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From:	General Secretariat of the Council
To:	Permanent Representatives Committee/Council
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Subject:	Recommendation for a COUNCIL RECOMMENDATION on the 2019 National Reform Programme of Cyprus and delivering a Council opinion on the 2019 Stability Programme of Cyprus

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Delegations will find attached the above mentioned draft Council Recommendation, as revised and agreed by various Council committees, based on the Commission Proposal COM(2019) 513 final.

## COUNCIL RECOMMENDATION

of ...

### **on the 2019 National Reform Programme of Cyprus and delivering a Council opinion on the 2019 Stability Programme of Cyprus**

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<sup>1</sup>, 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<sup>2</sup>, and in particular Article 6(1) thereof,

Having regard to the recommendation of the European Commission,

Having regard to the resolutions of the European Parliament,

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,

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<sup>1</sup> OJ L 209, 2.8.1997, p. 1.

<sup>2</sup> OJ L 306, 23.11.2011, p. 25.

Whereas:

- (1) On 21 November 2018, the Commission adopted the Annual Growth Survey, marking the start of the 2019 European Semester for 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 21 March 2019. On 21 November 2018, 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 date, the Commission also adopted a recommendation for a Council recommendation on the economic policy of the euro area, which was endorsed by the European Council on 21 March 2019. On 9 April 2019, the Council adopted the Recommendation on the economic policy of the euro area<sup>3</sup> ('2019 Recommendation for the euro area'), which sets out five euro-area recommendations ('the euro-area recommendations').
- (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 2019 Recommendation for the euro area, as reflected in recommendations (1) to (5) below. In particular, measures to decrease the administrative burden will help address the first euro-area recommendation as regards the business environment and productivity improvements for euro-area rebalancing; focusing economic policy related to investment on the specified areas will help address the second euro-area recommendation as regards supporting investment; tax measures and measures to improve skills will help address the third euro-area recommendation as regards the fight against aggressive tax planning and the functioning of the labour market; and measures to improve the functioning of the asset management company will help address the fourth euro-area recommendation as regards the reduction of non-performing loans.

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<sup>3</sup> OJ C 136, 12.4.2019, p. 1.

- (3) The 2019 country report for Cyprus was published on 27 February 2019. It assessed Cyprus's progress in addressing the country-specific recommendations adopted by the Council on 13 July 2018<sup>4</sup>, the follow-up given to the country-specific recommendations adopted in previous years and Cyprus's 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 27 February 2019. The Commission's analysis led it to conclude that Cyprus is experiencing excessive macroeconomic imbalances. In particular, it is essential that the Member State tackle the high stocks of private, public and external debt and non-performing loans.
- (4) Cyprus submitted its 2019 National Reform Programme on 15 April 2019 and its 2019 Stability Programme on 30 April 2019. In order 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 ('ESI Funds') for the 2014-2020 period. As provided for in Article 23 of Regulation (EU) No 1303/2013 of the European Parliament and of the Council<sup>5</sup>, 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 ESI Funds to sound economic governance.

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<sup>4</sup> OJ C 320, 10.9.2018, p. 55.

<sup>5</sup> 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).

(6) Cyprus is currently in the preventive arm of the Stability and Growth Pact. In its 2019 Stability Programme, the general government balance, which turned into a deficit of 4,8 % of gross domestic product (GDP) in 2018 and thereby exceeded the Treaty reference value of 3 % of GDP, is projected to reach a surplus in nominal terms of 3,0 % of GDP in 2019 and above 2,0 % of GDP over the programme period. Based on the recalculated structural balance<sup>6</sup>, the medium-term budgetary objective, set at a balanced budgetary position in structural terms, is planned to be reached over 2019-2022. After having increased to around 102,5 % of GDP in 2018, the general government debt-to-GDP ratio is expected to decrease to 95,7 % in 2019 and to continue to steadily decline thereafter, reaching 77,5 % by 2022, according to the 2019 Stability Programme. The macroeconomic scenario underpinning those budgetary projections is plausible. The risks associated with the macroeconomic and budgetary assumptions presented in the Stability Programme are tilted to the downside, mainly linked to external developments, as well as the potential fiscal impact of Court rulings on past fiscal reforms and the financing needs of public hospitals during the first years of the national health system. The Commission 2019 spring forecast projects the general government balance to register a surplus of 3,0 % of GDP in 2019 and 2,8 % of GDP in 2020. Based on the Commission 2019 spring forecast the structural balance is forecast to stand at 1,1 % of GDP in 2019 and at 0,7 % of GDP in 2020, remaining above the medium-term budgetary objective. Cyprus is forecast to comply with the debt rule in 2019 and 2020. Overall, the Council is of the opinion that Cyprus is projected to comply with the provisions of the Stability and Growth Pact in 2019 and 2020.

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<sup>6</sup> Cyclically adjusted balance net of one-off and temporary measures, recalculated by the Commission using the commonly agreed methodology.

- (7) On 5 June 2019, the Commission issued a report prepared in accordance with Article 126(3) of the Treaty, as, based on notified data, the headline deficit was in breach of the 3 %-of-GDP Treaty reference value in 2018. The report concluded that further steps leading to a decision on the existence of an excessive deficit should not be taken. Inefficiencies in the public administration and local governments remain a challenge despite some progress with e-government services. This has an impact on the business environment. Key legislative proposals 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, which has been a significant factor in fiscal consolidation in Cyprus, warrants continuation.
- (8) The fight against aggressive tax planning is essential in making tax systems more efficient and fairer, as acknowledged in the 2019 Recommendation for the euro area. Spillover effects of taxpayers' aggressive tax-planning strategies between Member States call for a coordinated action of national policies to complement Union legislation. Cyprus has taken measures against aggressive tax planning, but the high levels of dividend and interest payments (relative to GDP) indicate that Cyprus's tax rules may be used by companies that engage in aggressive tax planning. The absence of withholding taxes on outbound (i.e. from Union 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 facilitate aggressive tax planning. The Notional Interest Deduction scheme needs to be closely monitored to prevent any misuse for aggressive tax planning. Finally, the Scheme for Naturalisation of Investors in Cyprus by Exception and Residence by Investment Scheme give access to a low personal tax rate on income from foreign financial assets and do not require an individual to spend a significant amount of time in the jurisdiction offering the scheme. They have been listed by the OECD as having a potentially high risk for being misused to circumvent the automatic exchange of financial accounts.

- (9) Significant measures were implemented in the context of a comprehensive non-performing loans strategy. This led to a marked reduction in non-performing loans in the banking sector, mainly due to the sale and wind-down of the Cyprus Cooperative Bank and the transfer of its non-performing loans portfolio to a State-owned asset management company. Furthermore, the law on the sale of loans was improved and a law on the securitisation of loans was adopted. In order to maximise the proceeds from the sale of assets and ultimately help reduce private debt, it is essential for the State-owned asset management company to have an effective governance structure, a highly specialised management, operational independence from the Cypriot State, and well-defined targets in line with the commitments made by the government in the context of the State aid decision on the sale of the Cyprus Cooperative Bank, which was approved by the European Commission. Furthermore, it is important to set up an adequate supervisory framework for the credit-acquiring companies as the number of credit-acquiring companies, including the State-owned asset management company, has increased and more non-performing loans portfolio sales are planned in the future. The governance and administrative capacity of insurance and pension fund supervisors remains weak. The integration of these supervisors should be swiftly finalised. More generally, the supervisory framework for the capital markets has to be strengthened, given the relatively sizeable cross-border activities of the non-bank financial services companies and the exponential growth of licensed firms in recent years.
- (10) Employment is rising, unemployment is falling and the public employment services' short-term capacity to facilitate active support to employment has been improved. However, the long-term sustainability of the public employment services' capacity is still an issue, as the additional staff were recruited for only two years. In 2018 the proportion of young people not in education, employment or training was among the highest in the Union. The low efficiency of the public employment services and their limited rollout and participation in activation for helping people find work remain a challenge. Therefore, there is scope for reinforcing the outreach and activation support for access to employment, in particular for young people and the long-term unemployed. This includes promoting self-employment and the social economy as well as modernising labour market institutions and services to help people gain skills that better match labour market needs.

- (11) Skills shortages and mismatches are among the main obstacles to business investment, highlighting the need to invest more in training of unused and under-used labour potential, better aligning education curricula to labour market needs, and investing in matching vocational education infrastructure. Progress on crucial education and training reforms, such as improving the appointments and evaluation of teachers, is uneven. Educational achievements remain low, as does participation in early childhood education and care, which has become less affordable for households as their income during the crisis fell at a faster rate than childcare costs. Continuing efforts to modernise the education and training system at all levels will help to improve educational outcomes and increase the potential for sustainable growth in Cyprus. Revising the vocational and training curricula is a promising step in reducing the skills mismatches in the labour market. However, prevalent skills mismatches for tertiary graduates and low participation in adult learning, especially of the low qualified, indicate the need for enhanced upskilling and reskilling measures.
- (12) Cyprus has made 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. Preserving long-term sustainability of the system, including ensuring the financial and operational autonomy of public hospitals, as planned, remains crucial. Measures aimed at modernising and improving the efficiency of healthcare providers, including primary healthcare, introducing e-health and setting up a National Medicines Organisation would further strengthen the healthcare system. The level of long-term care is low and remains a challenge given the ageing population.



- (13) Cyprus's weak environmental performance is a major concern, and the country remains vulnerable to climate change. Cyprus needs to significantly improve its waste management system and the circular economy. Waste generation remains significantly higher than the Union average and has increased since 2014. The current facilities for waste treatment do not achieve high recycling rates, and the lack of economic instruments such as landfill taxes makes recycling economically unattractive. Water management, in particular in urban areas, is characterised by inefficiencies. Water scarcity, in combination with over-abstraction of groundwater, is the main challenge for Cyprus. On urban wastewater, there is a considerable amount of wastewater that is still discharged without collection or treatment — only around half of the total waste water undergoes secondary treatment. Droughts and water scarcity are major concerns, and an insufficient policy response might affect the Cyprus's rural economy and tourism. Therefore, sustainable management and an efficient use of its natural resources, along with stricter enforcement of environment and climate legislation, are essential for Cyprus to mitigate adverse climate change effects, preserve and restore its natural environment and ensure sustainable economic growth in the long term.
- (14) Cyprus can make much better use of its renewable energy sources — particularly solar — and address current energy inefficiencies. The renewable energy share in Cyprus was 9,72 % in 2017, with the 2020 target being 13 %. Residential and commercial buildings constructed with no or low levels of thermal protection, particularly in urban settings, are a substantial source of energy inefficiency. Framework conditions for investing in the renewable energy sector have improved, and several measures have been introduced, including installations of photovoltaic systems and support schemes for small and medium-sized enterprises (SMEs) and households. However, Cyprus has not yet taken full advantage of its considerable potential in renewable energy generation, in particular from solar sources. The reliance on roads for inland transport creates a number of policy challenges, most notably the struggle to reduce air pollution and greenhouse gas emissions, and also leads to severe congestion in urban areas during peak hours and on roads to and from ports. With a 2,7 % share in 2016, Cyprus is also lagging behind in the use of renewable energy sources in transport and may have difficulties reaching the binding 10 % target by 2020.

- (15) Investing in the digital economy and in improving workers' digital skills is essential for bolstering productivity. Cyprus ranks at the low end in the European Commission's 2019 Digital Economy and Society Index (DESI). Only 50 % of Cypriots between 16 and 74 years of age have basic digital skills, and ICT specialists still represent a lower proportion of the workforce compared to the Union as a whole (2,3 % versus 3,7 %), hampering the potential of the digital economy. There is a low level of online interaction between public authorities and citizens, with only 50 % of Cypriots interacting online. E-commerce is improving, but is still below the Union average.
- (16) Cyprus remains a moderate innovator, with innovation performance having declined since 2010. Public and private research and development expenditure levels are among the lowest in the Union, thus hindering the capacity of the research centres and the business sector to innovate. The interaction between academia and businesses is also very limited. Increasing the capacity of the business sector to innovate and boosting access to finance and investments that focus on well-defined areas of smart specialisation are crucial to improve Cyprus's competitiveness and that of its SMEs in particular.
- (17) The administrative burden is high, especially for initiating strategic investments. There is scope to significantly simplify the procedures for obtaining permits for strategic investments, and the relevant legislation is still pending.
- (18) Implementation of the action plan for growth has led to some progress in entrepreneurship and access to finance for SMEs. However, financial support measures for SMEs are still based mainly on grants and banking finance supported by Union and/or national funds. Alternative sources of finance such as venture capital, equity funding and crowdfunding remain marginal for Cypriot businesses. Better coordination of business support could improve uptake. Privatisation efforts to attract productivity-enhancing foreign investments are in many cases on hold, and only a few privatisation projects are gradually advancing.

- (19) Persisting inefficiencies in the justice system continue to affect contract enforcement and prevent the swift resolution of civil and commercial cases and the investigation of serious crimes. Cumbersome and outdated civil procedure rules 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 the outdated civil procedures rules, the low specialisation and digitalisation of courts, the clearance of the large backlog of cases and the lack of lifelong training for judges; but progress remains slow. The reform should be in line with the commitments undertaken by the government in the context of the State aid decision on the sale of the Cyprus Cooperative Bank, which was approved by the European Commission. Improved insolvency and foreclosure frameworks were adopted in 2018. Decisive implementation of the new laws together with ensuring an efficient judicial system and stricter enforcement of judgments should help improve the debt repayment discipline. A national anti-corruption strategy has been in place since December 2017 and has been reinforced by the approval of a national horizontal action plan against corruption by the Council of Ministers in May 2019. Draft laws for the establishment of a new independent anti-corruption agency and whistle-blower protection have been submitted to the parliament but are yet to be adopted. These laws would help to strengthen the national anti-corruption framework. The anti-corruption reforms should be accelerated through the swift implementation of the anti-corruption Action Plan. The independence of the prosecution has to be safeguarded and the capacity of law enforcement should be strengthened.
- (20) Despite some efforts to reduce the backlog in the issuance of title deeds, the backlog remains high. A structural solution to address the inadequacies of the property transaction system (i.e. the issuance and transfer of title deeds) is still lacking. This is essential to facilitate foreclosure procedures and enable liquidation of collaterals.

- (21) The programming of Union Funds for the period 2021-2027 could help address some of the gaps identified in the recommendations, in particular in the areas covered by Annex D to the 2019 country report. This would allow Cyprus to make the best use of those funds in respect of the identified sectors, taking into account territorial disparities. Strengthening the country's administrative capacity for the management of these funds is an important factor for the success of this investment.
- (22) In the context of the 2019 European Semester, the Commission has carried out a comprehensive analysis of Cyprus's economic policy and published it in the 2019 country report. It has also assessed the 2019 Stability Programme, the 2019 National Reform Programme and the follow-up given to the recommendations addressed to Cyprus in previous years. The Commission 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.
- (23) In the light of this assessment, the Council has examined the 2019 Stability Programme and is of the opinion<sup>7</sup> that Cyprus is expected to comply with the Stability and Growth Pact.
- (24) In the light of the Commission's in-depth review and this assessment, the Council has examined the 2019 National Reform Programme and the 2019 Stability Programme. Its recommendations under Article 6 of Regulation (EU) No 1176/2011 are reflected in recommendations (1) to (5) below. Those recommendations also contribute to the implementation of the 2019 Recommendation for the euro area, in particular the first, third and fourth euro-area recommendations,

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<sup>7</sup> Under Article 5(2) of Regulation (EC) No 1466/97.

HEREBY RECOMMENDS that Cyprus take action in 2019 and 2020 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. Address features of the tax system that may facilitate aggressive tax planning by individuals and multinationals, in particular by means of outbound payments by multinationals.
2. Facilitate the reduction of non-performing loans including by setting up an effective governance structure for the State-owned asset management company, taking steps to improve payment discipline and strengthening the supervision of credit-acquiring companies. Strengthen supervision capacities in the non-bank financial sector, including by fully integrating the insurance and pension-fund supervisors.
3. Complete reforms aimed at increasing the effectiveness of the public employment services and reinforce outreach and activation support for young people. Deliver on the reform of the education and training system, including teacher evaluation, and increase employers' engagement and learners' participation in vocational education and training, and affordable childhood education and care. Take measures to ensure that the National Health System becomes operational in 2020, as planned, while preserving its long-term sustainability.
4. Focus investment-related economic policy on sustainable transport, environment, in particular waste and water management, energy efficiency and renewable energy, digitalisation, including digital skills, and research and innovation, taking into account territorial disparities within Cyprus. Adopt legislation to simplify the procedures for strategic investors to obtain necessary permits and licences. Improve access to finance for SMEs, and resume the implementation of privatisation projects.

5. Step up efforts to improve the efficiency of the judicial system, including the functioning of administrative justice and revising civil procedures, increasing the specialisation of courts and setting up an operational e-justice system. Take measures to strengthen the legal enforcement of claims and ensure reliable and swift systems for the issuance and transfer of title deeds and immovable property rights. Accelerate anti-corruption reforms, safeguard the independence of the prosecution and strengthen the capacity of law enforcement.

Done at Brussels,

*For the Council*

*The President*

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