



# CONVERGENCE PROGRAMME

OF THE

REPUBLIC OF CYPRUS

2003-2007

MINISTRY OF FINANCE



MAY 2004

**CONVERGENCE PROGRAMME  
OF THE  
REPUBLIC OF CYPRUS**

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## **I. INTRODUCTION**

Pursuant to the Council's Regulation (EC) 1466/97, the Republic of Cyprus submits to the European Commission its first Convergence Programme 2003-2007, drawn up in accordance with the guidelines set out in the 'opinion on the content and format of stability and convergence programmes (2001 Code of Conduct)'.

Fiscal consolidation, aiming at putting public finances back on a sustainable track, is the cornerstone of this Convergence Programme. Another aspect of the Programme is the intensification of the implementation of the structural reforms in some important areas, in the context of the completion of the harmonisation process. Finally, the strategic goal of the earliest possible adoption of euro has been also accounted for, especially in the public finances and the fiscal adjustment scenario. The Authorities of Cyprus acknowledge that the promotion of the envisaged participation in the Exchange Rate Mechanism has to be supported by the preparation and implementation of a credible fiscal consolidation programme.

In view of this requirement and taking into consideration the admittedly slippages in the implementation of past fiscal consolidation programmes, the Council of Ministers decided to adopt the fiscal consolidation measures included in this programme in its meeting on the 21<sup>st</sup> of May. The Council of Ministers firmly commits itself to full and effective implementation of the proposed fiscal package and, furthermore, to take additional measures, if deemed necessary to achieve the fiscal targets in this Convergence Programme.

This Convergence Programme and the incorporated fiscal measures will be submitted to the House of Representatives. The Government of the Republic of Cyprus considers the fiscal targets set out in the Programme feasible and credible<sup>1</sup>.

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<sup>1</sup> Owing to the intensive negotiations for the solution of the Cyprus problem and the workload that had to be carried out by the technical committees during February-April 2004 and the appointment of the new Minister of Finance on 18 May 2004, it has not been possible to submit this Convergence Programme to the

On the negotiations for the solution of the Cyprus problem under the auspices of the UN and especially as regards the treatment of the economic aspects of the proposed plan, it should be noted that the authorities of Cyprus have submitted constructive proposals, with a view of meeting a three-pronged objective:

- safeguarding macroeconomic stability, after a solution of the Cyprus problem,
- securing the effective functioning of the market mechanism, and
- addressing effectively the issue of economic convergence between the G/C and the T/C constituent states.

A policy stance has been adopted so that modifications and additions sought to the Plan would be beneficial to both Greek Cypriots and Turkish Cypriots. Overall, the Ministry of Finance acknowledges that progress has been achieved in the economic sphere; however, some important issues remain to be addressed in the context of future negotiations.

## **II. ECONOMIC POLICY FRAMEWORK & OBJECTIVES**

Economic policy focuses on safeguarding macroeconomic stability and fostering sustainable economic growth under conditions of full employment, social cohesion, low inflation and a healthy balance of payments position. It also focuses on further promoting structural reforms and increasing the diversification of the economy towards higher valued added activities, in line with the parameters of the 2004 Broad Economic Policy Guidelines and pursuance to the Lisbon Strategy over the medium and long-term.

Macroeconomic stability and sustainable economic growth cannot be achieved without sound public finances. The Government of Cyprus acknowledges that, at this stage,

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House of Representatives of the Republic of Cyprus, prior to its submission to the European Commission. However, the Council of Ministers adopted the fiscal measures presented in this Convergence Programme

reaching its policy objectives first entails strict adherence to the fiscal consolidation programme put forward and, in this respect, commits itself to implement its undertakings embodied herein. Therefore, this overriding priority is inevitably the backbone of the economic policy framework and objectives set out in the Programme.

## **A. FISCAL POLICY**

Public finances continued deteriorating in the course of 2003, with the general government deficit and debt rising to 6,3% and 72,6% of GDP, respectively, compared with 4,6% and 67,4% of GDP in 2002. The poor performance in public finances in 2003 was mainly the result of the cyclical growth restraint on the economy for a second consecutive year, with economic activity much below the potential GDP growth and the consequential activation of the automatic stabilisers (1% of GDP), a tax reform that did not have a zero impact on the budget as originally anticipated (1,5% of GDP), discretionary expansionary measures introduced on the expenditure side (1,5% of GDP) and an acceleration of the implementation rate of the Development Programme (0,7% of GDP).

The Stability and Growth Pact requires public finances satisfying the medium-term objective of ‘a close to balance or in surplus’ budgetary position. Taking into account the deterioration in public finances over the preceding three years, this Programme estimates that the ‘close to balance’ objective could be reached by means of fiscal consolidation in a medium-term horizon by the end of 2008, when the deficit figure is forecast to settle below 1% of GDP. This pace of adjustment towards the above target appears appropriate sensible, especially if consideration is given to the projected short and medium-term outlook for the Cyprus economy. Relevant to these considerations is the effort to design and put forward concrete fiscal measures that, while addressing the fiscal deficiencies are not to the detriment of the main growth and sustainable development drivers of the Cyprus economy, nor to the progress of the structural reforms process.

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in an extraordinary meeting held on the 21<sup>st</sup> of May.

The strategy towards early ERM II participation and euro adoption has been also reflected in the fiscal consolidation programme. The intention of the Cyprus Government to enter the euro area as soon as possible after EU accession, if possible in 2007, remains unchanged and accordingly an early participation in the ERM II mechanism is foreseen. In terms of fiscal adjustment, this requires the general government deficit to satisfy the 3% reference value and the debt to be on a distinct downward path by 2005. This fact has been also incorporated in the Programme and is reflected in the length and pace of the projected fiscal adjustment path.

Taking into account the current status of public finances, other factors that have affected the design of the specific medium-term budgetary objectives include the overall macroeconomic framework, the possibility to deal with adverse cyclical developments and the impact of structural reforms, especially as regards institutional reforms in the budgetary process (e.g. imposition of expenditure ceilings) and government investment needs.

Overall, a tight fiscal stance is the presumed result of the corrective measures envisaged in this Convergence Programme. These measures reflect largely reinforcement and extension of the measures specified in the 2003 update of the PEP. In line with the above, the fiscal adjustment scenario projects a cautious adjustment in government balances, with the general government deficit expected to decline by 1,1 percentage points (p.p.) of GDP in 2004 to 5,2% from 6,3% of GDP in 2003, whereas gross debt is expected to increase further, up by 2,6 p.p., to 75,2% of GDP. A tight fiscal policy stance is forecast to result in a deficit level of 2,9% of GDP by the end of 2005, thus satisfying the reference value. Public debt is projected to decline to 74,8% of GDP in 2004 and be placed on a sustainable downward path for the rest of the Programme horizon. Further fiscal consolidation is expected to narrow the deficit by another 1,3 percentage points of GDP over the remaining time period (2006-2007).

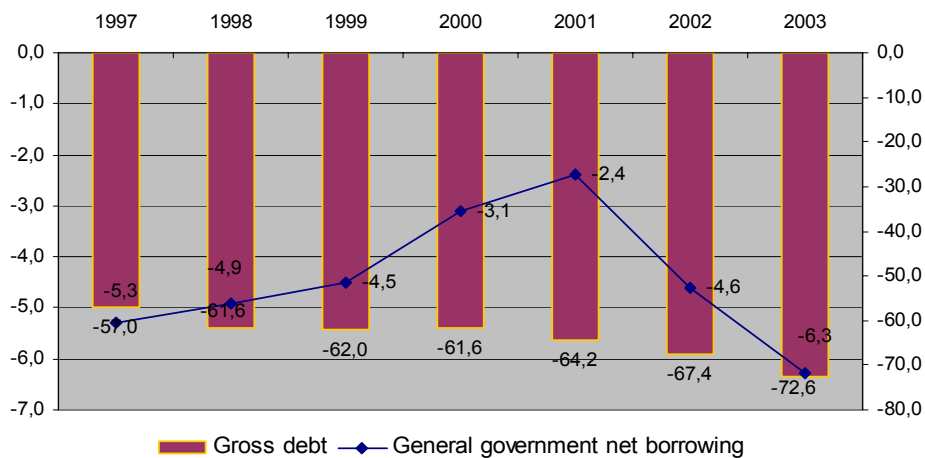
It should be stressed that the envisaged fiscal adjustment places particular emphasis on containing public consumption expenditures, while concurrently enhancing improving

revenue performance. The latter will be achieved through measures aiming at improving tax compliance and administration contributing to the adjustment process.

It is important to note that measures aimed at containing the growth of social security transfers will be a reversal in the anticipated decline in the surplus in the social security accounts and will contribute to the medium-term financial viability of the social security scheme.

As illustrated in Table 1 expenditure and revenue enhancing measures are expected to reduce the general government deficit by 2,1 p.p. of GDP in 2004, 2,6 p.p. in 2005 and by 0,8 p.p. of GDP by 2007, thus totaling 6,9 p.p. of GDP over the Programme time horizon. Improved tax compliance and administration and revenue enhancement measures are projected to raise revenues by 1,8 p.p. of GDP in 2004, 1,2 p.p. in 2005, thereby accounting for a total consideration of 3,0 p.p. of GDP. Finally, on revenue enhancing measures, the upward revision of fees and royalties for goods and services procured by the public sector, with a view to better reflecting the underlying cost, is projected to improve the fiscal stance by 0,2 p.p. of GDP over the time horizon.

**Graph 1: General Government Balance and Gross Debt (% of GDP)**





**Table 1: Implied contribution of the fiscal consolidation measures**

<i>in percent points of GDP</i>	2004	2005	2006	2007	2004-2007 Total Adjustment
<b>General Government Net Borrowing (trend scenario)</b>	<b>7,3</b>	<b>7,6</b>	<b>8,3</b>	<b>8,9</b>	<b>n/a</b>
Expenditure containing measures	0,3	1,4	0,6	0,6	2,9
Tax compliance, administration improving measures & revenue enhancing measures	1,8	1,2	0,8	0,2	4,0
<b>General Government Net Borrowing (adjustment scenario)</b>	<b>-5,2</b>	<b>-2,9</b>	<b>-2,2</b>	<b>-1,6</b>	<b>-6,9</b>

Given the fact that, fiscal consolidation went increasingly off-track in the preceding two years due to the lax and delayed implementation of policy measures outlined in the PEPs of 2002 and 2003, this Programme highlights the need of securing the political consensus for its timely and resolute implementation. It should be noted in this respect, that in-depth discussions pertinent to the specific package of measures proposed and the efforts towards achieving a broad political consensus have been delayed due to the negotiations for a solution of the Cyprus problem.

In a recent development, on 5 May 2004 the Council of Ministers has approved the introduction of two specific measures following the submission of a relevant proposal by the Ministry of Finance. These measures pertain to the imposition of expenditure ceilings on the government budget across the board, and the freeze of additional employment positions in the proposed budget for 2005. Furthermore, the Council of Ministers has adopted the whole fiscal consolidation package included in this Convergence Programme during its extraordinary meeting on the 21<sup>st</sup> of May, 2004.

## **B. MONETARY AND EXCHANGE RATE POLICY**

Historically, monetary and exchange rate policies in Cyprus have been geared towards maintaining macroeconomic stability and low inflation, in part, through the linkage of the Cyprus pound with a currency anchor, be it a single currency or a basket of currencies. As suggested by the overall positive economic performance of the country, particularly in the last two decades, where high growth, low unemployment and stable inflation rates were recorded, the policy of using the exchange rate as a means to contain inflation and inflationary expectations has served the economy well, not only in terms of safeguarding price stability, but also in terms of contributing to the country's development process, through the provision of a stable and supportive macroeconomic environment.

In the small, open economy of Cyprus domestic demand pressures are reflected in higher imports and rising external current account deficits. Generally, macroeconomic policies have been used to influence domestic demand, with a view to also keeping the current account deficit to manageable levels. However, in preparing for ERM II and eventually participation in Economic and Monetary Union, the authorities of Cyprus are aware that greater reliance has to be placed on structural reforms, labour market and fiscal policies, to maintain competitiveness and to adjust domestic demand to appropriate levels.

Moreover, in view of the prospect of giving up the exchange rate instrument in the foreseeable future and locking the Cyprus pound into the Euro, the issue of exchange rate competitiveness is being more closely monitored. Against the background of results from existing studies (including one from the IMF), which suggest that the exchange rate of the Cyprus pound was broadly in line with economic fundamentals, the recent appreciation of the Euro and its impact on exchange rate competitiveness of the Cyprus pound is being carefully monitored and analysed, also taking account various factors, including relative movements in key prices and costs affecting export profitability.

It is envisaged that the current ERM II-type exchange rate framework shall continue to be in place until the eventual adoption of the Euro. Notwithstanding the increased

difficulties that have risen because of the recent fiscal slippages, the authorities aim to join the Euro zone as early as possible after accession and towards this end, are determined to firmly maintain policies that safeguard the fulfillment of the Maastricht criteria.

The fact that the Cyprus pound has been pegged to the ECU since 1992 and the Euro since 1999, without this leading to balance of payments tensions and pressures on external reserves, provides evidence that the economy of Cyprus can sustain an early participation in the ERM II mechanism and successfully confront the challenge of adopting the Euro by 2007.

Concerning the main monetary and credit aggregates, these are expected to continue to evolve over time in accordance with the identity that links money, velocity of circulation of money, prices and real GDP, with the evolution of domestic and private credit in line with nominal GDP.

### **C. STRUCTURAL REFORMS**

Structural reforms procure the necessary grounds that, in a longer-term perspective, will enable Cyprus to develop a robust and flexible economy, exhibiting the desired resilience to external shocks, while enhancing the efficiency of the market mechanism and raising potential productive capacity.

Fiscal consolidation constitutes in its own right a structural reform to the extent that it is directed towards achieving a high degree of sustainable budgetary convergence. In that sense, restructuring public finances and tackling the issue of their quality with a view of promoting economic efficiency is crucial and this Programme incorporates this objective in the adjusted fiscal scenario (see Part IV, Fiscal Outlook and Policy Stance).

Despite the fact that the fiscal consolidation constitutes at this juncture the indisputable policy priority, other policies pursued are also expected to contribute in a longer-term

perspective towards sustaining growth performance. In the settings of this Programme, labour and product market policies, as well as policies aiming at diversifying the Cyprus economy towards higher value added activities are of particular relevance. With respect to the latter, fostering the knowledge-based economy and streamlining the business environment are key issues.

Particular attention is attached to the compliance of the objectives pursued with the 2004 update of the Broad Economic Policy Guidelines and in particular with the country-specific economic policy guidelines with regard to Cyprus. In a longer-term perspective, structural policy efforts are also directed towards meeting the objectives of the Lisbon Strategy.

#### **D. LABOUR AND PRODUCT MARKET POLICIES**

The labour market in Cyprus is relatively flexible and well functioning in conditions of nearly full employment. Cyprus is well placed in satisfying the quantified Lisbon targets. According to the Labour Force Survey, carried out in the second quarter of 2003, the unemployment rate stood at 4,1% of the economically active population, notwithstanding substantial foreign employment exceeding 10% of the gainfully employed population, indicating that Cyprus does not face an unemployment problem. The overall employment rate was 69,2%, close to the long-term Lisbon (2010) target of 70%. The respective percentage for males was 78,8% and females 60,2%. The employment rate of the persons aged 55-64 was 50,2%. Despite the specific labour market conditions, nominal wage increases from a medium-term perspective were consistent with price stability and productivity gains.

Notwithstanding the above, efforts to further enhance the labour market flexibility, improve the quality of labour supply, promote gender equality and social inclusion remain priorities. These are largely addressed by the Single Programming Document for Objective 3 of the EU structural funds, focusing on two general targets, namely the promotion of employment and the qualitative upgrading of the human capital. Relevant

policies implemented include inter alia the gradual introduction of a national system of vocational qualifications, reforms in upper secondary education, the introduction of information technology in all levels of education, continuing education and training and the development of supporting services for childcare provision and care for other dependants.

As far as the product markets are concerned, Cyprus has proceeded already to the lifting of legal and administrative restrictions and the opening up of the markets in the telecommunications, electricity and air-transport sectors, thereby fulfilling its undertakings vis-à-vis the EU. With respect to the conditions of competition, these are expected to be further strengthened following the reinforcement of the Commission for the Protection of Competition and the Commissioner for Public Aid.

In addition to the above, efforts to improve the efficiency of the public administration and other public services and the introduction of the broad tax reform implemented during 2002-2003 reducing the burden on both production factors, are contributing positively towards the creation of a business climate conducive to entrepreneurship.

## **E. DIVERSIFYING THE CYPRUS ECONOMY TOWARDS HIGHER VALUE ADDED ACTIVITIES**

In accordance with the country specific policy guidelines contained in the 2004 update of the Broad Economic Policy Guidelines, Cyprus attaches particular attention towards tackling the issue of its dependence on the tourism sector and diversifying towards higher value added activities. The need of diversification has been more profound following the September 11 events and other subsequent exogenous shocks affecting global tourism volumes, especially in the turbulent Middle East region.

Relevant to the diversification strategy is the vision of the Cyprus government to pursue, in conjunction with completing liberalisation, the enhancement of the role of Cyprus as an EU gateway in the Middle East region and a business centre providing advanced information and communication technologies.

In any case, efforts should take into account the comparative advantage and the fact that Cyprus' natural endowments favour tourism activities. This essentially means that, in parallel to the promotion of other activities a gradual diversification of the tourist product should be pursued. It should be pointed out, that the recently compiled Strategic Development Plan for Tourism acknowledges the need to differentiate Cyprus' tourist product and focus on quality through, inter alia, the advancement of infrastructure projects, the promotion of tourism incentives, special motives towards addressing the seasonality problem and the restructuring and reinforcement of the competent Cyprus Tourism Organisation (CTO).

Concurrently, the strategy to tackle the dependence on tourism problem is already in place and comes up to three main pillars: completing the structural changes in the product, capital and labour markets, intensifying the reforms targeting the transition to the knowledge-based economy and a supporting development strategy ameliorating the constraints to sustainable development mainly via the expansion and upgrading of basic

infrastructures and the development of human capital as well as the general improvement of a business climate conducive to growth.

Completing the liberalisation process of the economy through the elimination of the remaining market rigidities and the fostering of competition in goods and services markets, via also the further strengthening of the competition and regulatory authorities, will result in a reallocation of the factors of production in favour of the activities in which Cyprus possesses comparative advantages.

In addition, the liberalisation process in its own right is expected to contribute towards a higher involvement of the private initiative in the liberalised areas and thereby to the gradual transition to higher-value added activities in the tertiary sector. For instance, the recent liberalisation of the telecommunications sector and the introduction of alternative suppliers providing services in both mobile and fixed telephony has widened the variety of services and is expected to gradually lead to higher expertise and more sophisticated products and thus to higher value added.

Pertaining to the fostering of the knowledge-based economy, a range of policy objectives have been clearly set encompassing corresponding measures in the context of the Framework Programme for Research and Technological Development and the National Development Plan 2004-2006, with the overall target being the catch up with the 2006 target of a total R&D intensity of 0,5% of GDP. In broad categories these objectives pertain to advancing R&D and innovation, stepping up with the introduction of the information society, increasing the supply of trained researchers and qualified ICT personnel, upgrading of research infrastructures and improving the capability of education and training systems to adapt to skill requirements. In the context of this Convergence Programme, it should be stressed that the funds earmarked for the research projects and the supporting activities of the competent Research Promotion Foundation, were substantially increased for the 2003-2005 period.

Concerning the supportive development policy, the Government attaches particular emphasis to expanding and upgrading the infrastructure in the sectors of energy, telecommunications and transport, in line with the Growth Initiative of the EU, utilising to the extent possible the opportunities offered via the PPP initiatives. In the area of human capital development a Single Programming Document and the accompanying Programme Complement have been agreed with the European Commission and the included measures will begin to be implemented.

With respect to the business environment, enhancing competitiveness in key sectors constitutes a principal policy pillar. This includes initiatives that largely cope with the need of attracting private capital and in addition they comply with the objective of lifting technical, legal and administrative obstacles. In brief, schemes aiming at promoting entrepreneurship among women and young people with special attention on start-ups and SMEs fall in this category. In addition, the advancement of the linkages between the research and technological institutions and business, as well as the encouragement of the clustering of activities forms another intermediate objective.

### **III. ECONOMIC OUTLOOK**

#### **A. DEVELOPMENTS DURING 2003**

In 2003 real GDP continued to grow at an annual rate of 2% as in 2002, well below the potential rate of growth estimated at around 4,5%.

The slowdown is attributed mainly to the adverse external economic environment, namely the insecurity associated with the war in neighbouring Iraq and its repercussions, the subdued rate of growth within the EU, the nominal and real effective appreciation of the exchange rate of the Cyprus pound and the weak confidence environment among households and entrepreneurs.



The adverse external environment in conjunction with the nominal and real effective appreciation of the Cyprus pound resulted in a fall in tourism demand. In addition to lower tourist arrivals, there was a further decrease in per capita tourist expenditure owing mainly to the lower prices for accommodation offered by tour operators. Moreover, the weaker confidence among households and entrepreneurs led to a lower rate of expansion of private consumption and exercised a dampening impact on fixed investment. However, these adverse effects were partially offset by the relatively low interest rates prevailing in the market and the expansionary fiscal policy.

From the demand side, despite the weakening of confidence especially in the first months of 2003, growth was generated by private and public consumption, investment in construction and a satisfactory increase in exports of services other than tourism.

Private consumption though subdued during the first months of 2003, rose more rapidly later in the year due to the increase in disposable income resulting mainly from the implementation of the second phase of the tax reform. Overall, private consumption recorded a 2% increase in real terms compared to 2,5% in 2002.

Public consumption also accelerated reflecting the expansionary fiscal policy stance in an effort to boost the economy during and after the Iraq crisis recording a 2,7% increase in 2003.

The rate of expansion of gross fixed capital formation, excluding expenditure on aircrafts and ships, grew by almost 5% owing to the continued strong rate of expansion of investment in construction.

While exports of goods and tourism declined in 2003, a satisfactory growth was recorded in the exports of services other than tourism. Overall, the year closed with a very small increase in exports of goods of services in real terms equal to around 0,5% reflecting the dynamism exhibited by the other services beyond tourism and the gradual process of diversification of the economy leading to a lower dependency on tourism.

In the labour market a small increase in the LFS (Labour Force Survey) unemployment rate was recorded in the second quarter of 2003, compared with 3,3% in 2002. This development was due to the continued restrained rate of growth of real GDP for a second consecutive year. At the same time nominal wage increases were limited to a 5% increase. The cyclical slowdown in economic activity resulted in labour productivity rising by approximately 1% and an increase in unit labour costs by 3,5% affecting adversely short-term profitability and competitiveness.

Inflation, as measured by the GDP deflator, rose to 5,3% in the year due to a number of one-off factors such as the increase of the VAT rates, and other indirect taxes. In contrast, the subdued economic growth in conjunction with the nominal effective appreciation of the Cyprus pound vis-à-vis the U.S. dollar and pound sterling which led to an overall fall in import prices, exercised a dampening effect on inflation. As a result, core inflation remained low at around 2,5% in 2003.

According to the balance of payments data which are currently being revised the current account balance for 2003 recorded a deficit of 4,4% of GDP compared with 5,4% of GDP in 2002. The improvement in the 2003 current account balance reflects the decline in military imports and the impact of the once-off imports of aircraft that took place in 2002 and, on the other hand, the lower imports resulting from the restrained rate of growth and the improvement in the terms of trade due to the exchange rate changes. Revenue from tourism reported a similar decrease of around 10% as in 2002.

In 2003 there was a slowdown both in the growth of total money supply (M2) and credit to the private sector. The annual growth rates of these aggregates reached 4% and 5% respectively, compared with 10,3% and 8,0% in the previous year. The deceleration in M2 was partly the result of the low credit growth and increase in the loan capital of some banks. The deceleration in credit to the private sector was mainly due to the general economic slowdown and the stricter lending policies of banks. The short-term (3-month)

Nibor rate (Nicosia Interbank Offered Rate) averaged 3,90% in 2003, while the long-term interest rate (yield on 10-year government bonds) averaged at 4,70% in 2003.

During 2003, there was only one reduction in the official interest rate by 50 basis points, taking place in April, owing to the uncertainty entailed by the war in Iraq and the general slowdown in the domestic and international economies. This move followed corresponding interest rate reductions by major central banks, including the ECB. Since April 2003 and for the rest of the year the official interest rates remained unchanged. The wait-and-see stance is based on the fact that domestic economic activity was expected to rebound in 2004 and inflationary pressures are expected to subside in 2004, mainly due to the phasing out of VAT and excise duty rate effects. The Monetary Policy Committee (MPC) has repeatedly emphasised the need for fiscal discipline. As far as the operational framework is concerned, there have been no major changes since January 2003. The Central Bank of Cyprus continued to intervene in the market to absorb surplus liquidity via acceptances of deposits.

During 2003 the Cyprus pound displayed very small fluctuations against the euro reaching EUR 1,7054 on 31 December 2003 (opening selling price) compared with EUR 1,7390 on 31 December 2002. According to the present exchange rate policy framework, the fluctuation margins of the Cypriot currency are set at  $\pm 15\%$  of the central parity, which is in line with Exchange Rate Mechanism II. During 2003, as in previous years, the Cyprus pound fluctuated against the euro within the  $\pm 2,25\%$  of its central parity.

**Table 2: Selected Economic Indicators**

<i>Annual % change</i>	<b>2002</b>	<b>2003</b>	<b>2004</b>
Real GDP growth rate	2,0	2,0	3,5
Inflation rate (GDP Deflator)	2,8	5,3	1,7
Core inflation <sup>2</sup>	1,9	2,5	2,2
Unemployment rate (registered)	3,2	3,5	3,4
Unemployment rate (Labour Force Survey) <sup>3</sup>	3,3	4,1	3,9
Current account balance (% of GDP)	-5,4	-4,4	-4,4

<sup>2</sup> As a proxy for core inflation, the consumer price index excluding fresh fruit and vegetable items, petroleum products and indirect taxes (including VAT) is used.

<sup>3</sup> The LFS unemployment rate refers to the second quarter of each year.

## **B. SHORT-TERM PROSPECTS FOR 2004**

Economic developments are expected to improve in 2004 and GDP is expected to record an increase of 3,5% in real terms compared to 2% in 2003. It is noted that GDP growth will remain below the potential GDP growth, which was provisionally estimated at 4-4,5%.

Projections for 2004 are based on the assumption that there will be an acceleration of the rate of growth of our main economic partners this year hence benefiting tourism<sup>4</sup> and other tourism related activities. Furthermore, the anticipated improvement of confidence among households and entrepreneurs is also expected to contribute towards a rebound in economic activity. Both these factors, a more favourable external environment and an improvement of confidence are expected to lead to a narrowing of the output gap recorded in 2002-2003.

On the negative side, factors hindering growth are expected to be the continuing real effective appreciation of the exchange rate, the introduction of a more restrained fiscal policy and the increase in key Central Bank interest rates on 30/04/04. Concerning oil prices the assumption made for the price of oil was \$31,1 per barrel.

The main risks for the rate of growth of the Cyprus economy in 2004 are considered to be the following:

- a slower rate of growth for our main economic partners
- any further real effective appreciation of the Cyprus pound resulting from a further appreciation of the euro vis-à-vis the dollar and sterling pound

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<sup>4</sup> It is noted here that the liberalization in the movement of people and economic activity between the government-controlled area and the occupied part is expected to lead to a small diversion of tourism towards the occupied area but this is not expected to substantially affect the overall trends in tourism.

- the price of oil - should the price of oil remain at its mid May 2004 levels, it would have detrimental effects on the rate of growth, the current account balance and the rate of inflation<sup>5</sup>.

Regarding employment, owing to the recovery of economic activity, a reduction in the unemployment rate<sup>6</sup> is expected to approximately 3,9% for 2004 compared with 4,1% in 2003.

Inflation, as measured by the retail price index, is expected to fall to 2% in 2004 compared to 4,1% in 2003 due to the fact that the impact of the rise in the VAT and excise duty rates has ceased to exist. In addition, unit labour cost is projected to increase by 2,3%, broadly in line with the inflation rate, which in effect will result in near zero real increase. In contrast, the maintenance of international oil prices at current levels (at US\$37,5/barrel for Brent crude oil) will place upward pressures on domestic prices.

The current account deficit as a percentage of GDP for 2004 is expected to fluctuate at its 2003 level, reflecting a partial rebound in both the exports and imports of goods and services.

The negative political climate in April 2004 due mainly to the political instability and uncertainty supported by the referendum on the Annan Plan, combined with the abolition of capital controls on 1 May and the concurrent rumours of an imminent devaluation resulted in an increase in the outflow of capital during the last few weeks of April. Even though these outflows were not particularly large, the Monetary Policy Committee raised interest rates on 30 April by 100 basis points, a pre-emptive move meant to send a strong signal to the markets. Although it is very early to make a conclusive assessment of the result of these rate rises, so far it appears that markets have stabilised and the outflow of capital has been significantly reduced, and indeed during the last few days there have been inflows of capital.

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<sup>5</sup> According to recent developments, the price of oil accelerated further. The possible effects were not included in the current Convergence Programme.

<sup>6</sup> Unemployment rate here refers to the labour force survey rate of unemployment.

### **C. MEDIUM-TERM OUTLOOK FOR 2005-2007**

Buoyant domestic demand, growing by an average of around 4%, will be the main growth driver of the Cyprus economy for the 2005-2007 period, boosting the annual real GDP growth to peak to 4,5% by 2007. As a direct implication of the projected short and medium-term growth scenario, the output gap will gradually narrow and close by 2007, thereby putting an end to the less than optimal utilisation of the production factors, observed in the recent years.

As for the particular components of the domestic demand, private final consumption expenditure is projected to rise by around 3,7% per annum, while total investment is set to further grow by an average of 5,3% over the said period, with its main component being the investment in construction, assumed to expand annually by a constant 4% throughout the period. The latter is mainly driven by the strong demand for new buildings, expected to persist over the medium-term. Public final consumption is projected to increase in real terms by around 2,5% annually over the 2005-2007 period, after having fallen by 3,2% in 2004 owing to the containment of defence and other consumption expenditures, within the framework of the implementation of this Programme.

From the supply side, the tertiary sectors that continue to be the main contributor will marginally increase their share to 76,5% of GDP in 2005 and are projected to reach as much as 77,1% of GDP by the end of 2007. Real estate and business activities, communication and wholesale and retail trade, constitute the main growth sources of the tertiary sector. Noteworthy is the anticipated somewhat lower contribution of restaurants and hotels to GDP, following a sharper decline in the contribution of the sector in 2002 and 2003, implying the increasing role of other tertiary production sectors, such as health, education and of course real estate and business activities. Consistent with the above remark is the fact that exports of tourism to GDP are projected to fluctuate around 15%,

whereas the share of other services to GDP is expected to increase further over the time horizon and exceed 30% by the end of 2007.

In line with a strong revival in tourist revenues, up by 7% in 2005, the external sector, is set to support the rise in real GDP growth with total exports of goods and services growing by 6,4% in real terms and total imports growing at a lower rate of 4,9%, thereby resulting in an external stimulus. The latter is expected to continue for 2006 and 2007, with total exports surging by 6,8 and 6,9% and total imports advancing at lower rates, by 5,1% and 5,4% respectively. Therefore, receipts from services, income and transfers will to a great extent offset the trade deficit and the resulting current account balance is forecast to register an improvement. An average current account deficit of 3% of GDP is anticipated.

Following the completion of the capital account liberalisation in conjunction with the more liberalised environment, the contracting of more infrastructure projects to the private sector and profitable opportunities in the services sectors, including inter alia the area of education and health, as well as the increased tendency of foreigners to purchase real estate, inward foreign direct investment is forecast to expand. Overall, the financial account will continue financing to a large extent the current account deficit, thereby allowing official foreign exchange reserves to remain at a comfortable level.

Moderate inflationary pressures are assumed for the 2005-2007 period, as evidenced by the GDP deflator. A restrictive fiscal policy and lower unit labour cost increases are expected to contribute towards this development. The GDP deflator is expected to average 1,9% for the three-year period.

The labour market will continue functioning within nearly full employment conditions with an average 1,2% increase in the total employment rate. Employment will record an increase above average in construction, real estate and business activities and other community, social and personal services, in line with the forecast growth patterns of these sectors. Registered unemployment is expected to fall to 3,2% in 2005 and level off



at around 3% in 2007. Productivity is assumed to record average improvement of 3,1%, following the weak productivity performance due to cyclical factors over the preceding two years in most of the sectors of tertiary production. Nominal earnings increase is projected to be contained to around 4,5% per annum throughout the period, with real earnings expanding at an annual rate of 2,5%, thereby implying sound wage policy settings. Unit labour cost is forecast to show a moderate increase of 1,5% per annum, in line with the containment in nominal earnings and increased productivity.

On the medium-term programme, monetary sector developments for the period up to the year 2007 are envisaged to evolve in line with price and exchange rate considerations discussed previously and in line with the evolution of the real economy. In particular, based on the identity embodied in the relationship between money, on the one hand, and prices, real GDP and the velocity of circulation of money, on the other, broad money is calculated to accelerate after a significant drop in 2003 (table 3). The evolution of credit, both domestic and private, is again expected to rebound after a slump in 2003 exhibiting a moderate acceleration in the 2004–2007 period. These projections are consistent with a healthy evolution of the overall macroeconomic conditions under the medium-term programme, in that they do not introduce inflationary pressures in the economy.

**Table 3: Monetary and Credit Aggregates**

<i>in percent points of GDP</i>	1999	2000	2001	2002	2003	2004 proj.	2005 proj.	2006 proj.	2007 proj.
Broad Money (£ m.)	5993,0	6532,6	7402,6	8165,2	8491,4	9043,4	9676,4	10373,1	11151,1
Growth rate in %	17,2	9,0	13,3	10,3	4,0	6,5	7,0	7,2	7,5
Reserve Money (£ m.)	1023,8	1137,1	1221,9	1498,8	1571,4	1654,9	1746,6	1846,4	1962,6
Growth rate in %	15,0	11,1	7,5	22,7	4,8	5,3	5,5	5,7	6,3
Domestic Credit (£ m.)	6840,3	7661,1	8804,2	9642,4	10209,1	10967,6	11735,4	12575,7	13495,0
Growth rate in %	12,7	12,0	14,9	9,5	5,9	7,4	7,0	7,2	7,3
Private Credit (£ m.)	5702,2	6516,0	7320,1	7904,1	8302,4	8803,5	9344,1	10017,0	10782,8
Growth rate in %	14,4	14,3	12,3	8,0	5,0	6,0	6,1	7,2	7,6

## **IV. FISCAL OUTLOOK AND POLICY STANCE**

### **A. FISCAL OUTLOOK**

#### **1. Tax and Expenditure Policies**

Both tax and expenditure policies currently being introduced are directed towards achieving the basic target set in this Convergence Programme.

##### *Tax*

These policies will be implemented against the background of the recently implemented tax reform, that broadened the tax base and reduced, in parallel, the marginal tax rates and hence the tax burden on physical and legal persons considerably, placing it among the lowest in Europe. This reform is envisaged to foster economic growth and, in conjunction with the envisaged improvement in tax administration and compliance, boost tax revenues over the medium - term.

Cyprus was required to harmonise its indirect taxation laws, which basically encompass the VAT law and excise duties laws on four product categories, including the complete adoption of the Common Customs Tariff. In more specific terms, Cyprus had to adopt the minimum requirements prescribed by the relevant acquis with respect to the excise duties and VAT rates, including the establishment of a common value added tax base. This process of harmonization commenced in July 2002 with a comprehensive tax reform, and was fully implemented by May 2004. The tax reform focused on shifting the tax burden from direct to indirect taxation. Concurrently, expenditure compensating social measures have been introduced, addressed to specific social groups, in order to alleviate any negative effects of the tax reform.

Apart from the reinforcement of the tax administration and compliance measures envisaged in the last PEP, the Government plans to introduce the following taxation measures:

- Regularisation of dividend income policy for semi governmental organizations with a budgetary impact of 0,5% of GDP in 2004.
- Raising of airport taxes and landing fees in 2005 which will have a budgetary impact of 0,1% of GDP in that year.
- Introduction of a mobile telecommunications tax with a budgetary impact of 0,1% of GDP also in 2005.
- Introduction of betterment charge on land appreciation due to zoning changes or modifications in 2005 with a budgetary impact of 0,1% of GDP.

In conjunction to the above, the pending approval of the corresponding Bills governing the Bank secrecy and the taxation of undeclared income earned in the past is expected to raise revenues in 2004 by 0,7p.p. of GDP. In addition, the resolution of the issue of title deeds for buildings erected with minor irregularities is expected to enhance revenue considerably over the programming period.

It is noted that for the Convergence Programme period no further tax measures are anticipated. However, they may become necessary if for any reason divergences from the targets set in this Plan emerge.

#### Expenditure

With regard to expenditures policy the major objective is the containment of the growth of public expenditures to well below nominal GDP growth. Special attention is attached to restraining the growth of consumption expenditure items, particularly wages and salaries and current transfers that have risen rapidly in recent years.

Based on this policy, among other measures, a freeze of employment and contractual wage increases in the broad public sector is planned, while spending ceilings have been introduced in the compilation of the 2005 Government Budget. These ceilings were set at 3% and 4%, respectively, for increases of current and development expenditures compared with the 2004 Budget. The policy of applying annual expenditure ceilings will be continued over the medium term.

Furthermore, taking into consideration the demographic projections and the age-dependent profile of public expenditure, reform of the Social Security System as well as the Government's Pension System are considered essential elements of this Convergence Programme.

The above described tax and expenditure policies are in line with the BEPG recommendation on Cyprus to "ensure expenditure control at all levels of government".

## **2. Prospects for General Government Finances**

### (a) Overview of Public Finances

The deterioration in the general government finances continued in 2003, as the net borrowing rose from 4,6% of GDP in 2002 to 6,3%, while the government gross debt increased to 72,6% of GDP compared with 67,4% in 2002 (table 6). The targets of the Pre-accession Economic Program for fiscal deficit and public debt in 2003 were 5,4% and 63,6% of GDP<sup>7</sup> respectively. Although the rate of economic growth continued to be subdued in 2003 at 2%, estimates of the cyclically-adjusted budgetary balances show that the higher deficit in 2003 was mainly attributable to an expansionary fiscal policy stance (table 7). Indeed, the growth rate of government expenditure accelerated to over 18% in 2003 (table 9), while the net impact of the tax reform on the public finances was much more adverse than originally anticipated. As table 6 indicates total expenditure grew by 4 p.p. of GDP in 2003, while total revenues grew only by 2,3p.p. of GDP.

An important factor accounting for the deterioration in public finances during 2003 compared to the anticipated outcome for the same year outlined in the 2003 PEP was the acceleration of the government development programme. Development expenditures in 2003 grew by an average rate of 30% compared with the previous year. This is evident also in the rise of development expenditures as a percentage to GDP by 0,7 p.p., from 2002 to 2003. Additional factors affecting negatively the developments in public finances in 2003 were the excessive growth of other current transfers and purchases of goods and services which grew by more than 30% and 15% compared with the previous year respectively.

On the basis of the existing trends and policy stance, these unfavourable government finance developments were expected to continue into 2004 and beyond.

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<sup>7</sup> The considerable difference between debt as a percentage of GDP incorporated in the 2003 PEP and the one incorporated in this Convergence Programme is mainly attributed to the reclassification of sinking fund deposits under assets. Previously sinking fund deposits which were accumulated for the redemption of government long term debt were consolidated with short term liabilities thus leading to a lower debt level.

The projected worsening of the government finances, over the medium term especially as compared with the targets projected in the Pre-accession Economic Programme (PEP), 2003-2006 can be ascribed, largely, to the limited and lax implementation of the fiscal adjustment measures outlined in the 2003 PEP.

It is against this background, that the Government has taken action to reinforce, add to, and fully implement the revenue enhancement and expenditure restraining measures described in the 2003 PEP, so as to place the government finances on a sustainable path over the medium-term. These fiscal measures, which are described in detail below, constitute the foundation of a revamped fiscal consolidation programme for the period 2004 to 2007.

(b) Prospects for the Public Finances

The cyclical economic downturn and the associated lower than anticipated income and corporate profits, the negative impact of the tax reform and an expansionary fiscal policy, all led to a considerable rise of the general government net borrowing in 2003 and a worsening of the structural deficit of the Government by nearly 2 percentage points of GDP.

These unfavourable developments impacted negatively on the prospects for 2004 as well.

The general government deficit for 2004 is estimated to decrease both in absolute terms and as a percentage of GDP but not as much as originally anticipated in the 2003 PEP. It is estimated that the fiscal deficit will be contained to around 5,2% of GDP exhibiting a decrease of the order of 1,1 percentage points of GDP compared to the estimated outcome in 2003. The major factors that are driving the developments in public finances during 2004 are the continuing output gap, which negatively affects public revenues, the prevailing adverse effects of the compensating expenditure measures introduced in the

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Currently, sinking fund deposits are recorded under government assets thus having no impact on gross debt

context of the tax reform as well as continuing discretionary increases in public expenditures. Hence, notwithstanding the considerable deceleration in the growth of wages and salaries and the substantial reduction in defence outlays, the outlook of public finances is unfavourable and additional corrective measures were considered necessary by the Cyprus authorities.

### **3. Revenues**

#### (a) Tax revenue

The reform of the taxation system that was effected mainly in 2002 and 2003 (see details in Appendix II) was characterized by a shift of the tax burden from direct to indirect taxation. This structural change was reflected in the developments in 2003, where tax revenues compared to the previous year rose moderately by 9% as a result mainly of a 25% increase in indirect tax revenues, more than offsetting an 8% decline in direct tax revenues.

The tax reform, originally aimed at having a zero impact on public finances; during the negotiations process between the Government and the political parties this was not upheld, as concessions particularly in the form of compensatory current transfers were made, in order to secure broad political support. As a consequence, the outcome in 2002 and 2003 recorded a considerable deviation compared with the anticipated net impact. It is estimated that the impact on general government net borrowing of the tax reform in 2003 alone was of the order of 1,5% of GDP.

#### (b) Non - Tax revenue

Non-tax revenue exhibited a considerable increase in 2003 by approximately 35% compared to 2002, that was mainly attributed to the dividend income, approximating 1,9% of GDP, derived from two semi – governmental organizations, namely the Cyprus Telecommunications Authority and the Electricity Authority of Cyprus. In contrast non-

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level.

tax revenues during 2003 were also affected adversely by the government's policy aiming at alleviating the negative repercussions of the unfavourable external environment prevailing at the time on the tourist sector. Thus, the application of landing fees and airport taxes was suspended for a period of 12 months , leading to a loss of revenue approximating 0,3% of GDP.



#### **4. Public expenditure**

Government expenditure in 2003 exhibited a very high increase of around 18% compared to the previous year. This development resulted partly from the introduction of compensating social expenditure measures, in order to alleviate the negative effects of the tax reform, along with a counter-cyclical acceleration of the investment programme. In addition, contractual wage and salary increases granted to all public sector employees as well as the payment of salary arrears in 2003 resulted in an exceptional increase in the wage and salary bill of around 18%.

The growth of total public expenditure in 2004 is estimated to show a sharp deceleration, rising only by 4,5%, as compared with over 18% in 2003. This pronounced slowdown is attributed to:

- Deceleration in the growth of wages and salaries.
- Expected reduction in defence outlays by 1,3 percent points of GDP.
- Considerable moderation in the growth of capital expenditures, from the unusually high levels in 2003.

Although the above anticipated developments will have a positive impact on public finance developments, the developments in the area of revenues under a trend scenario more than offset any improvements on the expenditure side.

Over the medium term the annual growth rate of capital expenditure will be kept at around 6%, thus maintaining it stable as a percentage to GDP over the programming period. The Government intends to maintain its policy on containing direct outlays for infrastructure projects by using the Build Operate and Transfer (BOT) method, thus spreading the costs of these projects over a long period.

## **B. FISCAL POLICY STANCE**

### **(1) The 2003 Fiscal Consolidation Programme**

The Government elected in February 2002 committed itself to adhering to the guidelines and principles prescribed by the Stability and Growth Pact and the Broad Economic Policy Guidelines. Henceforth, with the aim of improving the performance of public finances and acceding to the Eurozone as soon as possible, a Fiscal Consolidation Programme was prepared covering the period 2003-2006. This Programme included a set of measures aimed at tackling rising fiscal imbalances and supporting the restraints on general government expenditure. Revenue measures were also included, concentrating on improving tax administration and tax compliance and revising the fees and royalties charged by the government for all goods and services provided. In addition, measures aimed at containing the rate of growth of certain types of current expenditures, especially wages and salaries and pensions and gratuities, are currently being instituted. The forecast recovery of the Cyprus economy was expected to improve prospects for the public finances. The revised Fiscal Consolidation Programme covering the said period targeted at a gradual reduction of the general government deficit to around 2,2% of GDP by 2006 and a containment of gross public debt to around 56% of GDP over the period. As outlined in the 2003 PEP, these fiscal adjustment measures were mainly based on the following policies:

#### (a) Revenue Enhancing Measures:

- Revision of all fees and royalties charged by the Government to reflect the cost of the service or product provided.
- Introduction of specific measures to strengthen tax administration.
- Introduction of specific measures to improve tax compliance.
- Accelerated collection of arrears of revenue.

(b) Expenditure Containing Measures:

- Introduction of measures to contain the wage bill and improve simultaneously the productivity of the civil service.
- Reduction and containment of certain expenditure items such as security outlays, subsidies and other current transfers.
- Gradual introduction of a Multi-Year Fiscal Framework, with pre-specified spending restraints for each Ministry.

The impact of the introduction of the above-mentioned revenue and expenditure measures were quantified and incorporated in the revised fiscal consolidation programme. In this connection, the introduction of the tax compliance and administrative improving measures along with the collection of tax arrears were estimated to bring additional tax receipts of the order of around 1,3% of GDP by 2006, while the revision of fees and royalties were projected to add another 1,1% of GDP. The expenditure containing measures have been quantified to reduce current expenditures by 2% of GDP by 2006.

The set of revenue improving and expenditure containing measures, proposed through the Programme failed to materialize as originally anticipated.

More specifically, the two Bills that have been submitted to the House of Representatives on 4 December 2003 offering tax concessions to physical and legal persons for undeclared income, including capital exported in the past have not yet been approved. Furthermore, the Bill addressing the issue of bank secrecy that was also submitted to the House of Representatives on 20 November 2003, has not been approved either. Therefore, the additional revenues that were expected to impact positively on public finances did not yet materialise. The corresponding Bills have been anticipated in the 2003 PEP to come into force by January 2004.

In addition, measures providing for the automatic exchange of information between the revenue collecting departments along with the replacement of the Cyprus Tourist Organization tax of 3% with the simultaneous increase of the VAT levied on restaurants and hotels have not been implemented, because of administrative difficulties.

Furthermore, the planned restraint over the growth of current transfers and other current expenditure items was not achieved owing to discretionary decisions such as increasing transfers to certain semi-government organisations and slippages in expenditure control.

The measures that have been implemented to date out of those outlined in last years' PEP are:

- Revision of fees and royalties charged by the Government for services rendered.
- Electronic submission of tax returns via the internet (Taxisnet).
- Setting of expenditure ceilings across the board for the compilation of the 2005 annual Budget.

The delay experienced in the implementation of the proposed fiscal consolidation measures impacted negatively on the developments and prospects for the public finances.

The government deficit as a percentage of GDP was originally estimated in last year's PEP at around 5,4% for 2003. Preliminary estimates based on data not yet finalized indicate that the government deficit for that year deviates considerably, rising to 6,3% of GDP.

This deterioration is attributed mainly to the following factors:

- Acceleration of the implementation of the development programme (0,7% of GDP).
- Increase in the provision of subsidies (0,3% of GDP).

- Improved revenue performance (0,1% of GDP)<sup>8</sup>.

The outcome for 2004 is anticipated also to be negatively affected from the carryover of actual unfavourable developments of 2003. In the PEP, it was projected that the government deficit for 2004 would be reduced to around 3,7% of GDP as a result of the timely implementation of the fiscal consolidation programme. Unfortunately, partly due to the limited application of the proposed revenue improving and expenditure containing measures set out in the 2003 PEP and partly due to the revision in the growth prospects of the domestic economy the outcome for the public finances looks unfavourable.

The deterioration in the prospects of public finances for 2004 will mainly stem from by:

- Slower domestic economic growth than originally anticipated.
- Increase of key interest rates by 100 basis points as from 30.4.2004.
- Delays in the implementation of the proposed fiscal consolidation measures set out in the PEP of 2003.

Furthermore, the outcome for 2004 will be affected negatively by the complete application of the Common Customs Tariff and the implementation of the final stage of the tax reform as from 1<sup>st</sup> May and 1<sup>st</sup> January 2004, respectively. It is noted that VAT revenues will be negatively affected during and after the year of accession to the EU as VAT from then on will be collected upon consumption of the product<sup>9</sup> or service and not upon arrival at the port of entry as was the case prior to accession. It should be also noted, however, that the harmonisation of the VAT base with the relevant acquis as from 1<sup>st</sup> May 2004 will marginally improve the revenue performance as the base was widened.

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<sup>8</sup> The improvement in revenue performance is due to collection of dividend income by the two semi-governmental organizations.

**(2) Fiscal Consolidation Programme 2004-2007**

The limited and delayed implementation of the proposed fiscal consolidation measures lead to the failure of containing the rising fiscal deficits and public debt. Hence, as the policy objective of the Government remains the accession to the Eurozone as soon as possible there was a need for the implementation of a comprehensive and revamped fiscal consolidation programme. This Programme must be rapidly implemented aiming at reversing the current trends and enabling the government to achieve the objectives set at the beginning of its term. These objectives include as already stated the sizeable reduction of the general government deficit to below 3% of GDP by 2005 and the setting of government gross debt on a distinct downward path.

The Government, acknowledging the fact that high deficits and rising public debt are undesirable and having regard to the effects of an ageing population on the long term sustainability of public finances decided to focus on a specific set of measures to reverse the current unfavourable trends and prospects. The aim of the measures is to effect a substantial reduction in the structural deficit, while concurrently raising the primary balance into a surplus, thus putting the debt to GDP ratio on a distinct downward path.

*Fiscal Sustainability*

The fiscal consolidation programme outlined in the Pre-accession Economic Programmes of 2002 and 2003 has deviated from targets. The current fiscal stance of public finances indicates a continued deterioration of the structural deficit of the general government sector under a base or non-adjustment scenario. Accordingly, the aim of this Convergence Programme which covers the period 2004-2007 is to gradually reduce the general government deficit to below 2% of GDP by 2007, create a rising surplus in the primary balance to around 2% of GDP by the said year and reverse significantly the upward trend of the ratio of debt to GDP. The final objective is to achieve over the medium term a general government net position close to balance and place the debt to

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<sup>9</sup> It refers to products and services originating from the EU. In 2003 55,5% of the total imports of goods of

GDP ratio on a distinct downward path to below 69% of GDP by the end of the programming period.

Having regard to the policy objective set, the Ministry of Finance has prepared a specific set of measures, which upon implementation will improve substantially the structural position of the general government.

The timetable of implementation of the proposed fiscal consolidation measures including their impact as a percentage to GDP on the general government net borrowing are outlined in the table below.

**Table 4: Fiscal Consolidation Measures**

budgetary impact as a % to GDP	2004	2005	2006	2007
<i>Expenditure</i>				
No general government sector employment increases including the semi governmental organizations	0,1	0,1	0,1	0,1
No contractual salary increases	0,2	0,2	0,2	0,2
Containment of the annual rate of increase of current expenses to under 3% in 2005 <ul style="list-style-type: none"> <li>○ Agricultural subsidies – maintaining them at 2004 levels</li> <li>○ Grants to semi governmental organizations – 0% increase</li> </ul>	-	-	-	-
Containment of the annual rate of increase of investments to under 4% in 2005	-	-	-	-
Marginal reduction of defence outlays	-	0,1	-	-
Containment of current transfers (pensions, monetary allowances etc.), below the rate of nominal GDP increase	-	0,2	0,2	0,2
Abolition of the unemployment benefit granted to general public sector retired employees	-	0,2	-	-
Increase of the retirement age of public sector employees from 60 to 63 years of age, with the prospect of increasing it further to 65 years of age	-	0,2	0,1	0,1
Increase of the retirement age limit of the Social Insurance Fund from 63 to 65 years of age with the prospect of increasing it further to 67 years of age	-	0,2	-	-
Abolition of the earnings-related pension scheme of public sector employees (increase of the public sector employees contributions to the same level as the private sector contributions)	-	0,2	-	-

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Cyprus were of EU origin.

Cyprus: Convergence Programme 2003-2007

<b>budgetary impact as a % to GDP</b>	<b>2004</b>	<b>2005</b>	<b>2006</b>	<b>2007</b>
<b><i>Revenues</i></b>				
Introduction of betterment charges on land appreciation due to zoning changes or modifications	-	0,1	-	-
Raising of airport and port taxes	-	0,2	-	-
Introduction of a mobile telecommunication tax	-	0,1	-	-
Improving the efficiency of tax collection	-	0,1	0,1	0,1
Approval of the pending legislation concerning bank secrecy and tax amnesty	0,7	0,1	0,1	0,1
Modification of the legislation concerning the issuance of title deeds for buildings erected with minor irregularities	0,6	0,6	0,6	-
Regularisation of dividend income policy for semi governmental organizations	0,5	-	-	-
<b>Total annual impact</b>	<b>2,1</b>	<b>2,6</b>	<b>1,4</b>	<b>0,8</b>

The implementation of the proposed fiscal consolidation measures will reverse the current trends and reduce the structural deficit over the period as depicted above.

Lower structural deficits will feed into lower debt levels and reduced interest payments and interest rates and contribute to further reductions in actual net borrowing by the general government, and together with beneficial effects on domestic economic growth, will create a positive virtuous circle. The envisaged containment in the growth of current expenditures from 2005 onward will be particularly instrumental in contributing to the emergence of a rising current surplus in the general government accounts. Furthermore, with the restraining of the growth of social security payments and the increase of the retirement age, the surplus in the social security accounts will be maintained, thus contributing to the financial viability of the Social Security Scheme over the medium-term.



**Table 5: General Government Consolidated Accounts; Adjustment Scenario**

<i>in millions of Cyprus Pounds</i>	2002	2003 prefinal	2004 est.	2005 proj.	2006 proj.	2007 proj.
<b>Revenue</b>	<b>2,086</b>	<b>2,385</b>	<b>2,580</b>	<b>2,815</b>	<b>3,018</b>	<b>3,237</b>
<i>Current Revenue</i>	2,083	2,383	2,578	2,813	3,016	3,235
Tax Revenue	1,760	1,918	2,069	2,240	2,410	2,582
Non Tax Revenue	323	465	509	573	606	653
<i>Capital Revenue</i>	1	0	0	0	0	0
Foreign Grants	2	2	2	2	2	2
<b>Expenditure</b>	<b>2,370</b>	<b>2,802</b>	<b>2,943</b>	<b>3,030</b>	<b>3,193</b>	<b>3,367</b>
<i>Current Expenditure</i>	2,131	2,492	2,621	2,690	2,833	2,982
Wages and Salaries	646	760	798	838	887	928
Other Goods and Services	224	258	269	285	305	327
Subsidies	64	80	70	70	70	70
Interest Payments	200	218	250	270	285	300
Social Security Payments	355	388	435	432	463	495
Other Transfers	486	638	729	735	763	802
Defence Outlays	156	150	70	60	60	60
<i>Capital Expenditure</i>	239	310	322	340	360	385
<b>Primary Balance</b>	<b>-84</b>	<b>-199</b>	<b>-113</b>	<b>55</b>	<b>110</b>	<b>170</b>
<b>Fiscal Deficit</b>	<b>-284</b>	<b>-417</b>	<b>-363</b>	<b>-215</b>	<b>-175</b>	<b>-130</b>

**Table 6: General Government Consolidated Accounts; Adjustment Scenario**

as a % of GDP	2002	2003 prefinal	2004 est.	2005 proj.	2006 proj.	2007 proj.
Current Revenue	33,9	36,1	37,1	38,0	38,3	38,5
Current Expenditure	34,6	37,7	37,7	36,3	36,0	35,5
Interest Payments	3,3	3,3	3,6	3,6	3,6	3,6
Current Balance	-0,7	-1,6	-0,6	1,7	2,3	3,0
Capital Expenditure	3,9	4,7	4,6	4,6	4,5	4,6
<b>General Government Net Borrowing</b>	<b>-4,6</b>	<b>-6,3</b>	<b>-5,2</b>	<b>-2,9</b>	<b>-2,2</b>	<b>-1,6</b>
Primary Balance	-1,3	-3,0	-1,6	0,7	1,4	2,0
<b>Government Gross Debt</b>	<b>67,4</b>	<b>72,6</b>	<b>75,2</b>	<b>74,8</b>	<b>71,5</b>	<b>68,4</b>

**Table 7: Cyclical Developments; Adjustment Scenario**

as a % of GDP	2002	2003 prefinal	2004 est.	2005 proj.	2006 proj.	2007 proj.
GDP growth at constant prices	2,0	2,0	3,5	4,3	4,4	4,5
<b>Actual balance</b>	<b>-4,6</b>	<b>-6,3</b>	<b>-5,2</b>	<b>-2,9</b>	<b>-2,2</b>	<b>-1,6</b>
Net Interest payments	3,3	3,3	3,6	3,6	3,6	3,6
Potential GDP, % change	4,5	4,5	4,5	4,5	4,5	4,5
GDP output gap	-2,5	-2,5	-1,0	-0,2	-0,1	0,0
Cyclical budgetary component	1,3	1,3	0,5	0,1	0,0	0,0
<b>Cyclically-adjusted balance</b>	<b>-3,3</b>	<b>-5,0</b>	<b>-4,7</b>	<b>-2,8</b>	<b>-2,2</b>	<b>-1,6</b>
Cyclically-adjusted primary balance	0,0	-1,7	-1,1	0,8	1,4	2,0

**Table 8: Composition of General Government Revenue; Adjustment Scenario**

as a % of GDP	2002	2003 pre final	2004 est.	2005 proj.	2006 proj.	2007 proj.
<b>Revenue</b>	<b>33,9</b>	<b>36,1</b>	<b>37,1</b>	<b>38,0</b>	<b>38,3</b>	<b>38,5</b>
<i>Current Revenue</i>	33,9	36,1	37,1	38,0	38,3	38,5
Tax Revenue	28,6	29,0	29,6	30,1	30,4	30,5
Direct Taxes	10,4	8,9	9,2	9,1	9,3	9,4
○ Income Taxes	7,5	6,1	6,4	6,1	6,2	6,3
-Companies	3,5	2,7	3,1	2,9	3,0	3,1
-Individuals	4,0	3,4	3,3	3,2	3,2	3,2
Indirect Taxes	13,3	15,3	15,8	16,2	16,3	16,4
○ Selective Excises	3,2	4,4	4,8	4,8	4,9	4,9
○ V.A.T.	6,6	8,2	8,5	8,7	8,8	8,8
○ Import Duties	1,2	0,9	0,6	0,6	0,6	0,6
Social Security Contributions	4,9	4,8	4,6	4,8	4,8	4,7
Non Tax Revenue	5,3	7,1	7,5	7,9	7,9	8,0

**Table 9: Composition of General Government Expenditure; Adjustment Scenario**

as a % of GDP	2002	2003 Pre final	2004 est.	2005 proj.	2006 proj.	2007 proj.
<b>Expenditure</b>	<b>38,5</b>	<b>44,2</b>	<b>43,8</b>	<b>42,4</b>	<b>42,0</b>	<b>41,6</b>
<i>Current Expenditure</i>	34,6	37,7	37,7	36,3	36,0	35,5
Wages and Salaries	10,4	11,5	11,5	11,3	11,3	11,1
Other Goods and Services	3,6	3,9	3,9	3,8	3,9	3,9
Subsidies	1,0	1,2	1,0	0,9	0,9	0,8
Interest Payments	3,3	3,3	3,6	3,6	3,6	3,6
Social Security Payments	5,8	5,9	6,2	5,9	5,9	5,9
Other Transfers	7,9	9,6	10,5	9,8	9,5	9,5
Defence Outlays	2,5	2,3	1,0	1,0	0,9	0,8
<i>Capital Expenditure</i>	3,9	4,7	4,6	4,6	4,5	4,6

### **(3) Debt Levels and Developments**

The level of government debt, excluding intragovernmental debt, reached a peak level of 72,6% of GDP during 2003. Of this, 9 percentage points correspond to sinking funds that are steadily being run down and are expected to be eliminated by 2008. The anticipated fiscal consolidation measures, which will be put into place during the programming period, will reverse the increasing trend exhibited by the public debt, which will reach a peak of 75,2% of GDP in 2004 and is expected to follow a decreasing trend from 2005 to 2007 reaching a level of 68,4% in 2007.

Foreign debt in 2004 is expected to increase as a percentage of total net debt to 30% from 22% in 2003 and remain at that level through 2005 and is projected to follow a downward trend during the period 2006 to 2007. During the period 2004 to 2007 an increase is expected in the percentage of long term debt to total net debt from 83,9% to 85,8%, in line with the strategic aim of promoting medium and long-term debt instruments.

During 2003 investors exhibited an increasing reluctance to commit to medium and long-term government debt especially during the last quarter of the year. In the first few months of 2004 this trend increased in intensity, with a direct result being, that 63% of debt issued during 2004 and still outstanding is of maturity of one year or less. The main reasons for this situation are:

- Absence of an active secondary market for government debt.
- Political uncertainty during the initial months of 2004.
- The relaxation of controls on external capital flows.

To help reverse this situation it has been decided to restructure the secondary market for public debt. The introduction of primary dealers is considered as the most likely solution in order to provide the much needed liquidity to the market. Current plans include the introduction of foreign entities as well as domestic ones in the role of primary dealers in order to attract a wider investor base and increase competition for funds.

Interest rates in 2003 recorded a declining trend during the first half of 2003, which was reversed during the last six months of the year. In the initial months of 2004 there was an increase in interest rates of more than one percentage point on all government instruments sold through auctions. The reasons for this sharp increase are:

- Increasing government deficits.
- Low demand of government securities from investors.
- Inability to draw funds from the international capital markets during the first months of 2004<sup>10</sup>.

During the next few months this upward pressure on interest rates is likely to be moderate and could be reversed as a large part of government financing will be covered by foreign borrowing through the EMTN and ECP programs (40% of the total gross financing needs, around 800 million euro) while improving at the same time the maturity structure of government debt.

Furthermore, the accession of Cyprus to the European Union can be expected to improve the credit standing of Cyprus entities, in part because the authorities will be required to exercise greater discipline in financial and fiscal policies. Already, in April 2004, one leading credit rating agency has upgraded the credit rating of Cyprus private entities on account of EU accession.

Finally, the planned restructuring of the secondary market for government debt denominated in domestic currency is expected to increase demand considerably. The increased competition for funds through the widening of the investor base is expected to reduce interest rate costs and allow for a better structuring of the outstanding government debt.

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<sup>10</sup> Borrowing limits from abroad had been reached in December 2003. Political approval for increased limits was granted on the 6<sup>th</sup> of May 2004.

Debt management policy is under review in an attempt to improve current structures and procedures. At present legal responsibility for debt management lies with the Central Bank whereas policies implemented in collaboration with the Ministry of Finance. The Ministry of Finance has the decision-making powers regarding the timing and amounts of debt issued and on the terms of any loans undertaken or bonds issued. There is, however, a stipulation in the relevant legislation which allows the government to remove this legal mandate from the Central Bank after giving notice of at least 24 months.

The main aims of debt management policy for the immediate future remain the same as outlined in the 2003 PEP:

- Better access to the capital markets both domestic and international.
- Creating a liquid and active secondary market for government securities.
- Smoothing the repayment schedule.
- Promoting medium-term debt (2 and 5 year Development Stock) as a stepping stone to increasing the average maturity of government debt and the increased issue of long-term debt (10 and 15 year) in the future.

These aims are to be achieved through a series of steps, which are now being determined through the review of the current debt management structure and procedures that are needed in order to meet future challenges. These steps are:

- Introducing a new structure for the primary and secondary market for government debt using primary dealers.
- Creating and maintaining channels of communication with other market participants and interested parties.
- Increasing the technical competence of the staff regarding debt management in the relevant departments.
- Creating a flexible decision-making structure and unit that can respond in a timely manner to market conditions.
- Introduction (in 2004) of a new computerized accounting system (FIMAS) connecting all government services which will help in the preparation of more

accurate projections for financing needs in a more timely manner. This will itself lead to more credible debt issuance calendars on behalf of the government.

**C. SENSITIVITY ANALYSIS OF THE GENERAL GOVERNMENT BALANCE AND PUBLIC DEBT**

The attainment of the fiscal targets set out in the current fiscal consolidation programme assumes that the economy will grow by 3,5% in 2004 increase to 4,3% in 2005 and further to its potential of around 4,5% per annum in real terms during 2006-2007.

In addition, the path of interest rates on government borrowing over the medium-term will be significant in determining the degree to which current expenditures can be contained. It is assumed that the average level of interest rates on new government borrowing will gradually converge toward interest rates in the Eurozone over the period 2004 to 2007.

**(1). Sensitivity of the general government balance and public debt to economic growth and interest rates**

Given the importance of the real growth rate and interest rates in determining the sustainability of fiscal policy, a sensitivity analysis similar to that included in the 2003 PEP was conducted and updated.

To assess the sensitivity of the government balance and government debt to different economic growth scenarios and also to interest rate changes, alternative assumptions have been taken into account, for real GDP growth rates and interest rates.

**Assumption 1:** the rate of annual real GDP growth is half a percentage point higher, on an annual average, than in the reference (central) scenario.

On this assumption, with other things being equal, and under the assumption that the Government assumes a neutral policy stance, the government deficit in 2007, expressed as a percentage of GDP, is 0,2 of a percentage point lower and the public debt ratio 1,1 of a percentage point lower than in the reference scenario.



**Assumption 2:** the rate of real GDP growth is half a percentage point lower, on an annual average, than in the reference (central) scenario.

On this assumption, with other things being equal, and under the hypothesis that the Government assumes the same neutral policy stance, the overall deficit in 2007, expressed as a percentage of GDP, is 0,3 of a percentage point higher and the public debt ratio 1,0 of a percentage point higher than in the reference scenario.

**Table 10: Three Scenarios for Public Finances**

<i>in percent of GDP</i>	2003	2004	2005	2006	2007	2004- 2007 4- year average
<b><u>Central Scenario</u></b>						
GDP	2,0	3,5	4,3	4,4	4,5	4,2
General Government Balance	-6,3	-5,2	-2,9	-2,2	-1,6	
General Government Debt	72,6	75,2	74,8	71,5	68,4	
<b><u>Upper Scenario (GDP growth 0,5 of a percentage point higher)</u></b>						
GDP	2,0	4,0	4,8	4,9	5,0	4,7
General Government Balance	-6,3	-4,9	-2,6	-1,9	-1,4	
General Government Debt	72,6	74,9	74,2	70,6	67,3	
<b><u>Lower Scenario (GDP growth 0,5 of a percentage point lower)</u></b>						
GDP	2,0	3,0	3,8	3,9	4,0	3,7
General Government Balance	-6,3	-5,4	-3,1	-2,5	-1,9	
General Government Debt	72,6	75,4	75,2	72,2	69,4	

**Assumption 3:** interest rates are 0,5 of a percentage point higher than in the reference (central) scenario.

In a scenario with higher interest rates the government deficit, expressed as a percentage of GDP, is 0,3 of a percentage point higher and the government debt ratio is 0,6 percentage point higher at the end of the programme period.<sup>11</sup>

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<sup>11</sup> In this scenario real GDP growth is assumed to remain unchanged even though higher interest rates could be expected to have a moderating effect on real economic growth

The impact of a rise in interest rates on government debt though significant, is moderated by the fact that a considerable part of the debt comprises fixed interest-rate borrowings made in previous years, so that the new interest rates will affect mainly the servicing costs for new debt issues.

**Table 11: Scenario with Higher Interest Rates Cumulative differential**

<b>in percentage points of GDP with respect to the reference scenario</b>	<b>2004</b>	<b>2005</b>	<b>2006</b>	<b>2007</b>
General Government Net Borrowing	0,0	0,1	0,2	0,3
General Government Gross Debt	-	0,1	0,3	0,6

Developments on the government finances in 2002 and 2003 and sensitivity analysis conducted on the government finances confirm that the magnitude of the real GDP growth rate is crucial to the outcome of the public finances. Accordingly, if the real growth rate of the Cyprus economy does not show a significant recovery over the medium-term it will be difficult to reduce the government fiscal deficit below 3% by 2007. Indeed, even with the full implementation of the fiscal adjustment measures required under the convergence programme, it is unlikely that the ratio of net general government borrowing to GDP will be contained below the 3% reference value by 2007 if real GDP growth were to continue at 2% per annum.

#### **D. LONG-TERM FISCAL SUSTAINABILITY**

In assessing long-term fiscal sustainability the new demographic projections prepared by the Statistical Service were used and key assumptions made about the macroeconomic framework, the labour market and trends over the long-term. The assumptions are as follows:

- **Employment growth:** based on the new demographic projections prepared by the CY Statistical Service until 2050 and assuming a gradual small increase of the employment rate of the female population and of old age persons and a small net migration, it is estimated that the annual employment growth would slow down, from 2,4% in 2000, to about 1,2% by 2005 to 0,7% by 2010, to 0,2% by 2020 and remain constant thereafter;
- **Annual labour productivity:** increases are projected to accelerate from 2,6% in 2000, to about 3,0% by 2005 and 3,3% in 2010, owing to the positive effects of envisaged structural reforms and greater utilisation of advanced technologies. Thereafter, it is assumed that productivity gains would decline to an average of around 3% per annum;
- **Real wage and salary incomes:** these are projected to grow in line with labour productivity gains;
- **GDP growth:** GDP is projected to grow at an annual rate of approximately 4% up to 2010 and around 3% thereafter
- **Inflation:** the average rate of inflation is projected to average 2% per annum over the period 2004 to 2050.
- **Other government expenditure and revenues:** it is assumed that government expenditure and revenues as a ratio to GDP, excluding expenditures for old age pensions, health care and interest payments would remain constant after 2006.

**(1) Demographics:**

According to the demographic projections prepared by the Cyprus Statistical Service, the population in the government-controlled area is expected to reach 822.069 by 2052 compared to 705.539 in 2002. The percentage of those aged 15-64 to the total population is projected to fall to 60,25% by 2052, compared to 66,83% in 2002. For those aged 65+, the percentage to total population is projected to increase to 28,51% by 2052 compared to 11,66% in 2002. The above data indicates the ageing affect on the population which will affect the labour force supply. This is expected to be partially offset by the inflow of immigrants.

**(2) No reform scenario:**

(a) Social Security System

Without any policy adjustments to the current social security system and assuming that the introduction of a National Health System will take place in 2006 as planned, the projections show increasing deficits in the public finances over the long-term, especially in the period after 2020. It is revealed that the ageing of the population of Cyprus places pressures on the government budget, particularly through the rising proportions of GDP required for government expenditure on old-age pensions and to a lesser extent on health care. Another factor leading to an increase of pension payments over the coming decades is the gradual maturing of the scheme.

The old-age (or demographic) dependency ratio - namely, population of 65 years and older in percent of the population of 15-64 years - is projected to nearly double to 31,8% by 2030 and rise further to 46,6% by 2050. As a result, the surplus of the social security funds will be transformed into a deficit by 2030.

While the social security system remains financially viable until about 2020, the longer-term projections show that by 2020, under an unreformed pensions system, expenditure

on pensions will exceed contributions to the fund, while at the same time, the reserves of the pension scheme will diminish and become negative by 2030, adversely affecting investment income and therefore revenues of the pension scheme.

It is noted here that these results are similar to those included in last year's PEP recording, however, an additional, deterioration due to the recent demographic projections which indicate a stronger ageing effect on the population.

(b) Health

At the same time, the relatively high-income elasticity of health expenditure, the planned introduction of a National Health Scheme by 2006, which foresees no fee at the point of consumption, the likely increase of demand for cost-intensive health care, especially of the old aged and the ageing population, are factors expected to lead to relatively high increases in health care expenditures. However, the introduction of a National Health Scheme is also expected to lead to savings, inter alia, through the implied competition pressure on the public hospitals to become more efficient, efficiency gains through the anticipated improvement of primary health care, savings due to the introduction of the concept of the family doctor and the introduction of the global budgeting concept for the National Health Scheme. The total impact of these factors on the evolution of health expenditure over the long-term is difficult to assess.

For the purpose of this exercise, projections were undertaken, based on the assumption that health care expenditure would exhibit a GDP growth elasticity of 1,1 between 2005-2010, which would decrease thereafter, gradually, to 1,03 by 2050, reflecting efficiency gains through the introduction of the National Health Scheme. Furthermore, based on the agreement between the Government and the social partners on the contribution rates of the Government (4,55% of earnings), employers (2,55% of earnings) and employees (2% earnings), it was estimated that the Government will cover roughly 52,5% of the total health care expenditure after the introduction of the National Health Scheme, planned to take place by 2006.

Based on the above-mentioned assumptions, it is estimated that the Government healthcare current and capital expenditure would rise from the current 3% of GDP to about 4% by 2050.

It emerges that, while in the coming few years pension and health care expenditures do not appear to pose a significant threat to fiscal sustainability, over the long term, policy reforms are essential, especially for the pension scheme, with a view to improving long-term fiscal sustainability.

### **(3) Policy Reforms Options of the Pension Scheme**

As stated last year in the PEP, the Government is focusing on the following reform options which are currently under discussion between the Government and the social partners:

#### *(a) First Tier Reform Options:*

- gradual increase of the normal pensionable age from currently 63 to 65 years over the period 2005-2011; the scope of further increasing the pensionable age to 67 years will be examined at a later stage;
- indexing of the lower band pensions based on a price index, instead of the wage index, as is currently the practice;
- increasing the rate of return of investment by investing part of the reserves in non-government assets;

#### *(b) Second Tier Reform Options:*

- gradual increase of the contribution rates, based on predetermined rules. In more specific terms, the policy option under consideration is to automatically increase contribution rates if the reserves of the Fund fall below a certain defined level. It should be noted that a gradual increase of contribution rates, as the Social Insurance Scheme is maturing is normal in partially funded pension schemes,

such as the one in Cyprus. This possibility was already foreseen when the Social Insurance Scheme was originally designed. However, the increases have to be restrained so as to contain the negative impact on the competitiveness of the Cypriot goods and services.

An actuarial exercise revealed that an increase of the normal pensionable age to 65 years, combined with indexing of the lower band pensions based on a price index and investing part of the reserves in non-government assets would lead to savings as shown in table 6b. Namely, as a result of the above reforms total revenues will exceed total expenditure on pensions until after 2030, while the reserves of the pension scheme remain positive until 2050 when they become negative.

Apart from the above mentioned reform measures, the long-term sustainability of the public finances can be further improved through achieving surpluses in the fiscal accounts, (excluding pension and health care). In more concrete terms, it is believed that savings will gradually increase and reach 5% of GDP until 2050, mainly through restraining the increase of public expenditure (excluding pensions and health-care payments) below the increase of nominal GDP growth, is feasible. The effects of the above mentioned measures are presented in table 6b.

Table 6b shows that notwithstanding the envisaged pension reforms, deficits would nevertheless occur amounting to 1,1% of GDP in 2020 and rising to 9% in 2050. At the same time, national pension fund assets become negative by 2050. Therefore, a gradual, until 2050, increase of the contribution rates from currently 16,6% of earnings is considered necessary, to neutralise the effects of the maturing pension scheme and population ageing on public finances and safeguard a viable financing of the pension scheme over the long-term.

**APPENDIX I**

**Table 1. Growth and Associated Factors**

Percentages unless otherwise indicated	ESA Code	Year	Year	Year	Year	Year
		2003	2004	2005	2006	2007
GDP growth at constant market prices (7+8+9)	B1g	2,0	3,5	4,3	4,4	4,5
GDP level at current market prices (£ mln)	B1g	6614,3	6959,7	7408,9	7880,9	8391,8
GDP deflator		5,3	1,7	2,1	1,9	1,9
CPI change (annual average)		4,1	2,0	2,0	2,0	2,0
Employment growth *		0,9	1,0	1,0	2,0	3,0
Labour productivity growth **		1,1	2,4	3,0	3,1	3,2
		<b>Sources of growth: percentage changes at constant prices</b>				
1. Private consumption expenditure	P3	2,0	3,3	3,7	3,7	3,7
2. Government consumption expenditure	P3	2,7	-3,2	2,3	2,7	2,8
3. Gross fixed capital formation	P51	-4,3	4,6	5,9	6,0	6,0
4. Changes in inventories and net acquisition of valuables as a % of GDP	P52+ P53	1,7	1,8	1,5	1,1	0,8
5. Exports of goods and services	P6	0,6	5,4	6,4	6,8	6,9
6. Imports of goods and services (excl. aircrafts and defence)	P7	-1,3	3,3	4,9	5,1	5,4
		<b><u>Contribution to GDP growth</u></b>				
7. Final domestic demand excl. Δ in Inventories		1,1	2,5	3,8	4,1	4,1
8. Change in inventories and net acquisition of valuables	P52+ P53	-0,2	0,1	-0,2	-0,3	-0,2
9. External balance of goods and services	B11	1,1	0,9	0,5	0,6	0,6

\* Occupied population, domestic concept, persons, national accounts definition

\*\* Growth of GDP per person employed at constant prices



**Table 2 General Government Budgetary Developments (Adjustment Scenario)**

% of GDP	ESA code	2003	2004	2005	2006	2007
<b><i>Net lending (B9) by sub-sectors</i></b>						
1. General Government	S13	-6,3	-5,2	-2,9	-2,2	-1,6
2. Central Government	S1311	-8,7	-7,6	-5,8	-5,2	-4,6
3. State Government	S1312	-	-	-	-	-
4. Local Government	S1313	-0,2	-0,2	-0,2	-0,2	-0,2
5. Social Security Funds	S1314	2,6	2,6	3,1	3,2	3,2
<b><i>General Government (S13)</i></b>						
6. Total Receipts	ESA	38,5	39,4	40,4	40,7	40,9
7. Total Expenditure	ESA	44,8	44,6	43,3	42,9	42,5
8. Budget Balance	B9	-6,3	-5,2	-2,9	-2,2	-1,6
9. Net Interest Payments		3,3	3,6	3,6	3,6	3,6
10. Primary Balance		-3,0	-1,6	0,7	1,4	2,0
<b><i>Components of Revenues</i></b>						
11. Taxes	D2+D5	27,5	28,3	28,6	28,8	29,0
12. Social Contributions	D61	7,0	7,0	7,3	7,4	7,3
13. Interest Income	D41	0,3	0,3	0,3	0,3	0,3
14. Other		3,7	3,8	4,2	4,2	4,3
15. Total receipts	ESA	38,5	39,4	40,4	40,7	40,9
<b><i>Components of Expenditure</i></b>						
16. Collective Consumption	P32	11,1	9,3	9,1	9,0	8,9
17. Social Transfers in Kind	D63	9,0	10,1	10,0	9,9	9,8
18. Social Transfers Other Than in kind	D62	10,5	11,2	10,4	10,4	10,4
19. Interest Payments	D41	3,3	3,6	3,6	3,6	3,6
20. Subsidies	D3	1,2	1,0	0,9	0,9	0,8
21. Gross Fixed Capital Formation	P51	3,8	3,8	3,8	3,8	3,8
22. Other		5,9	5,6	5,5	5,3	5,2
23. Total Expenditures	ESA	44,8	44,6	43,3	42,9	42,5

**Table 3 General Government – Debt Developments (Adjustment Scenario)**

% of GDP	ESA code	2003	2004	2005	2006	2007
Gross Debt Level		72,6	75,2	74,8	71,5	68,4
Change in Gross Debt		5,2	2,6	-0,4	-3,3	-3,1
<b><i>Contributions to Change in Gross Debt</i></b>						
Primary Balance		-3,0	-1,6	0,7	1,4	2,0
Interest Payments	D41	3,3	3,6	3,6	3,6	3,6
Nominal GDP Growth	B1g	7,4	5,2	6,5	6,4	6,5
Other Factors Influencing Debt Ratio						
Of which:						
Privatization receipts		-	-	-	-	-
p.m. implicit interest rate on debt		4,5	4,4	4,4	4,4	4,4

**Table 4 Cyclical Developments (Adjustment Scenario)**

% of GDP	ESA code	2003	2004	2005	2006	2007
1. GDP Growth at Constant Prices	B1g	2,0	3,5	4,3	4,4	4,5
<b>2. Actual Balance</b>	<b>B9</b>	<b>-6,3</b>	<b>-5,2</b>	<b>-2,9</b>	<b>-2,2</b>	<b>-1,6</b>
3. Interest Payments	D41	3,3	3,6	3,6	3,6	3,6
4. Potential GDP Growth		4,5	4,5	4,5	4,5	4,5
5. Output Gap		-2,5	-1,0	-0,2	-0,1	0,0
6. Cyclical Budgetary Component		+1,3	+0,5	+0,1	0,0	0,0
<b>7. Cyclically – Adjusted Balance (2-6)</b>		<b>-5,0</b>	<b>-4,7</b>	<b>-2,8</b>	<b>-2,2</b>	<b>-1,6</b>
8. Cyclically – Adjusted Primary Balance (7-3)		-1,7	-1,1	0,8	1,4	2,0

**Table 5 Divergence from previous update (Adjustment Scenario)**

% of GDP	ESA code	2003	2004	2005	2006	2007
<b><i>GDP Growth</i></b>						
Previous Update	B1g	2.0	4.0	4.6	4.6	
Latest Update	B1g	2.0	3.5	4.3	4.4	4.5
Difference		0.0	-0.5	-0.3	-0.2	
<b><i>Actual Budget Balance</i></b>						
Previous Update	B9	-5,4	-3,7	-2,8	-2,2	n.a.
Latest Update	B9	-6,3	-5,2	-2,9	-2,2	-1,6
Difference		0,9	1,5	0,1	0,0	
<b><i>Gross Debt Levels</i></b>						
Previous Update		63,6	62,6	60,7	56,1	n.a.
Latest Update		72,6	75,2	74,8	71,5	68,4
Difference		9,0	12,6	14,1	15,4	

**Table 6 Long-term Sustainability of Public Finances (Unreformed policy scenario)**

	<i>% of GDP</i>	<b>2000</b>	<b>2005</b>	<b>2010</b>	<b>2020</b>	<b>2030</b>	<b>2040</b>	<b>2050</b>
1.	Total expenditure	36,1	42,4	43,5	46,8	49,8	51,7	53,3
2.	Old age pensions	4,1	4,7	5,5	8,5	11,1	12,7	14,1
3.	Health care (including care for the elderly)	2,6	3,1	3,6	3,8	3,9	4,0	4,0
4.	Interest payments	5,7	5,1	4,9	5,0	5,3	5,5	5,7
5.	Other savings		0	0	0	0	0	0
6.	Total revenues	33,8	39,5	39,5	39,7	38,3	36,0	33,0
7.	Of which: from pensions revenues	6,9	7,6	7,6	7,8	6,4	4,1	1,1
8.	National pension fund assets	37,0	40,3	41,1	31,6	-6,5	-61,2	-127,3
<b>Assumptions</b>								
9.	Employment growth	2,4	1,2	0,7	0,2	0	0	0
10.	Labour productivity	2,6	3	3,3	3	3	3	3
11.	Real GDP growth	5,1	4,3	4	3	3	3	3
12.	Participation rate males (aged 15-64)	78,9	80	81	81,5	82	82,5	83
13.	Participation rates females (aged 15.64)	52,5	55	57,5	60	61	62	63
14.	Total participation rates (15-64)	65,5	67,5	69	70,5	71,5	72	73
15.	Unemployment rate (ILO definition)	3,4	3,2	3	3	3	3	3

**Table 6a Long-term Sustainability of Public Finances (Reformed policy scenario)**

	<i>% of GDP</i>	<b>2000</b>	<b>2005</b>	<b>2010</b>	<b>2020</b>	<b>2030</b>	<b>2040</b>	<b>2050</b>
1.	Total expenditure	36,1	42,4	41,9	43,3	44,6	44,7	44,9
2.	Old age pensions	4,1	4,3	4,5	6,6	8,5	9,3	10,3
3.	Health care (including care for the elderly)	2,6	3,1	3,6	3,8	3,9	4,0	4,0
4.	Interest payments	5,7	5,1	4,9	5,0	5,3	5,5	5,7
5.	Other savings		0	1	2	3	4	5
6.	Total revenues	33,8	39,5	39,7	40,9	40,3	39,0	36,9
7.	Of which: from pensions revenues	6,9	7,9	8,1	9,3	8,7	7,4	5,3
8.	National pension fund assets	37,0	41,7	47,5	57,2	45,0	19,3	-17,3
<b>Assumptions</b>								
9.	Employment growth	2,4	1,2	0,7	0,2	0	0	0
10.	Labour productivity	2,6	3	3,3	3	3	3	3
11.	Real GDP growth	5	4,3	4	3	3	3	3
12.	Participation rate males (aged 15-64)	78,9	80	81	81,5	82	82,5	83
13.	Participation rates females (aged 15-64)	52,5	55	57,5	60	61	62	63
14.	Total participation rates (15-64)	65,5	67,5	69	70,5	71,5	72	73
15.	Unemployment rate (ILO definition)	3,4	3,2	3	3	3	3	3

**Table 7 Basic assumptions on the external economic environment for Cyprus**

VARIABLE	ASSUMPTIONS FOR				
	2003	2004	2005	2006	2007
(annual averages)					
<b>Interest rates (in % p.a)</b>					
-euro area: short-term (3 months money markets)	2,3	2,2	2,8	3,3	3,5
-euro area: long-term (10- year government bonds, lowest one prevailing in euro area)	4,1	4,3	4,8	5,3	5,5
-U.S.A.: short term (3 months money markets)	1,2	1,3	1,8	2,8	3,0
- U.S.A.: long-term (10 year government bonds)	4,0	4,2	4,6	5,1	5,3
<b>Exchange rates ("–" depreciation)</b>					
USD/€ (level)	1,13	1,20	1,20	1,20	1,20
Nominal effective exchange rate of the Cyprus pound (% change)					
Exchange rate per Cyprus pound: (levels)					
US Dollar	1,93	2,04	2,04	2,04	2,04
Pound Sterling	1,18	1,13	1,13	1,13	1,13
Euro	1,71	1,70	1,70	1,70	1,70
<b>GDP (in real terms, % change)</b>					
-World, excluding EU (in PPP terms)	4,4	5,1	4,7	4,6	4,5
-USA	3,1	4,2	3,2	3,2	3,2
-United Kingdom	2,1	3,1	2,6	2,5	2,5
-EU-15	0,8	2,0	2,4	2,5	2,5
<b>World trade (% change)</b>					
EU export markets, Extra-EU (volumes)	6,7	9,2	8,3	7,8	7,5
World import volumes, excluding EU	7,3	9,7	8,5	8,0	7,7
World import prices (goods, in USD)	8,8	6,4	0,7	1,0	1,0
<b>Commodity prices</b>					
Oil prices (Brent, level in USD/barrel)	28,5	31,1	28,9	27,0	27,5
Non-oil commodity prices (in USD, % change)	6,6	15,6	-2,6	0,0	0,0

**APPENDIX II**

**THE TAX REFORM**

**Indirect Taxation**

**1. VAT**

- Increase of the standard VAT rate from 10% to 13%, as from 1.7.2002
- Increase of the standard VAT rate from 13% to 15%, as from 1.1.2003
- Introduction of a minimum VAT rate of 5% on non-bottled water, liquid petroleum gas, books, newspapers and magazines and ice lollies, yoghurt, ice-cream, savoury products and other foodstuffs as from 1.5.2004.
- Introduction of a minimum VAT rate of 15% on children clothing and footwear as from 1.5.2004.
- Introduction of minimum rate of 5% for the acquisition of the first new residence and the standard rate of 15% for any other acquisition of new buildings.

**2. Excise duties:**

**Gas-Oil**

- Increase of the excise tax on gas oil and kerosene by 5 cent per litre, as from 1.7.2002
- Increase of the excise tax on gas oil and kerosene by 4 cent per litre, as from 2.1.2003
- Increase of the excise tax on gas oil and kerosene by 3 cent per litre, as from 2.10.2003.

**Petrol**

- Increase of the excise tax on petrol (leaded and unleaded) by 2 cents per litre, as from 1.7.2002
- Increase of the excise tax on petrol (leaded and unleaded) by 3 cents per litre, as from 2.1.2003

**Alcoholic drinks**

- Increase as from 1.1.2004 of the excise duty rate by £2 per litre of pure alcohol for imported drinks and by £1,31 per litre of pure alcohol for home produced



drinks thus reaching at £2,50 per litre of pure alcohol of the excise duty rate, at the same time the import duty rate of alcoholic drinks was reduced by £1 per liquid litre of pure alcohol.

- Increase of the excise duty rate by £1 per litre of pure alcohol as from 29.4.2004 thus reaching the £3,50 per litre of pure alcohol of the excise duty rate for both imported and locally produced alcoholic drinks.
- Abolition of the 30% ad valorem excise duty rate on sparkling wines as from 29.4.2004.
- Imposition of £26,30 per 100 litres (equivalent to 45 euro per 100 litres) on intermediate alcohol products.
- Adoption of the import duty rates prescribed by Common Customs Tariff as from 1.5.2004.

#### Temporary Refugee Levy

- Abolition of the temporary refugee levy applied on imports as from 1.1.2003.

#### Cigarettes

- Increase in the excise tax on cigarettes by 20 cents per packet of 20 cigarettes, as from 30.5.2002
- Increase in the excise tax on cigarettes by 10 cents per packet of 20 cigarettes, as from 19.12.2002
- Increase in the excise tax on cigarettes by 20 cents per packet of 20 cigarettes, as from 2.10.2003.

#### Tobacco products

##### Cigarettes

- Adoption of the structure of the excise duty rate for cigarettes prescribed by the acquis on the basis of the price category most in demand i.e. 44,5% on the retail selling price per 20 cigarettes plus 24 cents (0,41 euro) per 20 cigarettes. The effective tax on the price category most in demand is 59,1%.

Cigars and Cigarillos

- Adoption of £40 per kilogram excise duty rate instead of 40% ad valorem excise duty rate, which was valid until 29.4.2004.

Fine cut tobacco for the rolling of cigarettes

- Adoption of £20 per kilogram, excise duty rate, instead of 35% ad valorem excise duty rate which was valid until 29.4.2004.

Other smoking tobacco

- Adoption of £20 per kilogram, excise duty rate, instead of 50% ad valorem which was valid until 29.4.2004.

Motor Vehicles

- The whole system of the taxation of motor vehicles was replaced as from 24.11.2003. Excise duty is calculated on the basis of the engine cubic capacity instead of the dutiable value as it was valid until 24.11.2003. The following excise duty rates have been adopted as from 24.11.2003.

Cubic Capacity	Saloons (per c.c.)	Vans (per c.c.)	Double Cabins (per c.c.)
<1450 c.c.	£0,50	£0,10	£0,50
>1450-1650 c.c.	£0,85	£0,25	£0,50
>1650-2050 c.c.	£2,70	£0,75	£0,50
>2050-2250 c.c.	£2,85	£0,75	£0,50
>2250-2650 c.c.	£5,50	£0,75	£0,50
>2650 c.c.	£8,00	£1,00	£0,50

Luxury goods

- Increases in the excise duties levied on luxury products such as leisure boats, inboard and inboard/outboard marine engines, motorcycles above 100 cc, smoked salmon, caviar, cigars and cigarillos and sparkling wines by 10 p.p. from 1.7.2002.
- Increase of the excise tax levied on refreshments by £0,01 c/lit. as 1.7.2002.

## **Direct Taxation**

### 1. Physical persons

- Increase of the tax-free income by £3.000 to £9.000, as from 1.1.2002.
- Abolition of the employees, self-employed and pensioners' defence levy contribution applied on their income, as from 1.7.2002.
- Reduction of the tax rates, as from 1.1.2003 and realignment of the income tax brackets with the simultaneous abolition of tax allowances for the dependants, the spouse and interest expenses other than on housing loans, as follows:

<b>Taxable Income</b>	<b>Rate</b>
£0-£9.000	0%
£9.001 -£12.000	20%
£12.001-£15.000	25%
£15.001 and over	30%

Increase of the tax-free income to £10.000 and realignment of the income tax brackets with the simultaneous abolition of the tax allowance for interest expense on housing loans, as from 1.1.2004, as follows:

<b>Taxable Income</b>	<b>Rate</b>
£0-£10.000	0%
£10.001-£15.000	20%
£15.001-£20.000	25%
£20.001 and over	30%

### 2. Professional Tax

- Abolition of the professional tax levied on income of physical persons as from 1.1.2003.

### 3. Property Tax

- Abolition of the urban property tax as from 1.1.2003.

### 4. Interest Income

- Abolition of the 3% defence levy on interest income and its substitution by a withholding tax rate of 10% levied at source, as from 1.7.2002.

5. Corporate taxation

- Introduction of a unified tax rate of 10% as from 1.1.2003.
- Introduction of a windfall tax of 10% on profits for Semi-Government organisations in 2002.
- Introduction of a windfall tax of 5% on profits exceeding £1mln for semi-government organisations and corporations in 2003 and 2004.
- Abolition, as from 1.1.2006, of the 4,25% corporate tax rate for international business companies, which were in operation as at 31.12.2001.
- Imposition, as from 1.1.2003 of a 10% corporate taxation for the taxable income of international companies, which were registered or will be registered after 1.1.2002.
- Dividends are exempt from income tax but they are subject to special contribution at a rate of 15%. Seventy percent of undistributed profits are subject to a 15% tax.
- Abolition of the defence fund levy of 3% on corporate profits as from 1.1.2003.

6. Defence Fund

- Abolition of the defence fund levy of 2% on the emoluments of physical persons as from 1.7.2002.
- Abolition of the defence fund levy of 2% of employers levied on their payroll as from 1.1.2003.
- Abolition of the defence fund levy on company profits as from 1.1.2003.

## Compensatory Expenditure Measures

### 1. Child Benefits

Expansion of the child grant scheme, as from 1.1.2003. More specifically, the annual grant introduced is as follows:-

#### Child Benefits

	<b>Grants £</b>
<b>1 child:</b>	
Basic annual supplement	200
Additional annual supplement for families with income up to £6.000	50
Additional annual supplement for families with income up to £6.001 - £12.000	25
<b>2 children :</b>	
Basic annual supplement	400
Additional annual supplement for families with income up to £6.000	200
Additional annual supplement for families with income up to £6.001 - £12.000	150
<b>3 children:</b>	
Basic annual supplement	1.200
Additional annual supplement for families with income up to £6.000	450
Additional annual supplement for families with income up to £6.001 - £12.000	375
<b>4 children :</b>	
Basic annual supplement	600 per child
Additional annual supplement for families with income up to £6.000	200 per child
Additional annual supplement for families with income up to £6.001 - £12.000	125 per child

### 2. Public assistance allowance

Increase of the public assistance allowance per adult person from £150 per month to £175 per month, as from 1.7.2002. It is noted that public assistance is provided to persons who are not voluntarily unemployed and their income is not sufficient for their basic and special needs as determined by the Public Assistance and Services Law.

### 3. Special Grants

Special grants were introduced and granted to old age pensioners or persons with individual needs financed wholly from the budget of the Central Government as from 1.7.2002. More specifically:

- To persons over 65 eligible for social pension £540 annually.
- To the beneficiaries of basic pension or any other equivalent type of benefit or allowance £456 annually.
- To the beneficiaries of minimum pension £650 annually.

### 4. Visually Impaired Persons

Introduction of a yearly allowance of £1800 for persons visually impaired.

**APPENDIX III**

**NEGOTIATIONS FOR A SETTLEMENT TO THE CYPRUS PROBLEM  
BASED ON THE ANNAN PLAN**

The last round of negotiations for the settlement of the Cyprus problem, based on the Annan Plan started in February 2004 and ended on 31 March 2004 in Switzerland, when the final version of the Annan Plan was delivered to the G/C and T/C negotiating parties by the UN Secretary-General.

Regarding the economic aspects of the settlement, the Ministry of Finance, the Central Bank of Cyprus and the Planning Bureau were heavily involved in the negotiations, through the Technical Committee on Economic Aspects chaired by the UN, whereby representatives of both communities took part in an effort to achieve an improvement of the economic aspects envisaged by the proposed solution in the Annan Plan.

The Government of Cyprus submitted concrete and detailed proposals with a view of addressing and correcting the deficiencies of the Plan, without undermining its overall philosophy. The modifications and additions sought would be beneficial to both the Greek Cypriots and the Turkish Cypriots, as they target the improvement of functionality and the safeguarding of financial viability of the solution. Overall, the Government submitted well-documented and constructive recommendations, a fact acknowledged by the UN.

More specifically, the Government of Cyprus had three main objectives throughout this effort:

- safeguard macroeconomic stability
- secure the effective functioning of the market mechanism for a unified economy, and
- address the issue of economic convergence between the Greek Cypriot and Turkish Cypriot constituent states.

On the first objective of safeguarding macroeconomic stability, improvement was achieved in some areas. Namely, the framework and the structure of institutions for conducting and coordinating monetary and fiscal policy were addressed in a satisfactory manner. However, in the case of the Central Bank, it should be noted that the provision in the Annan Plan for existence of a branch in the T/C Constituent State and the possibility of widening its functions could seriously undermine the effective exercise of monetary policy. Problematic was also the long transitional period foreseen in the Annan Plan for the conversion of Turkish Lira into Cyprus Pound. Concerning fiscal policy, the Plan provides for the setting up of a Macroeconomic Stability Council, which will, however, have only an advisory role. The recommendations of the G/C side for the introduction of an internal stability pact between the federal Government and the G/C and T/C constituent state, with a view to strengthening the commitment towards satisfying the provisions of the Maastricht Treaty and the Stability and Growth Pact have, unfortunately, not been adopted.

On the property issue, there has been some noteworthy improvement especially as regards the fiscal implications of the property compensation arrangements, even though the proposed arrangement does not safeguard a minimum level of acceptable compensation to dispossessed owners whose property will not be reinstated, compatible with the fairness principle.

Some important concerns did remain unresolved, however, which endanger the macroeconomic stability of a reunified Cyprus. These include the issues of:

- The guarantee by the Federal Government of the Mortgage Guarantee System and expenditure for the interest rate subsidisation scheme.
- The assumption of responsibility by the Federal Government for the relocation and rehabilitation of the current inhabitants of areas subject to territorial adjustment, with foreign assistance.
- Potential assumption of the cost for the restructuring of the T/C banking sector.
- The existence of transitional provisions for the implementation of the Banking Law in the T/C Constituent State for a minimum of two years.
- Assumption of part of the cost of the UN peace keeping operation.



- Potential demands for considerable transfers from the T/C side for economic convergence.
- The guaranteeing of the external debts of the constituent states by the Federal Government.

On the second objective of securing the effective functioning of the market mechanism, a major area of concern is the suspension of the acquis in the T/C constituent state. Specifically, according to the “Federal Law on the Application of Certain Federal Laws Transposing the European Union Acquis”, the acquis is suspended in the T/C constituent state until a “decision is taken by the Council of the European Union to withdraw, in part or in whole, the suspension of the application of the acquis in the territory administered by the Turkish Cypriot constituent state.” This implies that it is unknown when the safeguarding of the four fundamental freedoms will be secured. What is explicitly stated in the Plan is that restrictions of natural persons who have not been permanent residents for at least three years in the Turkish Cypriot constituent state, and of legal persons, to purchase immovable property in the Turkish Cypriot constituent state, will be retained for fifteen years or for as long as the gross domestic product per capita in that constituent state does not reach the level of 85% of the gross domestic product per capita in the Greek Cypriot state, whichever is the earlier.

However, any restrictions imposed on the free movement of people, goods, services and capital are expected to lead to an inefficient allocation of resources and hinder the economic development of the T/C constituent state.

In addition, despite efforts to highlight the need for setting up concrete federal structures to ensure the implementation of the acquis in different sectors, little progress was achieved in this respect. Furthermore, the need for short transitional periods as regards the harmonization of the T/C constituent state with the acquis was not endorsed in the Plan, leaving the door open for the creation of market distortions.

In the area of taxation, no timetable is provided either in the Plan or in the attached laws for the harmonization of indirect taxation, whereas there are no provisions to avoid harmful tax competition between the two constituent states.

The third objective was to adequately address the issue of achieving economic convergence between the two constituents states. This objective cannot be achieved over a short period of time and it can lead to excessive pressures for transfer payments from the federal government to the T/C constituent state. In view of the weak financial position of the federal government, this could endanger fiscal sustainability.

Moreover, the Plan does not take a position on this issue, namely that economic convergence can be achieved primarily through the prompt and resolute elimination of all restrictions on the four fundamental freedoms of the internal market (free movement of goods, services, labour and capital).

In many ways therefore, the Annan Plan essentially preserves the current unsuccessful system of operation and management of the economy in the non-government controlled area, at the cost of the G/C taxpayer. In general, the UN has adopted, for political reasons, most of the T/C positions with a view of preserving bizonality (e.g. restrictions on the mobility of goods, services, labour and capital) leading to market distortions, a potential inefficient allocation of resources thus imposing restraints on the advancement of the T/C standard of living.

Overall, the final version of the Annan Plan, despite the progress achieved vis-à-vis the previous versions, retains features that undermine the functionality and the financial viability of the United Cyprus Republic.

### **Economic projections with a solution**

Assuming a static scenario, in which foreign financial assistance will be secured and costs associated with the operation of the Property Board and the UN peacekeeping force are not borne by the federal government, the following fiscal situation arises as shown in the table below:

- Preliminary considerations of the budgetary burden, highlight resettlement and infrastructure as the main charges on the consolidated budget.
- Other factors contributing to the reduction of deficit to more sustainable levels include higher economic growth and policy adjustments.
- Reunification is likely to result in a combined supply and demand shock in the economy and public finances.

In general terms, it can be shown that the impact of the reunification shock would remain within manageable levels if the areas of concern regarding the economic aspects of the Annan Plan are addressed in a satisfactory manner in forthcoming negotiations.

The following table shows that the reunification related additional expenses over a transitional period of 5-8 years would amount annually to 4,5% of GDP. Therefore, with the promised financial assistance from in the EU, the United States and other international Governments and institutions in the context of the donor conference, the fiscal implications of a solution of the Cyprus problem would be addressed in a way that the macroeconomic stability of the United Republic of Cyprus would not be endangered.

<b>Effects of Reunification on Annual General Government Consolidated Budget (in 2004 prices)</b>	
	<b>% of UCR GDP</b>
<b>Starting budgetary positions of the constituent states</b>	
Greek Cypriot Constituent State Budget pre-solution deficit	5,0
Turkish Cypriot Constituent State Budget pre-solution deficit	1,5
	<b>6,5</b>
<b>Annan Plan budgetary effects</b>	
Capital costs for resettlement and infrastructure	3,0
Public administration expenses	1,5
UN peacekeeping force	1,0
Peace dividend	-1,0
	<b>4,5</b>
<b>Estimated general government deficit</b>	<b>11,0</b>
<b>Contributions to deficit reduction</b>	
Higher economic growth	0,5
Policy adjustments	1,0
No bearing of cost of UN peacekeeping force	1,0
International financial assistance (grants)	3,0
<b>Result on general government deficit (year t+3)</b>	<b>5,5</b>