of the five largest banks (% of total assets)	64.9	63.8	64.9	65.8	…
Foreign ownership of banking system (% of total assets)	0.0	38.1	37.0	…	…
Financial soundness indicators:					
- non-performing loans (% of total loans) [1)]	...	3.6	4.5	5.6	6.7
- capital adequacy ratio (%) [1) 2)]	...	11.0	12.1	12.5	13.3
- return on equity (%) [1), 3)]	...	14.5	14.0	11.0	-2.5
Bank loans to the private sector (year-on-year % change)	22.5	28.4	9.9	7.9	8.1
Lending for house purchase (year-on-year % change)	27.4	22.5	11.2	14.3	5.1
Loan to deposit ratio	100.6	109.4	114.0	103.9	112.7
CB liquidity as % of liabilities	0.0	4.3	5.9	4.5	4.6
Banks' exposure to countries receiving official financial assistance (% of GDP)[4)]	…	…	…	…	…
Private debt (% of GDP)	213.3	261.6	287.8	296.7	308.7
Gross external debt (% of GDP)					
- Public	…	…	…	…	…
- Private	…	…	…	…	…
Long term interest rates spread versus Bund (basis points)*	25.8	61.6	137.8	185.7	317.9
Credit default swap spreads for sovereign securities (5-year)*	…	…	…	…	…

Notes:

[1)] Latest available June 2011.

[2)] The capital adequacy ratio is defined as total capital divided by risk weighted assets.

[3)] Net income to equity ratio.

* Measured in basis points.

Source :
Bank for International Settlements and Eurostat (exposure to macro-financially vulnerable countries), IMF (financial soundness indicators), Commission (long-term interest rates), World Bank (gross external debt) and ECB (all other indicators).

Table VIII Labour market and social indicators

Labour market indicators	2006	2007	2008	2009	2010	2011
Employment rate (% of population aged 20-64)	75.8	76.8	76.5	75.7	75.4	73.8
Employment growth (% change from previous year)	2.7	5.8	1.3	-0.4	1.0	-2.5
Employment rate of women (% of female population aged 20-64)	65.9	67.7	68.2	68.1	68.5	67.3
Employment rate of men (% of male population aged 20-64)	86.2	86.4	85.2	83.5	82.5	80.4
Employment rate of older workers (% of population aged 55-64)	53.6	55.9	54.8	56.0	56.8	55.2
Part-time employment (% of total employment)	7.9	7.5	8.0	8.7	9.6	10.3
Part-time employment of women (% of women employment)	12.2	11.0	11.6	12.7	12.9	13.3
Part-time employment of men (% of men employment)	4.4	4.6	5.0	5.4	6.8	7.8
Fixed term employment (% of employees with a fixed term contract)	13.1	13.2	13.9	13.4	13.5	13.6
Unemployment rate[1] (% of labour force)	4.6	3.9	3.7	5.3	6.2	7.8
Long-term unemployment[2] (% of labour force)	0.9	0.7	0.5	0.6	1.3	1.6
Youth unemployment rate (% of youth labour force aged 15-24)	10.0	10.2	9.0	13.8	16.7	22.4
Youth NEET[3] rate (% of population aged 15-24)	10.7	9.0	9.7	10.1	11.7	:
Early leavers from education and training (% of pop. 18-24 with at most lower sec. educ. and not in further education or training)	14.9	12.5	13.7	11.7	12.6	:
Tertiary educational attainment (% of population 30-34 having successfully completed tertiary education)	44.6	47.0	48.0	47.5	47.9	:
Labour productivity per person employed (annual % change)	2.3	1.8	1.4	-1.3	1.1	-0.1
Hours worked per person employed (annual % change)	0.9	-0.5	-0.5	-0.3	0.0	-0.2
Labour productivity per hour worked (annual % change; constant prices)	1.4	2.3	1.9	-1.0	1.1	0.1
Compensation per employee (annual % change; constant prices)	-0.1	-1.3	-1.3	5.2	-1.9	0.0
Nominal unit labour cost growth (annual % change)	0.9	1.2	1.8	6.7	-1.3	2.0
Real unit labour cost growth (annual % change)	-2.4	-3.0	-2.7	6.6	-2.9	0.0

Notes:

[1] According to ILO definition, age group 15-74)
[2] Share of persons in the labour force who have been unemployed for at least 12 months.
[3] NEET are persons that are neither in employment nor in any education or training.

Sources:
Commission (EU Labour Force Survey and European National Accounts)

Table VIII Labour market and social indicators (continued)

Expenditure on social protection benefits (% of GDP)	2005	2006	2007	2008	2009
Sickness/Health care	4.54	4.64	4.51	4.47	5.07
Invalidity	0.68	0.71	0.66	0.67	0.75
Old age and survivors	7.18	7.20	7.17	7.08	7.92
Family/Children	2.12	1.94	1.93	2.07	2.19
Unemployment	1.09	1.22	0.91	0.86	0.95
Housing and Social exclusion n.e.c.	0.41	0.49	0.63	0.82	1.11
Total	18.4	18.5	18.2	18.5	20.9
of which: Means tested benefits	1.53	1.61	1.83	2.22	2.75
Social inclusion indicators	**2006**	**2007**	**2008**	**2009**	**2010**
Risk-of-poverty or exclusion[1] (% of total population)	25.4	25.2	22.2	22.2	24.0
Risk-of-poverty or exclusion of children (% of people aged 0-17)	21.3	20.8	18.8	17.6	21.4
Risk-of-poverty or exclusion of elderly (% of people aged 65+)	55.6	55.6	50.7	50.1	47.2
At-risk-of-poverty rate[2] (% of total population)	15.6	15.5	16.2	16.2	17.0
Value of relative poverty threshold (single household per year) - in PPS	9817	10951	11451	11781	11840
Severe material deprivation[3] (% of total population)	12.6	13.3	8.2	7.9	9.1
Share of people living in low work intensity households[4] (% of people aged 0-59 not student)	3.8	3.7	4.1	4.0	4.0
In-work at-risk-of poverty rate (% of persons employed)	7.2	6.3	6.4	7.0	7.7

Notes:

[1] People at risk of poverty or social exclusion (AROPE): individuals who are at risk of poverty (AROP) and/or suffering from severe material deprivation (SMD) and/or living in households with zero or very low work intensity (LWI).

[2] At-risk-of poverty rate: share of people with an equivalised disposable income below 60% of the national equivalised median income.

[3] Share of people who experience at least 4 out of 9 deprivations: people cannot afford to i) pay their rent or utility bills, ii) keep their home adequately warm, iii) face unexpected expenses, iv) eat meat, fish, or a protein equivalent every second day, v) enjoy a week of holiday away from home once a year, vi) have a car, vii) have a washing machine, viii) have a colour TV, or ix) have a telephone.

[4] People living in households with very low work intensity: share of people aged 0-59 living in households where the adults work less than 20% of their total work-time potential during the previous 12 months.

Sources:

For expenditure on social protection benefits ESSPROS; for social inclusion EU-SILC.

Table IX Product markets performance and policy indicators

Performance indicators	2002-2006	2007	2008	2009	2010	2011
Labour productivity[1] total economy (annual growth in %)	**0.2**	**1.9**	**0.8**	**-1.2**	**1.4**	**1.2**
Labour productivity[1] in manufacturing (annual growth in %)	**-1.5**	**1.3**	**1.9**	**-5.0**	**-2.4**	**n.a.**
Labour productivity[1] in electricity, gas, water (annual growth in %)	**n.a.**	**n.a.**	**n.a.**	**n.a.**	**n.a.**	**n.a.**
Labour productivity[1] in the construction sector (annual growth in %)	**-0.2**	**2.6**	**-0.5**	**-1.6**	**-3.4**	**n.a.**
Patent intensity in manufacturing[2] (patents of the EPO divided by gross value added of the sector)	**0.8**	**0.8**	**0.8**	**n.a.**	**n.a.**	**n.a.**
Policy indicators	**2002-2006**	**2007**	**2008**	**2009**	**2010**	**2011**
Enforcing contracts[3] (days)	**n.a.**	**n.a.**	**735**	**735**	**735**	**735**
Time to start a business[3] (days)	**n.a.**	**n.a.**	**8**	**8**	**8**	**8**
R&D expenditure (% of GDP)	**0.4**	**0.4**	**0.4**	**0.5**	**0.5**	**n.a.**
Tertiary educational attainment (% of 30-34 years old population)	**40.8**	**46.2**	**47.1**	**44.7**	**45.1**	**n.a.**
Total public expenditure on education (% of GDP)	**6.9**	**6.9**	**7.4**	**n.a.**	**n.a.**	**n.a.**
	2005	**2006**	**2008**	**2009**	**2010**	**2011**
Product market regulation[4], Overall (Index; 0=not regulated; 6=most regulated)	**n.a.**	**n.a.**	**n.a.**	**n.a.**	**n.a.**	**n.a.**
Product market regulation[4], Retail (Index; 0=not regulated; 6=most regulated)	**n.a.**	**n.a.**	**n.a.**	**n.a.**	**n.a.**	**n.a.**
Product market regulation[4], Network Industries[5] (Index; 0=not regulated; 6=most regulated)	**n.a.**	**n.a.**	**n.a.**	**n.a.**	**n.a.**	**n.a.**

Notes:

[1]Labour productivity is defined as gross value added (in constant prices) divided by the number of persons employed.

[2] Patent data refer to applications to the European Patent Office (EPO). They are counted according to the year in which they were filed at the EPO. They are broken down according to the inventor's place of residence, using fractional counting if multiple inventors or IPC classes are provided to avoid double counting.

[3] The methodologies, including the assumptions, for this indicator are presented in detail on the website http://www.doingbusiness.org/methodology.

[4] The methodologies for the product market regulation indicators are presented in detail on the website http://www.oecd.org/document/1/0,3746,en_2649_34323_2367297_1_1_1_1,00.html. The latest available product market regulation indicators refer to 2003 and 2008, except for Network Industries.

[5] Aggregate ETCR.

*figure for 2007.

Source:

Commission, World Bank - *Doing Business* (for enforcing contracts and time to start a business) and OECD (for the product market regulation indicators).

Table X – Indicators on green growth

Cyprus		2001-2005	2006	2007	2008	2009	2010
Green Growth performance							
Macroeconomic							
Energy intensity	kgoe / €	0.23	0.21	0.21	0.21	0.21	0.20
Carbon intensity	kg / €	0.85	0.80	0.77	0.77	0.72	n.a.
Resource intensity (reciprocal of resource productivity)	kg / €	1.59	1.54	1.60	2.03	1.95	n.a.
Waste intensity	kg / €	n.a.	0.10	0.12	0.14	n.a.	n.a.
Energy balance of trade	% GDP	-3.6%	-5.5%	-5.6%	-7.1%	-5.0%	-6.6%
Energy weight in HICP	%	8	11	11	12	12	11
Difference between change energy price and inflation	%	5.4	9.6	-1.5	12.5	-16.5	18.9
Environmental taxes over labour taxes	ratio	32.7%	29.8%	31.1%	28.4%	23.6%	n.a.
Environmental taxes over total taxes	ratio	10.4%	9.0%	8.2%	8.0%	8.2%	n.a.
Sectoral							
Industry energy intensity	kgoe / €	0.33	0.21	0.20	0.21	0.19	n.a.
Share of energy-intensive industries in the economy	% GDP	5.8	5.8	5.8	5.3	5.2	n.a.
Electricity prices for medium-sized industrial users	€ / kWh	0.09	0.11	0.10	0.14	0.12	0.15
Public R&D for energy	% GDP	n.a.	0.00%	0.00%	0.00%	0.00%	n.a.
Public R&D for the environment	% GDP	n.a.	0.00%	0.00%	0.01%	0.01%	n.a.
Recycling rate of municipal waste	ratio	10.4%	12.6%	12.8%	12.8%	12.9%	n.a.
Share of GHG emissions covered by ETS	%	n.a.	54.2%	54.8%	54.8%	57.0%	n.a.
Transport energy intensity	kgoe / €	1.03	0.96	0.90	0.87	0.90	n.a.
Transport carbon intensity	kg / €	1.75	2.08	2.02	1.96	2.01	n.a.
Change in the ratio of passenger transport and GDP	%	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Security of energy supply							
Energy import dependency	%	97.8%	102.5%	95.9%	97.6%	97.3%	n.a.
Diversification of oil import sources	HHI	n.a.	0.00	0.00	0.00	0.00	n.a.
Diversification of energy mix	HHI	0.93	0.93	0.92	0.91	0.92	n.a.
Share of renewable energy in energy mix	%	2.0%	2.1%	2.6%	3.2%	3.5%	n.a.

Country-specific notes:

The year 2011 is not included in the table due to lack of data.

General explanation of the table items:

Source: Eurostat unless indicated otherwise; ECFIN explanations given below

All macro intensity indicators are expressed as a ratio of a physical quantity to GDP (in 2000 prices)

Energy intensity: gross inland energy consumption (in kgoe) divided by GDP (in EUR)

Carbon intensity: Greenhouse gas emissions (in kg CO2 equivalents) divided by GDP (in EUR)

Resource intensity: Domestic Material Consumption (in kg) divided by GDP (in EUR)

Waste intensity: waste (in kg) divided by GDP (in EUR)

Energy balance of trade: the balance of energy exports and imports, expressed as % of GDP

Energy weight in HICP: the share of the "energy" items in the consumption basket used in the construction of the HICP

Difference between energy price change and inflation: energy component of HICP, and total HICP inflation (annual %-change)

Environmental taxes over labour or total taxes: from DG TAXUD's database "Taxation trends in the European Union"

Industry energy intensity: final energy consumption of industry (in kgoe) divided by gross value added of industry (in EUR)

Share of energy-intensive industries in the economy: share of gross value added of the energy-intensive industries in GDP

Recycling rate of municipal waste: ratio of municipal waste recycled over total municipal waste

Public R&D for energy or for the environment: government spending on R&D (GBAORD) for these categories as % of GDP

Share of GHG emissions covered by ETS: based on greenhouse gas emissions as reported by Member States to EEA (excl LULUCF)

Transport energy intensity: final energy consumption of transport (in kgoe) divided by gross value added of industry (in EUR)

Transport carbon intensity: greenhouse gas emissions in transport divided by gross value added of the transport sector

Passenger transport growth : measured in %-change in passenger kilometres

Energy import dependency: net energy imports divided by gross inland energy consumption incl. of international bunkers

Diversification of oil import sources: Herfindahl index (HHI), calculated as the sum of the squared market shares of countries of origin

Diversification of the energy mix: Herfindahl Index over natural gas, total petrol products, nuclear heat, renewable energies and solid fuels

Share of renewable energy in energy mix: percentage-share in gross inland energy consumption, expressed in tonne oil equivalents