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Recommendation for a

COUNCIL RECOMMENDATION

on the 2018 National Reform Programme of Cyprus

and delivering a Council opinion on the 2018 Stability Programme of Cyprus

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THE COUNCIL OF THE EUROPEAN UNION,

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

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

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

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

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

Having regard to the conclusions of the European Council,

Having regard to the opinion of the Employment Committee,

Having regard to the opinion of the Economic and Financial Committee,

Having regard to the opinion of the Social Protection Committee,

Having regard to the opinion of the Economic Policy Committee,

Whereas:

(1) On 22 November 2017, the Commission adopted the Annual Growth Survey, marking the start of the 2018 European Semester of economic policy coordination. It took due account of the European Pillar of Social Rights, proclaimed by the European Parliament, the Council and the Commission on 17 November 2017. The priorities of the Annual Growth Survey were endorsed by the European Council on 22 March 2018. On 22 November 2017, on the basis of Regulation (EU) No 1176/2011, the Commission also adopted the Alert Mechanism Report, in which it identified Cyprus as one of the Member States for which an in-depth review would be carried out. On the same day, the Commission also adopted a recommendation for a Council recommendation on the economic policy of the euro area, which was endorsed by the

1 OJ L 209, 2.8.1997, p. 1.
2 OJ L 306, 23.11.2011, p. 25.
3 COM (2018) 412 final.
4 P8_TA(2018)0077 and P8_TA(2018)0078.

European Council on 22 March 2018. On 14 May 2018, the Council adopted the recommendation on the economic policy of the euro area ('recommendation for the euro area').

(2) As a Member State whose currency is the euro and in view of the close interlinkages between the economies in the economic and monetary union, Cyprus should ensure the full and timely implementation of the recommendation on the economic policy for the euro area, as reflected in recommendations (1), (3) and (5) below.

(3) The 2018 country report for Cyprus[5] was published on 7 March 2018. It assessed Cyprus' progress in addressing the country-specific recommendations adopted by the Council on 11 July 2017, the follow-up given to the recommendations adopted in previous years and Cyprus' progress towards its national Europe 2020 targets. It also included an in-depth review under Article 5 of Regulation (EU) No 1176/2011, the results of which were also published on 7 March 2018[6]. The Commission's analysis leads it to conclude that Cyprus is experiencing excessive macroeconomic imbalances. In particular, it is essential that the country tackles the large stock of imbalances in the form of private, public and external debt overhang, and the high level of non-performing loans.

(4) Cyprus submitted its 2018 National Reform Programme on 19 April 2018 and its 2018 Stability Programme on 30 April 2018. To take account of their interlinkages, the two programmes have been assessed at the same time.

(5) Relevant country-specific recommendations have been addressed in the programming of the European Structural and Investment Funds for the 2014-2020 period. As foreseen in Article 23 of Regulation (EU) No 1303/2013 of the European Parliament and of the Council[7], where it is necessary to support the implementation of relevant Council recommendations, the Commission may request a Member State to review and propose amendments to its Partnership Agreement and relevant programmes. The Commission has provided further details on how it would make use of that provision in guidelines on the application of the measures linking the effectiveness of the European Structural and Investment Funds to sound economic governance[8].

(6) Cyprus is currently in the preventive arm of the Stability and Growth Pact and subject to the debt rule. In its 2018 Stability Programme, the government plans a budgetary surplus in nominal terms of 1.7 % of GDP in 2018 and slightly below 2.0 % of GDP over the programme period. The medium-term budgetary objective, set at a balanced budgetary position in structural terms, is planned to be reached over 2018-2021. After having decreased to around 97.5 % of GDP in 2017, the general government debt-to-GDP ratio is expected to increase to 105.6 % in 2018 and to steadily decline thereafter, reaching 88 % by 2021, according to the 2018 Stability Programme. The macroeconomic scenario underpinning those budgetary projections is plausible. The risks associated with the macroeconomic assumptions presented in the Stability

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[5] SWD(2018) 211 final.

[6] COM(2018) 120 final.

[7] Regulation (EU) No 1303/2013 of the European Parliament and of the Council of 17 December 2013 laying down common provisions on the European Regional Development Fund, the European Social Fund, the Cohesion Fund, the European Agricultural Fund for Rural Development and the European Maritime and Fisheries Fund and laying down general provisions on the European Regional Development Fund, the European Social Fund, the Cohesion Fund and the European Maritime and Fisheries Fund and repealing Council Regulation (EC) No 1083/2006 (OJ L 347, 20.12.2013, p. 320).

[8] COM(2014) 494 final.

Programme are to the downside, mainly linked to the high stock of non-performing loans in the financial sector.

(7) On 11 July 2017, the Council recommended Cyprus to remain at the medium-term budgetary objective in 2018. This is consistent with a maximum nominal growth rate of net primary government expenditure[9] of 1.9 % in 2018, corresponding to an allowed deterioration in the structural balance by 0.4 % of GDP. Based on the Commission 2018 spring forecast, the structural balance is projected to register a surplus of 0.8 % of GDP in 2018 and 0.5 % of GDP in 2019, above the medium-term budgetary objective. Cyprus is forecast to comply with the transitional debt rule in 2018 and the debt rule 2019. Overall, the Council is of the opinion that Cyprus is projected to comply with the provisions of the Stability and Growth Pact in 2018 and 2019. At the same time, expenditure developments should be monitored carefully in the short and the medium term, especially in light of possible future risks to the robustness of revenues.

(8) Despite recent efforts on e-government services, regulatory quality and staff mobility, inefficiency in the public administration remains a challenge and has an impact on the business environment. Key legislative proposals aiming to address the issue remain pending. These include draft laws on the reform of the public administration and of local governments. Shortcomings in the governance framework for state-owned entities might facilitate the build-up of public contingent liabilities and hinder investment capacity in key utilities, such as telecoms and energy. The containment of the public sector wage bill has been a significant factor in fiscal consolidation in Cyprus. Yet, the current collective agreement limiting the growth of public sector wages expires in 2018 and a more permanent solution is still lacking.

(9) A national anti-corruption strategy and action plan were adopted in December 2017. The existing anti-corruption body remains inadequately resourced, but the government is considering the establishment of a new independent agency. Various legislative initiatives, such as draft laws on whistle-blower protection, lobbying and asset declarations, are currently under parliamentary scrutiny and, if adopted, would also help to strengthen the national anti-corruption framework.

(10) As indicated in the 2018 euro area recommendation, the fight against aggressive tax planning strategies is essential to impede distortions of competition between firms, provide fair treatment of taxpayers and safeguard public finances. Spill-over effects of taxpayers' aggressive planning strategies between Member States call for a coordinated action of national policies to complement EU legislation. The high levels of dividend and interest payments (relative to GDP) continue to suggest that Cyprus' tax rules are used by companies that engage in aggressive tax planning. The absence of withholding taxes on outbound (i.e. from EU residents to third country residents) dividend, interest and, in many cases, royalty payments by Cyprus-based companies to third country residents may lead to those payments escaping tax altogether, if they are also not subject to tax in the recipient jurisdiction. The absence of such taxes, together with the corporate tax residency rules, may continue to facilitate aggressive tax planning. While notional interest deduction regimes help to reduce the debt equity

[9] Net primary government expenditure comprises total government expenditure excluding interest expenditure, expenditure on Union programmes fully matched by Union funds revenue and non-discretionary changes in unemployment benefit expenditure. Nationally financed gross fixed capital formation is smoothed over a 4-year period. Discretionary revenue measures or revenue increases mandated by law are factored in. One-off measures on both the revenue and expenditure sides are netted out.

bias, they can also be used for tax avoidance purposes, if there are no effective anti-abuse rules. The Commission takes note of recent positive steps announced or adopted (i.e. the announced review of corporate tax residency rules, planned changes on transfer pricing provisions). Based on recent exchanges, the Commission will continue its constructive dialogue to fight against taxpayers aggressive planning strategies.

(11) Inefficiencies in the justice system continue to affect contract enforcement and the swift resolution of civil and commercial cases. Cumbersome civil procedures and weak enforcement of court decisions weigh on banks' incentives to use the insolvency and foreclosure frameworks to reduce their stock of non-performing loans. A series of reforms have started to address the most critical problems in the justice system, in particular low digitalisation of courts and the lack of life-long training for judges.

(12) Use of the new insolvency and foreclosure frameworks remains limited, undermining efforts to reduce non-performing loans. A stakeholders' working group was set up to review the implementation and performance of the frameworks. Some administrative measures have been taken to reduce the backlog in the issuance of title deeds. However, backlogs remain high and a structural solution to address the inadequacies of the property transaction system (i.e. the issuance and transfer of title deeds) is still lacking.

(13) The high level of non-performing loans remains the key vulnerability of the banking sector and affects credit supply. Banks still face impediments in enforcing their claims on defaulted borrowers and weak repayment discipline remains problematic. In 2017, non-performing loans decreased, albeit unevenly across banks, as a result of debt restructuring through write-offs and debt-to-asset swaps. Uncertainties remain over the sustainability of banks reduction plans, as loan re-defaults and re-restructuring remain high and banks' direct exposure to the property market increases. These factors point to the need for swift implementation of a more comprehensive strategy to accelerate the clean-up of banks' balance sheets, having regard to social consequences for vulnerable groups and carefully designed incentives to strengthen repayment discipline. As part of this strategy, legislative amendments to allow for the effective enforcement of claims and to facilitate the sale of loans appear necessary, including on borrower protection and the introduction of electronic auctions. In addition, the governance and administrative capacity of insurance and pension-fund supervision remain weak. The government intends to table legislative proposals to address this issue in the course of 2018.

(14) Implementation of the action plan for growth has led to some progress in the areas of strategic investments, entrepreneurship and better regulation. However, some important reforms have stalled, notably as regards the granting of licences authorising investment projects. Access to finance has improved, thanks to some improvements in collateral requirements, but it remains a key issue, notably for small and medium-sized enterprises. Financial support measures are based mainly on grants. Alternative sources of finance such as venture capital, equity funding and crowdfunding, remain marginal for Cypriot businesses. Privatisation efforts, aimed at attracting productivity-enhancing foreign investments, are in many cases on hold and only a few privatisation projects are gradually advancing (e.g. the Larnaca port).

(15) Employment is on the rise and unemployment is falling fast, although it remains high among young people and the long-term unemployed. Efforts to improve the administrative capacity of the public employment services continue. However, providing services to employers, securing customer categorisation, personalised

guidance and activation, including for recipients of guaranteed minimum income, remain a challenge. The proportion of young people (aged 15-24) not in employment, education, or training is still one of the highest in the EU. Outreach measures and timely, tailor-made assistance for young people are limited, as confirmed by their low numbers in relevant activation schemes.

(16) The modernisation of the education sector has advanced but important challenges remain. Recent positive developments include a thorough revision of school curricula and the implementation of a new appointment system for teachers. Cyprus' education spending is above the EU average, demonstrating a strong commitment to education, training and life-long learning. However, educational achievements remain poor and early school leaving, while well below the EU average, has increased significantly. Participation in vocational education and training is low, the reform of the teacher evaluation system is still pending and a high proportion of tertiary graduates continue to work in occupations that do not necessarily require an academic degree.

(17) Cyprus has made substantial progress on healthcare by adopting legislation to establish the new National Health System. The new system seeks to improve access, introduce universal health coverage, reduce the high level of out-of-pocket payments and increase the efficiency of care delivery in the public sector. Before the system becomes fully functional in 2020, there are major implementation challenges and investment needs. Efforts should continue towards safeguarding against possible cost overruns, modernising and improving the efficiency of healthcare providers, including primary healthcare, introducing e-Health and setting up a National Medicines Organisation. The level of long-term care is low and remains a challenge given the ageing population.

(18) In the context of the 2018 European Semester, the Commission has carried out a comprehensive analysis of Cyprus' economic policy and published it in the 2018 country report. It has also assessed the 2018 Stability Programme and the 2018 National Reform Programme and the follow-up given to the recommendations addressed to Cyprus in previous years. It has taken into account not only their relevance for sustainable fiscal and socioeconomic policy in Cyprus but also their compliance with Union rules and guidance, given the need to strengthen the Union's overall economic governance by providing Union-level input into future national decisions.

(19) In the light of this assessment, the Council has examined the 2018 Stability Programme and is of the opinion that Cyprus is expected to comply with the Stability and Growth Pact.

(20) In the light of the Commission's in-depth review and this assessment, the Council has examined the National Reform Programme and the Stability Programme. Its recommendations under Article 6 of Regulation (EU) No 1176/2011 are reflected in recommendations 1 to 5 below.

HEREBY RECOMMENDS that Cyprus take action in 2018 and 2019 to:

1. Adopt key legislative reforms to improve efficiency in the public sector, in particular as regards the functioning of the public administration and the governance of state-owned entities and local governments.

2. Step up efforts to improve the efficiency of the judicial system by revising civil procedures, increasing the specialisation of courts and setting up a fully operational e-justice system. Take measures to fully operationalise the insolvency and

foreclosure frameworks and ensure reliable and swift systems for the issuance of title deeds and the transfer of immovable property rights.

3. Accelerate the reduction of non-performing loans by implementing a comprehensive strategy, including legislative amendments allowing for the effective enforcement of claims and facilitating the sale of loans. Integrate and strengthen the supervision of insurance companies and pension funds.

4. Prioritise the implementation of key elements of the action plan for growth, in particular fast-tracking strategic investments, and take additional measures to improve access to finance for small and medium-sized enterprises. Improve the performance of state-owned enterprises including by resuming the implementation of privatisation projects.

5. Complete reforms aimed at increasing the capacity and effectiveness of the public employment services and reinforce outreach and activation support for young people who are not in employment education or training. Complete the reform of the education and training system, including teacher evaluation and actions to increase the capacity of vocational education and training. Take measures to ensure that the National Health System becomes fully functional in 2020, as planned.

Done at Brussels,

For the Council
The President