

A stylized map of Europe composed of a grid of dots. The dots are mostly grey, with several red dots highlighting specific countries: Cyprus, Greece, and the United Kingdom.

# Social Cohesion and the State in times of Austerity

Cyprus

**ODYSSEAS CHRISTOU, CHRISTINA IOANNOU, ANTHOS I. SHEKERIS**

September 2013

- On 2 April 2013 Cyprus reached an agreement with the Troika on an Economic Adjustment Program aimed at addressing the country's financial, fiscal and structural imbalances. A general assessment of the overall impact of the austerity program illustrates that the specified targets have been met both in terms of objective and the scheduled timeframe of implementation thus far.
- An analysis of different sectors of the economy illustrates that the »bubble« sectors of construction and financial services largely account for the economic contraction. Conversely, tourism and company registration services have remained resilient with little downward change. The extent of the impact of the banking crisis remains undetermined and could pose further future risks, while unanticipated problems in the banking sector may resurface.
- The recession continues unabated, confirming predictions that the trend is not expected to reverse prior to 2015.



## Contents

<b>Introduction</b> .....	<b>2</b>
<b>1. Economy</b> .....	<b>2</b>
1.1 Growth rates .....	2
1.2 Changes of imports and exports .....	3
1.3 Which sectors have been hit most by the austerity? Which succeed despite austerity? .....	3
1.4 Wage development .....	4
1.5 Minimum wage .....	5
1.6 Role of trade unions and collective bargaining .....	5
<b>2. Society</b> .....	<b>5</b>
2.1 Population and Employment .....	5
2.2 Poverty .....	7
2.3 Household income .....	8
2.4 Pensions .....	8
2.5 Reforms in the health care system .....	9
<b>3. State</b> .....	<b>9</b>
3.1 The level of state debt .....	9
3.2 The interest rates for state bonds .....	10
3.3 The costs and number of employees of the state sector .....	10
3.4 Privatization of state assets .....	12
<b>4. Conclusion</b> .....	<b>12</b>
<b>References</b> .....	<b>13</b>

## Introduction

On 2 April 2013 Cyprus reached an agreement with the Troika (the group of international lenders, comprised of the European Commission, the European Central Bank and the International Monetary Fund) on an Economic Adjustment Program aimed at addressing the country's financial, fiscal and structural imbalances. The Program, which covers the period 2013–2016, involves a financial package of €10 billion, €1 billion of which comes from the IMF. The main aims and expected outcomes of the Program were laid down in a draft Memorandum of Understanding (MoU) between the European Commission (EC) and the Republic of Cyprus. Amongst other things, the Program includes an extensive restructuring and downsizing of the banking sector – enhanced with the bail-in of uninsured depositors – fiscal consolidation, structural reforms and privatizations.

Even though it is rather premature to assess the results of the austerity policy on the Cypriot economy, society and state, this paper attempts to evaluate the first consequences in the past few months. The paper consists of three main parts. Section 1 analyses the effects of the austerity program on the Cypriot economy, evaluating growth rates, changes in imports and exports, the various sectors affected by the crisis, wage development, minimum wage, as well as the role of trade unions and collective bargaining. Section 2 delves into societal developments, focusing mainly on unemployment rates, state support of the unemployed, poverty rate, family income, reliance on social security, the pension system and reforms in the health care system. Section 3 deals with the austerity effects on the state, with an emphasis on the level of state debt, the cost of refinancing, the number of employees of the state, the costs of the state sector, as well as the privatization of state assets and the effect on basic services. In the final section a general assessment of the effects of the austerity program is made and the current socio-political situation is assessed.

## 1. Economy

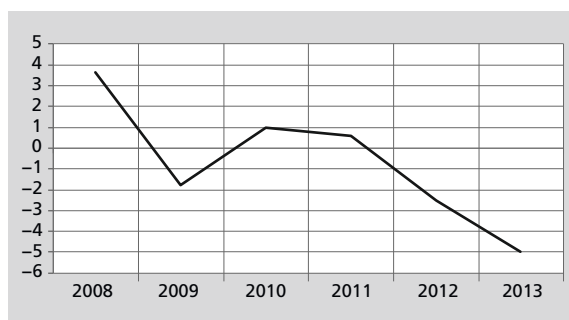
### 1.1 Growth rates

According to the EC, economic activity in Cyprus exhibited strong growth in the first decade of the millennium, with an average annual GDP growth rate of 3.0% in real terms, twice that of the euro-area.<sup>1</sup> »Growth took place in conditions of almost full employment, with remarkably high job creation (3% per year on average), low inflation and rising real disposable income.«<sup>2</sup>

As depicted in Figure 1, the country's GDP annual growth rate started exhibiting a downward trend from 2011 onwards, with an even more rapid decline in the first half of 2013, even reaching a record high decline of 5.7%.

The rate of growth of the Cypriot economy is expected to be even more adversely affected in the second half of 2013 and 2014. It is estimated that GDP will in fact decline by 8.7% in real terms in 2013<sup>3,4</sup>.

Figure 1: GDP Growth [%]



Source: Statistical Service, Republic of Cyprus

The forecasted decline owes primarily to the negative climate created and the lack of trust in the Cypriot economy and its banking system by local and foreign investors and depositors. This is further worsened by the temporary imposition of controls on capital flows, enforced following the Eurogroup decision on Cyprus,

1. European Commission, European Economy: The Economic Adjustment Programme for Cyprus, Occasional Papers 149 | May 2013, p. 7.

2. Ibid.

3. Ministry of Finance, Strategic Fiscal Policy Framework 2014–2016: Budget 2014, 29 May 2013.

4. This figure is corroborated by the EC in its latest forecast: European Commission, »The Economic Adjustment programme for Cyprus: Conclusion of the 1st review – Summer 2013«, Brussels, 18 Sept. 2013.

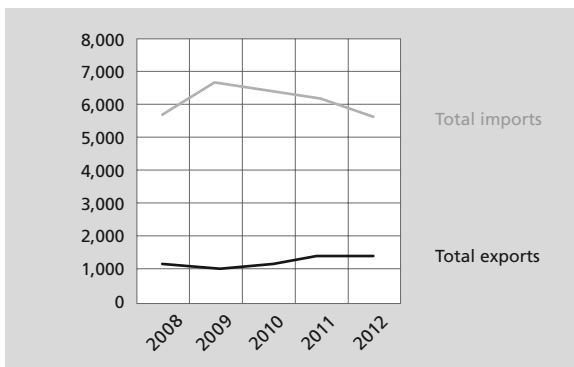
as well as the contractionary fiscal policy followed by the Government and the fiscal consolidation program, which have significantly reduced private consumption spending. The restructuring of the banking sector and the bail-in of uninsured depositors further contribute to this negative forecast, as they have resulted in significant loss of wealth and uncertainty in general.

Clearly however, the exact growth rate figure will finally depend on how effectively the banking sector problems are dealt with, the realization of the fiscal and structural programming included in the MoU, as well as the overall recovery of the global economy, especially the recovery of the country's main trade partners.

## 1.2 Changes of imports and exports

Foreign trade plays a crucial role in the Cypriot economy. Owing to the small size of the domestic market, the country relies largely on imports, mainly in oil, food, construction products and defense equipment.

Figure 2: Imports/Exports



Source: Statistical Service, Republic of Cyprus

As illustrated in Figure 2, even though exports remained largely constant, there was a considerable decline in imports from 2010 onwards. The growth in imports exhibited in 2008 and 2009 was directly related to the construction boom, which led to higher imports of goods for construction purposes. With the onset of the crisis – the uncertain climate initially and the austerity measures thereafter – demand for construction products fell significantly. Similarly, the austere situation has caused a decline in the demand for oil and imported food commodities. According to the latest IMF country report

on Cyprus, the fall in imports is in line with domestic demand.<sup>5</sup>

## 1.3 Which sectors have been hit most by the austerity? Which succeed despite austerity?

The service sector plays a very prominent role in the Cypriot economy. In 2012 it was estimated that around 82 % of employment came from services (compared to 75 % in the EU). The contributions of tourism, financial intermediation, local services (wholesale and retail trade), construction and public administration to both employment and GDP are high.<sup>6</sup>

One of the biggest contributors to GDP and employment has until recently been the country's financial services. According to the EC, »financial and insurance activities contributed 9.2 % to GDP in 2012 and provided employment to 19,300 people or 5 % of total employment, above the EU averages of 5.7 % and 2.7 %, respectively.«<sup>7</sup>

The sector hit most by the crisis has been the banking sector. Since the second half of 2011 the banking sector was increasingly cut off from international market funding and major financial institutions recorded substantial capital shortfalls against the backdrop of the exposure to the Greek economy<sup>8,9</sup>. Despite this, in the run-up to the March Eurogroup meetings on Cyprus, the banking sector represented 550 % of the Cyprus' GDP (including cooperative banking institutions).<sup>10</sup>

The MoU involved a condition that the country's second largest bank, Cyprus Popular (Laiki) Bank would be resolved with the full contribution of equity shareholders, bond holders and uninsured depositors. Laiki would further be split into a good bank and a bad bank, with the

5. International Monetary Fund, »Cyprus: First Review under the extended arrangement under the extended fund facility and request for modification of performance criteria« IMF Country Report No. 13/293, Sept. 2013.

6. European Commission, »European Economy: The Economic Adjustment Programme for Cyprus«, Occasional Papers 149 | May 2013, p. 25.

7. Ibid, p. 14.

8. Ibid, p. 7.

9. The two largest Cypriot banks had expanded substantially in Greece and this left them exposed to the adverse macroeconomic developments there.

10. European Commission, Έγγραφο Εργασίας των Υπηρεσιών της Επιτροπής, Αξιολόγηση του εθνικού προγράμματος μεταρρυθμίσεων και του προγράμματος σταθερότητας του 2013 για την ΚΥΠΡΟ, SWD(2013) 363 final, Brussels 29.5.2013, p. 11.

good bank folded into the Bank of Cyprus (the country's largest bank), taking €9 billion of Emergency Liquidity Assistance (ELA) with it. The Bank of Cyprus would be recapitalized through a deposit/equity conversion of uninsured deposits with full contribution of equity shareholders and bond holders.

Following the MoU and the new legal framework approved by the House of Representatives on 22 March 2013, concerning the recovery and resolution of banking institutions, but also as a result of the capital restrictions imposed, the size of the banking sector suffered an immediate decline of 350 % of GDP.<sup>11</sup> This figure has since dropped even further following the very recent decisions concerning the resolution of cooperative credit institutions. The overall picture may worsen even further if one also considers the increasing number of non-performing loans. According to the last recorded figures for loans not covered by tangible assets, total provisions reached 50 % of total non-performing loans in end-2011, well below the 75 % recorded at the end.

Another sector that has been severely hit by the crisis and the austerity measures has been construction. Table 1 illustrates that despite the fact that the prices of construction materials remained relatively constant in the past three years, their sales have been progressively and significantly affected.

Table 1: Prices and sales of construction material

	2010	2011	2012	2013
Price index of construction materials (2005 = 100%)	120.4	125.3	125.5	124.5
Local sales of cement (000s metric tonnes)	1,335.0	1,152.0	781.0	562.0 (est.)

Source: Statistical Service, Republic of Cyprus

Tourism is yet another major sector (hotels, restaurants) for the Cypriot economy and of great importance as an employer. According to the EC, since 2011 the country

11. European Commission, Έγγραφο Εργασίας των Υπηρεσιών της Επιτροπής, Αξιολόγηση του εθνικού προγράμματος μεταρρυθμίσεων και του προγράμματος σταθερότητας του 2013 για την ΚΥΠΡΟ, SWD(2013) 363 final, Brussels 29.5.2013, p. 11.

has experienced a significant increase in tourism arrivals and incomes, while the prospects for the continuation of that upward trend in 2013 are excellent.<sup>12</sup>

Table 2: Tourist Arrivals

	2010	2011	2012
Tourist arrivals (000's)	2,173.0	2,392.2	2,464.9

Source: Statistical Service, Republic of Cyprus

As per Table 2, in 2011, there was an increase of 10 % in tourism arrivals compared to 2010, while in 2012 there was a further increase of 3 %. Further improvements are expected, with a study on a new tourism business model and an update of the Tourism Strategy 2011–2015 having been prepared. Both are set to form the bases for a new action plan, which will be published later this year.

It should be underlined that another sector which will contribute significantly in the future is the energy sector and more specifically that of the Liquefied Natural Gas (LNG), associated with the exploration of Cypriot hydrocarbons. Yet, as the EC highlights, the country needs to produce a more comprehensive outline on the regulatory regime and market organization for the energy sector and gas exports.<sup>13</sup>

#### 1.4 Wage development

The Cypriot authorities have agreed to introduce reforms to the country's framework of setting wages. Following a progressive scale of wage cuts in 2012 and streamlining of allowances in 2013 with a full year effect of 1.2 % of GDP, an additional 3 % horizontal wage cut will take place in the public sector as of 1st January 2014 (reduction of 0.4 % of GDP).<sup>14</sup>

The Cypriot authorities have also agreed to suspend the Cost of Living Allowance (COLA) system until the end of

12. European Commission, »European Economy: The Economic Adjustment Programme for Cyprus«, Occasional Papers 149 | May 2013, p. 52–3.

13. European Commission, »The Economic Adjustment programme for Cyprus: Conclusion of the 1st review – Summer 2013«, Brussels, 18 Sept. 2013.

14. European Commission, »European Economy: The Economic Adjustment Programme for Cyprus«, Occasional Papers 149 | May 2013, p. 47.

2016. This system adjusts salaries based on changes in a cost-of-living index, known as the Consumer Price Index (CPI). Its suspension is aimed at inducing adjustment in real wages, which will help reflect better developments in labour productivity and competitiveness.

### 1.5 Minimum wage

Cyprus does not have a system of a comprehensive national minimum wage, but relies rather on a ministerial order issued annually (on 1st April of each year), which sets the minimum wage. The latter is applicable only to specific professions, which are not covered by collective agreements and that are considered vulnerable, such as sales persons, clerks, cleaners, and auxiliary healthcare staff. These count for around 13–14 % of the total employed population.

Currently the level of the monthly minimum wage is €870 for new hires and €924 after six months on the job, as per the order issued on 1st April 2012. The minimum wage after six months on the job is now at around 40 % of the average wage, with the country enjoying one of the highest minimum wages in the EU.<sup>15</sup>

The Ministry of Labour and Social Insurance did not renew the order on 1st April 2013, as the system is currently subject to restructuring and the authorities will only revise the minimum wage following consultation with the program partners.

### 1.6 Role of trade unions and collective bargaining

Traditionally the role of trade unions and collective bargaining in Cyprus has been extensive, as organised interests – in the form of organised employers and organised labour – play a central role in the structure and are actively incorporated into the policy-making process. Workers are represented through their trade unions, ranging from national, multi-sectoral bodies, to smaller ones that stand for independent sectoral interests.

The two main multi-sectoral unions, PEO and SEK, control the process to a large extent. Other multi-sectoral unions

15. Ibid, p. 26.

include the Democratic Labour Federation of Cyprus (DEOK), which is a splinter trade union from SEK, and the Pancyprian Federation of Independent Trade Unions (POAS), which consists of workers from minor enterprises and from the British Sovereign Bases on the island. As far as the sectoral trade unions are concerned, these include the Pancyprian Union of Public Servants (PASYDY), the Pancyprian Organisation of Greek Teachers (POED), the Organisation of Greek Secondary Education Teachers (OELMEK), the Pancyprian Organisation of Technical School Teachers (OLTEK) and the Union of Banking Employees of Cyprus (ETYK).<sup>16</sup>

Cyprus had traditionally enjoyed a relatively high level of trade union organization. According to official government statistics, trade union membership was around 55 % to 58 % of the total number of employees in 2009. Following the onset of the financial crisis, the implementation of austerity measures and the rise in unemployment, trade union organization has largely decreased.

## 2. Society

### 2.1 Population and Employment

As per Table 3, the total population of Cyprus since 2008 has risen from 796 900 to 850 880 in 2011.<sup>17</sup> The increase is not only due to a rise in the fertility rate in Cyprus, unlike many of its EU counterparts,<sup>18</sup> but can also be attributed to a large increase in incoming migration.<sup>19</sup>

Table 3: Total Population of Cyprus

<b>2008</b>	796,900.0
<b>2011</b>	850,880.0

Source: European Central Bank

16. For a more in-depth analysis on this, see Ioannou, C. (2009). »The Development of the »Cypriot Corporatist Model: The Emergence of a »Corporatist Culture« and its Impact on the Process of Europeanisation«, Cyprus and European Law Review, November 2009 (10), pp. 700–36.

17. European Central Bank, official website, last accessed on 10 September 2013.

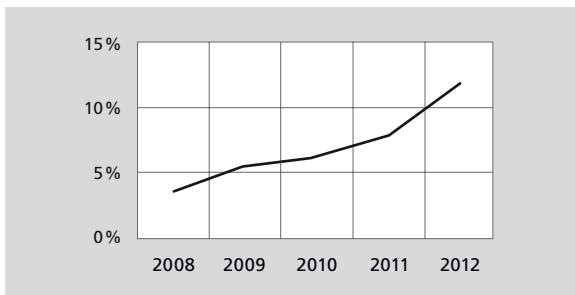
18. European Commission, The 2012 Ageing Report: Economic and budgetary projections for the EU27 Member States (2010–2060), Joint Report prepared by the European Commission (DG ECFIN) and the Economic Policy Committee (AWG), 2012, p.45.

19. Gregoriou, P., Kontolemis, Z. and Matsi M. »Immigration in Cyprus: An Analysis of the Determinants Cyprus,« Economic Policy Review, Vol.4, No. 1, 2010, p. 64–65.



The active population has also increased, owing to the excellent economic results of Cyprus (particularly in the 1990s) and the growing number of immigrants. Also indicative of this is the tripling of the active population from 3.7 % in 2008 to 11.8 % in 2012 (Figure 3).

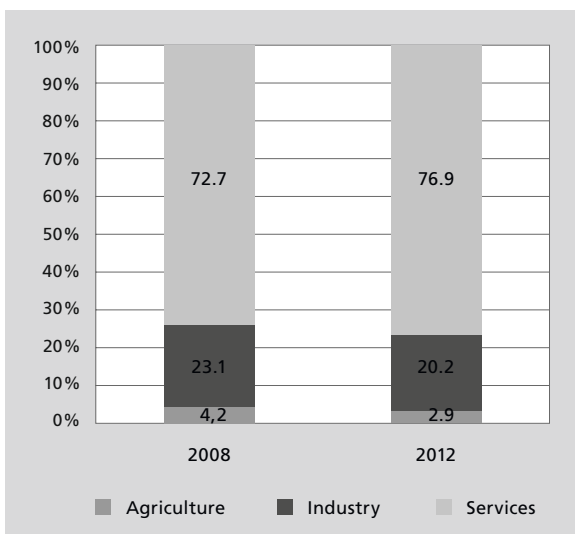
Figure 3: Active Population as percentage share of total population in Cyprus



Source: Statistical Service, Republic of Cyprus

Figure 4 highlights the fact that the biggest segment of those employed in Cyprus, to date is in the service sector. In the period 2008–2012 the percentage of those employed in the agriculture and industry sectors shrank from 4.2 % to 2 % and from 23.1 % to 20.2 % respectively.

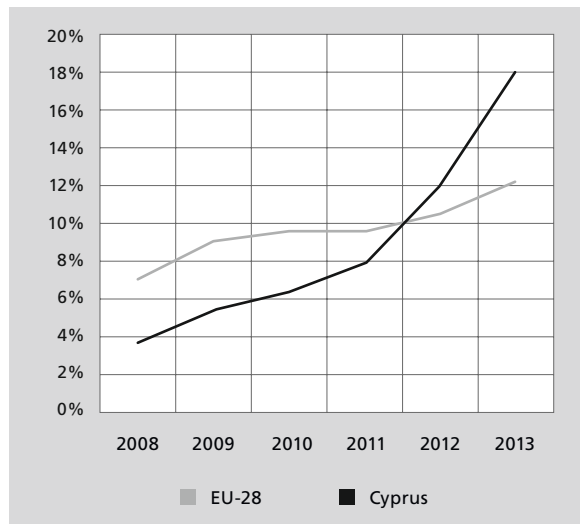
Figure 4: Employment by branch of economic activity in Cyprus: 2008, 2011



Source: Statistical Service, Republic of Cyprus

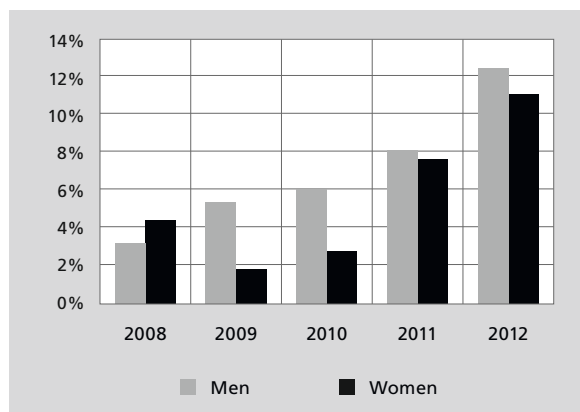
What is a very worrying is the rapidly growing unemployment rate. From the early 1980s until the late 2000s the island had prided itself for its particularly low unemployment rate. As of 2010 Cyprus has seen an unprecedented increase in unemployment reaching 17.9 % (to-date) in the second quarter of 2013 (Figure 5). The majority of unemployed are male (Figure 6).

Figure 5: Unemployment Rate



Source: Statistical Service, Republic of Cyprus

Figure 6: Unemployment Rate differentiated by Gender



Source: Statistical Service, Republic of Cyprus

Unemployment rates are expected to rise even further, with many businesses, including Small and Medium Enterprises (SMEs), declaring bankruptcy, especially in the construction sector. The freezing of hiring by all banks, coupled with the closure of the second largest bank, are

also expected to contribute to rising unemployment rates. Adding to this overall picture is the public sector, which has abolished some 1000 vacancies, previously allocated to temporary staff. The sector has also instituted a hiring freeze. Further to this, the MoU clause calling for the privatization of various semi-governmental organizations is expected to lead to further redundancies.

Clearly, the deteriorating and gloomy economic outlook is expected to keep growing in 2013 and 2014, if not further. The latest Eurozone forecast estimates that the unemployment rate will reach 19.1 % in 2013, 24.1 % in 2014 and 25.3 % in 2015.<sup>20</sup>

It should be noted that this rapidly rising unemployment rate had to some extent been anticipated within the MoU, hence the need for labour market reforms. These are intended to mitigate the impact of the crisis on employment by urging the government to limit the occurrence of long-term and youth unemployment, facilitate occupational mobility and contribute to improving the future resilience of the Cypriot economy in the face of adverse economic effects.<sup>21</sup> This mitigation of the effects of the reforms is however questionable, due to the fact that foreign investment has not picked up in Cyprus.

What is even more alarming is the soaring youth unemployment rate. The total youth unemployment ratio (for persons aged 15–24 years) is growing fast and already it seems that emigration amongst youth with professional or university skills has started and is expected to lead to a serious brain-drain. In early 2006 the average youth unemployment rate was only 10 %, while it reached 37.5 % by the first trimester of 2013.<sup>22</sup>

## 2.2 Poverty

In 2011 23.7 % of the population faced the risk of poverty<sup>23,24</sup>. The greatest poverty risk was faced by the elderly (those above 65 years of age). In 2011, 40.6 %

of the elderly faced the risk of poverty, whereas the EU average for the same period was 20 %.<sup>25</sup> 25.5 % of women face the risk of poverty as opposed to 21.8 % of men. Furthermore, non-EU nationals residing in Cyprus are at greater risk of poverty and social exclusion than either people who were born in Cyprus or in any other EU country.<sup>26</sup>

In 2011, 14 % of the population lived in households where the annual income was below the poverty rate – that is less than €10.328 per person.<sup>27</sup> What must be underlined for 2011 though is that, whereas the percentage of the population at poverty risk is decreasing (in contrast to 2010 and previous years), the figure for those at both poverty and social exclusion risk is increasing.

The current availability of data gives us limited visibility of potential shifts in poverty, inequality and social exclusion. Indeed, it is still too early to draw conclusions on more recent poverty levels. In light however of the overall assessment that 2014 is expected to be worse than 2013, in terms of economic performance,<sup>28</sup> one can expect the numbers to be overwhelming.

What can be predicted is that, with the signing of the MoU, an increasing number of households will fall below the poverty line.<sup>29</sup> Not only is the unemployment rate increasing, but a very large number of social transfers are being adjusted. Moreover one can expect that considerable re-allocation of poverty risk will take place across all age groups.

The MoU clearly and specifically highlights that many of the social transfers have to be reformed through both merging and phasing out and/or better targeting of various social transfers, so as to reduce the total number of beneficiaries while protecting the most vulnerable. This is expected to be dealt with through »the introduction of a common definition of income sources, financial assets and movable and immovable property to be

20. Ernst & Young, »Ernst & Young Eurozone Forecast: Outlook for Cyprus«, June 2013, p. 2.

21. Cyprus Memorandum of Understanding on Specific Economic Conditionality on Specific Economic Policy Conditionality, 2013, p. 25.

22. Source: Statistical Service, Cyprus.

23. *Ibid.*

24. More recent statistics do not exist poverty and social exclusion are not available at the time of writing this report.

25. Statistical Service, Έρευνα Εισοδήματος Και Συνθηκών Διαβίωσης Των Νοικοκυριών 2008–2011, Republic of Cyprus. 2011, p.6.

26. *Ibid.*, p.8.

27. *Ibid.*, p. 9.

28. European Economy, »European Economy: The Economic Adjustment Programme for Cyprus« Occasional Papers 149 | May 2013, p.53.

29. Koutsampelas C., »Social Transfers and Income Distribution in Cyprus«, Cyprus Economic Policy Review, Vol. 5, No. 2, pp. 35–55, 2011, p. 53.



taken into account for means-testing.«<sup>30</sup> This involves, amongst other things, the lowering of income thresholds, accounting for wealth and broadening the sources of income.<sup>31</sup> Taking into account that about one third of the income of the poor is derived from social transfers, these readjustments may alter the rates of poverty in the country by increasing the percentage of the population classified as poor.

### 2.3 Household income

The reforms that were undertaken in 2011 as part of the run-up to the MoU, coupled with the current austerity measures, have already reduced household income. Many businesses have made salary cuts and/or redundancies, or even closed down, causing a significant reduction in household income. Further to this there has been an increase in different forms of taxation, namely property tax, the statutory corporate income tax, tax on interest income, the bank levy on deposits raised by banks and credit institutions, as well as an overhaul of the tax system for motor vehicles.

Of importance also is the clause for the reduction of expenditure on various housing schemes. The MoU contains clauses for a Comprehensive Housing Scheme, discontinuing the special grant for acquiring a first residence and ceasing the provision of loans and loan guarantees related to house construction and acquisition under all government-administered housing schemes.<sup>32</sup>

It must be highlighted that in 2011 the then government, in the run-up to the signing of the MoU, initiated a first round of austerity cuts that had affected households located in the middle and upper strata of income distribution. The post-MoU era, with the taxes imposed and restrictions on the welfare system, will also affect the low-income households.<sup>33</sup>

30. Cyprus Memorandum of Understanding on Specific Economic Conditionality, 2013, p. 24.

31. *Ibid.*

32. Cyprus Memorandum of Understanding on Specific Economic Conditionality, 2013, p. 12–13.

33. Koutsampelas C. and Polycarpou A., »Austerity and the Income Distribution: The Case of Cyprus« EUROMOD Working Paper, 2013, No. EM 4/13.

### 2.4 Pensions

The General Social Insurance Scheme (GSIS) run by the Social Security Fund (SSF) was introduced in 1963. From 1964 onwards a reform extended compulsory insurance to every person gainfully employed in Cyprus, including all categories of self-employed. The 1980 reform introduced an earnings-related insurance scheme. This replaced the previous scheme of flat-rate contributions and benefits.<sup>34</sup>

The pension schemes in Cyprus include:<sup>35</sup>

- the General Social Insurance Scheme (GSIS) and,
- the Government Employee Pension Scheme (GEPS)
- Voluntary Provident Funds (VPFs)

It must be noted that due to the fact that the earnings-related insurance feature of the GSIS was introduced only in 1980, the pension system is still to a very large extent maturing, and many pensioners continue to face the risk of poverty today.

The occupational pension plans provide supplementary pensionable benefits to their members. The GEPS are specifically for government employees and to the Semi-governmental Sector Employees. The latter are financed almost entirely by general taxation on a pay-as-you-go basis.

The majority of private sector employees have no supplementary pension protection at all or are covered by other VPFs. These may take the form of defined contribution provident funds, which have serious weaknesses in terms of their effectiveness as retirement income vehicles.

The main source of retirement income for the majority of the workforce is the GSIS. This however does not allow for an adequate, safe and sustainable pension income. Over the years the GSIS has become financially unsustainable. The challenges it faces are multidimensional and stem from, amongst others, the decrease of fertility, increasing longevity, inadequate financing and design faults.

34. *Ibid.*, p: 175

35. Mannaris, P. »The Cypriot Pension System: Adequacy and Sustainability«, Cyprus Economic Policy Review, 2012, Vol. 6, No. 2, p. 49–58

Over the last few years reforms of the pension system have been undertaken to improve its long-term financial viability, with measures regarding the GSIS from as early as 2009 and measures targeting specifically the GEPS<sup>36</sup> in the second half of 2011.<sup>37</sup>

The MoU is directly tackling the issue of the pension system with significant reforms. It sets out the following overarching objectives regarding the reforms:

- a) To reduce the increase in pension spending
- b) To ensure the long-term financial viability of the pension system through 2060, and
- c) To limit the fiscal subsidy to the General Social Insurance Scheme for credited contributions for current and future pensioners and for the non-contributory pensions.<sup>38</sup>

## 2.5 Reforms in the health care system

It must be underlined from the onset that Cyprus lacks a universal health care system. Compounding this are issues regarding the organization as well as management of the health care system that have been depicted as obsolete and deficient. Moreover, it has a huge array of private health facilities, without any effective control by the government, or formal coordination with public healthcare, which is characterized as fostering »duplication, waste of resources and poor quality of services.«<sup>39</sup>

Access to public health remains income-related whereas free access until now was guaranteed for certain groups, specifically all public sector employees, individuals below a certain income threshold as well as certain specific categories. Over the years Cyprus has devoted a relatively small share of resources to healthcare. Healthcare expenditure as a share of GDP is one of the lowest among EU countries and well below the EU average.

36. Petmesidou, M., »Annual National Report 2012: Pensions, HealthCare and Long-term Care,« European Commission DG Employment, Social Affairs and Inclusion, 2012, p.7.

37. Cyprus Memorandum of Understanding on Specific Economic Policy Conditionality

38. *Ibid*, p: 15

39. Petmesidou, M., 2012, p. 7.

The MoU specifically outlines changes to the healthcare system, jeopardizing to a large extent the free universal coverage objective of the government. Overall it introduces or increases fees, in an attempt to create a sustainable healthcare system. It underlines the need to re-evaluate the category system, limiting access to chronic disease patients. It also specifies a contribution (1.5% of gross salaries) by public servants and public servant pensioners. It increases the fees for medical services for non-beneficiaries by 30% and pursues the increase of fees for usage of higher levels of care. It introduces financial disincentives for using emergency care services in non-urgent situations and minimizes the provision of medically unnecessary laboratory test and pharmaceuticals.<sup>40</sup> Moreover it seeks a restructuring plan for public hospitals in order to improve quality and optimize costs of hospital management.<sup>41</sup>

Clearly at a time when demand for public health services is on the rise, the government is reducing its spending on the sector in a need to meet its fiscal sustainability targets.

## 3. State

With respect to its effects on the state, the MoU aims at the promotion of fiscal consolidation through reduced spending by the public sector, increasing the efficiency of public spending and the functioning of the state apparatus, as well as enhancing revenue collection. The austerity program includes a variety of structural adjustments in order to reach these goals, including public spending cuts and tax increases such as raising VAT to 19% by 2014 and the corporate tax from 10% to 12.5% in 2013, in addition to a privatization scheme of semi-government and public-affiliated organizations that will be further described below.

### 3.1 The level of state debt

Prior to the global economic crisis, Cyprus enjoyed periods of budget surplus including in 2008 (Table 4). The crisis had an immediate and enduring effect on the state's finances with deficits consistently reaching more than 5%

40. Cyprus Memorandum of Understanding on Specific Economic Policy Conditionality

41. *Ibid*



Table 4: State budget/State debt

	2008	2009	2010	2011	2012
State budget (% of GDP)	0.90	-6.10	-5.30	-6.30	-6.30
State budget (EUR mln)	161.00	-1,031.00	-920.00	-1,132.00	-1,127.00
State debt (% of GDP)	48.90	58.50	61.30	71.10	85.80
State debt (EUR bln)	8.39	9.86	10.67	12.78	15.35

Source: Statistical Service, Republic of Cyprus

of GDP, a condition that is expected to continue unabated in 2013 and is projected to start showing signs of recovery after 2016. The level of state debt has followed a similar pattern: in real terms it has approximately doubled since 2008, while the level of state debt as a percentage of GDP has increased from 48.9% in 2008 to 85.8% in 2012 (Table 4).

In 2013, this figure is expected to exceed 120% and future projections are even grimmer: within the next three years, state debt is expected to almost double the country's GDP. This, however, is not simply an effect of public spending since the absolute level of state debt is expected to coincide with further contraction of the Cypriot economy with GDP growth anticipated no earlier than 2017 (Table 5). The first review of the austerity program by the IMF makes a more favorable prediction of state debt gradually declining toward 105 percent of GDP by 2020.<sup>42</sup>

Table 5: GDP growth

	2013	2014	2015	2016	2017
GDP growth (%)	-10.2	-7.8	-2.3	-0.2	2.2
State budget (% of GDP)	-6.0	-6.9	-5.8	-4.2	-3.4
State debt (% of GDP)	120.5	161.7	189.4	191.8	188.3

Source: Statistical Service, Republic of Cyprus

### 3.2 The interest rates for state bonds

Harmonized long-term interest rates for government bonds are used for the assessment of convergence among the EU Member States. In the case of Cyprus, average annual percentages of primary market yields are reported. Prior to the crisis, interest rates were at 4.60% starting in October 2007. They remained unaffected until June 2011 when they were increased to 5.78%. Throughout the rest of 2011 they were readjusted a number of times peaking at 7% in September. In July 2013, they were reduced to 6%.

Interest rates are relatively high compared to the rest of the Euro-area where the average of interest rates reported in August 2013 is 3.97% and even more so in comparison to the European Union as a whole which reports an average of 3.72%. According to the criterion on the convergence of interest rates all EU Member States must maintain an average nominal long-term interest rate that does not exceed by more than 2 percentage points that of, at most, the three best performing Member States in terms of price stability. Thus, Cyprus is not significantly adrift of the averages in the Eurozone and performs significantly better than other Member States that suffer the effects of the crisis such as Greece which stands at 10.01%. At the same time, it must be noted that the most stable members of the Eurozone – such as Germany and Luxembourg – have maintained interest rates of less than 2% in the past couple of years.

### 3.3 The costs and number of employees of the state sector

Public sector expenditure is one of the primary targets of the Memorandum and bringing the financial affairs of the state in order is considered essential to the

42. IMF Country Report No. 13/293.

stabilization of the economy. The objectives specified in the Memorandum are to sustain the ongoing process of fiscal consolidation in order to achieve a GDP surplus of 4% by 2018, to curtail what is deemed to be excessive public spending, and to undertake structural adjustments in order to improve taxation and fiscal sustainability.

A primary method of achieving these goals will be the implementation of measures on expenditure that target the public sector wage bill which represents a significant portion of public expenditure and the growing size of which can be regarded as a major cause of the growing government deficit. Undoubtedly, this issue was not caused by the global financial crisis as it represents a systemic effect of how the public sector model of governance was implemented in Cyprus since its independence in 1960 and how it evolved over the ensuing years. Prior to the implementation of the austerity measures that will be explained further below, the public sector wage bill accounted for between 30% and 35% of public spending between 2007 and 2012. The reported expenditure during the first two quarters of 2013 suggests that a reduction of about 9% has already been achieved, which exceeds the projection of a reduction of 7.3% by the end of the year as a result of the measures implemented. The first review of the program by the IMF illustrates that all primary balance and spending targets have either been already comfortably met or will be met by the end of the year; as a result, no additional measures have been or are expected to be proposed, while measures for 2014 and beyond will be reassessed in future reviews.

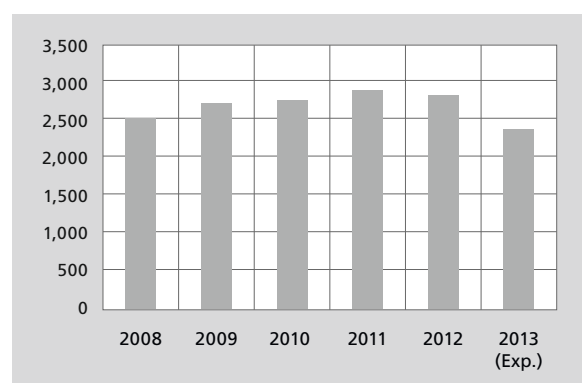
In 2012, Cyprus implemented a progressively scaled reduction in emoluments of public and broader public sector employees that ranged from 0% for the lowest wage bracket (below EUR 1000) up to 12.5% for the highest (above EUR 4000). An additional flat-rate reduction of 3% on all wages of public and broader public sector employees and pensioners will be implemented in 2014. Additional expenditure measures included the extension of the suspended practice of Cost-of-Living Adjustment (COLA) for the public and broader public sector, as well as the extension of the freeze of increments and general wage increases on gross earnings and pensions until the end of the program in 2016.

Steps were also taken to reduce the number of public sector employees by at least 4,500 over the period of

2012–16 through the implementation of a hiring freeze of new personnel on first entry posts in the broader public sector until the end of 2016, by implementing a four-year plan aimed at the abolition of at least 1880 permanent posts, and by instituting a ratio of recruitment for new positions to retirements of 1:4, as well as a hiring freeze of new hourly paid employees. Additional streamlining measures intended to bring about efficiency included measures to increase the mobility of civil servants within and across line ministries and other government entities. The reported figures of employment in the broader public sector in the first quarter of 2013 indicate that 2278 positions have already been vacated, the lion's share of which is in the central government sector.

New measures introduced in 2013 are expected to produce a reduction of at least EUR 29 million in the total outlays of allowances for public sector. This will be achieved by taxing the pensionable allowances of senior government officials and employees such as secretarial services, representation, and hospitality allowances, by implementing a 15% reduction in all other allowances provided to public sector employees and by reducing the daily overseas subsistence allowance for business trips by 15%. Additional measures include the suspension of first/business class travel by state officials other than the President of the Republic of Cyprus and the President of the House of Representatives with the exception of transatlantic travel, the abolition of the right to duty free vehicles for employed and retired senior public sector officials and the extension of the wage freeze to all state officials and permanent secretaries until 2016.

Figure 7: Public sector compensation



Source: Statistical Service, Republic of Cyprus

### 3.4 Privatization of state assets

In its letter of intent to the International Monetary Fund the Cypriot government proposed »substantial structural reforms to improve the efficiency of the public sector, including through the timely privatization of viable state-owned enterprises (SOEs),« as a central pillar of the structural fiscal reform package to be undertaken which also included the streamlining of extra-budgetary entities and the rationalization of the public sector through the discontinuation of non-core activities.

The privatization process will follow a series of steps. First, the state will establish an inventory of all assets owned by all levels of state administration (central government, municipalities and regional administrations) by the end of 2013 in order to assess the expedience of divestment, restructuring or liquidation of all SOEs. A concurrent process will determine the degree to which SOEs can conform to international standards of compatible best practices in terms of governance and will assess the business prospects, and potential liabilities of the SOEs for the state as well as the scope for orderly privatisation. The privatization plan targets specific SOEs, especially in cases where natural monopolies tend to arise, such as the telecommunications (CYTA), electricity (EAC) and ports (CPA) authorities. The plan is intended to improve economic efficiency through enhanced competition and encouragement of capital inflows, and to restore debt sustainability. The expected fundraising for the state through the privatization plan is at least EUR 1 billion by the end of the program period in 2016 and an additional EUR 400 million by 2018.

## 4. Conclusion

- The austerity program has met its targets both in terms of objective and the timeframe thus far.
- On the other hand, confidence has not been restored, primarily due to the lingering uncertainty surrounding the banking sector and the future projected performance of the Bank of Cyprus.
- The impact of the banking crisis remains undetermined and could pose further future risks, while unanticipated problems in the banking sector may resurface.
- The recession continues unabated, confirming predictions that the trend is not expected to reverse prior to 2015.
- Sectoral analysis illustrates that the »bubble« sectors of construction and financial services largely account for the economic contraction. Conversely, tourism and company registration services have remained resilient with little downward change.
- Policy implementation has been hampered by internal political divisions that are likely to further polarize the sociopolitical climate in the future.



## References

**Cyprus Memorandum of Understanding on Specific Economic Conditionality**, 2013.

**Ernst & Young**, »Ernst & Young Eurozone Forecast: Outlook for Cyprus«, June 2013.

**European Commission**, »European Economy: The Economic Adjustment Programme for Cyprus«, Occasional Papers 149 | May 2013.

**European Commission**, »The Economic Adjustment Programme for Cyprus: Conclusion of the 1st Review – Summer 2013«, Brussels, 18 Sept. 2013.

**European Commission**, »The 2012 Ageing Report: Economic and budgetary projections for the EU27 Member States (2010–2060)«, Joint Report prepared by the European Commission (DG ECFIN) and the Economic Policy Committee (AWG), 2012.

**European Commission**, Έγγραφο Εργασίας των Υπηρεσιών της Επιτροπής, Αξιολόγηση του εθνικού προγράμματος μεταρρυθμίσεων και του προγράμματος σταθερότητας του 2013 για την ΚΥΠΡΟ, SWD(2013) 363 Final, Brussels 29.5.2013.

**Gregoriou, P., Kontolemis, Z. and Matsi M.** »Immigration in Cyprus: An Analysis of the Determinants Cyprus,« Economic Policy Review, Vol.4, No. 1, 2010.

**International Monetary Fund**, »Cyprus: First Review under the extended arrangement under the extended fund facility and request for modification of performance criteria« IMF Country Report No. 13/293, Sept. 2013.

**Ioannou, C.** (2009). »The Development of the »Cypriot Corporatist Model: The Emergence of a »Corporatist Culture« and its Impact on the Process of Europeanisation«, Cyprus and European Law Review, November 2009 (10).

**Koutsampelas C.**, »Social Transfers and Income Distribution in Cyprus«, Cyprus Economic Policy Review, Vol. 5, No. 2, pp. 35–55, 2011.

**Koutsampelas C. and Polycarpou A.**, »Austerity and the Income Distribution: The Case of Cyprus« EUROMOD Working Paper, 2013, No. EM 4/13.

**Mannaris, P.** »The Cypriot Pension System: Adequacy and Sustainability«, Cyprus Economic Policy Review, Vol. 6, No. 2, 2012.

**Ministry of Finance**, Strategic Fiscal Policy Framework 2014–2016: Budget 2014, 29 May 2013.

**Petmesidou, M.**, »Annual National Report 2012: Pensions, HealthCare and Long-term Care,« European Commission DG Employment, Social Affairs and Inclusion, 2012.

**Planning Bureau**, Cyprus National Reform Programme 2013, »Europe 2020 Strategy for: Smart, Sustainable and Inclusive Growth,« Republic of Cyprus, May 2013.

**Statistical Service**, »Monthly Economic Indicators January–June 2013,« Report No. 152, Republic of Cyprus, 26 July 2013.

**Statistical Service**, »Έρευνα Εισοδήματος και Συνθηκών Διαβίωσης Των Νοικοκυριών 2008–2011,« Republic of Cyprus, 2011.



### About the authors

**Dr. Odysseas Christou** ([christou.o@unic.ac.cy](mailto:christou.o@unic.ac.cy)) is a Lecturer with the Department of European Studies and International Relations and an Associate Faculty Member of the Law Department of the University of Nicosia.

**Dr. Christina Ioannou** ([ioannou.ch@unic.ac.cy](mailto:ioannou.ch@unic.ac.cy)) is Assistant Professor of European Politics at the Department of European Studies and International Relations of the University of Nicosia and an Associate member of the Law Department.

**Mr. Anthos I. Shekeris** ([shekeris.a@unic.ac.cy](mailto:shekeris.a@unic.ac.cy)) is the Acting Director of the Research and Innovation Office of the University of Nicosia, Cyprus.

### Imprint

Friedrich-Ebert-Stiftung | Western Europe/North America |  
Hiroshimastraße 28 | 10785 Berlin | Germany

Responsible:  
Anne Seyfferth, Head, Western Europe/North America

Tel.: ++49-30-269-35-7736 | Fax: ++49-30-269-35-9249  
<http://www.fes.de/international/wil/>

To order publications:  
[FES-WENA@fes.de](mailto:FES-WENA@fes.de)

Commercial use of all media published by the Friedrich-Ebert-Stiftung (FES) is not permitted without the written consent of the FES.

The Friedrich-Ebert-Stiftung (FES) is a non-profit-making, private, independent and cultural organisation. It is represented in 14 locations in Western Europe/North America and has been active in Cyprus since 1986. The Nicosia office is part of a global network of FES offices comprising more than 100 local branches. Between 1986 and 2011, the Cyprus branch was administered by the FES Athens office, however, since 2011 Cyprus has had its own small FES office in Nicosia. As part of its activities, the FES Nicosia office organizes seminars, workshops and conferences in cooperation with local or regional NGOs, politicians, diplomats, and journalists as well as other disseminators and prepares briefings for political decision-makers.

For more information please visit: <http://www.fescyprus.org>

The views expressed in this publication are not necessarily those of the Friedrich-Ebert-Stiftung or of the organization for which the author works.



ISBN 978-3-86498-737-3