KKTC fokus

Benchmark Report on Economic and Financial Governance in the Republic of Cyprus

Embassy of the Turkish Republic in Nicosia

tepav

türkiye ekonomi politikaları araştırma vakfı

The Turkish Republic of Northern Cyprus Prime Ministry

Contents

Introduction

This report has been prepared primarily on the basis of questionnaires and interviews with responsible officials in a number of different organizations, while the author's own insights have been added where it has been considered useful and relevant. Information in Section 1 is drawn largely from government websites as well as an analysis of the institutional setting by a former attorney-general, who also served as a member of the House of Representative and stood as a presidential candidate. For Section 2, the researchers received very detailed information from officials in the Ministry of Finance, as well as information from the Public Debt Management Office, the Planning Bureau and the Central Bank of Cyprus. For Section 3, the researchers received information from the Cyprus Chamber of Commerce and Industry (KEVE), the Industrial Development Service of the Ministry of Commerce, Industry and Tourism, the Cyprus Investment Promotion Agency (CIPA), the Cyprus Development Bank and the Human Resources Development Authority (HRDA). Information from Section 4 came primarily from the key policy documents and progress reports produced at national and EU level in the pre-accession period, as well as from interviews with the Planning Bureau and written answers from the Law Office of the ROC.

Section 1 outlines the institutional setting, with a focus on the institutions that govern economic and financial management and their inter-relationships with each other. Since the Republic of Cyprus (ROC) has in practice an unusual constitutional setting, Section 1 also goes into some detail to describe this and its impact on policy-making. Section 2 discusses long-term policy formulation and budget management, with a focus on macroeconomic management, medium-term planning and expenditure forecasting, budget formulation and execution, public investment management, treasury management and crisis management. Section 3 describes private-sector development policies and institutions, with a focus on small and medium enterprises (SMEs), foreign direct investment (FDI), state aid, and the relations between the private sector and governmental economic and financial management institutions. Section 4 gives an historical account of the major economic and financial reform agenda since the 1980s, in particular, in the light of the process of European integration, as well as the current focus of reforms and the introduction of impact assessments. Finally, the appendix provides a comparative time series of relevant economic and fiscal data.

Section 1: The institutional setting

1.1 The constitution and the doctrine of necessity

The constitution came into force with the establishment of the Republic of Cyprus (ROC) on 16 August 1960. It is the supreme law of the land, although following the accession of the ROC to the EU on 1 May 2004, the constitution was amended in July 2006 to grant higher authority to the *acquis communautaire*, the body of European Union (EU) law (Markides 2007). Not all of ROC constitution's provisions are practically in force, however. As a consequence of the events of 1963, which led by 1964 to the withdrawal from government of the Turkish community

(nowadays referred to as the Turkish Cypriot community), case-law, notably *Ibrahim and Others* v. *The Attorney General*[1], has led to the application of what is termed "the law of necessity". This allows "a temporary deviation from the strict letter of the Constitution" (Markides 2007: I-6) as long as the repercussions of the withdrawal of the Turkish community continue. The law of necessity is mainly applied to areas in which the constitution provides for representation by the Turkish community. For example, the constitution provides for "the President being Greek and the Vice-President being Turk elected by the Greek and the Turkish Communities of Cyprus respectively" (Article 1) but there is in practice only a (Greek Cypriot) president. The constitution provides for ten members of the executive body, the Council of Ministers, seven of which should be from the Greek community and three of which should be from the Turkish community. In practice there are 11 ministries (the education ministry was added in 1965 after the abolition of the Greek communal Chamber), all of whom belong to the Greek community.[2]

1.2 The organs of financial and economic governance

The primary organs of governance are as follows. Those with particular focus on economic and financial management are discussed in more detail below.

- Presidency (executive)
- Council of Ministers (executive), in particular the Ministry of Finance, the Ministry of Commerce, Industry, and Tourism and the Ministry of Communications and Works (which includes transport)
- House of Representatives (legislature), in particular the House Finance Committee and the House Commerce Committee
- Judiciary (independent)
- "Semi-government organizations" (described as "common utility organizations which provide essential services", each with a reporting line to a particular ministry)
- "New institutions" ("common utilities organizations" which were created as a result of the EU accession process, some of which have regulatory oversight, such as the Office of the Commissioner for State Aid Control)
- "Independent officials" (independent bodies with supervisory or regulatory oversight), including the Central Bank of Cyprus.
- Social partners, in particular the employer organizations: the Cyprus Chamber of Commerce and Industry (KEVE), the Cyprus Employers' and Industrialists Federation (OEV) and the Cyprus Federation of Professional Craftsmen and Shopkeepers (POVEK), as well as the trade

[1] 1964 *Cyprus Law Reports* 195.

[2] Under Article 2(3) religious groups (Maronites, Armenians and Latins) were obliged to choose to belong either to the Greek or the Turkish community. All groups chose to belong to the Greek community.

unions: the main union representing the public sector (PASYDY), the left-wing trade union (PEO), the right-wing trade union (SEK) and others.

Relevant new institutions and independent officials will be treated below under Section 1.7 below, "Accountability and oversight", while the role of social partners will be examined more fully in Section 3.1.

1.3 The presidency

The president is in practice elected on the basis of universal suffrage for a period of five years, although the constitution provides for election of the president and vice-president "by the Greek and the Turkish Communities of Cyprus respectively". Since there is no prime minister, the president is both head of state (Article 36) and, by virtue of Article 48, head of government, meaning that "The government is the president's government and the policy of the government is the president's policy"(Markides 2007, p. I-29). The constitutional provisions for removing the president from office before an election are quite restrictive, applying only in case of "physical or mental incapacity", "high treason" or "moral turpitude" (Article 44).

Even without the application of the doctrine of necessity, the president has extensive powers. Indeed, it has been argued that the president of the ROC "exerts greater control over domestic political affairs than any other European Union (EU) leader" (Ker-Lindsay 2006, p. 21), as a result of the combination of the powers already vested in the presidency, the application of the doctrine of necessity, and the moral authority of the president as the (Greek Cypriot) national leader on the Cyprus problem.

This combination has a bearing on governance issues, since it gives the president of the ROC considerable powers as both head of state and head of government. For example, the president has the right to appoint and dismiss all members of the executive body, the Council of Ministers, whereas under the constitution he may choose only the Greek ministers. The president has a great deal of freedom in his choice, since the Council of Ministers are typically not elected representatives but rather party loyalists (or, on occasion, technocrats), who are appointed without scrutiny by any third party (Ker-Lindsay 2006).

Without the vice-president, the president has in practice the exclusive right to prepare the Council of Ministers' agenda, thus giving him control over policy priorities, the exclusive right to return decisions of the Council of Ministers and the exclusive right to veto decisions of the Council of Ministers in matters of foreign affairs, defence or security (Articles 48 and 57). As a result of the law of necessity, the president is also unencumbered by the veto rights of the vice-president in areas of foreign affairs, defence or security (Article 49). Although the president cannot veto all decisions of the Council of Ministers, the fact that he has the power to appoint and dismiss each one of them means that in practice no decision is made by the Council of Ministers without presidential approval.

Similarly, without the vice-president, the president has the exclusive right of veto over laws and decisions of the House of Representatives concerning foreign affairs, defence or security and the right to return other laws and decisions (Articles 48, 50 and 51), as well as a range of rights

relating to references to the Supreme Constitutional Court (in 1964 the Supreme Court, the Supreme Constitutional Court and the High Court of Justice were merged). The president (and in theory, the vice-president) have a defined right to return the budget to the House of Representatives, although this particular right is not used in practice since its purpose is to ensure non-discrimination between the two communities: "on the ground that in his or their judgement there is a discrimination" (Article 51). The right to return the budget therefore falls under the general rights mentioned above.

Since the president is unable to dismiss the House of Representatives, and the House of Representatives also has a right to initiate legislation, his powers over the House of Representatives are not as extensive as those over the Council of Ministers. This can have an important impact on governance when the ruling party has only a minority in parliament. This was the case for the Progressive Party of Working People (AKEL) after August 2011, when its coalition partner, the Democratic Party (DIKO), quit the coalition. If the president returns a law twice to the House of Representatives and the House refuses to amend it, it is referred to the Supreme Court. Although Supreme Court judges are appointed by the president, they hold office until retirement and have a reputation for independence. One prominent case lost by the president was in 2009, when the Supreme Court ruled that while Article 80 prohibits the House of Representatives from passing legislation that increases government expenditure, there was no constitutional basis for preventing the House from passing legislation that would decrease government revenue, in this case, a reduction in the rate of value-added tax (VAT) applicable to restaurants (see Section 2.3.1).

1.4 The Council of Ministers and Ministries

The Council of minister comprises the President and the ministers of the following eleven ministries. The ministries most closely involved in economic and financial governance are marked with an asterisk.

- Ministry of Agriculture, Natural Resources and Environment
- Ministry of Commerce, Industry and Tourism*
- Ministry of Communications and Works*
- Ministry of Defence
- Ministry of Education and Culture
- Ministry of Finance*
- Ministry of Foreign Affairs
- Ministry of Interior
- Ministry of Labour and Social Insurance*
- Ministry of Health

- Ministry of Justice and Public Order

The Government Spokesman and the Under Secretary to the President also tend to take part in meetings of the Council of Ministers. The addition of new ministries has effectively been barred by case-law (Markides 2007) and is occasionally cited as an impediment to efficient government. Two ministries in particular have very large portfolios. The Ministry of Commerce, Industry and Tourism is also responsible for almost all private-sector activity apart from telecommunications, as well as (mainly state-owned) electricity generation and the extraction and exploitation of hydrocarbons. The Ministry of Communications and Works is also responsible for transport networks and infrastructure such as roadbuilding.

As mentioned above, typically a minister is not a member of the House of Representatives and those who are taken from the House of Representatives resign their post on assuming their ministerial position. A certain amount of political experience is normally expected, however. Article 59 of the constitution states that the minister must have "the qualifications required for a candidate for election as a member of the House of Representatives". In practice, with the exception of technocrats, ministers who are politically active have often stood in the past as candidates in elections for the House of Representatives, even if they were unsuccessful.

1.4.1 The Ministry of Finance and the Planning Bureau

The most important ministry as regards economic and financial governance is the Ministry of Finance. Its main duties and responsibilities include the following (Ministry of Finance website):

- Formulation of economic policy
- Preparation and implementation of the budget of the central government
- Taxation policy, tax collection and the customs
- Effective utilization of the economic resources of the public sector
- Borrowing requirements of the central government
- Promotion of the computerization of the public services
- Development and utilization of the human resources of the public sector

There are eight directorates, seven departments and three other services. Those that are most heavily involved in economic and financial management are indicated by an asterisk below. A full description of the Ministry of Finance's role in economic and financial governance is given in Section 2.

1.4.1.1 Directorates

- Financial Management (Public Sector)
- Coordination of the Computerization of the Public Sector
- Economic Research and EU Affairs*
- Budget and Fiscal Control*
- Tax Policy and Implementation*
- Investment and Finance*
- Insurance Companies Control Service*
- Grants and Benefits Service

1.4.1.2 Departments

- Customs & Excise Department - VAT Service
- Inland Revenue Department
- Statistical Service Department
- Government Purchasing and Supply Department
- Public Administration and Personnel Department
- Printing Office
- Information Technology Services

1.4.1.3 Other services

- The Grant and Benefits Service
- Public Debt Management Office*
- Investment Service Firm Certificates division

The Directorate for Economic Research and EU Affairs is the main body responsible for macroeconomic forecasting and long-term planning. The Directorate for Budget and Fiscal Control is the main body responsible for preparing the budget and monitoring the fiscal balance, while the Public Debt Management Office carries the main responsibility for cash and debt management. Tax Policy and Implementation, as its name indicates, is the main body

responsible for direct and indirect taxation management and policy, in collaboration with the Department of Customs and Excise, the Department of Inland Revenue and the Service of Value Added Tax, all of which fall under the umbrella of the Ministry of Finance.

The Directory of Investment and Finance has a broad role. It is the main coordinator for legislation governing regulation of the financial sector and also has responsibilities relating to the support for foreign direct investment and participation in international financial institutions.

The Ministry of Finance also acts as supervisor of the insurance sector through the Insurance Companies Control service (supervision of the capital markets and banking sectors are not concentrated in one body). A full description of capital and financial market regulation is given in Section 1.7.1 below.

1.4.1.4 The Planning Bureau

The Planning Bureau is technically independent but falls under the Ministry of Finance, which has two separate but equivalent permanent secretaries, one for the Ministry of Finance proper and one for the Planning Bureau. The Planning Bureau, founded in 1961, is the main body responsible for development policy. Before the consolidation of the budgets (see Section 2.3.2), the Planning Bureau prepared the annual development budget. In the aftermath of the event of 1974 it was the Planning Bureau which undertook the main task of re-housing the Greek Cypriot displaced and in the run-up to EU membership the Planning Bureau played a key role at the technical level in the EU accession negotiations as well as the large number of EU harmonization programmes in all aspects of the EU's *acquis communautaire* (body of EU law).

Today, the Planning Bureau prepares which national-level development plans in that are guided by broader EU strategies (see Section 2.1.2). It is also responsible for the management and absorption of the EU structural funds, cohesion funds and other EU funds.

1.4.2 The Ministry of Commerce, Industry and Tourism

The Ministry of Commerce, Industry and Tourism is responsible for "the formulation and implementation of government policy on matters pertaining to trade, industry, tourism and consumers". As mentioned above, it has a very broad remit, being responsible for tourism, retail and wholesale trade, manufacturing, mining, energy production, import and exploitation, as well as other private-sector services, which together amount to some 70% of GDP.[3] It is also the ministry responsible for supporting enterprises. The various departments and services of the Ministry of Commerce are as follows.

- Competition and Consumer Protection Service
- Department of Registrar of Companies and Official Receiver

[3] Author's estimate derived from Statistical Service national accounts by sector at current prices.

- Energy Service European Union
- European Union Unit (EU representation in various bodies)
- Industrial Development Service (business support)
- Nautical Tourism Development Unit (marina development)
- Technology Service (technology promotion)
- Trade Service (trade promotion)

The Ministry of Commerce is also the reporting line for two semi-government organizations, the Cyprus Electricity Authority (the state-owned, dominant electricity provider) and the Cyprus Tourism Organization, the body responsible for promoting tourism.

1.4.3 The Ministry of Communications and Works

The Ministry of Communications and Works is responsible for "the provision of efficient and effective services in telecommunications, postal services, road safety with a sufficient road network, modernized buildings, up to-date airports and ports with efficient services, and the promotion of our culture and heritage." Though not said explicitly in its mission statement, it is also responsible for shipping, balance-of-payments income from which accounts for some 6% of GDP.[4] It has 12 departments as follows.

- Department of Antiquities
- Department of Public Works
- Department of Merchant Shipping
- Department of Electronic Communications
- Department of Electrical and Mechanical Services
- Department of Road Transport
- Department of Civil Aviation
- Department of Postal Services
- Department of Control
- Road Safety Unit
- Design Bureau for the Accessibility of Persons with Disability

[4] Derived from Central Bank of Cyprus balance-of-payments data and the Statistical Service's national accounts.

- European Affairs Unit

1.4.4 Ministry of Labour and Social Insurance

The Ministry of Labour and Social Insurance has some impact on economic governance in so far as it is the reporting ministry for the Human Resources Development Authority and the Cyprus Productivity Centre (see Section 3.3.3). In practice, however, it is a ministry that implements, rather than devises, government policy in areas such as effective tax on labour.

1.5 Semi-government organizations

There are in total 14 semi-government organizations—autonomous "common utility organizations" that report to individual ministries. Only the Human Resources Development Authority, which reports to the Ministry of Labour and Social Insurance, has a role in economic governance, by implementing labour market policies and supporting small and medium-sized enterprises (see Section 3.3.3). The semi-government organizations include state-owned and majority state-owned utilities such as Cyprus Airways (the national carrier), the Cyprus Telecommunications Authority (the dominant telecoms provider) and the Electricity Authority of Cyprus (the dominant electricity provider). The semi-government organizations that have a role in the economy are as follows, with their ministerial reporting lines indicated in brackets.

- Cyprus Airways (Communications and Works)
- Cyprus Broadcasting Corporation (Interior)
- Cyprus Ports Authority (Communications and Works)
- Cyprus Telecommunications Authority (Communications and Works)
- Cyprus Tourism Organization (Commerce, Industry and Tourism)
- Electricity Authority of Cyprus (Commerce, Industry and Tourism)
- Human Resources Development Authority of Cyprus (Labour and Social Insurance)

1.6 The House of Representatives

After the Council of Ministers the House of Representatives is probably the next most influential institution as regards policy-making. The constitution provides for 50 members of the House of Representatives (Article 62) but by virtue of the law of necessity, there are in practice 56 members who come only from the Greek (Cypriot) community. They are elected for a five-year term that is not concurrent with the presidential term.

After the Greek Communal Chamber dissolved itself in 1965 and its powers were transferred to the House of Representatives, the House is now the sole body vested with legislative power. All

laws are passed by a simple majority of deputies present and voting, since the Article 78(2) requirement for majorities from both communities for certain laws is not implemented. The president does not have the power to dissolve the House (and nor does the House have the power to dismiss the president). The House president holds a powerful position, in so far as the House president deputizes for the president of the republic when he is temporarily incapacitated or absent.

Under Article 80 of the constitution, it is not only the Council of Ministers but also the House of Representatives that has the right to initiate legislation. When the governing party has a minority in the legislature or struggles with indiscipline within its coalition, the House's rights of initiative can make life difficult for the president.

The House also plays an important role in governance through its ability to submit questions by representatives of the House to the ministries; to register a matter for debate in the House in a plenary session; and to register a matter for examination by one of the House committees.

1.6.1 House Committees

House Committees are considered to be the most effective way of calling the government to account (Markides 2007: I-49), because the committees have the power to call the executive and other responsible officers to the House for information, explanations and clarifications and those called are obliged to tell the truth, or face criminal prosecution. The committees tend to reflect the party representation in the House. All draft laws must be referred to the appropriate committee for an initial debate. Except in the case of urgent bills, committees are given at least 48 hours to examine bills before they are considered and the House of Representatives is given at least 48 hours to examine the report of the relevant committee before a bill is debated in the plenary.

There are nine committees, mainly reflecting the relevant ministries. Those with the greatest role in economic and financial governance are indicated with an asterisk.

- Committee on Communications and Works*
- Committee on Finance and Budgetary Affairs*
- Committee on Development Plans and Public Expenditure Control*
- Committee on Foreign and European Affairs
- Committee on Institutions, Values and Ombudsman*
- Committee on Interior
- Committee on Labour and Social Insurance
- Special Committee on Declaration of Interests
- Committee on Trade and Industry*

1.6.1.1 The Committee on Finance and Budgetary Affairs

The Committee on Finance and Budgetary Affairs is the primary organ in the House of Representatives for scrutinizing the budget. It examines bills and issues of an economic nature, including the annual state budget and the annual budgets of agencies and semi-government organizations, the operation of the commercial banks and the work of the Central Bank of Cyprus, the credit cooperatives and the general functioning of the financial system. This committee may also examine explanatory memoranda relating to employment or extension of temporary staff services. In 2011 this committee played an important role in forcing pushing the government to pass tougher fiscal reforms than the government itself had desired.

1.6.1.2 Committee on Trade and Industry

The Committee on Trade and Industry examines matters within the competence of the Ministry of Commerce, Industry and Tourism and semi-government organizations operating under the ministry's supervision. This includes draft laws and regulations relating to trade, industry and tourism, cooperative credit institutions, standards and quality control of products, energy policy, consumer protection, fair competition and the development and promotion of handicraft. In 2011 and early 2012 this committee became the focus of attempts to wrest control of hydrocarbons away from the Minister of Commerce, Industry and Tourism.

1.6.1.3 Committee on Communications and Works

The Committee on Communications and Works deal with matters falling within the jurisdiction of the Ministry of Communications and Works and semi-government organizations operating under its control. The work focuses on the construction of public works, road transport, motor vehicles, telecommunications, radio communications, postal and electrical services, the development and management of ports and airports, antiquities, archaeological sites and ancient monuments.

1.6.1.4 Committee on Institutions, Values and Ombudsman

The Committee on Institutions, Values and Ombudsman has competence in issues of principles, values, institutions and good governance in general. The legislative work and parliamentary review by this committee is primarily aimed at action, legal or otherwise, to fill gaps or weaknesses and to correct the incongruities in the functioning of the administration to consolidate meritocracy and enhance reliability towards its citizens.

1.7 Accountability and oversight

Accountability and oversight is undertaken by Independent Offices and "New Institutions" created as a result of EU membership. The Independence Offices and New Institutions are as follows. Those with a particular role in economic and financial governance are indicated with an asterisk.

Independent Offices

- Attorney-General of the Republic
- Governor of the Central Bank of Cyprus*
- Audit Office*
- Cyprus Energy Regulatory Authority (CERA)*
- The Treasury
- Public Service Commission
- Education Service Commission
- Planning Bureau* (see Section 1.4.1 above)
- Office of the Commissioner for Administration (Ombudsman)
- Office of the Coordinator for Harmonization
- Cyprus Securities and Exchange Commission*
- Cyprus Radio-Television Authority
- Cyprus Agricultural Payments Organization (for EU funds)
- The Tax Tribunal

New Institutions

- Commission for the Protection of Competition*
- Office of the Commissioner of Electronic Communications and Postal Regulation*
- Cyprus Agricultural Payments Organization
- The Office of the Commissioner for Personal Data Protection
- Cooperative Societies' Supervision and Development Authority*

- Internal Audit Service*
- Office of the Commissioner for State Aid Control*
- Tenders Review Authority
- Cyprus National Bioethics Committee

1.7.1 Financial supervisory authorities

1.7.1.1 The Central Bank of Cyprus

The Central Bank of Cyprus has a central role in the supervision of the commercial banking sector. Its operations are governed by the Central Bank of Cyprus Laws 2002-2007, which established full independence and compatibility with various EU-related laws, such as the Statute of the European System of Central Banks and of the European Central Bank. Upon adoption of the euro in January 2008, the Central Bank of Cyprus was legally integrated into the Eurosystem.

Political influence is exerted to some extent on the central bank in so far as the governor is appointed by the president of the republic for a renewable term of five years. While the president has the power not to renew the term, Article 18(4) of the Consolidated Bank of Cyprus Laws ensures that the president does not have the sole power to remove the governor. Moroever, those powers that do exist for the governor's removal are severely restricted by Article 153(8) of the Constitution. During his term of office, therefore, the governor is able to act independently. Indeed, the AKEL-led government clashed frequently with the governor appointed in 2007, Athanasios Orphanides, and Mr Orphanides was not reappointed for a second term.

The Central Bank of Cyprus' man functions are implementing the European Central Bank's monetary policy decisions; holding and managing the official international reserves; supervising banks; safeguarding the stability of the financial system; promoting, regulating and overseeing the smooth operation of payment and settlement systems; and acting as banker for the government.

1.7.1.2 EU bodies

As a member of both the EU and the eurozone, the ROC financial system is also regulated by European System of Financial Supervision, which is of growing importance. It consists of three supervisory authorities: the European Banking Authority (EBA), the European Insurance and Occupational Pensions Authority (EIOPA) and the European Securities and Markets Authority (ESMA), as well as the European Systemic Risk Board, which is responsible for macro-prudential oversight of the financial system within the EU. Since the eurozone crisis, the powers of the EBA have been considerably enhanced. For example, it has the power to monitor banks, such as through the EU-wide stress tests, and to issue binding guidelines on capital ratios.

1.7.1.3 Other financial and capital supervisory institutions

Despite the strong role of the Central Bank of Cyprus and the enhanced role of the EU institutions, supervision of the entire financial, capital and insurance market is somewhat disparate within the ROC, with three different supervisory bodies for the following types of institutions.

- Cooperative societies are regulated by the Authority for the Supervision and Development of Cooperative Societies (ASDCS, also known as CSSDA). The Council of Ministers appoints the commissioner and four other members of the governing body for five years. The International Monetary Fund (IMF) recommended in its 2008 Financial Sector Assessment Program (FSAP) that there should be a single supervisor for banks and cooperative credit institutions. However, while there have been steps to improve supervision of the cooperatives and improve coordination with the Central Bank, the government appears to have no intention to merge the two institutions.

- Insurance companies are regulated by Insurance Company Control Service (ICCS), a division within the Ministry of Finance. The powers of the ICCS conferred upon the Superintendent of Insurance, who is assisted by two Assistant Superintendents of Insurance. The Superintendent and the Assistant Superintendents of Insurance are public officers appointed by the Council of Ministers.

- The Cyprus Stock Exchange is regulated by the Cyprus Securities and Exchange Commission (CySEC), whose board is appointed by the Council of Ministers on the basis of a proposal from the Minister of Finance. Board meetings are attended by a representative of the Governor of the Central Bank, who has the right to register subjects in the agenda, participate in discussions and express opinions but does not have the right to vote.

1.7.2 Other non-financial supervisory bodies

The primary role of the Cyprus Energy Regulatory Authority, the Commission for the Protection of Competition and the Office of the Commissioner of Electronic Communications and Postal Regulation is to ensure that the sectors within their competence abide by domestic and EU laws on competition and the internal market.

The Audit Office is responsible for the audit of government accounts, statutory bodies, special funds, local authorities and other public organisations. It has played an important role in highlighting shortfalls in funding of contingent liabilities, such as payments for property expropriation, and questioning continued spending on projects that have not fully implemented their business plans, such as the Cyprus Institute. The Internal Audit Service is responsible for the audit of the various programmes co-funded by the EU in the ROC. The Ombudsman exercises control over actions or inaction of public administrative authorities but excluding the president, House of Representatives, Council of Ministers, Supreme Court and other courts, other Independent Offices, the Governor of the Central Bank and the Public Service Commission.

Section 2: Long-term policy formulation and budget management

2.1 Macroeconomic management

The Ministry of Finance Directorate for Economic Research and EU Affairs is the main body responsible for macroeconomic forecasting and long-term planning. Since the ROC is a member of both the EU and the eurozone, EU institutions, in particular the European Commission Directorate-General for Economic and Financial Affairs (DG ECFIN) also play a role, for example in supervising adherence to the Growth and Stability Pact and applying sanctions where necessary.

Now that the ROC is a member of the eurozone, monetary policy, which used to be the preserve of the Central Bank of Cyprus, is conducted at the level of the European Central Bank.

2.1.1 The Stability Programme

The primary macroeconomic policy document is the five-year Stability Programme, which runs to some 100 pages, and is produced every year by the Directorate for Economic Research and EU Affairs and then submitted to the European Commission. Prior to euro adoption, the Directorate produced five-year Convergence Plans and prior to EU accession, it produced Pre-Accession Programmes. The earlier strategy documents had broadly similar content.

As well as defining macroeconomic objectives, the Stability Programme, is essentially a tool that forces the government to justify its forecasts, acknowledge short-term risks, plan for long-term contingencies, and generally to seek continually to improve the allocation of resources.

The main themes of the Stability Programme are as follows.

- Overall policy framework and objectives: including fiscal policy, monetary and financial sector policies, and structural reforms
- Economic outlook: including the global and domestic outlook and a medium-term (five-year) scenario
- Key issues relevant for policy: such as the banking system, the current account
- General government balance and debt: including a detailed five-year forecast running to some 30 pages
- Sensitivity analysis of the general government balance and debt: including alternative scenarios and risks
- Quality of public finances: an analysis of optimal resource allocation and priorities
- Long-term sustainability of public finances: in particular, age-related expenditure

2.1.2 The National Reform Programme

At the strategic level, the main policy document is the five-year National Reform Programme 2011, produced by the Planning Bureau, which set out targets for development policy in the subsequent five years in the context of the EU 2020 Strategy for Smart, Sustainable and Inclusive Growth. The National Reform Programme presents the structural reforms that aim to boost growth, employment and social cohesion. A second policy document, the Strategic Development Plan 2007-13, promotes measures that were part of the National Reform Programme of the EU's Lisbon Strategy programme that ended in 2010. Particular emphasis was laid on implementing measures that would be co-financed by European funds. The 2007-13 Plan promoted research and innovation, lifelong learning, the environment, energy and health, as well as the measures for improving basic infrastructure and rural development. A new seven-year plan will be produced in 2014 in line with the EU's 2020 Strategy. .

2.2 Medium-term planning and expenditure forecasting

2.2.1 Macroeconomic forecasting

The Ministry of Finance conducts macroeconomic forecasts twice a year, once during March-April and once during September-October. The first forecasting round has a five-year time horizon, while the second one has a three-year time horizon. Both rounds cover all main macroeconomic indicators. These forecasts are firstly prepared within the context of the annual Stability Programme and secondly for the purposes of the government's budget. These forecasts fulfil the ROC's obligation to the European Commission's spring and autumn economic forecasting rounds, in which the European Commission produces its own forecasts of each member state.

The forecasts produced by the Ministry of Finance are prepared following a model that takes into consideration long-term trends and the potential growth of the economy, as estimated by the European Commission. Diversions from long-term trends are estimated by taking into account several indices, in an effort to estimate the dynamics of the different macroeconomic variables.

For the purposes of delivering estimates for the five-year period in the context of the annual Stability Programme, it is assumed that the economy gradually reverts to its potential growth rate.

In order to validate the results stemming from the aforementioned methodology, the Ministry of Finance examines the forecasts made by other international organizations for the ROC, and also holds meetings and regularly exchanges views with the Central Bank of Cyprus and the University of Cyprus, which also runs a forecasting model.

As regards expenditure forecasts, the Stability Programme produces five-year forecasts as a percentage of GDP for expenditure (and revenue), as well as the following components of expenditure: compensation of employees, intermediate consumption, social payments, social transfers, interest payments, subsidies and gross fixed capital formation.

During the preparation of the annual budget, a more detailed three-year expenditure forecast is prepared, forecasting expected expenditure, in current-price terms, down to the level of subhead.

2.2.2 The role of statistical agencies

As regards macroeconomic forecasting it is important to mention the supporting role played by the Statistical Service of the Republic of Cyprus (CYSTAT), the Central Bank of Cyprus and the Public Debt Management Office in helping officials gain a comprehensive picture of current trends. With its 146 permanent staff, CYSTAT produces, in Excel format, around 25 statistics each month (an average of more than one per day) on all aspects of the economy, including full quarterly national accounts data. It also has a large online archive. While CYSTAT technically functions under the Ministry of Finance, it maintains its autonomy both in theory and in practice[5]. The Central Bank of Cyprus produces quarterly and annual data on the balance of payments and the international investment position, as well as a monthly Excel file called Monetary and Financial Statistics, which includes data on lending and deposits. The Ministry of Finance's Public Debt Management Office produces a Quarterly Debt Bulletin, as well as more frequent statistics on outstanding loans.

All of the statistics produced by these institutions are available for free in Greek and in English, and the officials are encouraged to answer queries from the public. These factors allow for close scrutiny of the government's forecasts by independent forecasters and therefore help raise the government's accountability.

2.3 Budget formulation and public investment plan

2.3.1 Constitutional provisions for budget formulation

Under Article 167 of the ROC constitution, the Minister of Finance is responsible for the preparation a comprehensive budget every financial year. Article 167 also states that once the budget is approved by the Council of Ministers, it is laid before the House of Representatives.

Under Article 81 of the Constitution, the budget must be introduced to the House of Representatives "at least three months before the day fixed by law for the commencement of the financial year and is voted by it not later than the day so fixed". The financial year runs from 1 January to 31 December, therefore the budget must be introduced before 31 October and be

[5] The sole exception being its estimates for the Turkish Cypriot population.

voted on by 31 December. Normally the budget is introduced in early to mid-October and voted on in mid-December.

In practice, owing to the various consultations that take place as part of the preparation of the budget with political parties and, where relevant, social partners, it is rare for the budget not to be approved by the House of Representatives once it is formally submitted, although individual "votes" (lines) of the budget may undergo revision.

In the event that the budget has not been adopted by the House by the first day of the financial year to which it relates, the House of Representatives may authorize the meeting of any expenditure required for the continuance of the public services shown in the budget. The authorization is done by a resolution and may only be done one month at a time and for no longer than two months in total (Article 168(3)). The same article also states that expenditure authorized for any service "shall not exceed the proportion with respect to such period of the amount voted for that service [head of expenditure] in the Budget for the preceding financial year". This means, for example, that if the particular expenditure item was 5% of total expenditure in the approved budget for 2012, it must not exceed 5% in the expenditure approved for 2013. Another restriction is that expenditure under any given subhead may not exceed the provision proposed under the same subhead in the budget for the new financial year under consideration by the House. In other words, it is not possible to authorize more expenditure for an expenditure item than is already proposed in the budget. Finally, expenditure for new services and the filling of new posts before the adoption of the budget by the House is not allowed.

One weakness in the budget is that there is no constitutional or other legislative provision for what occurs if the budget is still not adopted after the two months has expired. If two months have expired, no expenditure on salaries or other services can be approved. The passage of the budget therefore depends on the collective good will of the executive and legislature. Indeed, the non-passage of the taxation laws was one of the key triggers that led to the breakdown of relations between the two communities in 1963 (Markides 2007). During the 2008-12 period of negotiations to find a settlement of the Cyprus problem, the two communities agreed[6] that in the event of the budget not being passed, the provisions of the budget in the previous year would remain in force and that the first budget would be agreed upon before the settlement came into force.

The House of Representatives has the right to adopt or not adopt any expenditure included in the budget or any supplementary budget laws. That is, it may reject individual lines of the budget over which it has voting powers, which it often does. This is part of the political trade-off that leads to the budget finally being approved in full. However, the House does not have the power to increase the "votes of expenditure" (the technical term used by the Ministry of Finance to denote each budget line) or change the purpose intended for such votes. That is, the House cannot initiate any proposal to increase expenditures or change the purpose of expenditure (Article 167(6)).

[6] Subject to the general guiding principle that "nothing is agreed until everything is agreed": Joint statement of the Cyprus leaders contained in the Secretary-General Report on his mission of good offices in Cyprus, 11 May 2010.

However, the constitutional provision on expenditure in Article 167 as well as Article 80(2) has been found not to prevent the House from voting through measures that might *reduce the revenue* of the government. In 2009 the government put forward a bill that reduced value-added tax (VAT) on hotels and tourism packages but not restaurants from 8% to 5%. Parliamentary parties passed a law to reduce VAT on restaurants as well. The president sent the proposal back to parliament twice, which triggered referral to the Supreme Court. The Supreme Court ruled that the law was not unconstitutional. [7]

When the budget is finally adopted by the House, it is enacted as the budget law for the relevant year and is published as such in the *Official Gazette*. The Minister of Finance then issues a general warrant to the Accountant-General, authorizing him to incur expenditure from the budget.

2.3.2 Expenditure budget

The constitution provides for the preparation of a single budget. However, for a certain period more than one budget was prepared. In the beginning, following the establishment of the Republic of Cyprus in 1960, two separate budgets, the ordinary budget and the development budget, were introduced before the House of Representatives. The ordinary budget included all the current operational expenditures of the government (wages and salaries, operational expenses, etc.), while the development budget covered the expenditures for the implementation of the various development programmes.

In 1975, following large-scale internal displacement as a result of the events of 1974,[8] the Special Relief Fund for the Displaced and Affected Persons was established to handle swiftly and efficiently with the complex and severe problems that arose as a result, such as the need for re-housing. Expenditure out of this fund mainly covered the creation of the necessary infra-structural works for the physical survival of the displaced and affected persons, the provision of the necessary social services and other assistance and their economic reactivation.

Originally, an independent budget was set-up for the needs of the above fund, which was then submitted to the Council of Ministers for approval and subsequently to the House of Representatives for adoption.

In 1984 the Defence Fund was established as the fourth budget of the Republic, covering expenses relating to national defence.

Eventually these budgets were merged by a decision of the Council of Ministers No.48.868 of 16 December 1998. This approved the consolidation of all four budgets and the provisions of the Special Relief for the Displaced and Affected Persons Budget were incorporated into the consolidated budget for 2000.

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[7] *Cyprus Mail*, 3 December 2009, "VAT ruling shifts balance of power between Presidency and Parliament".

[8] For one of the more balanced accounts of then events, see Ker-Lindsay (2011).

The consolidated budget contains the following information.

2.3.2.1 Expenditure

a) Estimates of the ordinary expenditure, which is chargeable on the Consolidated Fund as defined by Article 166 of the Constitution.

b) Estimates of other ordinary expenditure, which has to be adopted by the House of Representatives.

c) Estimates of development expenditure, which is subject to adoption by the House of Representatives.

d) Estimates of defence expenditure.

The House therefore has the right only to vote on parts (b) and (c). The protection of the Consolidated Fund relates to the separation of powers, since the Consolidated Fund includes, for example, the remuneration of the president and independent officers such as the attorney-general and auditor-general. The protection of defence expenditure relates to the president's executive power in matters relating to defence (Article 48 of the constitution).

2.3.2.2 Revenues

a) Estimates of revenue for the budgeted year based on legislation already enacted or pending before the House for adoption (such as changes in tax rates).

2.3.2.3 Supplementary data

a) A statement of assets and liabilities of the ROC at the end of the last completed financial year.

b) Estimated balances of the Consolidated Fund at the end of the last completed financial year.

c) Loans to be granted by the Loan Commissioners for development projects.

d) Salary scales, the creation and abolition of posts, list of officers in control of expenditure votes and a list of officers responsible for the collection of revenue.

2.3.3 Preparation and approval of the budget

2.3.3.1 Preparation

Budget preparation starts early in the year for the following financial year's budget. The budget is prepared and considered on the basis of a policy determined in advance by the Minister of Finance. Then in March or April circulars are communicated to all ministries, departments and independent offices. This policy aims, inter alia, to allocate the scarce financial resources according to carefully established needs and priorities.

These circulars, one for ordinary expenditure and one for development expenditure, give the basic guidelines, specifying the fiscal policy framework within which the ministries, departments and independent offices should submit their proposals. They set out the macroeconomic scenario, noting fiscal targets and giving indications of what the level of expenditure should be, as well as an indicative growth rate compared with last year's expenditure. The circulars also indicate policy priorities.

The circular for the category of development expenditure contains the main guidelines for the proper allocation of resources by order of priority and in accordance with the objectives set out in the five-year Strategic Development Plan.

Budget proposals for the ordinary expenditure of the budget are submitted to the Budget and Fiscal Control Directorate of the Ministry of Finance where they are checked, scrutinized and evaluated. They are then referred to the Estimates Committee of the Ministry of Finance, where they are widely discussed, at meetings held especially for this purpose. Permanent secretaries of ministries and heads of departments are invited to these meetings to give further details on their proposals.

The Estimates Committee decides on each proposal and makes a concrete recommendation on each proposal to the Minister of Finance. The Minister then considers each proposal along with the relative recommendation and decides accordingly.

The development expenditure of the budget for any particular year is in effect the public investment programme for that year; it constitutes in essence the main instrument for the implementation of the public investment component of the Strategic Development Plan.

The Estimates Committee proposals for the development expenditure of the budget are submitted to the Planning Bureau, where they are checked and evaluated from the planning and economic points of view. They are then referred to the Ad Hoc Committees on Development Expenditure and are widely discussed by these committees at meetings held especially for this purpose. Permanent secretaries of ministries and heads of departments are invited to these meetings to support their proposals.

The Ad Hoc Committees on Development Expenditure decide on each proposal and make a concrete recommendation on each proposal to the Minister of Finance. These recommendations are presented to the Minister of Finance in the form of a draft budget for consideration and final decision.

The draft budget incorporating the Minister´s decisions is then compiled by the Budget Directorate of the Ministry of Finance, incorporating the ordinary and the development expenditures, and is subsequently submitted to the Council of Ministers for their consideration and approval.

When the draft budget is approved by the Council of Ministers, it is then tabled before the House of Representatives for consideration and adoption, accompanied by two explanatory memoranda, giving details and analysis on the disbursement of all votes (budget lines) of ordinary and development expenditures separately. The Committee on Finance and Budgetary Affairs of the House of Representatives evaluates the draft budget and arranges meetings with all Ministries and Independent Offices where general or specific questions of the Members of the Committee are answered. The Parliamentary Committee submits to the House a Special Report on the Budget. Before the Parliamentary debate on the Budget, the Minister of Finance addresses the House of Representatives. The purpose of this address is to brief the House on the situation of the economy during the preceding year and on the macro economic and sectoral policies to be followed, during the new financial year and on the future economic prospects.

There is no legislative requirement to engage social partners in the preparation of the budget. However, in practice, unions and employers' representatives are consulted on an ad hoc basis when the budget includes matters of particular concern to their members and the government needs political support for the passage of the budget. This occurred in the second half of 2011, when the government introduced a range of measures relating to tax rates, social insurance contributions and public-sector pay that affected both public-sector workers and private-sector business.

2.3.3.2 Contingencies and Reserve head

According to the notes of the annual budget law, the provision under this head is to be allocated to and reallocated from other heads and subheads on the authority of the Minister of Finance. It can be used in cases of exceptional, urgent and unforeseen expenditure.

The allocation from this head to other heads and subheads is made by a special warrant issued by the Minister of Finance.

In cases where a sub-head has been supplemented by the issue of a special warrant from the Contingencies and Reserve head, the Minister of Finance may, with a new special warrant, transfer back to contingencies the supplementary amount that remained unspent so that it can be reallocated to other heads and sub-heads.

2.4 Budget execution

2.4.1 Budget implementation

After the adoption by the House of Representatives, the budget is enacted as the budget law for that particular year and the implementation phase of the budget begins. By law the controlling officers of votes (lines of budget) have the responsibility for the disbursement of funds.

Implementation is strictly monitored via the online Financial Integrated Management System. Before any payments can be made, the system checks in real time whether there are available funds for the expenditure. If there are no available funds, then the expenditure cannot be authorized. This methodology ensures that there is no over-spending by ministries, departments and independence offices. The government is gradually introducing new budget management methods through pilot projects, with the aim of introducing a fully fledged Medium-Term Budgetary Framework by 2015 that will introduce further expenditure discipline, allocate expenditure in favour of on growth-enhancing activities and force spending agencies to prepare indicative rolling three-year budgets. A draft bill on budgetary stability will also incorporate an automatic correction mechanism.

Under the provisions of section 4(I) of the annual budget law, the Council of Ministers may authorize the provision of additional funds under any subhead or head of expenditure against equivalent savings from other subheads of the same head and category of expenditure. In order to protect the provision of services this is allowed on condition that any saving caused by the omission to perform any service or purpose shall not be regarded as a saving.

It is also provided that any savings on subheads 02000 "Officials of the Republic - Emoluments", 02100 "Emoluments of State Officers", 03001 "Travelling" and 03020 "Office Expenses" cannot be spent to make up a deficiency in the sums spent for any of these subheads. Nor can it be used for any other subhead under the same head. At the same time, no saving on any other subhead of the same head can be spent in making up a deficiency in the sums spent for any of the aforesaid subheads. In sum, if the budget for salaries, travel and office expenses is not spent, it cannot be allocated elsewhere. The Ministry of Finance explained that one of the primary reasons for this is that, at any given time there are around 3,000 vacant posts out of a total of around 71,500 civil servants and other public-sector employees (Statistical Service 2011) which have a six-month appropriation. Using savings from these vacant posts, it is argued, would easily lead to over-commitments in expenditure, especially given that wages and salaries account for 27% of current expenditure (Ministry of Finance, 2011).

The transfer of funds under section 4(I) is made by the issue of a special warrant by the Minister of Finance. Around 100 such special warrants are issued each year.

2.4.2 Procedure for special warrants

With Decision No. 3727 of 19 March 1964 the Council of Ministers conferred on the Minister of Finance the authority to authorize expenditure by special warrant under section 3(1) of the Statutory Functions (Conferment of Exercise) Law (No. 23 of 1962).

The following conditions must be met.

a) The Minister of Finance is authorized to sanction, without prior approval of the Council of Ministers, and on his own responsibility, additional provision under any individual subhead and for any amount on the clear understanding that such additional provision:

   i. will not cause an excess on the head of that subhead, that is, that the extra sum required will be recovered from savings from other subheads of the same head, and in the case of exceptional, urgent and unforeseen expenditure from the head "Contingencies and Reserve";

   ii. will not be of a nature as to raise a question of principle or involve a breach of some regulations;

b) The Minister of Finance should submit to the Council for "covering approval" of all the additional provisions thus sanctioned at quarterly or shorter intervals, as the case may be; and

c) If for any reason the Minister of Finance is not prepared to approve an application for a special warrant, then the minister concerned could ask that the matter be referred to the Council for a decision.

The Ministry of Finance explained that b) is deemed necessary because the Council of Ministers has shifted the responsibility to the Minister of Finance by law.

Under the provisions of section 4(2) of the annual budget law, a statement showing all special warrants issued and the circumstances under which they were issued must be laid before the House within one month from the date of the Council's authority for their issue.

Special warrants issued by the Minister of Finance can only be reported to the House after the Council's covering approval is obtained.

Special warrants issued as a direct charge on the Consolidated Fund, in accordance with Article 166 of the Constitution, can be issued by the Minister of Finance without any reference to the Council. Similarly, these special warrants do not have to be reported to the House.

Under the provisions of section 4(3) of the budget law, any excess of votes (budget lines) in contravention of the procedure described above is deemed to be not legally made and the controlling officers of the votes under which the excess has been made are held personally liable for any excess expenditure incurred or to be incurred.

2.4.3 Supplementary appropriation (supplementary budget)

Under the provisions of Article 167(5) of the constitution and the provisions of section 4 of the annual budget law, supplementary appropriation by the House is required under the following circumstances:

a) when no equivalent savings are available under other subheads of the same head of expenditure;

b) when the additional expenditure has to be charged to a new subhead, even though equivalent savings are available under other subheads of the same head; in these cases the savings are shown on the relevant bill; and

c) when the additional expenditure cannot be met from funds approved under head, "Contingencies and Reserve".

Supplementary appropriation is made by the introduction by the Minister of Finance of a supplementary appropriation bill to the House. As no bill can be introduced to the House without the prior approval of the Council, the matter must first be submitted to the Council for its approval. In practice, there are typically around two to three supplementary budgets each year.

On the enactment of the bill by the House and on its publication in the *Official Gazette* as a law, a special warrant is issued in the usual way. These special warrants do not have to be reported to the House.

2.4.4 "Daggered" votes and procedure for de-daggering

In certain cases, even after the budget has been made law, it is found necessary to restrict expenditure on a number of votes until the Ministry of Finance (for current expenditure) and the Planning Bureau (for development expenditure) have had the opportunity to examine the case/project programme/scheme in more detail and to assess the full financial impact of its implementation.

The above objective can be achieved by marking the votes in question with a dagger(+). No expenditure can be incurred from daggered votes unless the funds are de-daggered by the Minister of Finance through the Budget and Fiscal Control Directorate of the Ministry of Finance.

Before funds can be de-daggered, the Ministry and or the Department concerned must send for consideration full details of the project/programme/scheme to the Ministry of Finance, in the case of ordinary expenditure, and to the Planning Bureau, in the case of development expenditure. The final approval for de-daggering rests with the Minister of Finance.

2.4.5 Amendment bills

Any other modification of the budget during the year which is not related to supplementary appropriation, such as the change of a title of post, change of salary scale of a post, abolition of an existing post of votes or a change in the description of a head or subhead, should be made with the submission of an amendment bill to the Council of Ministers for approval and onward transmission to the House of Representatives for enactment.

An amendment bill is also required in the cases of an excess in an expenditure vote of past year's budget which had not been covered during the course of that particular year.

In practice there are normally around two amendment bills each year.

2.5 Treasury management (cash and debt)

Following a decision by the Council of Ministers in July 2008, the public debt management responsibilities were transferred from the Central Bank of Cyprus to the Ministry of Finance as of 1 August 2010. Responsibility for treasury management lies with the Ministry of Finance's Public Debt Management Office (PDMO).

The PDMO stresses that it considers transparency as one of the main pillars for safeguarding the legitimate interests of both the taxpayers and the investors. For this reason, all transactions are published and the publications of the PDMO are not subject to political approval.

2.5.1 Legal framework for public debt management

Debt management is based mainly on the following legislation:

i. The Loan (Development) Laws and Regulations;

ii. The Cyprus Treasury Bills Laws;

iii. The Loan (Savings) Law and Regulations;

iv. Terms of Issue domestic Government Bonds and Treasury Bills;

v. The Euro Medium Term Note (EMTN) and Euro Commercial Paper (ECP) Programmes;

vi. The Central Bank of Cyprus Laws;

vii. Council of Ministers Decision No. 45.382 of 8 January 2007, transferring the issuance of Treasury Bills from the Council of Ministers to the Minister of Finance;

viii. Council of Ministers Decision No. 45.727 of 19 March 1997, transferring the issuance of Government Registered Development Stock from the Council of Ministers to the Minister of Finance

ix. The Council of Ministers Decision No. 67.443 of 9 July 2008, transferring responsibility for public debt management to from the Central Bank of Cyprus to the Ministry of Finance.

2.5.2 Public debt management objectives

The main objectives in managing the public debt are as follows:

- Ensuring easy funding of the gross financing requirements of the government, through unrestricted access to domestic and international capital markets
- Minimizing borrowing cost at each acceptable level of risk
- Developing the domestic market for government securities and strengthening its competitiveness, liquidity and efficiency

It should be noted that although it has been a long-term government aim to create a liquid domestic secondary market for government bonds, this has not yet occurred.

2.5.3 Main tasks of the PDMO

The PDMO's primary purpose is to manage the public debt and its associated risks, which it does through the following tasks:

a) drafting legislation for the management of public debt and modernizing the legal framework governing the management of public debt;

b) developing a medium-term public debt management strategy;

c) preparing the annual borrowing policy;

d) preparing the annual issuance programme based on the estimated amount of the deficit and the forecast for overall financing needs of the year;

e) preparing, planning and executing all new government securities issues of the ROC in the domestic and international markets, including organizing road-shows for investors and negotiation of relevant documents;

f) negotiating loan agreements, agreements relating to transactions on derivative products and other related documents;

g) cash management for the central government and ensuring sufficient liquidity of the government general account to service its debt;

h) intervening in the secondary market for domestic government bonds and treasury bills;

i) management of foreign exchange and interest rate risk;

j) management of the surpluses of the Social Security Fund;

k) development of domestic Government securities market;

l) maintaining relations with credit rating agencies and investors; and

m) preparing and submitting statistical data on government debt.

2.5.4 Financing instruments

There are four main types of financing instruments.

Treasury bills. These are issued to investors via auctions with a maturity of up to 52 weeks. They are listed and traded on the Cyprus Stock Exchange.

Government Registered Development Stocks (GRDS) are bonds issued using a bid-price auction system in the domestic market with maturities of 2, 5, 10 and 15 years. Buyers may be both legal and natural persons. The stocks are listed and traded on the Cyprus Stock Exchange.

The Euro Commercial Paper (ECP) Programme is a multi-currency programme of up to €5 billion. It allows short-term borrowing of between 7 days and 12 months. Notes under the Programme are not listed on any stock exchange and may be issued in euro, US dollars and Swiss francs. Notes in other currencies may also be issued subject to any necessary approval and consents having been obtained.

The Euro Medium Term Note (EMTN) Programme of €6 billion facilitates issuance in several currencies and structures.

There are also institutional loans from the European Investment Bank and the Council of Europe Development Bank.

In 2012, as yields on international markets became prohibitive, the ROC took a €2.5bn bilateral loan from the Russian Federation.

A number of retail schemes were previously available but have now been terminated.

2.5.5 Forthcoming reforms[9]

The current legislation pertaining to debt management covers only issuance and servicing of debt. There are no provisions as regards targets, policy, risk or accountability, nor are there any provisions for derivatives or other financial instruments. Therefore, effective debt management legislation is currently lacking. Anecdotally, it is said that the Public Debt Management Office suffered from political interference with the timing of debt issuance from a former finance minister, which led to the spikes in debt repayments in 2012-13.

New legislation has been prepared, which is targeted for adoption by June 2012. It was prepared with the assistance of the World Bank and deals with all aspects of debt management, such as the auction calendar, central government cash balance management and a liquidity buffer. In particular, the new legislation:

- Provides for the creation of a debt management unit with clearly defined powers and responsibilities
- Puts forward a risk-cost trade off as the basis for debt management

[9] Source: PowerPoint presentation: "Debt Management Legislation overhaul".

- Separates policy-making from implementation
- Provides for accountability and control procedures and the role of the Auditor-General
- Concentrates all functions regarding debt, guarantees and liquid asset management at the PDMO
- Defines the relationship between PDMO, Minister of Finance and the House of Representatives

2.6 Crisis management

2.6.1 Central policy management institutions

The focus of crisis management in the ROC is on financial stability, given the very large size of the financial sector relative to gross domestic product (GDP)[10] and consequently its importance for the wider economy.

Coordination frameworks exist at both the domestic and international level. Domestically, coordination is formalized through a Memorandum of Understanding (MoU) between the Ministry of Finance, the Central Bank of Cyprus and the other supervisory agencies: the Authority for the Supervision and Development of Cooperative Societies (ASDCS), the Cyprus Securities and Exchange Commission (CySEC) and the Insurance Companies Control Service (ICCS).

The domestic MoU was the basis for a "Financial Stability Committee", composed of representatives of the Central Bank, supervisors, and the Ministry of Finance to facilitate information exchange and coordination. The Committee meets when the need arises, but convenes on at least a quarterly basis. Overall, the main powers and responsibilities in crisis management are reasonably clear and the tasks of each agency are explicitly listed in the MoU. The authority to provide initial Emergency Liquidity Assistance is reserved to the Central Bank of Cyprus, the facilities offered by the European Central Bank (ECB) providing a first line of defence. In the event of a possible need to use public funds to resolve a crisis, the Ministry of Finance would be closely involved well in advance, as soon as potential risks have become clear, in the process of crisis management and resolution.

The Financial Stability Committee could face its first real test in 2012. The private-sector initiative (PSI) which led in March 2012 to provisions of up to 70% on Greek sovereign debt has had a severe impact on the capital adequacy ratios of the main three banks. This could lead one of the banks to call on the government for capital, which in turn could trigger the government entering an EU support mechanism (Economist Intelligence Unit 2012).

[10] According to the Central Bank of Cyprus *Monetary and Financial Statistics*, total deposits of monetary and financial institutions amounted to €69.6 billion at the end of February 2012, or almost four times the size of nominal annual GDP in 2011 of €17.8 billion.

2.6.2 Legal instruments for crisis management

The various legal instruments underlying crisis management are in the Banking Law, the Cooperative Societies Laws and Rules, the Cyprus Securities and Exchange Commission (Establishment and Responsibilities) Law, the Insurance Services and other Related Issues Laws and Regulations, and the Company Law.

In December 2011 the following remedial action measures were also passed into law.

- Law for the Management of Financial Crises. The purpose of the Law is to enable the Council of Ministers, following a proposal of the Central Bank of Cyprus and after taking into account the opinion of the respective supervisory authority, to take, in a period of a financial crisis, measures intended to address solvency problems of the financial system and/or to enhance the capital base and/or the balance sheet of financial institutions in the ROC, under conditions that should comply with the European Community rules for state aid as well, as with the provisions of the state aid control laws.

- Law for the Establishment of an Independent Financial Stability Fund. The purpose of this Law is the establishment of an independent Financial Stability Fund, financed by contribution from credit institutions, with a view to enhancing the current crisis management and resolution framework in the ROC and thus contributing to the safeguarding of financial stability. It is emphasized that the Fund does not aim at bailing out or preventing the failure of credit institutions.

2.6.3 Key policy documents

A number of MoUs constitute the key policy documents for crisis management.

(a) An MoU among between the supervisory authorities has been signed between the CBC, the Cyprus Securities and Exchange Commission, the Insurance Companies' Control Service, and the Authority for the Supervision and Development of Cooperative Societies (ASDCS, also known as CSSDA). The memorandum has been amended three times, in 2004, 2006 and 2008. This MoU allows the competent supervisory authorities of the financial sector to cooperate and exchange information between them and/or with other supervisory authorities, whether in the ROC or elsewhere, with a view of discharging their functions and responsibilities in a more effective manner.

(b) An MoU signed in 2007 between the abovementioned supervisory authorities and the Ministry of Finance to facilitate crisis management.

(c) An MoU at the EU level between the Central Banks and the Ministries of Finance came into effect in 2005 and was amended in 2008. The EU Memorandum is designed to facilitate the management and resolution of cross-border systemic financial crises. It seeks to facilitate private-sector solutions, to minimize economic and social costs, while promoting market discipline and limiting moral hazard.

(d) A National Contingency Plan has been drafted which describes what processes should be activated for crisis prevention; crisis alert; crisis assessment; crisis management; crisis resolution; public communication; and crossborder implications and coordination.

Section 3: Private-sector development policies and institutions

3.1 Relations between the government and the private sector

Relations between the government and the private sector are primarily conducted via the Cyprus Chamber of Commerce and Industry (KEVE) and the Employers' and Industrialists Federation (OEV). A smaller role is played by the Cyprus Federation of Professional Craftsmen and Shopkeepers (POVEK).

While it appears that there is no legislative mechanism for systematically consulting the social partners (representatives of employers and employees), it does happen in practice. Moreover, it is increasingly becoming a requirement to consult stakeholders for the purposes of pre-implementation impact assessment (see Section 4.7). KEVE informed the author that, together with OEV and the unions, they take part in a range of advisory committees on issues such as labour, economic matters and planning. At these committees, an attempt is made to reach convergence before legislation is drafted by the Council of Ministers. While this means that the process of drafting legislation can be slow, it also means that legislation tends to be pass once it is submitted to the House of Representatives. For EU directives, which are transposed into national law and therefore have some scope for national customization, social partners must be consulted in keeping with the EU principle of public consultation. One recent example was the EU directive on late payments. As discussed in Section 2.3.3, social partners are also consulted when annual or supplementary budgets or other changes affect issues such as taxation or other labour-related charges such as social insurance.

3.2 Tax policy

When examining policy towards private enterprises it is easy to forget the important role play by the taxation system. In the author's opinion the ROC's taxation system is far more important than any micro-level policy and lays the basis for the flourishing of the private sector in general and small and medium-sized enterprises (SMEs) in particular. The three most important features of the tax system that support the private sector are as follows.

- Standard, low corporate tax rate of 10%, the lowest in the EU together with Bulgaria
- High personal income tax threshold of €19,500 and four other income-tax bands

- Comparatively low social insurance rates (6.8% for employee, 6.8% for employer)

These factors mean that, together with the cost of share capital, registration, legal documents and related professional services, one can set up a company for only €1,000.[11] Moreover, depending on the company's profits, a company with only the director as employee might only pay social insurance premiums plus one or two other small, labour-related premiums. For the government, the fact that the threshold for value-added tax (VAT) registration is low, at €15,600, is also a source of income. An additional factor that attracts non-resident companies and the professional services that support them is that there is no tax on dividends for non-resident companies.

Tax rates did increase in 2011, however. The tax rate on director's dividends was raised from 15% to 17% and then 20%, an annual levy of €350 for registered companies was introduced that may prove permanent and a new top rate of income tax was introduced at 35% (previously 30%) on incomes over €60,000. The VAT rate rose from 15% to 17% on 1 March 2012. However, in general the tax system remains supportive of private-sector activity.

3.3 Small and medium-sized enterprises

The ROC is almost exclusively a micro-enterprise economy. According to the most recent Census of Establishments conducted in 2005, over 92% of enterprises had less than ten employees (the EU definition for a micro enterprise), while only 111 enterprises (0.1%) out of a total 76,499 had more than 250 employees (the EU definition for an SME).

3.3.1 The Industrial Development Service

Until EU membership, therefore, there was no separate policy for SMEs. After EU accession new measures to support industry were designed and implemented, such as grant schemes for the following:

- Technological upgrading
- Adaptation of standards
- Creating quality control laboratories
- Conducting market research
- Participation in exhibitions
- Personnel education and training

In addition, EU guidelines for the development of SMEs were adopted. The coordinating role for the SME policy, support and development was assigned to the Industrial Development Service of

[11] The author confirmed this with a subcontractor who had set up a company in 2012.

the Ministry of Commerce, Industry and Tourism, which together with other government and private-sector agencies, implements and coordinates the appropriate measures and actions for SMEs in line with the EU's Small Business Act and its guiding principle of "Think Small First".

A special Steering Committee on SMEs was established under the chairmanship of the Ministry of Commerce, Industry and Tourism and including the Ministry of Finance, the Planning Bureau, the Ministry of Labour and Social Insurance, the Accountant General Office, theHRDA, the Productivity Centre and the employer representatives, KEVE, OEV and POVEK.

The various tools used to promote and develop SMEs include the following:

- Grant schemes funded either by purely national funds or with co-financing from EU funds (e.g. investments, technological upgrading and creation of new industrial units for processing and marketing agricultural products, e-commerce, women and youth entrepreneurship, personnel training, incentives for employment of unemployed graduates, participation in exhibitions to promote exports, etc.).
- Actions and measures to reduce bureaucracy and administrative burdens on SMEs.
- Creation of infrastructure to accelerate and facilitate the creation of businesses, such as the One Stop Shop and point of single contact.
- Offices for SME access to information at the national and European level.
- Schemes that facilitate the financing of SMEs, such as the EU's JEREMIE products for loans or guarantees, and the recent decision by the government to established a guarantee mechanism for the facilitation of the financing of SMEs, which is financed by the European Investment Bank.
- Deletion of unnecessary legislation and improvement of legislation affecting SMEs negatively and introduction of new legislation that benefits them, such as late payments legislation.
- Measures on access to markets, such as participation in public procurement competitions.

3.3.2 The Cyprus Development Bank

In the context of financial support for SMEs, it is illustrative to report on an interview with the Cyprus Development Bank (CDB). The CDB was contacted because it is an exclusively corporate bank, which was state-owned until 2008. Under state ownership it implemented an EU programme, funded by the European Investment Bank (EIB), which was at that time a shareholder in the CDB. The programme provided low-cost support to SMEs and the CDB was obliged to report, *inter alia*, on additional employment created through its EU-funded schemes. The CDB continues to have a separate department for dealing with financing of SMEs but revealingly, has not taken part in the EU JEREMIE programme. The EIB-supported programmes

are now open to any bank, and the CDB, which has less than €0.5 billion in total deposits,[12] has found that the administrative cost of applying for EU funds is simply too high.

Instead, the CDB's main support for SMEs is in what it termed as the "softer elements" of financing. These are not necessarily priced in or packaged as a separate product but assist smaller companies that do not have a large organizational structure such as a chief financing officer. Support for SMEs involves listening and giving advice and guidance, although the CDB emphasizes that it does not have the authority actually to produce business plans, since this is up to the individual company. Policy instruments provided for SMEs and other corporates include short-term financing, medium- and long-term financing, letters of credit, providing guarantees and a range of other products.

3.3.3 The Human Resources Development Authority

The Human Resource Development Authority (HRDA) is a semi-government organization under the Ministry of Labour. Five members of the Board of Governors are government representatives, four are employer representatives and four are trade unions representatives. Its nationally funded activities are financed by a 0.5% levy on salaries. The HRDA operates a number of schemes co-funded by the EU. For SMEs, the HRDA operates two schemes:

The "Enhancement of the Competitiveness of Micro-Enterprises with 1-4 Employees", with a budget of €4.5 million for 1,200 enterprises. This uses special consultants to identify needs, diagnose weaknesses that might affect the enterprise's competitiveness, develop management skills and prepare an enterprise medium-term operational plan.

The "Improvement of the Productivity of Small and Medium-Sized Enterprises with 5-249 employees", with a budget of €1.55 million for 250 enterprises. This scheme also uses specialist consultants to offer practical tools for improvements in productivity, better utilization of human resources and the preparation of a medium-term operational plan for the development of the enterprise.

3.4 State aid

3.4.1 The EU legal framework

As an EU member, state aid in the ROC is restricted by EU rules, in particular Article 107(1) of the Treaty on European Union, which states, "Save as otherwise provided in the Treaties, any aid granted by a Member State or through State resources in any form whatsoever which distorts or threatens to distort competition by favouring certain undertakings or the production of certain goods shall, in so far as it affects trade between Member States, be incompatible with the internal market."

[12] Central Bank of Cyprus, "Total deposits and market shares for 2011".

The same article goes onto say that the following state aid is compatible: aid having a social character; certain aid to consumers; aid "to promote development of areas where the standard of living is abnormally low or where there is serious underemployment"; aid to regions referred to in Article 349 (named islands such as Guadeloupe and Madeira); "aid to promote the execution of an important project of common European interest or to remedy a serious disturbance in the economy of a Member State"; aid to promote cultural heritage; and certain other aid subject to conditions.

However, under the *de minimis* rule, aid of no more than €200,000 granted to an enterprise over a period of three fiscal years is not regarded as state aid within the meaning of Article 107(1).[13] In addition, state aid is specifically allowed for EU policy priorities such as research and development, environmental protection, training, female entrepreneurship, and aid for disabled and disadvantaged entrepreneurs. Additional measures to support access to finance have been brought in as a response to the eurozone financial crisis.

3.4.2 The Office of the Commissioner for State Aid Control

The ROC Office of the Commissioner for State Aid Control was established in June 2001 as part of the EU harmonization process. It is an independent office. Its primary role is not to distribute state aid but to monitor state aid and rule on whether proposed state aid is compatible with EU or national legislation. It also collects data on all state aid granted.

Inferring from the Commissioner's report, the largest amount of state aid in 2010 (€21 million) was distributed by the HRDA to support the employment of university graduates. The second largest (€13 million) was to the Cyprus Tourism Organization for the enhancement of the tourism product, while the third largest (€4.5 million) was to the Ministry of Labour for other unemployment schemes.

3.5 Foreign direct investment

3.5.1 The legal framework for FDI

As of 1 October 2004 almost all of the remaining restrictions on FDI were liberalized for both EU citizens and third-country nationals as follows.

- Restrictions relating to the minimum level of investment and the percentage of foreign participation were abolished in most sectors of the economy, allowing for up to 100% equity participation in registering companies or acquiring shares in existing companies.
- The few remaining restrictions relate to media, employment agencies, tertiary education and medical services.

[13] European Union, Handbook on Community State Aid Rules for SMEs, 25 February 2009.

- Administrative procedures were simplified and measures were taken to streamline the infrastructure regarding foreign investment.

Apart from this broad legal framework, and in view of EU state aid rules, the ROC does not offer any special tools such as tax subsidies or special treatment to attract FDI. Instead, in order to attract FDI, emphasis is laid on the structural factors: the natural attractiveness of the ROC as a strategically located EU member state with low taxes, more than 40 double taxation treaties, a strong legal framework, a low crime rate, a pleasant climate, decent infrastructure, a highly educated workforce, and so on.

3.5.2 The Cyprus Investment Promotion Agency

The Cyprus Investment Promotion Agency (CIPA) was established (after considerable delay) in 2008 as a not-for-profit company limited by guarantee and now plays a key role in promoting investment abroad, including marketing, advertising, articles, marketing material, films, events and roadshows. CIPA also works with KEVE, which focuses on trade and promoting the ROC to external markets. CIPA also organizes events targeted at specific investors in countries such as Russia, China and Dubai.

CIPA has succeeded the Foreign Investor's Service in the Ministry of Commerce, Industry and Tourism as the key organization that acts a facilitator for investors, communicating with new and existing investors to facilitate any requirements they may have, ranging from acquiring licences to issuing visa/work permits for employees. As a third pillar, CIPA is also engaged in advocacy in order to enhance the ease of doing business in the ROC by proposing amendments to the legal framework which affects businesses and foreign investments.

Section 4: The major reform agenda since the 1980s

4.1 Main drivers of reforms

4.1.1 From the Association Agreement onwards

Without doubt the major drivers of reforms in the 1980s were preparations for EU accession. However, institutional arrangements between the ROC and what is now the EU began in the early 1970s, with the signature by the ROC of the Association Agreement on 19 December 1972. This was prompted by the accession to the European Economic Community (EEC) of the UK, which at the time was the primary market for both imports and exports of goods. The Association Agreement focused primarily on the liberalization of trade between the ROC and the EEC. The EEC implemented cuts in tariffs or increases in quotas for ROC industrial and agricultural products, as well as certain other special arrangements, in return for the ROC gradually reducing tariffs on products from the EEC. During this period the ROC also received financial and technical assistance (Ministry of Commerce 1982). However, despite the reduction

in tariffs in both directions, exports to the UK and the six founding members[14] fell as a proportion of the total between 1972 and 1987, even as total export volumes of key products, such as potatoes, rose. Imports from the EC countries did rise as a proportion of the total, but those from the UK fell. By contrast, exports to Arab countries rose from 7.1% of the total in 1972 to 35.3% in 1987 (Mullen 2011). This could mean that the local response to competition from Europe did more to raise the attractiveness of ROC exports in less developed countries outside the EEC than it did to raise the attractiveness of ROC goods in the EEC itself.

The Association Agreement envisaged the transition to a full customs union in two stages. After two extensions of the first phase, the second phase came into force in 1982 and a customs union was signed on 19 December 1987, which expanded the range of import and export products that were no longer subject to restrictions. In product markets, the data suggest that the ROC could compete in higher value-added categories such as pharmaceuticals and foodstuffs but was unable to compete in lower value-added areas such as textiles. The net result was a large fall in agriculture and manufacturing as a proportion of GDP. Agriculture fell from 17.2% in 1972, to just 3.9% in 1988, partly exacerbated by the loss of around 50% of cultivated land available to Greek Cypriots after the events of 1974 (Ministry of Commerce 1991). Manufacturing fell from 15.2% of GDP in 1972 to 9.9% of GDP in 1998. By contrast, services rose from 37.9% to 73% in the same period. The main long-term impact of both the Association Agreement and the customs union, therefore, was probably to accelerate the natural shift in the structure of GDP towards services that was already under way as a result of global trends.

The major reform phase took place once EU accession negotiations began from March 1988. The main governance-related reforms in this period are dealt with in Section 4.2.

4.1.2 Cost of reforms

In terms of cost, the total cost of harmonization for the period 2001-02 was estimated in 2001 at €400 million, of which €160 million related to the environment, dominated by infrastructure relating to waste and water management. The total post-accession investment cost was estimated at €1.25 billion, of which €700 million related to the environment. Together these costs amounted to €1.65 billion, or 15.6% of 2001 GDP. The vast proportion of this spending was met by national funds. Inferring from the 2002 European Commission Progress Report, less than €100 million of this expenditure was met by the EU, although the ROC was also eligible for loans from the European Investment Bank.

4.2 Aspects of the economic management system subject to reform

Clearly, in the run-up to EU accession there was barely any aspect of the economic and financial management system that did not undergo reform. In the interests of space, this subsection will focus on the following five aspects of the management system.

[14] Belgium, France, Germany, Italy, Luxembourg and the Netherlands.

- Macroeconomic and fiscal policy, in particular changes to the way in which the government produced economic forecasts or budget plans.
- Monetary policy and capital account regulation, in particular changes in which the Central Bank of Cyprus managed foreign exchange capital, the exchange rate and rules on interest rates.
- Financial supervision, in particular changes to the way in which the banks, cooperatives, insurance services and capital market were supervised.
- Competition policy, in particular changes to regulation or regulatory bodies.
- Utilities regulation, in particular changes to the way in which electricity and gas, and postal and telecommunications services were regulated.

Most of the information in the following paragraphs comes from the National Programme for the Adoption of the Acquis 2001; the Pre-Accession Programmes 2001-2005 and 2002-2006; the Convergence Programmes 2003-2007, 2004-2008, 2005-2009 and 2006-2010; and the EU pre-accession progress and monitoring reports.

Although EU accession negotiations began in 1988, the institutional and legislative changes did not begin to accelerate until 2000-01 and continued right up until EU membership on 1 May 2004. Therefore, it can be concluded that the most intensive reform phase took place within a period of around three years.

4.2.1 Macroeconomic and fiscal policy

4.2.1.1 External surveillance

Probably the most important change in macroeconomic and fiscal policy was external scrutiny by the European Commission. The government was obliged to produce and justify medium-term economic and fiscal performance forecasts, and later, in the Convergence Programme 2003-07, to produce alternative scenarios in case its real GDP growth forecasts did not turn out as expected. In the same report, the government also began to produce long-term projections of the sustainability of the pensions system.

In order to adopt the euro, the ROC was obliged to meet the five so-called Maastricht criteria relating to the stability of inflation and interest rates relative to the eurozone average, the stability of the exchange rate relative to the euro, and thresholds for the ratios to GDP of public-sector debt (below or approaching 60% at a satisfactory pace) and the budget deficit (no more than 3%). Once the ROC adopted the euro, it was also subject to the Growth and Stability Pact, which aims for budgetary close to balance or in surplus in the medium term. The EU supervisory mechanism also includes an excessive deficit procedure, a system that puts member states under watch if they exceed the 3% deficit ceiling and can lead to fines.

However, since the Stability and Growth Pact was considerably weakened at the political level by Germany and France in 2005 (Citigroup 2012), a new preventive system, the Alert Mechanism Report (ARM) and the Macroeconomic Imbalance Procedure was introduced in

February 2012. The AMR aims to "identify countries and issues for which an in-depth review is deemed necessary" (European Commission 2012) and the ROC was among the 12 member states that were deemed to warrant an in-depth review. Depending on the outcome of the review, a member state could be subject to an Excessive Imbalance Procedure, which implies increased EU surveillance, with semi-automatic fines if recommendations are not followed.

The AMR examines five indicators of external imbalance and five indicators of internal imbalance. The external imbalances relate to the current-account balance; the net international investment position; the change in export market share; the change in nominal unit labour costs and the change in the real effective exchange rate (REER) relative to consumer price inflation among trading partners. The internal imbalances relate to private-sector debt; private-sector credit; changes in house prices; public-sector debt; and the unemployment rate.

What is different about this methodology is that, for the first time, policy-makers have paid official attention to house prices as a source of imbalance, whereas the prevailing view before the global financial crisis, at least of central banks, was the asset prices were not their concern. As part of the new process, the Central Bank of Cyprus now produces a quarterly house price report.

At least until the adoption of the euro, the externally imposed constraints led to a reduction in the ROC budget deficit from a peak of 6.6% in 2003 to a surplus of 3.5% of GDP in 2008. However, the fiscal performance has deteriorated rapidly since, with a budget deficit of 6.3% of GDP in 2011 and a debt/GDP ratio of 71.6% of GDP (Public Debt Management Office, 2011). The ROC is again under the excessive deficit procedure and may even have to enter the EU support mechanism (see Section 4.6).

4.2.1.2 Medium Term Budgetary Framework

In 2006 the ROC began the process of gradually introducing a binding Medium-Term Budgetary Framework (MTBF), with the aim of institutionalizing expenditure rules and giving more independence to spending ministries, while increasing their accountability (Stability Programme 2010-2014). From 2007, all spending agencies are required to prepare indicative three-year budgets. Pilot projects covering three ministries were introduced in 2007, with the number gradually increasing each year. The aim is that by 2013 all agencies will prepare their budgets in line with both the new framework and the old input-based method, so that they can have two trial years to test the new methods. The MTBF is being introduced alongside the introduction of the Financial Management Accounting System (FIMAS) (see Section 2.4.1).

4.2.1.3 Comprehensive tax reform

Prior to EU accession, the ROC applied a preferential tax rate of 4.25% to offshore companies, compared with 25% for local companies. This constituted a form of state aid that had to be abolished as a result of EU membership but also as part of the ROC's attempt to improve the poor reputation as regards money-laundering it had acquired as a result of its role in by exporting cash from the former Yugoslavia (Torkildsen 2002). This resulted in it being placed

on the Financial Action Task Force watchlist of the Organisation for Economic Cooperation and Development (OECD) until June 2000 (FATF 2000).

The government committed in the NPAA 2001 to reforming anti-money laundering legislation and tax systems and in 2003 implemented a comprehensive tax reform. The reform included harmonizing the corporate tax rate at 10% for all companies (apart from the state-owned EAC and CYTA), an increase in the income-tax threshold initially to CYP 9,000 (€15,377) and a reduction in the top rate of income tax to 30% (Pre-accession Programme 2001-05). The 10% corporate tax rate gave the ROC the lowest tax rate in the EU, which bolstered the business services sector (see Section 4.7). The standard rate of VAT, which had been introduced in 1992 at 8%, was increased gradually to the minimum rate of 15% in January 2003 (it was raised to 17% in March 2012). There were also increases in excise duties in alcohol, tobacco and petrol (Central Bank of Cyprus 2002).

4.2.2 Monetary policy and capital account regulation

4.2.2.1 Liberalization of interest rates

In the run-up to EU accession, changes to the monetary policy framework were introduced in the context of the liberalization interest rates and the capital account. In January 2001 the statutory ceiling on interest rates was abolished. While this was intended to prevent excessive interest-rate charges, in practice the ceiling had in fact acted as a minimum interest rate and thus reduced competition. As soon as the interest-rate ceiling was abolished, official and commercial rates began to fall. Indeed, with the exception of the period April 2004 to February 2005, they fell continuously until the adoption of the euro in January 2008.

4.2.2.2 Monetary policy framework

A new monetary policy framework was introduced in January 2006. With a view to responding more quickly to changes in the market and controlling liquidity in the economy more effectively, the Central Bank of Cyprus shift to market-based tools, rather than direct instruments that had been used previously (NPAA 2001). Repurchase transactions replaced the liquidity ratio as the main tool of liquidity management, minimum reserve requirements were reduced and two standing facilities introduced to absorb overnight liquidity. Once the ROC adopted the euro, official interest rates were set by the European Central Bank (ECB).

4.2.2.3 Capital account liberalization

In order to protect a small, open economy with its own currency the ROC used to impose a number of restrictions on incoming and outgoing flows. From July 2000 foreign direct investments abroad were allowed by ROC residents from (the Central Bank retained a right to intervene in the case of large investments) and EU residents could make direct and portfolio investments into the ROC, subject to a few exceptions including real estate. From December

2000 restrictions on lending in Cyprus pounds to non-residents were lifted and from January 2001 restrictions were lifted on medium- and long-term loans to residents in foreign currencies as well as on transfers abroad by non-residents in "blocked accounts".

The remaining restrictions were lifted upon accession in May 2004. These included restrictions on non-resident portfolio investments in the ROC and of resident portfolio investments abroad; real estate investments abroad; loans to non-residents; and the export of cash (EU ruels late imposed certain restrictions on amounts above €10,000). Restrictions on the purchase of property were also were also eventually lifted.

4.2.3 Financial supervision

4.2.3.1 Non-cooperative banking sector

The first enhancement of financial supervision took place in July 1997, with the enactment of new banking legislation that provided for more robust supervision and the implementation of prudential rules. Prudential rules and minimum authorization requirements followed EU directives on credit institutions. According to the National Programme for the Adoption of the Acquis (NPAA), the Banking Law of 2007 reflected "to a very large extent the principles and rules of the EU Directives on credit institutions" (NPAA 2011: p. 119).

Further harmonization took place in the run-up to EU accession. In May 2009, the Central Bank of Cyprus issued a directive on the control and supervision of large exposures, in order to comply with EU Directive 92/121/EEC.

In December 1999, in compliance with Directive 86/635/EEC, the Central Bank of Cyprus issued a directive on the presentation of balance sheets and profit and loss accounts.

In September 2000 two deposit protection schemes for commercial banks and cooperative credit and savings societies were introduced for deposits in Cyprus pounds. By January 2004 the scheme had been expanded to cover all European currencies. In 2009, in the wake of the global financial crisis, the amount insured was raised from €20,000 to €100,000.[15]

The EU Directive 93/6/EEC on capital adequacy of credit institutions and EU Directive 96/10/EC on contractual netting came into force in January 2003.

Full central bank independence came in July 2002, with the passing of a new Central Bank of Cyprus Law. From then until euro adoption, monetary policy decisions were made by the Monetary Policy Committee (MPC), which had only had an advisory roles since its establishment in 2000, rather than the central bank board. The MPC comprised six members, three from the central bank including the governor and three external members chosen by the finance ministry in consultation with the governor (Economist Intelligence Unit 2002). The power to appoint the central bank governor remained with the ROC president. The new law on independence also prohibited the government or other public institutions from borrowing from the central bank via overdraft or other credit facilities.

[15] Association of Cyprus Banks.

The administrative capacity of the Banking Supervision and Regulation Division was strengthened via the recruitment or transfer of staff. The number of officers rose from 15 to 18. The number of administrative assistants rose from 5 to 10, while the number of clerks fell from 22 to 18. Staff also underwent training on EU legislation organized both locally and abroad.

4.2.3.2 Cooperatives

Prior to EU accession, the cooperative credit and savings societies were regulated by the Department of Cooperative Development, now called the Authority for the Supervision and Development of Cooperative Societies (ASDCS, also known as CSSDA). To meet its new supervisory responsibilities, the Department's administrative capacity was enhanced with additional staff (and additional eight by the end of 2002), training, and the introduction of electronic monitoring systems. The Cooperative Central Bank was the primary liquidity management institution for the cooperative sector (EC Regular Report 2002) and eventually came under the supervision of the Central Bank of Cyprus.

However, regulation of the cooperatives remains a concern of the International Monetary Fund (IMF) even to this day. The IMF has consistently called for single supervision, most recently in its November 2011 Staff Report: "Staff also reiterated its [*sic*] long-standing advice that supervision and regulation of banks and cooperatives should be unified, and that as an intermediate step the regulatory frameworks should be harmonized." (IMF 2011, p. 21). The resistance to merging supervision seems to be related to the traditional links of cooperatives to AKEL, currently the ruling party and consistently the first or second largest party in parliament.

The cooperatives were obliged to adopt the EU *acquis* on credit institutions. During the screening process they requested a five-year period to comply fully with Directive 2000/12/EC with respect to own funds, the solvency ratio and large exposures. In the event, upon accession in 2004 they were given a transitional period of just over three and half years to the end of 2007 (EC Regular Report 2003). With the passage of the 2007 Banking Law, cooperatives were divided into two groups: "conforming" institutions, which would be treated as authorized credit institutions, and "non-conforming institutions" which took longer to harmonize with EU requirements. They were allowed to continue carrying out their business within the ROC.

4.2.3.3 Insurance sector

The insurance sector is supervised and licensed by the Insurance Companies Control Services (ICCS), heading by the Superintendent of Insurance. As part of the accession process the number of staff including the superintendent was increased from 12 in 2001 to more than 20 by accession. The ICCS became fully computerized with software to assist financial analysis, for example.

The insurance sector was already mature before EU accession negotiations began, therefore the legal basis for supervision was already quite developed. The main change required in supervision related to prudential provisions, for example, solvency margins, admissible assets and accounting requirements. A new law that brought all insurance legislation in line with the

EU *acquis*, the Insurance Services and Other Related Issues Law, was passed in April 2002 (EC 2002). The same law provided that rules relating to the single passport and home country control entered into force upon accession. Motor insurance was fully harmonized in July 2000 and the Cyprus Motor Insurers' Fund (the guarantee fund) became a member of the Multilateral Guarantee Agreement in January 2001.

4.2.3.4 Capital markets sector

The Cyprus Securities and Exchange Commission (CySEC) is the main body responsible for supervision of the sector. It expanded staff considerably in the run-up to EU accession and its powers were enhanced in 2001. However, anecdotally, investment professionals have complained that CySEC does not have the capacity for proper supervision of the sector, nor the skills to keep up with changes in the way capital is invested. CySEC was unable to prevent the bull run in 1999-2001, and no one was brought to account for the large losses sustained by retail investors as a result of poor investment advice by professionals (or, it is suspected, because of insider trading by the same professionals giving the advice). Retail investment in the Cyprus Stock Exchange has never really recovered since the crash that followed the boom and today only seven companies are listed on the main exchange.

A secondary bond market in government bonds has been on the agenda for years but has not been created. Reportedly this is partly because of rivalry between CySEC and the Central Bank of Cyprus over who should have the power to regulate it. This makes the government dependent mainly on local banks for funding and, during the fall-out from the eurozone crisis, dependent on ad hoc bilateral loans to rollover external debt.[16]

The Securities and Stock Exchange Law was amended in June 2002, which liberalized the sector in important respects, such as allowing companies from EU member states to list on the exchange and allowing banks to act as brokers. A covering the EU directives on investment services, capital adequacy and investor compensation came into force in July 2002. Provisions for mutual acceptance of prospectuses and recognition of home state supervision came into force upon EU accession.

4.2.4 Competition policy and state aid

4.2.4.1 Protection of competition and control of mergers

[16] In 2011 yields on the ROC's international bonds rose to more than 10%, effectively closing off access to international markets. The government covered its large financing needs in 2012 with a discounted-rate bilateral loan of €2.5 billion from the government of Russia.

The Commission for the Protection of Competition was established as an independent authority in 1990 in the context of the 1988 customs union agreement, in order to enforce legislation relating to the protection of competition and merger control. In 2000 the Commission was given greater investigative powers, the power to impose larger fines and a full-time president with the right to appoint specialized staff. The board of the commission was reduced from seven to five, in an attempt to speed up decision-making, but the number of qualified and support staff was increased. Further amendments were made in 2008.

Today the main competences of the commission are:

- "To control restrictive agreements and concerted practices by enterprises having as their object or effect the elimination, restriction or distortion of competition
- To control the abuse of dominant position possessed by one or more enterprises
- The control of concentrations between enterprises aiming at preventing distortions in effective competition and ensuring that the principles of competitive markets are respected." (Commission for the Protection of Competition 2010, p. 5).

However, for a small economy in which the risk of cartel agreements must by nature be high, there have been notably few high-profile cases. This is partly because of multiple changes in the Commission's leadership. The Commission itself is aware that its powers are limited. In its 2010 Annual Report, it noted "the absence of the desirable autonomy", referred to the "time-consuming procedures of the governmental budget and other bureaucratic procedures" and said that without flexibility of actions and financial and administrative independence "we will continue to trail behind Europe". (Commission for the Protection of Competition 2010, p. 45).

As regards legislative changes, the protection of competition is one of the cardinal principles of the EU, therefore much of the legislation is in the form of regulations, which are directly applicable in member states, rather than in the form of directives, which are first transposed into national law. However, certain preparations were made to align competition policy with the EU *acquis* in advance of EU accession. In 1999 a new law on mergers aligned national law to that of the EU and in 2000 an amendment to the protection of competition law placed public undertakings and "undertakings with special and exclusive rights" under the competition rules of what was then Article 86 of the EC Treaty. A range of measures to mirror the EU block exemption regulations[17] was also introduced.

4.2.4.2 State aid

[17] For example, one block exemption allows certain kinds of exemption from competition rules when it concerns agreements on research and development or technical co-operation in air transport.

As noted in section 3.4, state aid is subject to strict EU rules and compliance with such rules upon accession was one of the pre-conditions of receiving EU structural funds (EC Progress Report 2003). The independent Office of the Commissioner for Public Aid (now the Office of the Commissioner for State Aid Control) was established with the entry into force of the Public Aid Control Law in April 2001. The Commissioner's first task was to obtain a picture of the extent of state aid by preparing an inventory of state aid granted to date. Relevant authorities, including local authorities, were given six months until October 2001 to notify the Commission of existing state aid schemes and other ad hoc measures. The survey showed state aid amounting to €118.2 million, or around 1% of GDP, of which the largest proportion (28%) was for the media and cultural sector (Pre-Accession Programme 2002-2006).

The ROC undertook to align or eliminate all incompatible schemes and measures by the end of April 2003. By March 2003 the Commissioner had completed the assessment of 203 cases for compatibility with the new law and found that 92 were not compatible (Pre-Accession Programme 2002-2006). Thereafter, all measures not falling within the *de minimis* rule (see Section 3.4) or measures relating purely to agriculture or transport were submitted to the European Commission Directorate General for Competition. A transition period for fiscal aid (including the preferential corporate tax rate) for offshore companies was granted until the end of 2005.

One of the measures that had to be adopted was to limit the income-tax exemption for cooperatives to profits arising from transactions with other members as well as greater transparency in book-keeping.

Competent authorities in the ROC were also invited to seminars to explain the new law. The Public Aid Office began with staffing of three professionals, three support staff and an economist employed on a contractual basis and staff took part in training sessions for candidate countries.

As regards legislation, a number of laws were passed in 2001 to align ROC laws with relevant EC regulations. These included those relating to public said for SMEs, research and development, professional training, rescuing and restructuring firms in difficulty, environmental protection and state guarantees. Export aid was also prohibited.

4.2.5 Utilities regulation

When EU accession negotiations began, semi-government organizations such as the Electricity Authority of Cyprus (EAC) and the Cyprus Telecommunications Authority (CYTA) enjoyed legal monopolies in the market.

4.2.5.1 Electricity and gas

Liberalization of electricity (and gas, although at present gas does not play a role in the market) entailed establishing an independent regulator for electricity and gas, establishing a transmission system operator, abolishing the monopoly status of the EAC and eliminating price distortions. As regards security of supply stocks, the ROC was obliged to establish an oil stocks body and was meant to build up 60 days of oil stocks by 2002. It was granted until the end of

2007 to build up oil stocks to the full requirement of 90 days, although the infrastructure for meeting this requirement only began to be built in 2011.

A law on the transparency of gas and electricity prices for industrial end-users was passed in November 2001 and legislation on the cost of crude oil supply and consumer petroleum products pries was passed in July 2002. Efficiency requirements for certain categories of products were introduced and the ROC submitted a plan for the promotion of renewable energy sources.

However, perhaps because of the monopoly status of the EAC, its links with the political party, AKEL, and the fact that the government had used the profits of EAC an ad hoc basis to fund its budget deficit, the alignment of electricity legislation with the EU *acquis* proceeded more slowly than in other areas. The Commission reported in its 2002 Progress Report published in the fourth quarter of 2002 that it had provisionally closed 28 of the 30 chapters under discussion but noted that the alignment with the EU *acquis* of electricity legislation (among others) had yet to be addressed. The Report noted that legislation remained pending on the opening up the electricity market and on oil stocks, and that the ROC had yet to establish a regulatory authority or a transmission operator for electricity. There were also remaining price distortions.

The Commission considered the situation to be serious enough to send a letter to the ROC in June 2003, calling for urgent action to address shortcomings in the transposition of the electricity and gas directives, among others.[18] By the fourth quarter of 2003 the government had responded by abolishing the monopoly of EAC and passing a law on electricity (but not the implementing legislation), appointing a chairman for the energy regulator (but not actually establishing the authority) and addressing some price distortions by raising electricity tariffs for domestic users (EC Progress Report 2003). Tariff rebalancing began in March 2003 and, despite warnings from the EU about the slow pace, was still continuing in 2012.

A new law in 2003 provided for the establishment of the Cyprus Energy Regulatory Authority (CERA), which started operations in February 2004. EAC lost its monopoly status in terms of supply upon accession in May 2004, when in theory 35% of the electricity market was liberalized. However, EAC remained the sole generator and supplier of electricity in practice for the first few years. The market was liberalized again to 65% (again in theory) in 2009 but EAC remains the dominant producer.

4.2.5.2 Postal and telecommunications services

A regulatory authority, the Office of the Commissioner of Electronic Communications and Postal Regulation (OCECPR), was established in 2002 and before that, the number of personnel at the Directorate of Telecommunications in the Ministry of Communications and Works was increased. These staff underwent training, including spending time in the national regulatory bodies of other EU member states. In 2004, the Cyprus Telecommunications Authority (CYTA),

[18] The others were requirements on oil stocks within the energy chapter, a new Internal Audit Act within the financial control chapter and preparations for the application of the *acquis* within the customs union chapter (Progress Report 2003, p. 10).

the dominant state-owned provider, was transformed into a company limited by guarantee but with the state remaining as the full share-owner. Tariff re-balancing saw a reduction, inter alia, in rates for mobile phone calls, international fixed-line calls and ISDN installation and rental, while rates for local calls, installation and rental were increased.

The market for internet service providers was already liberalized but the market for mobile telephony was not liberalized until the second provider, ScanCom, later operating as areeba and then MTN, was awarded a licence in October 2003. During 2003 licences were issued for data and Very Small Aperture Terminals (VSAT) services and the provision of leased lines by an alternative network provider. Today there are a number of fixed line operators (who generally offer services in combination with television network services) and two mobile phone operators, CYTA and MTN, although CYTA remains the dominant provider.

The OCECPR has been far more active in defending competition in its own area of competence than the Commission for the Protection of Competition or CERA. For example, in recent years it has forced CYTA to raise prices or withdraw advertisements until it had received approval from the regulator. It should be noted that tariffs charged by CYTA for mobile and fixed-line calls remain very low by international standards (Eurostat 2011).

Postal regulation was also brought into line with the *acquis*. The Telecommunications and Postal Services Regulation Law adopted in 2002 liberalized licensing and provided for a universal service. In its 2002 Progress Report the Commission said that the market for postal services was a "*de facto* liberalized market" (EC 2002, p. 93). This might relate to the fact that within the main towns, letters and small packages are often hand-delivered on mopeds by messengers—typically semi-retired men hired by both private companies and the public sector.

4.3 How the reforms were managed

4.3.1 Institutional environments

The primary office responsible for EU reforms was the Office of the Coordinator for Harmonisation (formerly the Office of the Chief Negotiator), established as accession negotiations began in March 2008. The importance attached by the government to this institution was indicated by the fact that it was headed for most of the pre-accession period by the preceding president, George Vassiliou. During the pre-accession period, the Office of the Coordinator worked closely with four other bodies:

1. The Planning Bureau (responsible for coordination among government ministries and agencies)
2. The Law Office of the Republic (drafting new laws and legal advice)
3. Ministry of Foreign Affairs Ministry (dealing mainly with the political aspects of membership)
4. The ROC Representation in Brussels (for information and exchange of knowledge)

The Planning Bureau had the main role in EU screening, identifying sectors for reform and planning the reform programme, while the Law Office bore the main burden of the harmonization of Cypriot legislation with EU *acquis*. A new section in the Law Office was created for this purpose, the EU Law Section. It employed 21 lawyers, all of whom held post-graduate degrees in EU law. All draft legislation prepared for purposes of harmonization with the EU *acquis* was first drafted by the various ministries, with the assistance and legal advice of the Law Office, and then sent to the Law Office for legal vetting and, as the Law Office reported, extensive re-drafting. The most complicated pieces of legislation were drafted directly by the Law Office. By the time of accession, approximately 1,300 pieces of legislation had been drafted or vetted by the Law Office.

Work accelerated gradually, becoming most intense in 2002-2004 to ensure that all the legislation and institutions were in place on the date of accession. This period also coincided with settlement negotiations that culminated in the Comprehensive Settlement of the Cyprus problem (the "Annan Plan") on 31 March 2004. The Law Office was therefore also responsible for preparing the 9,000 or so pages of legislation in English that would have constituted federal legislation from the first day of the United Cyprus Republic, had the Annan Plan been approved by both communities.

The Law Office also provided legal advice to all the public sector on legal and institutional matters relating to accession and provided legal support in the negotiation process, both at the *acquis* screening stage and during the actual negotiations of the 31 negotiating chapters. The majority of the Law Office's staff was involved in the process and two of its senior officers were part of the ROC negotiating team.

4.3.2 Tools for implementation in the private sector

Despite the fact that the services sector constitutes around 70% of GDP (or just over 50% when public-sector services are excluded), there appears to have been little in the way of support for the services sector in meeting EU requirements, beyond a certain amount of training, such as HACCP food hygiene regulations for the food retail sector, and public awareness programmes. For the manufacturing sector, there was a more specific policy, namely the "The New Industrial Policy" with five key aims (NPAA 2011, p. 263):

- Modernization of the traditional industrial sector (such as textiles)
- Assistance to existing production units and attraction of new high-tech industries
- Attraction of capital-intensive foreign investment
- Creation of an environment favourable to business cooperation

Implementation of the policy included promotion of business incubators (this measure has in practice produced few results); creation of centres for technology research (the Cyprus

University of Technology in Limassol and the less successful Cyprus Institute); and the promotion of mergers, joint ventures and subcontracting.

As regards financial assistants; grants were awarded to upgrade new or existing industrial units; for improving the quality of manufactured products, for example through quality testing abroad; for equipment and consultancy purchases; accreditation of laboratories; and equipment purchase for implementation of the HACCP food-safety system. Subsidies were award for studies or software to assist the adoption of HACCP, ISO 9000 and CE standards; market research studies; automation software; and other consultancy services. The government also provided guarantees and interest-rate subsidies for loans to SMEs.

4.4 New institutions created

Prior to EU accession negotiations, the main governance-related reform after 1974 was in 1985, when direct elections for mayors and municipal and communal councils was introduced. The competences and budgets of municipalities and communities were also increased. The result was that local authorities became much more active in the economic, social and cultural development of towns and villages.

As noted in Section 1.7, the new institutions that were created as a result of the EU customs union or accession were as follows:

- Authority for the Supervision and Development of Cooperative Societies (see Section 4.2.3.2)
- Commission for the Protection of Competition (see Section 4.2.4.1)
- Office of the Commissioner for State Aid Control (see Section 4.2.4.2)
- Cyprus Energy Regulatory Authority (see Section 4.2.5.1)
- Office of the Commissioner of Electronic Communications and Postal Regulation (see Section (see Section 4.2.5.2)
- Cyprus Agricultural Payments Organization
- Internal Audit Service
- Tenders Review Authority
- The Office of the Commissioner for Personal Data Protection
- Cyprus National Bioethics Committee

Since five of these institutions have been discussed in previous sections, only the remaining ones relating to economic and financial governance, the Cyprus Agricultural Payments Organization, the Internal Audit Service and Tenders Review Authority, are discussed below.

4.4.1 Cyprus Agricultural Payments Organization

The main responsibility of the independent Cyprus Agricultural Payments Organization (CAPO) is the payment and the management of EU funds for the agricultural sector. In that sense, CAPO implements the EU's Common Agricultural Policy through its payments. CAPO also manages all other aid granted from national funds to support farming and rural areas.

CAPO was one of the last institutions to be created, partly because of the large amount of work, investment and personnel recruitment involved in meeting EU requirements. Before the Payments Agency was established the ROC had invest in the hardware and software to establish an Integrated Administration and Control System (IACS) for arable crops and livestock support schemes. This system allows land parcels to be identified using a computerized land registry, the Computerised Integrated Land Information System developed by the Department of Land and Surveys. The IAS system became operational in 2003 but the Payments Agency was not fully operational until 2004. An Animal Identification and Registration System was developed by the Department of Veterinary Services and this was linked to a Geographical Information System (GIS) for checking land and usage. The IACS was incorporated into the paying agency. Setting up of the payments agency also involved recruiting some 70 members of staff.

4.4.2 Internal Audit Service

The Internal Audit Service was established in 2003 as an independent body responsible for internal audits of government and public services. The board of the Internal Audit Service is headed by the Minister of Finance. From 2004 a new section audits programmes co-funded by the EU. A third section deals with strategic planning, including auditing information systems in the public sector. Thus, the Internal Audit Service aims to become one of the main pillars involved in the reform of the public service.

The aim of the audits is to strengthen management and control systems and improve risk management and governance procedures in order to protect the public interest, ensure good governance, and ensure that public resources are utilized in an efficient, economic and effective way, while ensuring that the quality of services is high, costs are minimized, and government revenue is secured. Audit reports include findings and recommendations. Once the contents have been discussed and agreed with the auditee, an agreed action plan is prepared with an implementation timetable. Follow-up audits ensure that the auditee has taken appropriate action.

As regards EU co-funded programmes, the EU Section performs audits with the purpose of verifying the effective functioning of the management and control systems. The main bodies audited include those involved in the management and implementation of structural funds, the Cohesion Fund, the European Fisheries Fund, solidarity funds and the European Economic Area Financial Mechanism and Norwegian Financial Mechanism. The Internal Audit Service also plays an advisory role here, giving recommendations on actions that need to be taken by auditees.

4.4.3 The Tenders Review Authority

The Tenders Review Authority was established one month before EU membership on 1 April 2004, with the aim of enhancing transparency and efficiency in public procurement. The Authority examines appeals against actions and decisions of contracting authorities that contravene the law on tenders. These appeals must take place before public contracts are signed an implemented. The appeals procedure is open to any interested party.

4.5 Organizations or functions abolished or substantially changed

The major governance change that took place as a result of EU membership was that most applicable legislation in the ROC now comes from the EU, either directly applicable treaties and regulations or as directives that need to be transposed into national law. The ROC also has a role in designing these laws though its participation in the EU Council, the European Parliament and the European Commission.

While the ROC missed the opportunity to abolish or merge some organizations, the main changes occurred to those organizations that enjoyed a monopoly in the provision of services. As well as changes to the utilities discussed in Section 4.2.5, a number of organizations relating to agriculture also had their trading monopolies removed upon accession. These were the Cyprus Grains Commission, which had a monopoly in trading cereals, the Cyprus Potato Marketing Board, the Cyprus Milk Industry Organisation and the Vine Products Commission. The Cyprus Olive Products Marketing Board (SEKEP), which was transformed into an intervention agency, had its monopoly removed in 2003.

Upon adoption of the euro the Central Bank of Cyprus relinquished authority on the setting of interest rates to the European Central Bank. As mentioned in Section 1.7.1.2, following the financial crisis supervisory functions are also increasingly decided at EU level.

4.6 The current reform agenda

4.6.1 Short-term reform priorities

The current reform agenda has been somewhat overtaken by events, in particular the combined impact of a deterioration in public finances and the exposure of local banks to Greek debt, which has led to several downgrades in sovereign credit ratings. The ROC is now rated speculative (junk) status by both Moody's Investor Service and Standard & Poor's and is unable to access international financial markets. It financed its main debt rollover in 2012 with a €2.5bn bilateral loan from Russia, but faces another spike in repayments in 2013 (Public Debt Management office 2012). If it is still unable to tap capital markets in 2013 and cannot secure another bilateral loan, it could be forced to enter the EU support mechanism (Oxford Analytica 2012).

As well as the fiscal deterioration, another reason for the downgrade is that there is a risk that the government will have to bail out Marfin Popular Bank (renamed Cyprus Popular Bank, CPB),

which faces steep capital requirements after announcing in late February that it had written off just under €2bn of the €3.2bn it held in Greek sovereign debt. It seems unlikely that the bank will find strategic investors to raise the capital, in which case a government bail-out would be inevitable. However, since the government does not have the funds to bail out the bank, it might have to borrow from the EU to do so, unless the EU sanctions a proposal that the government pays for new bank shares issued to the government with government bonds issued to the bank.

These developments have put a premium on rapid fiscal consolidation, with the government declaring that it aims to cut the budget deficit from 6.3% of GDP in 2011 to less than 2.5% of GDP in 2012. Since, as mentioned in Section 4.2.1.1, the ROC is already subject to the EU's Excessive Deficit Procedure and an in-depth review of imbalances, it seems likely that the government will be subject to enhanced surveillance, along with further pressure to reduce the fiscal deficit.

4.6.2 Longer-term reform strategies

Longer-term policy strategies are guided by strategy at the EU level and are laid out in the National Reform Programme 2007-13. It has the following eight axes:

- Enhancing the competitiveness of the economy
- Promoting research and innovation
- Reinforcing social cohesion
- Improving and protecting the environment
- Upgrading the quality of life
- Improving accessibility (such as infrastructure)
- Developing human capital
- Promoting balanced regional and rural development

A seven-year development budget of just under €6.6 billion (around 38% of GDP at current prices in 2007) for the period 2007-13 was set aside for grants, subsidies and training in all of these areas, while the EU committed €822.6 million. To implement the strategy a development planning committee was established, headed by the Director of the Planning Bureau. The remaining members are the Directors of the Ministries of Finance, Agriculture, Natural Resources and Environment, Labour and Social Insurance, Interior, Trade, Industry and Tourism, Education and Culture, Transport and Works and Health. In addition, all government agencies, social partners and non-governmental organizations participated in the planning of projects co-financed by the EU. For this purpose, an advisory planning commission was established. The Planning Bureau also organized public dialogue events for the Strategic Development Plan in all major towns. This included special meetings with the main trade unions, the Cyprus Chamber of Commerce and Industry and the Farmers' Union.

The National Reform Programme notes that an EU study identified that "the basic weakness of the programming procedure is the lack of mechanisms to monitor the Plan's implementation and its readjustment to possible socio-economic changes (National Reform Programme, p. 177). In particular, there was a gap between the Strategic Development Plan and the annual budget. The report recommended that that the long-term goals set out in the development plan are reflected in the medium-term financial and strategic plans of each ministry.

Alongside the National Reform Programme, the Stability Programme 2010-14 sets out the following fiscal reforms.

- Reforming the wage-indexation system known as COLA, "without affecting the low and middle income groups." This is a highly sensitive issue and while the government has managed to implemented a two-year freeze of COLA for public-sector workers, dialogue with stakeholders about more permanent reform has only just begun.
- Strengthening one-stop shop arrangements for investors. This is in response to the fact that the ROC has lately fallen behind countries such as Malta in ease of setting up a business.
- Maintaining a business friendly taxation regime and extending double tax treaties. The 40-odd double taxation treaties are a key advantage for the important professional business services sector, which now generates more balance-of-payments income than tourism.
- Reducing red tape and administrative burden, in line with the policy initiative of the EU (see Section 4.7.2).

4.7 Impact of the reforms

4.7.1 Macroeconomic impact

To date there has been no formal mechanism for assessing the post-implementation impact of any legislative reforms. However, an unofficial assessment of the broad macroeconomic impact of EU membership was published in 2011 (Mullen 2011). Here, it is argued that falling interest rates, together with the opening up of the foreign labour market that increase the population, led to increased demand for housing. This, in turn, led to a strong rise in property prices and an acceleration in construction investment, which drew in imports, leading to a sharp widening of the current-account deficit and a loss of competitiveness measured as the real effective exchange rate relative to unit labour costs. Mullen called for more structural reforms if the ROC were to avoid the fate of the "PIIGS" (Portugal, Ireland, Italy, Greece and Spain).

As regards tax reform, Mullen notes that in the short term, since it coincided with the negative impact on the economy or the Iraq war, it had a negative impact on public finances but that it supported a healthy labour market and low unemployment in the medium term (unemployment has, however, risen sharply since 2010). Mullen also argues that the most profound impact was on exports of business services, which benefited from a combination of EU membership and the lowest corporate tax rate in the EU.

Capital account liberalization led to an increase non-resident deposits but also an increase in external debt, mainly as a result of borrowing by non-Cypriot banks, which borrowed on the wholesale market. It did not have a significant impact on foreign direct investment (FDI), probably, Mullen argues, because there has been little privatization and foreign participation in the banking sector is low.

4.7.2 Impact assessment

As part of the EU's "Better Regulation" initiative, however, the government has begun a process that focuses on identifying, quantifying and reducing the administrative burden and introducing impact measurement. During the first phase, the government is prioritizing reducing the administrative burden in eight specific areas: Inland Revenue, VAT, Social Insurance, Registrar of Companies and Official Receiver, Civil Registry and Migration, environment, tourism and agriculture (Ministry of Finance, 2012). The Company Registrar has come under criticism for still being a paper-based and falling behind countries such as Malta in terms of company registration turnaround, while the Cyprus International Business Association (CIBA) has complained in the past about the difficulty of hiring skilled non-EU labour.

Impact assessment prior to legislation coming into force began on an ad hoc basis in 2007 but was codified in 2009. An impact assessment is now attached to all bills upon their submission to the Law Office, the Council of Ministers and the House of Representatives. Today, no legislation in the specific areas can be passed or considered if it does not include an impact assessment that reports on consultation with stakeholders and issues raised. A consultation guide was issued in 2010 to assist civil servants in completing the impact assessment.

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Public Debt Management Office: www.mof.gov.cy/pdmo/pdmo.nsf
Statistical Service: www.mof.gov.cy/cystat
Supreme Court: www.supremecourt.gov.cy

5.3 List of abbreviations

AKEL: Progressive Party of Working People
ARM: Alert Mechanism Report
ASDCS: Department of Co-operative Development
CAPO: Cyprus Agricultural Payments Organization
CDB: Cyprus Development Bank
CERA: Cyprus Energy Regulatory Authority
CIBA: Cyprus International Business Association
CIPA: Cyprus Investment Promotion Agency
CSSDA: Authority for the Supervision Development of Cooperative Societies
CySEC: Cyprus Securities and Exchange Commission
CYSTAT: Statistical Service of the Republic of Cyprus
CYTA: Cyprus Telecommunications Authority
DG ECFIN: European Commission Directorate-General for Economic and Financial Affairs
DIKO: Democratic Party
EAC: Electricity Authority of Cyprus
EBA: European Banking Authority
ECB: European Central Bank
ECP: Euro Commercial Paper
EIB: European Investment Bank
EIOPA: European Insurance and Occupational Pensions Authority
EMTN: Euro Medium Term Note
ESMA: European Securities and Markets Authority
FDI: Foreign direct investment
FIMAS: Financial Management Accounting System
FSAP: Financial Sector Assessment Program
GIS: Geographical Information System
GRDS: Government Registered Development Stocks
HRDA: Human Resources Development Authority
IACS: Integrated Administration and Control System
ICCS: Insurance Companies Control Service
IMF: International Monetary Fund
KEVE: Cyprus Chamber of Commerce and Industry
MTBF: Medium-Term Budgetary Framework
MoU: Memorandum of Understanding
MPC: Monetary Policy Committee
NPAA: National Programme for the Adoption of the Acquis
OCECPR: Office of the Commissioner of Electronic Communications and Postal Regulation
OECD: Organisation for Economic Cooperation and Development
OEV: Cyprus Employers' and Industrialists Federation
PASYDY: Pancyprian Public Employees Trade Union
PEO: Pancyprian Federation of Labour
PSI: Private-sector initiative
PDMO: Public Debt Management Office
POVEK: Cyprus Federation of Professional Craftsmen and Shopkeepers

REER: Real effective exchange rate
ROC: Republic of Cyprus
SEK: Cyprus Workers' Confederation
SEKEP: Cyprus Olive Products Marketing Board
SMEs: Small and medium enterprises
VAT: Value-added tax
VSAT: Very Small Aperture Terminals

Section 6: Statistical Appendix

COMPARATIVE ECONOMIC INDICATORS

Population (a)	2006	2007	2008	2009	2010
Cyprus: North	220,289	257,513	260,819	*274,436*	*279,925*
Cyprus: South	757,800	772,600	784,000	793,100	800,050
North as % of all island	22.5%	25.0%	25.0%	25.7%	25.9%

GDP at current prices (USD billion)	2006	2007	2008	2009	2010
Cyprus: North	$2.3	$2.8	$3.5	$4.0	$3.5
Cyprus: South	$16.7	$18.1	$21.7	$25.1	$23.4
North as % of all island	12.0%	13.3%	14.1%	13.6%	12.9%

GDP per capita (USD)	2006	2007	2008	2009	2010
Cyprus: North	$10,321	$10,744	$13,600	$14,422	$12,391
Cyprus: South	$21,993	$23,434	$27,635	$31,689	$29,264
North as % of south	46.9%	45.8%	49.2%	45.5%	42.3%

GDP at current prices (EUR billion)	2006	2007	2008	2009	2010
Cyprus: North	€1.8	€2.2	€2.6	€2.7	€2.5
Cyprus: South	€13.4	€14.4	€15.8	€17.2	€16.9
EU27: total	€11,695.0	€12,397.5	€12,466.8	€11,745.4	€12,255.5

GDP per capita (EUR at current prices)	2006	2007	2008	2009	2010
Cyprus: North	€8,342	€8,642	€9,899	€9,709	€8,920
Cyprus: South	€17,685	€18,680	€20,191	€21,633	€21,066
Turkey (Eurostat)	€6,000	€6,700	€7,000	€6,100	€7,500
EU27: average	€23,700	€25,000	€25,000	€23,500	€24,400

Real GDP growth (%)	2006	2007	2008	2009	2010
Cyprus: North	12.7	2.8	-2.9	-5.5	3.7
Cyprus: South	4.1	5.1	3.6	-1.9	1.1
EU27: average	3.3	3.0	0.3	-4.3	2.0
Turkey	6.9	4.7	0.7	-4.8	9.2

Consumer price inflation (% change)	2006	2007	2008	2009	2010
Cyprus: North (end-period)	2.7	19.2	9.4	14.5	5.7
Cyprus: South	2.6	2.5	2.4	4.7	0.3
EU27: average (harmonised rate)	2.2	2.3	3.7	1.0	2.1
Turkey	9.6	8.8	10.4	6.3	8.6

Unemployment rate (% of labour force)	2006	2007	2008	2009	2010
Cyprus: North (derived from TC Competitiveness Report)	10.4	10.4	10.8	14.1	13.9
Cyprus: South (Labour Force Survey)	4.5	3.9	3.7	5.3	6.2
EU27: average (Labour Force Survey)	8.3	7.2	7.1	9.0	9.7
Turkey (Labour Force Survey)	10.6	10.3	10.2	11.0	14.0

Employment	2006	2007	2008	2009	2010
Cyprus: North (Turkish Cypriot Competitiveness Report)	91,815	89,787	91,223	9,155	93,086
Cyprus: South	374,285	393,377	397,374	402,590	410,465

Public-sector employ't as % of total inc health & ed'n	2006	2007	2008	2009	2010
Cyprus: North (derived from TC Competitiveness Report)	22.5	23.8	24.1	25.3	25.9
Cyprus: South	17.4	16.8	17.2	17.4	17.4

Budget balance (% of GDP)	2006	2007	2008	2009	2010
Cyprus: North (Turkish Cypriot Competitiveness Report)	-10.1	-7.1	-9.3	-14.1	-10.1
Cyprus: South	-1.2	3.5	0.9	-6.1	-5.3
EU27: average	-1.5	-0.9	-2.4	-6.9	-6.5
Turkey (Eurostat definition)	0.8	-1.0	-2.2	-6.7	n/a

Public debt (% of GDP)	2006	2007	2008	2009	2010
Cyprus: North (Turkish Cypriot Competitiveness Report)	79.0	100.0	116.0	130.0	139.0
Cyprus: South	64.7	58.8	48.9	58.5	61.5
EU27: average	61.5	59.0	62.5	74.8	80.0
Turkey (Eurostat definition)	46.1	39.4	39.5	45.4	n/a

Current-account balance (% of GDP)	2006	2007	2008	2009	2010
Cyprus: North (Turkish Cypriot Competitiveness Report)	-5.0	-5.0	-6.0	-6.0	-5.0
Cyprus: South	-7.0	-11.8	-15.6	-10.7	-9.9
EU27: average (derived from Eurostat)	-1.2	-1.0	-2.1	-0.8	-0.7

Exchange rates	2006	2007	2008	2009	2010
TL per USD (State Planning Organization)	1.3505	1.4415	1.2980	1.2835	n/a
TL per USD (IMF, International Financial Statistics)	1.4285	1.3029	1.3015	1.5500	1.5028
TL per EUR (derived from IMF)	1.7920	1.7833	1.9065	2.1532	1.9904

(a) Turkish Cypriot population is estimated in 2009-10 as no official figures have been released for these years.

Sources unless otherwise indicated: Statistical Service (Cyprus south); State Planning Organization (Cyprus north); Eurostat (EU27); Turkstat (Turkey).

Bu rapor KKTC Devleti ńde Fonksiyonel ve Kurumsal Gözden Geçirme Projesi" (KKTC-FOKUS) kapsamında hazırlanmıştır.

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