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Recommendation for a

COUNCIL RECOMMENDATION

on Cyprus's 2012 national reform programme

and delivering a Council opinion on Cyprus's stability programme for 2012-2015

{SWD(2012) 308 final}

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THE COUNCIL OF THE EUROPEAN UNION,

Having regard to the Treaty on the Functioning of the European Union, and in particular Articles 121(2) and 148(4) thereof,

Having regard to Council Regulation (EC) No 1466/97 of 7 July 1997 on the strengthening of the surveillance of budgetary positions and the surveillance and coordination of economic policies[1], and in particular Article 5(2) thereof,

Having regard to Regulation (EU) No 1176/2011 of the European Parliament and of the Council of 16 November on the prevention and correction of macroeconomic imbalances[2], and in particular Article 6(1) thereof,

Having regard to the recommendation of the European Commission[3],

Having regard to the resolutions of the European Parliament,[4]

Having regard to the conclusions of the European Council,

Having regard to the opinion of the Employment Committee,

After consulting the Economic and Financial Committee,

Whereas:

(1) On 26 March 2010, the European Council agreed to the European Commission's proposal to launch a new strategy for jobs and growth, Europe 2020, based on enhanced coordination of economic policies, which will focus on the key areas where action is needed to boost Europe's potential for sustainable growth and competitiveness.

(2) On 13 July 2010, the Council adopted a recommendation on the broad guidelines for the economic policies of the Member States and the Union (2010 to 2014) and, on 21 October 2010, adopted a decision on guidelines for the employment policies of the

1 OJ L 209, 02.08.1997, p. 1
2 OJ L 306, 23.11.2011, p. 25
3 COM(2012)308 final
4 P7_TA(2012)0048 and P7_TA(2012)0047

Member States[5], which together form the 'integrated guidelines'. Member States were invited to take the integrated guidelines into account in their national economic and employment policies.

(3) On 12 July 2011, the Council adopted a recommendation on Cyprus's national reform programme for 2011 and delivered its opinion on Cyprus's updated stability programme for 2011-2014.

(4) On 23 November 2011, the Commission adopted the second Annual Growth Survey, marking the start of the second European Semester of ex-ante and integrated policy coordination, which is anchored in the Europe 2020 strategy. On 14 February 2012, the Commission, on the basis of Regulation (EU) No 1176/2011, adopted the Alert Mechanism Report[6], in which it identified Cyprus as one of the Member States for which an in-depth review would be carried out.

(5) On 2 March 2012, the European Council endorsed the priorities for ensuring financial stability, fiscal consolidation and action to foster growth. It underscored the need to pursue growth-friendly fiscal consolidation, to restore normal lending conditions to the economy, to promote growth and competitiveness, to tackle unemployment and the social consequences of the crisis, and to modernise public administration.

(6) On 2 March 2012, the European Council also invited the Member States participating in the Euro Plus Pact to present their commitments in time for inclusion in their stability or convergence programmes and their national reform programmes.

(7) On 7 May 2012, Cyprus submitted its stability programme covering the period 2012-2015 and, on 10 May 2012, its 2012 national reform programme. In order to take account of their interlinkages, the two programmes have been assessed at the same time. The Commission has also assessed, in an in-depth review under Article 5 of Regulation (EU) No 1176/2011, whether Cyprus is affected by macroeconomic imbalances. The Commission concluded in its in-depth review[7] that Cyprus experiences an internal imbalance due to its banking sector and the indebtedness of the corporate sector and an external and an internal imbalance on its fiscal dynamics and competitiveness, although not excessive.

(8) Based on the assessment of the 2012 stability programme pursuant to Council Regulation (EC) No 1466/97, the Council is of the opinion that the macroeconomic scenario underpinning the budgetary projections in the programme appears optimistic in 2012-2014. Although incorporating a major downward revision of the growth outlook, the macroeconomic scenario underpinning the budgetary projections in the programme remains subject to downside risks, relating in particular to the evolution of domestic demand in 2012-2013. The objective of the budgetary strategy outlined in the programme is to correct the excessive deficit by 2012 and to reach the medium-term budgetary objective (MTO) by 2014, and to stay at MTO in 2015. The programme confirms the previous MTO of a balanced budget in structural terms, which adequately reflects the requirements of the Stability and Growth Pact. The

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5 Council Decision 2012/238/EU of 26 April 2012

6 COM(2012) 68 final

7 SWD(2012)152 final

planned correction of the excessive deficit is in line with the deadline set by the Council recommendation issued in the context of the Excessive Deficit Procedure on 13 July 2010. Based on the (recalculated) structural deficit,[8] the average annual fiscal effort planned at 1.5% of GDP for the period 2011-2012 is equal to the effort recommended by the Council. The envisaged progress towards the MTO in 2013 is sufficient as it is higher than the 0.5% of GDP benchmark of the Stability and Growth Pact both according to the Commission's 2012 spring forecast and the programme. The growth rate of government expenditure, taking into account discretionary revenue measures, is in line with the expenditure benchmark of the Stability and Growth Pact in 2013-2014, but not in 2015. There are risks accompanying the budgetary targets of the programme linked to the macroeconomic scenario appearing optimistic in 2012-2014 and the planned consolidation effort in 2013, party relying on not fully specified measures. According to the programme, the debt-to-GDP ratio, which amounted to 71.6% in 2011, is to increase to 72.1% in 2012 before gradually dropping to 65.4% in 2015. In terms of the debt reduction benchmark of the Stability and Growth Pact, Cyprus will be in a transition period in the years 2013-2015 and the plans presented in the programme would ensure sufficient progress towards compliance with the debt reduction benchmark. However, there are risks attached to this projection linked to the possible rescue operations of financial corporations.

(9) Tax administration is inefficient as administrative costs in relation to revenue collection in Cyprus are very high. Tax collection is relatively low. Particularly, tax administration expenditure as a share of GDP and the administration costs in relation to net revenue collection are high and on a rising trend. Measures to encourage a move away from informal/undeclared work and tackle tax evasion are necessary. Furthermore, initiatives to render tax collection more efficient should be reinforced.

(10) Given the wide exposure of Cyprus's banking institutions to the Greek economy, 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. Total exposure of the consolidated Cypriot banking sector to Greece is very high. The Cyprus Parliament adopted, on 14 December 2011, two bills to strengthen the financial system's resilience against banking crises. However, progress with the strengthening of supervision of the cooperative credit societies, which hold about 40% of all domestic deposits, has so far not been satisfactory.

(11) Cyprus faces challenges in ensuring the long-term sustainability of public finances, notably in the area of pensions. Cyprus implemented two important structural measures to reform its pension system. However, while the measures adopted are relevant and credible, the response of Cyprus is not sufficiently ambitious to secure sustainability and adequacy, and improve the system's fairness in the longer term. Measures are still required to maintain the employability of workers within enterprises and underpin the increase in the effective retirement age. In terms of poverty of the elderly, Cyprus has only partly addressed their high at-risk-of-poverty rate. The

[8] 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.

adopted measures are insufficient to improve the short-term adequacy of income for pensioners at risk of poverty.

(12) Inequity and inefficiencies in the healthcare sector have not been tackled in a meaningful manner. In spite of the recommendation given last year, no clear timeline for proceeding with the National Health Insurance System has been presented so far. This poses risks to the long-term control and sustainability of public finances and the quality of healthcare provided.

(13) The Cypriot government took some steps to respond to the 2011 recommendation on wage indexation (cost of living allowance - COLA), notably by adopting a two-year pay freeze in the broader public sector. The government and social partners also agreed to initiate a dialogue with the aim of reviewing the COLA system by the end of June 2012. A comprehensive reform of the system should be pursued, in consultation with social partners and in accordance with national practices, with a view to strengthening the link between real wages and productivity developments and making the system more equitable. This would not only support the country's competitiveness, but would also lead to a more efficient allocation of labour. While these developments are first steps in the right direction, their relevance and credibility depend 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.

(14) The worsening of the macroeconomic outlook adversely affected the Cypriot labour market, raising the unemployment rate and causing a large increase in youth unemployment. Cyprus has taken a number of positive steps to address this challenge. These measures are relevant but not ambitious enough, in particular in education and vocational training where implementation should be speeded up. Further efforts are required for resolving youth unemployment as well as for the re-skilling and up-skilling 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.

(15) As regards 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 some sectors (e.g. retail, tourism, and construction services) the adoption of sector-specific legislation is still pending. There are regulated professional services where fixed tariffs still exist, such as lawyers and architects.

(16) On the basis of the analysis in the in-depth review, it can be concluded that Cyprus is affected by imbalances. In particular, macroeconomic developments in the current account, public finances and the financial sector require close monitoring and urgent economic policy attention in order to avert any adverse effects on the functioning of the economy and economic and monetary union. More specifically, the Cypriot economy has experienced persistent and sizeable current account deficits, driven by deficits in the volume of trade due to a gradual loss in price/cost competitiveness, imbalances in the government finances that have swung to annual deficits which have widened even as the economy recovered from recession, and increasing private indebtedness. Particularly, non-financial corporations are very vulnerable due to their high indebtedness coupled with their low profitability, resulting to a significant increase in non-performing loans in this sector. Also, the high exposure of the banking sector to sovereign Greek bonds and the Greek economy is very risky. Moreover,

growth prospects are dim which further hinders the relatively slow unwinding of imbalances.

(17) Cyprus has made a number of commitments under the Euro Plus Pact. These commitments, and the implementation of the commitments presented in 2011, relate to improving competitiveness, improving the employment rate, the sustainability of public finances, and strengthening financial sustainability. The Commission has assessed the implementation of the Euro Plus Pact commitments. The results of this assessment have been taken into account in the recommendations.

(18) In the context of the European Semester, the Commission has carried out a comprehensive analysis of Cyprus's economic policy. It has assessed the stability programme and national reform programme, and presented an in-depth review. It has taken into account not only their relevance for sustainable fiscal and socio-economic policy in Cyprus but also their observance of EU rules and guidance, given the need to reinforce the overall economic governance of the European Union by providing EU-level input into future national decisions. Its recommendations under the European Semester are reflected in recommendations (1) to (7) below.

(19) In the light of this assessment, the Council has examined Cyprus's 2012 stability programme, and its opinion[9] is reflected in particular in recommendation (1) below.

(20) In the light of the results of the Commission's in-depth review and this assessment, the Council has examined Cyprus's 2012 national reform programme and Cyprus's stability programme. Its recommendations under Article 6 of Regulation (EU) No 1176/2011 are reflected in particular in recommendations (1), (2) and (7) below,

HEREBY RECOMMENDS that Cyprus should take action within the period 2012-2013 to:

1. Take additional measures to achieve a durable correction of the excessive deficit in 2012. Rigorously implement the budgetary strategy, supported by sufficiently specified measures, for the year 2013 and beyond to ensure the achievement of the medium-term budgetary objective (MTO) by 2014 and compliance with the expenditure benchmark and ensure sufficient progress with the debt reduction benchmark. Accelerate the phasing-in of an enforceable multiannual budgetary framework with a binding statutory basis and corrective mechanism. Take measures to keep tight control over expenditure and implement programme and performance budgeting as soon as possible. Improve tax compliance and fight against tax evasion. .

2. Harmonise the supervision of the cooperative credit societies in line with the standards applied for the commercial banks. Strengthen regulatory provisions for the efficient recapitalisation of the financial institutions in order to limit exposure of the financial sector to external shocks.

3. Further improve the long-term sustainability and adequacy of the pensions system and address the high at-risk-of-poverty rate for the elderly. Align the statutory retirement age with the increase in life expectancy.

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9 Under Article 5(2) of Council Regulation (EC) No 1466/97.

4. Complete and implement the national healthcare system without delay, on the basis of a roadmap, which should ensure its financial sustainability while providing universal coverage.

5. Improve the skills of the workforce to reinforce their occupational mobility towards activities of high growth and high value added. Take further measures to address youth unemployment, with emphasis on work placements in companies and promotion of self-employment. Take appropriate policy measures on the demand side to stimulate business innovation.

6. Remove unjustified obstacles in services markets, in particular by improving the implementation of the Services Directive in service sectors with the most growth potential (including tourism) and by opening up the provision of professional services.

7. Improve competitiveness including through the reform of the system of wage indexation, in consultation with social partners and in line with national practices, to better reflect productivity developments. Take steps to diversify the structure of the economy. Redress the fiscal balance by restraining expenditure.

Done at Brussels,

For the Council
The President