

UNICE TASK FORCE ON ENLARGEMENT

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TOWARDS EU ACCESSION**

CYPRUS

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Executive Summary

Cyprus leads the race to join the EU, as negotiations have moved well ahead with the majority of chapters having been closed, specifically 27 out of 30. During the last year the macro-economic environment has improved due to further adoption of a market-oriented system, pursuit of appropriate macro-economic policies and the existence of dynamic entrepreneurship combined with a competent labour force. Economic growth remained strong (3.8%), inflation was down to 2% and unemployment fell to 3%, the public sector deficit continued to decline and dropped to 2.9% of GDP, while the current account deficit deteriorated, increasing to 4.5%.

Over the last year there has been progress in adopting legislation in key areas of the internal market. There has been a wide-ranging abolition of price controls and imposed tariffs have been lowered for many products. Good progress has been made in free movement of services and capital, areas which are expected to comply with the Acquis in good time. Legislation for partial liberalisation of the energy market is in preparation, industrial policy is showing satisfactory alignment and the Commissioner for Public Aid has been appointed. The Government intends to liberalise the telecommunications sector and the law to create a Regulatory Body has been passed. In the areas of standardisation and certification, the CE mark has recently been introduced and the newly established "ISO 9000" Certified Enterprises Association will promote the certificate.

Tax reform is still under discussion and there is a need to develop a credible and coherent approach to fiscal consolidation in order to ensure macro-economic stability. Companies still find some tariffs an obstacle and bureaucratic procedures, especially in customs, are still a major constraint for European companies which export to Cyprus. Abolition of preferential treatment in public tenders is a strong request of European businesses as well as the need for liberalising air transport. Maintaining the attractiveness of Cyprus as an international business centre is a challenge, as its comparative advantage for offshore companies will be affected by the imposition of corporate tax.

Actions recommended

- Further reduction of public sector and promotion of privatisation.
- Reduction of current account deficits.
- Further liberalisation of the banking system.
- Abolition of remaining exchange controls.
- Reduction of imposed tariffs and customs procedures simplification.
- Rational tax reform and gradual VAT harmonisation.
- Abolition of preferential treatment in public tenders.
- Maintaining attractiveness as an international business centre.
- Further promotion of standardisation and certification.
- Financial assistance for adoption of environmental requirements.
- Air transport liberalisation.

A. Introduction

1. Relations between the European Union and Cyprus

Cyprus and the EU have been linked since 1973 by an Association Agreement, which was intended to lead to a customs Union. The Agreement contained arrangements on trade as well as on financial and technical cooperation. Full liberalisation of trade, as foreseen in the second phase of the Agreement has not been completed in view of the start of the accession negotiations. Cyprus has continued to implement the Association Agreement correctly with a view to creating conditions of stability, security, cooperation and thus prosperity. The relationship with the EU is also supported by a Council Regulation on the implementation of actions in the framework of the pre-accession strategy.

European Union is the most important commercial partner of Cyprus. According to the latest data (2000) the European market supplied 52% of imported products and absorbed 48% of total exports of Cyprus. The main export market of Cyprus within the EU is the United Kingdom, followed by Greece and Germany. It is estimated that the income from exported products and services equals 46% of GDP. The main imports are consumer and capital goods such as manufactured, agricultural and construction products as well as transport equipment. The main exports to the EU are industrial products, mainly clothing, unprocessed agricultural products (potatoes and citrus fruits) as well as minerals.

2. Political Criteria

Cyprus leads the race to join the European Union. Negotiations have moved well ahead with the majority of chapters having been closed –specifically 27 out of 30 - and Cyprus is expected to be ready for membership by 1 November 2003 and to become a full member in 2004.

At the Helsinki Summit in December 1999 the EU committed to negotiation process and eventual accession of Cyprus to the EU irrespective of solution of Cyprus's political problem. This important decision provided confidence for business and has improved growth prospects. It is hoped that enlargement of the EU will bring a glimmer of hope for resolving Europe's outstanding territorial dispute.

Cyprus fulfils the Copenhagen criteria and brings stability in the Eastern Mediterranean. Cyprus has achieved stability of institutions guaranteeing democracy and the rule of law and is a country that respects human rights and freedoms.

B. Economic Context and Developments/Investment Climate

During the last year the macroeconomic environment has improved. Cyprus has a record of successful economic performance and is classified by the World Bank as a high-income country. The Cypriot economy's success is attributed to the adoption of a market-oriented economic system, pursuit of sound macro-economic policies by the Government and the existence of a dynamic and flexible spirit of enterprise, combined with a highly educated labour force. The economy of the island has benefited significantly from close cooperation between the public sector and the social partners as well as from economic links with Europe, which have intensified during the last decade.

Cyprus enjoys a well functioning market economy with per capita GDP of € 15,093 (for 2001). Economic growth remains strong, 3.8% for 2001 and is operating at near full employment conditions. Such a growth rate is considered fairly satisfactory in the context of globalisation and international competition, as well as taking into account foreign exchange fluctuations, increase in oil prices and - most importantly - implications for international markets after last

year's tragic events. Inflation in 2001 reduced to 2% whereas in the labour market unemployment fell to 3%, even among "vulnerable groups" such as the young, higher education graduates and women. The public sector deficit continued to decline and has fallen to 2.9% of GDP, thus fulfilling the Maastricht convergence criterion. However, the current account has worsened substantially and thus the current account deficit has increased to 4.5% of GDP.

Macroeconomic stability has weakened recently, with the current level and stance of fiscal policy not sustainable even in the medium term. Tax reform is still under discussion and there is a need to develop a credible and coherent approach to fiscal consolidation in order to ensure macroeconomic stability. With a view to progressive capital liberalisation, monetary policy must be made more efficient and market-oriented. Completion of price liberalisation is also required.

Business calls for less state involvement and privatisation of public sector entities. The private sector must be prepared to operate in the open environment that integration into the EU requires. Extended consensus is needed to develop a comprehensive structural reform agenda that should limit the state involvement in economic activities, even though the latter is considered relatively small by international standards. Regarding public projects financing the Build-Operate-Transfer (BOT) method was recently adopted at a political level and the necessary legal changes are under discussion.

The Cypriot economy is basically service-oriented with more than 65% of its population employed in this sector, particularly in tourism. Although industry and agriculture together employ close to 30% of the population, their contribution to the GDP is lower (21% for industry, 4% for agriculture) and the trend is downwards year on year. The importance of services in the economy has allowed the Cypriot economy to benefit from productivity gains and has showed impressive growth during the last years. The tourism sector has grown very rapidly, accounting to approximately 22% of GDP, mainly due to increased numbers of visitors to Cyprus and favourable exchange rate developments. Tourism is the lifeblood of the island contributing about one fifth of its gross domestic product. Cyprus also remains a favoured destination in the Mediterranean and further investments in the sector are expected in order to attract more visitors.

The Cypriot Authorities have started major health sector reform which is proceeding satisfactorily, with the enabling legislation that was passed last year entering its implementation phase.

The pension system, which was introduced many years ago, is a full three-tier system based on earnings-related contributions. It is functioning well with 24 pensioners for every 100 contributors, a ratio which is expected to be stable for a number of years. In the long term, though, adjustment measures must be taken to ensure sustainability.

The prospect of EU accession continues to sustain the momentum behind wide-ranging structural reforms, such as liberalisation of the financial and capital markets, Central Bank independence and the sale of public monopolies. The banking system is highly sophisticated, with a few remaining restrictions and regulations still prohibiting its full evolution to competitiveness. Supervision must be improved in the co-operative banking sector, which plays a very important role in providing financial services, in particular to the household sector. The financial system is highly developed and it provides effective intermediation between savers and investors.

More than 100 registered international financial services companies reside in Cyprus, several of which manage domestic collective investment schemes. They are attracted by the liberal financial environment, the low tax rate for expatriates and the zero capital gains tax on share sales – which is due to change with the upcoming new law - as well as by the legal framework which is modelled on Britain's judicial system.

It is considered that the abolition of the 9% interest rate ceiling was an important change with a positive impact on business. The obsolete regime of a legally fixed ceiling on interest rates, which had existed since the 1940s, was finally brought to an end, providing scope for further development of the capital market. The monetary policy which has entered in a transitional phase needs to be further improved according to European business and foreign investors. It is estimated that the gradual abolition of remaining exchange controls will be completed in an orderly manner by the time of accession to the EU.

An indicator of the improved business and financial climate is the Cyprus Stock Exchange. With "wiser" investment behaviour after the upheavals in 1999 and 2000, companies realise that the demand for stock exchange transactions will rise and have started to become interested in listing. However, rural and urban households are still showing some conservatism in investing funds in shares.

In real estate, though, it is noted that, due to declining interest rates, domestic and foreign demand has risen - especially near seashore areas - as there is a calculation that prices will increase after accession to the EU.

Cyprus has a highly effective legal system with a well-established body of commercial law. The relative strength of its legal system is a major contributory factor to growth as property rights are well established in Cyprus.

C. Progress in Adoption, Implementation and Enforcement of Acquis

• Free movement of goods

Over the last year there has been progress in adopting legislation in key areas of the internal market.

Price controls have been abolished except for cement and petrochemical products. In the areas of standardisation and certification progress has been delayed and further efforts are still needed. However, change has started to take place since the beginning of this year with respect to the CE mark.

With respect to New Approach Directives, they have not yet been approved by the Legislative Body. There is need for rapid development on this, so that institutional functioning is in play, experience is gained and foreign investments are attracted.

In relation to concerns expressed by European companies about high tariffs for certain products, progress has been made since last year.

- in pharmaceuticals, CCT is in place and there are no tariffs from the EU
- in the paper packaging, there are no import duties from the EU
- for cigarettes, if they are produced from tobacco grown in the EU or Cyprus, they have the same tariff as Cypriot-produced cigarettes
- for all other items, for which concerns were expressed in the previous year (spirits, confectionery products, ice-creams, paints, packaging nets, bakery products, coffee, honey, cocoa, chocolate), tariffs are now much lower with the exception of agricultural products where tariffs are still high.

Some European firms from the food and beverages sectors still find tariffs a little higher than appropriate, implying that if they are lowered it would enhance their activities in the island.

Bureaucratic procedures – especially in customs - is a major constraint expressed by a few European companies which export to Cyprus. These companies coming from the pharmaceuticals and furniture sectors complain about complex procedures that cause long delays and high costs.

Some companies from the electrical appliances and machinery sector still complain that they face competition from products of unknown origin which are not certified, while others from the marble sector noted that ISO 9000 does not offer a competitive advantage. However, it should be noted that for the promotion of ISO 9000, a newly established "ISO 9000 Certified Enterprises Association" has begun a campaign to promote this certificate widely among businesses and consumers.

In the area of telecommunications, European business expressed some concerns with regard to free movement of services. However, the Government has declared its intention to liberalise the telecommunications sector as a top priority, and the law to create a Regulatory Body for the sector (National Telecommunication Committee) has been passed and the Body has already been created. Liberalisation of the market is expected to proceed through invitations to tender for a second or third license in mobile telephony, and fixed-line telephony will follow, with the scope to establish a genuinely open market by 2003.

Quite a few European firms requested that preferential treatment of domestic industry in public tenders is abolished as soon as possible, despite the provisions of the existing Public Procurement Law that this protectionism will be eliminated upon accession. European businesses claim that transparency and equal participation in public tenders is an urgent need for a well-functioning entrepreneurial environment.

- ***Free movement of services***

Cyprus has made good progress regarding financial services and enhancing administrative capacity. The private sector for services (banks, insurance companies, consulting enterprises etc.) is considered to be able to cope with the necessary liberalisation and, therefore, European firms express satisfaction for progress regarding harmonisation.

- ***Free movement of capital***

Cyprus is continuing to make satisfactory progress in liberalising this field and is expected to comply with the *acquis* in good time. A more liberal policy for direct investments is in place and the abolition of the 9% interest rate ceiling was a significant step, as well as the measures for cross-border credit transfer and the legislation for prevention of use of the financial system for money-laundering.

- ***Transport***

In Cyprus there are no state-owned transport companies and what is needed is liberalisation of the regime. Monopolistic structures no longer serve the interests of the economy and liberalisation in this area is not only desirable but of utmost importance. Some European businesses explicitly requested the abolition of protectionism in air transport, which has been proved to cause inefficiency, higher costs and a questionable level of services.

In the field of commercial maritime transport, the Merchant Shipping Laws which were adopted move in the direction of improving the system of inspection and control in the area of maritime safety, responding to requests of European shipping. Cyprus is well advanced in the harmonisation of the basic legislative and administrative framework with the *acquis*. This is important as maritime is crucial for the island's economy, with one of the largest commercial fleets worldwide.

- **Company Law**

Further progress has been made in the area of company law where a significant amount of legislation has been adopted. Items awaiting adoption are the 4th Directive for companies' accounting documents and Directives on intellectual property, data bases and computer programs.

- **Competition Policy**

The Competition Committee is in place (since July 2001) and is functioning at a satisfactory level. Also, the Commissioner for Public Aid has been appointed, and the smooth operation of his office is expected to enhance private investments.

- **Taxation**

Cyprus has declared its intention to align its taxation legislation with the acquis. The main challenge remains the level of VAT, as following accession the current standard rate of 10% will see an increase to up to 15%.

- **Energy**

The adoption to acquis is considered to be at a good point but further efforts need to be made to cope with deadlines. While the existence of the appropriate institutional framework is fundamental, legislation is in preparation for liberalising 32% of the market and establishment of the *Regulator and the Transmission System Operator* is foreseen.

- **Industrial policy**

Industrial policy is showing substantial alignment with European policy, whereas the role of State is limited to creating the appropriate institutional framework and environment which will enhance investments. The main problem is alignment with environmental requirements, where companies are very concerned about the heavy costs they will have to bear and, therefore, a transition period is under discussion and financial assistance in the form of grants, long-term loans and tax allowances is required.

- **Regional Policy and Coordination of Structural Instruments**

In the area of regional policy, taking into consideration the island's population factor, it has been agreed that the country is considered an Objective I region and is expected to receive structural funds which will be used for restructuring and balancing regional differences.

- **International Business Centre**

Cyprus is an international business centre, which provides comparative advantage to offshore companies, many of which come from the European Union. This is mainly due to its strategic geographical location, as well as to rich human capital, high quality services, advanced infrastructure, favourable tax regime and double taxation avoidance treaties with several countries. As the size of the Cypriot market is relatively small, international companies use the island as a base for export activities to the Middle East or ex-USSR countries. However, in the upcoming tax reform it is scheduled that the special regime for offshore companies will be abolished in order to comply with the Code of Conduct for Business Taxation to the same extent as current Member States. According to the new tax reform, offshore companies will have to pay corporate tax in the same way as local onshore companies (expected rate 10%). As a result, this tax might be a reason for a number of international companies to move into other countries.

D. General Evaluation

1. Conclusions

Cyprus, having completed 27 chapters, has gained the highest marks among the candidates for admission to the European Union from the Commission and is considered to function as a market economy which should be able to cope with competitive pressure and market forces in the EU.

Progress is being made in the areas of liberalisation and structural reforms posing new challenges to the economy. However, the current account deficit has increased significantly. State involvement in economic activities should be limited, while key sectors should be opened up to foreign competition and important environmental constraints need to be resolved.

By joining the EU, Cyprus will acquire political security and stability, becoming even more prosperous. It will participate in the decision-making process of a Union that is assuming a leading international political and economic role. Positioning the Cypriot economy within the European Union will act as a catalyst for even greater openness and cooperation. Cyprus will be a bridge between Europe, North Africa and the Middle East.

The accession of Cyprus will ease fears about the future of the island and will contribute to the development of relations and cooperation between Greece and Turkey, with positive consequences both for the area of the Eastern Mediterranean and for much-needed stability in the Balkans.

2. Recommendations

European companies are generally satisfied regarding the entrepreneurial climate in Cyprus and strongly believe that Cyprus's accession will significantly strengthen the ties, supporting and facilitating expansion of business activities. The sample of companies interviewed come from a wide variety of sectors such as food and beverages, construction, pharmaceuticals, chemicals, banking, cement, electronics, paper, ceramics, household appliances, agricultural, transport, furniture, metallurgy. Specific recommendations from the business perspective for improvement can be summarised as follows:

- further reduction of public sector involvement in economic activities to the minimum necessary, and promotion of privatisation
- efforts to reduce current account deficits
- further liberalisation of the banking system
- gradual harmonisation of VAT
- abolition of remaining exchange controls
- abolition of preferential treatment given to domestic businesses for public tenders
- reduction of imposed tariffs
- simplification of customs procedures
- maintaining the International Business Centre which has a crucial role
- assistance for alignment with environmental requirements
- promotion of standardisation and certification
- liberalisation of air transport

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