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Fiscal Affairs Department

CYPRUS

OPTIONS FOR SHORT-TERM EXPENDITURE RATIONALIZATION

Aide-Mémoire

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PREFACE

In response to a request of the Ministry of Finance of Cyprus, a mission from the International Monetary Fund's Fiscal Affairs Department (FAD) visited Nicosia, Cyprus during the period February 26–March 11, 2013 to help the authorities identify additional expenditure measures in support of ongoing fiscal consolidation efforts. The mission was led by Mr. David Coady and comprised of Mr. Csaba Feher, Ms. Katja Funke, and Mr. Mauricio Soto (all FAD), and Platon Tinios (FAD external expert). The team also benefitted from comments and suggestions from staff members of the European Commission and the European Central Bank.

The mission wishes to thank all of the government and private sector officials it met for their excellent cooperation and their generosity with their time. The mission met with Christos Patsalides (Permanent Secretary of the Ministry of Finance), Stavros Michael (Director of Finance-Budget and Fiscal Control), Rea Georgiou (Accountant General), George Papageorgiou (Permanent Secretary of the Ministry of Labor and Social Security), Olympia Stylinau (Permanent Secretary, Ministry of Education and Culture), Dionysis Mavronicolas (Permanent Secretary, Ministry of Health), George Oxinos (Permanent Secretary, Human Resource Development Authority), Alekos Stamatis (Permanent Secretary, Bank of Cyprus Oncology Centre), and with members of their staff. The mission also benefited greatly from consultations with staff from the Audit Office, Public Service Commission, Ministry of Interior, Health Insurance Organization, and the Cyprus Statistical Service. The mission expresses its gratitude to Maria Tsiakka for outstanding coordination and logistical help during the team's stay in Nicosia.

EXECUTIVE SUMMARY

Increasing public spending had contributed to a substantial deterioration of public finances in Cyprus over recent years. To address fiscal imbalances, the government introduced an initial set of fiscal reforms in late 2012. However, additional measures are needed to ensure the sustainability of public finances. The size of the necessary adjustment will depend, among other things, on the magnitude of spillovers from financial sector restructuring.

This report provides options for further rationalizing public spending, both in support of ongoing fiscal consolidation efforts and to enhance the efficiency and equity of public spending. The report focuses on rationalization of the public sector wage bill, education and health spending and social protection spending (including pension and non-pension social benefits). A menu of possible expenditure measures is identified and their short-term fiscal impact quantified.

Expenditure rationalization should give priority to reducing the public sector wage bill, especially in education. While total public spending as a percent of GDP is similar to the average for EU countries, spending on wages and on education are among the highest in the EU. Also, while public pension spending is low by EU standards, the existing system is extremely favorable to public sector workers, and any further spending cuts should address this inequity in a progressive manner.

Public Sector Wage Bill. The relatively large size of the wage bill is mainly the result of high average compensation—even after the recent wage bill measures, a premium of about 30 percent in government pay remains relative to the EU average. Government employment is also similar to the EU average, although pockets of excess employment seem to exist in certain areas such as education. The wage bill could be reduced through flat rate pay reductions, including the elimination of the 13^{th} wage. More targeted reductions could aim to reduce the premium for seniority instead of focusing on gross salary levels. In the medium term, the wage grid could be revised to better link compensation and performance. In terms of employment, targeted reductions focused on casual employees, particularly in education, could deliver some savings. In addition, mandatory unpaid leave could be required to some workers in low priority areas.

Education. In spite of high spending, the quality of primary and secondary education is compromised by several practices related to the hiring, evaluation and promotion processes for teachers. Measures to improve the quality of public education include increasing teaching hours (particularly for senior teachers), extending school schedules, and further consolidating within and across schools aiming to reduce class size. Wages could be adjusted in the short term following adjustments to the overall wage grid. Public spending on tertiary education is especially high, reflecting high salaries and allowances and the creation of two new public universities over the past decade. Expenditure allocations to tertiary education could be reduced through the introduction of tuition fees and the elimination of the "incentive" allowance for professors. In the medium term, compensation for public sector teachers could be brought more in line with private sector remuneration and the hiring of teachers could be based on merit rather than on waiting lists. The administrative structure, including school boards, should also be reviewed.

Public Pensions. Recent parametric reforms address the long-term rise in spending. In GSIS, little room remains for further savings. However, substantial savings could be achieved by further adjusting benefits for government employees (including pensions in payment), which are much larger than what would be justified on the basis of their contributions. A significant reduction of the lump-sum gratuity could also be considered, either through outright termination or a reduction coupled with mandatory annuitization. Relatively large savings could be achieved by progressive reductions to GEPS and state officials' benefits in service.

These spending reforms can be supplemented by reforms in other areas focused on containing, or even reducing, spending and enhancing its efficiency and equity. This could be achieved as follows:

Public Health Spending. Public and also total spending on health care is relatively low. However, the absence of a universal public health care system, and the limited public sector capacity to serve those patients that are eligible for free public health care, results in long waiting times in the public sector and large out-of-pocket spending for private health care. This raises affordability and equity concerns. The healthcare system is also fragmented with health services delivered by public and private providers in a largely uncoordinated manner. This causes inefficiencies in terms of the cost and quality of health care provision. The introduction of the General Health Insurance System would address many of these problems but will take time and should only go ahead if correct costing and functional financing arrangements to safeguard the system's fiscal sustainability are in place. In the meantime, pressure on the public healthcare system can be reduced by tightening eligibility criteria for subsidized public health care and increasing the number of patients that pay for public services. The collected revenues could be used to buy additional services from the private sector to address identified bottlenecks in public service delivery.

Other Social Protection Spending. Although spending is low by EU standards, the current system is fragmented and benefits are not sufficiently targeted to those most in need. The system also needs to be reformed to better address the social challenges resulting from the economic downturn, in particular the rise in unemployment. Expenditure savings generated through better targeting and the scaling back or elimination of some social benefits can help to finance an expansion of active labor market programs with a focus on incentivizing the unemployed to reenter the labor market. Specific attention needs to be given to addressing the sharp rise in youth unemployment, including through enhanced public employment services and training. Consideration could also be given to introducing a flat-rate means-tested unemployment assistance benefit for those not eligible for unemployment insurance. To improve the overall cost-effectiveness of these social benefits, existing plans to streamline administrative structures and consolidate benefits should be expedited.

The menu of expenditure reforms identified in the report can make a significant contribution to short-term fiscal consolidation efforts and improve the efficiency and equity of public spending. However, the actual package of measures adopted and their timeline will reflect a range of factors, including: (i) the extent of short-term expenditure consolidation required; (ii) the possibilities for generating fiscal space in other areas, including on the revenue side and by decreasing other public spending not covered by this report (e.g., spending on goods and services and capital spending); and (iii) the administrative, political, and social constraints facing the government. Table 1 provides a summary of identified measures, including a quantification of their likely fiscal impact.

Table 1. Expenditure Reform Options, 2013-2016

(Savings in percentage points of GDP)

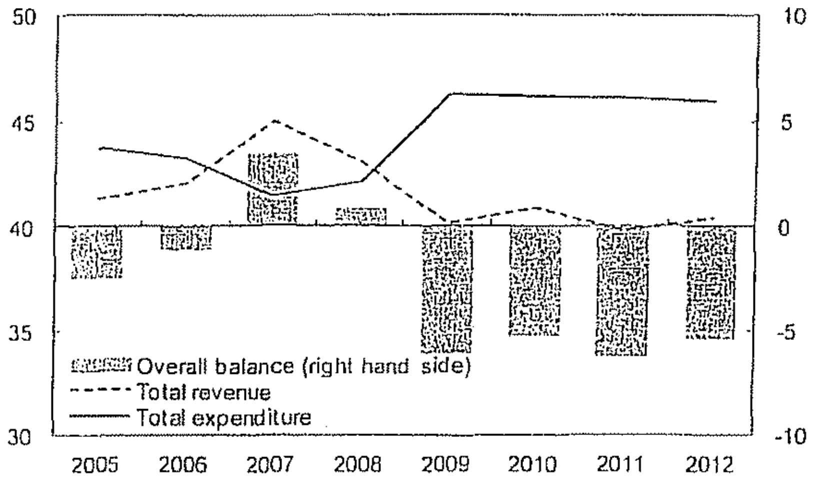
	2013	2014	2015	2016
Wage measures	1.0	2.5	2.4	2.4
Increase flat reduction from 3 to 5 percent	0.0	0.3	0.3	0.3
Elimination of the 13th wage payment	1.2	1.1	1.1	1.1
Introduce 13th payment, flat €500	-0.2	-0.2	-0.2	-0.2
Adjust step increases to 2 percent for all scales	0.0	1.2	1.2	1.2
Employment measures	0.0	0.3	0.5	0.6
Reduce employment in education by 2,000	0.0	0.1	0.3	0.4
Reduce casual staff in public service by 500	0.0	0.0	0.1	0.1
Establish furlough targets	0.0	0.2	0.2	0.1
Education measures				
Increase statutory teaching time	+	+	+	+
Increase average class size	+/-	+	+	+
Extent school schedule	+	+	+	+
Adjust wages for public sector teachers	+	+	+	+
Enhance mobility of teaching staff	+	+	+	+
Introduce fees for tertiary education	0.2-0.5	0.2-0.5	0.2-0.5	0.2-0.5
Eliminate incentive allowance for professors	+	+	+	+
Public pension measures	0.6	1.0	1.2	1.3
Reduction of GEPS benefits in service	0.2	0.3	0.4	0.4
Reduction of GEPS gratuities				
via immediate termination	0.3	0.6	0.6	0.6
via mandatory annuitization	0.3	0.6	0.5	0.5
via full income tax liability	0.2	0.2	0.2	0.2
Career average assessment for all new retirees, for all accruals				
if lumpsum gratuity remains unchanged	0.1	0.2	0.2	0.3
if lumpsum gratuity is terminated or annuitized	0.0	0.1	0.1	0.1
Increasing the eligibility age for gratuity and unreduced pension	0.0	0.1	0.1	0.1
Price indexation of the GSIS basic pension and the social pe	0.0	0.0	0.0	0.1
Social protection measures				
Unemployment assistance scheme for 12 months, benefit at current basic amount for one person (€410)				
Assume *all* in LFS between 6-11 months eligible	..	..	-0.3	-0.2
Assume means test *excludes 30%*	..	..	-0.2	-0.2
(Scheme for 9 months)				
Assume *all* in LFS between 6-11 months eligible.	-0.1	-0.2		
Assume means test *excludes 30*	-0.1	-0.1		
Expand Active Labour Market programs				
Increase by 0.2 percentage points of GDP	-0.1	-0.2	-0.2	-0.2
Child (and single parent) benefits: tighter means testing				
set income at 39 thousand (30% excluded)	0.0	0.0	0.0	0.0
set income at 19 thousand (70% excluded)	-0.1	0.3	0.3	0.3
Student grants.				
set income at 49 thousand (34% excluded)	0.0	0.1	0.1	0.1
set income at 39 thousand (47% excluded)	0.0	0.1	0.1	0.1
set income at 19 thousand (73% excluded)	0.0	0.2	0.2	0.2
Taxation of all benefits as income				
Social insurance benefits @ 3%		0.0	0.0	0.0
non-work related benefits @ 5%		0.1	0.1	0.1
public assistance @ 2%		0.0	0.0	0.0
Rationalization of housing benefits				
extend agreed streamlining	0.0	0.2	0.2	0.2
Suspend grants; - means test rent subsidies	0.5	0.5	0.5	0.5

Source: IMF staff calculations.

I. Introduction

1. **Public finances in Cyprus have weakened significantly over recent years.** Between 2007 and 2012, the overall fiscal balance deteriorated by over 9 percent of GDP (Figure 1.1). This deterioration in the fiscal balance has been driven both by falling revenues and increasing public spending. Over the same period, public debt has increased from just below 60 percent to nearly 90 percent of GDP. Contingent liabilities arising from the banking sector may lead to further significant increases in debt levels.

Figure 1.1. Main Fiscal Indicators, 2005-2012



Source: AMECO.

2. **To address fiscal imbalances, the government introduced an initial set of fiscal reforms in late 2012.** During discussions with the EC/ECB/IMF in November 2012, the government committed to undertake ambitious fiscal consolidation and broad public sector reforms. A range of measures to contain public expenditure and to improve revenues have already been legislated with the 2013 budget. On the expenditure side, the measures focused on:

- reducing the *public sector wage bill* by freezing employment, cutting and freezing public sector wages, and streamlining allowances for public sector employees;
- containing public pension spending by freezing benefits, introducing an actuarial penalty for early retirement, and other parametric reforms to both the public sector pension scheme (GEPS) and the general pension schemes (GSIS); and
- reducing *other social spending* by discontinuing and cutting some of the benefits, and improving the targeting of benefits.

3. **However, additional measures are needed to ensure the sustainability of public finances.** The size of the necessary adjustment will depend, among other things, on the magnitude of spillovers from the financial sector restructuring. There is also an additional need for sufficient fiscal space to support the social safety net to mitigate the adverse social impact of the economic downturn. Against this background, further fiscal consolidation measures of some 2-4 percentage points of GDP might have to be considered through 2016.

4. **This report provides options for further rationalizing public spending, both in support of ongoing fiscal consolidation efforts and to enhance the efficiency and equity of public spending.** The report focuses on rationalization of the public sector wage bill, education and health spending, and social protection spending (including pension and non-pension social benefits). A menu of expenditure measures are identified that can deliver further expenditure consolidation needs over the short term and cover any shortfalls from measures that have already been legislated. The identified measures can also facilitate the transition from measures primarily focused on delivering short-term expenditure savings to higher quality measures that also enhance the efficiency and equity of public spending over the medium term. The actual package of measures adopted and their timeline will reflect a range of factors, including: (i) the extent of short-term expenditure consolidation required; (ii) the possibilities for generating fiscal space in other areas, including on the revenue side and by decreasing other public spending not covered by this report (e.g., spending on goods and services and capital spending); and (iii) the administrative, political, and social constraints facing the government. This report is intended to provide input into these decisions by taking a comprehensive view of all spending within the areas covered, and highlighting the equity and efficiency implications of different expenditure rationalization choices.

5. **The report is organized as follows.** Subsequent chapters provide a detailed discussion of reform options in the public expenditure areas covered in this report and, where possible, quantify their likely impact on public expenditure over 2013-2016. The areas covered include: the public sector wage bill (Chapter II), public education spending (Chapter III), public health care spending (Chapter IV), public pension spending (Chapter V), and other social benefit spending (Chapter VI). A summary of the report's findings are provided in the Executive Summary, which also includes a table summarizing possible expenditure reforms and their contribution to fiscal consolidation over the short term.

II. Government Wage Bill

A. Background

6. **The wage bill encompasses compensation for employees in the general government, including the central government, non-profit organizations, and local authorities.**[1] Government employees are entitled to monthly base wages and allowances plus an additional base wage payment in December (13^{th} wage). Compensation also includes contributions to social security funds. For example, in the central government, which accounts for 83 percent of general government employment and 89 percent of the wage bill, compensation is distributed between wages (70 percent of total compensation), allowances (6 percent), and social contributions (24 percent) (Table 2.1). Non-profit organizations and local authorities follow similar compensation rules, including equivalent grade scales and promotion policies.[2]

Table 2.1. Government Employment and Compensation, 2011

	Employment			Compensation		
	Number of workers	Percent of economy-wide employment	Percent of government employment	Billion euro	Percent of GDP	Percent of total government compensation
(1) Central government	52,198	13.4	83	2,573	14.3	89
Of which:						
Salaries				1,801	10.0	70
Allowances				144	0.8	6
Social contributions				628	3.5	24
(2) Non-profit organizations	5,717	1.5	9	173	1.0	6
(3) Local authorities	4,796	1.2	8	149	0.8	5
(4=1+2+3) General government	62,711	16.1	100	2,894	16.1	100
Addendum:						
State-owned enterprises	8,842	2.3		529	2.9	

Sources: Eurostat, Ministry of Finance, CYSTAT, and IMF staff calculations.

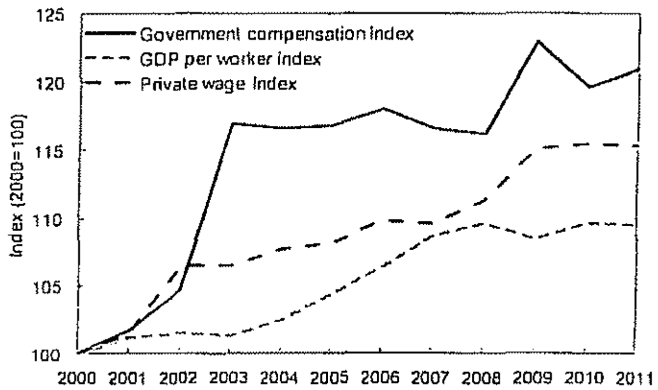
7. **The wage bill has increased rapidly over the past decade, reflecting the growth of both wage levels and employment.** Total compensation of government employees increased by 2½ percentage points of GDP over 2000-2011—the second largest increase in the euro area over this period, after Ireland.

[1] Outside the general government, and thus not included in the wage bill, are nearly 40 state owned enterprises (SOE) employing 2.3 percent of the workforce and with a payroll of nearly 3 percent of GDP.

[2] In practice, however, these lower levels of government have some leeway in hiring and promoting personnel.

- The growth in compensation as a share of GDP mainly reflects increases in wage levels, particularly in 2003 (when average government compensation increased by 11.7 percent in real terms compared to a 0.3 percent growth in GDP per worker) and 2009 (when average government compensation increased by 6 percent compared to a drop of 1 percent in GDP per worker) (Figure 2.1). These increases typically follow collective agreements for state-owned enterprises, which set the main compensation parameters generally adopted by the government.

Figure 2.1. Compensation of Government Sector, Private Sector, and GDP per Worker, 2000-2011



Sources: CYSTAT; and IMF Staff calculations.

- The increase in the wage bill also reflects additional government employment. Over 2007-2011, the share of government workers in total employment increased from 15 percent to 16 percent (Table 2.2). In part, this increase reflects new employees hired in the non-profit organizations, particularly those devoted to education, including in two newly created universities.[3] Other areas of the central government also expanded, including the ministries of Commerce, Finance, and Health. In addition, employment in other institutions might have not been reduced according to sectoral developments.

[3] Over 2007-2012, about 400 new employees were added to the University of Cyprus, 400 to the Cyprus University of Technology, 100 to the Open University, and 300 to the School Committees.

Table 2.2. Public Sector Employment, 2000-2011

(Percent of total workforce)

	2000	2005	2006	2007	2008	2009	2010	2011	Change 2000-2011
(1) Central government	13.4	12.9	13.0	12.8	12.9	13.3	13.4	13.4	0.1
(2) Non-profit organizations	0.5	0.8	0.8	1.1	1.2	1.3	1.4	1.5	0.9
(3) Local authorities	1.1	1.1	1.1	1.1	1.1	1.2	1.2	1.2	0.1
(4=1+2+3) General government	15.0	14.7	14.9	15.0	15.2	15.8	16.1	16.1	1.1
Addendum:									
State-owned enterprises	3.0	2.8	2.7	2.4	2.4	2.4	2.4	2.3	-0.8

Source: CYSTAT (2011).

8. **Recent measures have been implemented to reduce the government wage bill.** As part of the ongoing fiscal consolidation efforts, Cyprus has adopted measures to address the relatively high level of the wage bill over 2013-2016 (Table 2.3). These include:

- *Government wage policies*. For all government employees, the levels of wages, including cost-of-living allowances (COLA) and other allowances, are frozen in nominal terms over 2012-2016. Entry wages have been reduced by 10 percent for new hires. Compensation was reduced progressively, ranging from 6.5 percent for those earning €12,001- €18,000 per year to 12.5 percent for those with earnings above €48,000 per year (an additional 3 percent across-the-board reduction is planned starting in 2014).[4] Allowances are expected to be reduced by 15 percent. Together, these measures are expected to deliver savings of up to 2 percentage points of GDP over 2013-2016.

- *Government employment policies*. The number of posts has been frozen for permanent, fixed-term (casual) staff, and hourly-paid workers. A few areas have been exempted from this freeze, including health care and education, for which a cap on the number of new posts has been imposed. A new-hire-to-exit ratio of 1:4 has been set for professional staff (1 hiring per 4 retirements) and 1:5 for hourly-paid workers. Overall, mainly through the normal attrition of the workforce via retirements, these measures should reduce employment by 5,000 individuals with savings of up to ½ percentage point of GDP over 2012-2016.

- *Public administration policies*. A broad review of the public administration is planned for 2013-2014, focused on examining the organizational structure of general government and the broad public sector, public compensation, and performance appraisal.

[4] A temporary progressive levy on wages of between 0 and 3.5 percent of wages (which applies also to the private sector) will further reduce net pay.

Table 2.3. Impact of Recent Wage Bill Measures, 2013-2016

(Savings in percent of GDP)

	2013	2014	2015	2016
Wage measures	0.8	1.4	1.5	1.7
Of which: Wage and promotion freeze	0.0	0.2	0.4	0.6
Scaled reduction (0-12.5 percent)	0.7	0.7	0.7	0.7
Additional 3 percent reduction	0.0	0.4	0.4	0.4
Employment measures	0.1	0.1	0.3	0.4
Of which: Hiring freeze	0.0	0.0	0.1	0.2
1:4 attrition rule	0.1	0.1	0.2	0.3
Increase in retirement age	0.0	0.0	-0.1	-0.1
Total adopted wage bill measures	0.8	1.5	1.8	2.1

Source: IMF staff calculations.

B. Key Issues

9. **The wage bill in Cyprus is extremely high by international standards.** At 16 percent of GDP, spending in compensation of government employees is nearly 4¾ percentage points above the euro area average (Table 2.4).[5] Relative to other countries, the wage bill seems high in functions such as public services, education, defense, and public order. Spending compensation of employees corresponds to 35 percent of total public spending compared to an average of 23 percent in the euro area.

10. **The relatively large size of the wage bill is mainly the result of high average compensation.** Despite the high level of spending, the size of the general government sector relative to total employment is not among the highest by international standards (Figure 2.2). Even after taking the recent wage bill measures into account (which reduce spending by about 2 percentage points of GDP over 2013-2016), this implies a premium of about 30 percent in government pay to the average euro area economy. Furthermore, other euro area counties have also taken measures to reduce their wage bills further (including Greece, Portugal, Ireland, Italy, and Spain).[6]

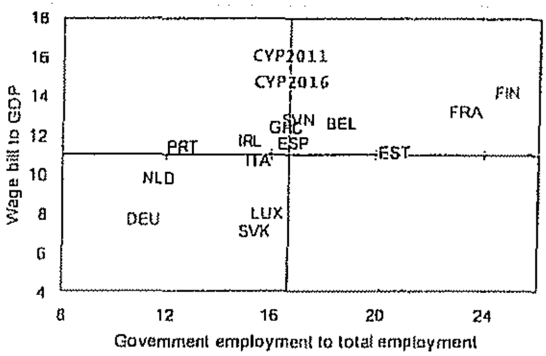
[5]The wage bill is estimated to increase by another ½ percentage point in 2012 to about 16½ percent of GDP. See AMECO series S.13, D1p, available at: http://bit.ly/13LN0RS.
[6]See IMF's Fiscal Monitor, October 2012, available at: http://bit.ly/13LMZ0h.

Table 2.4. Public Expenditure by Economic Activity, 2011
(percent of GDP)

	Cyprus	Euro area average	Difference To Euro area average
Public services and other	5.7	3.1	2.6
Defense	1.3	0.7	0.6
Public order and safety	1.9	1.3	0.6
Health	1.7	1.8	-0.1
Education	5.3	3.7	1.6
Social protection	0.2	0.8	-0.6
Total	16.1	11.4	4.7

Source : Eurostat.

Figure 2.2. Government Compensation and Employment, 2011
(Percent of GDP)



Source: Eurostat.
Note: CYP2011 and CYP 2016 refer illustrate the position of Cyprus in 2011 and projected 2016, respectively.

11. **Public sector wages are also high relative to the wages of comparable private sector workers, in particular for teachers and low-skilled workers.** In 2009, average public sector wages were 27 percent higher than those for private sector workers, after controlling for educational achievement and age (Figure 2.3)[7] These differences vary substantially by occupational group—from more than 100 percent for teachers to 13-18 percent for professionals and skilled workers. Only upper management and senior officials seem to have, on average, lower wages than their private sector counterparts. Nevertheless, these differentials exclude other compensation components such as pensions (see Chapter V), which suggest that the *total* compensation differentials would be much higher, including for management and senior officials.

12. **The pay and promotion structure does not seem to reward performance.** Government employees follow a career path that combines scales and steps.[8] Promotions beyond the career path to upper management positions depend, according to law, on seniority, merit (including performance as measured by the appraisal system), and qualifications (including educational achievement).

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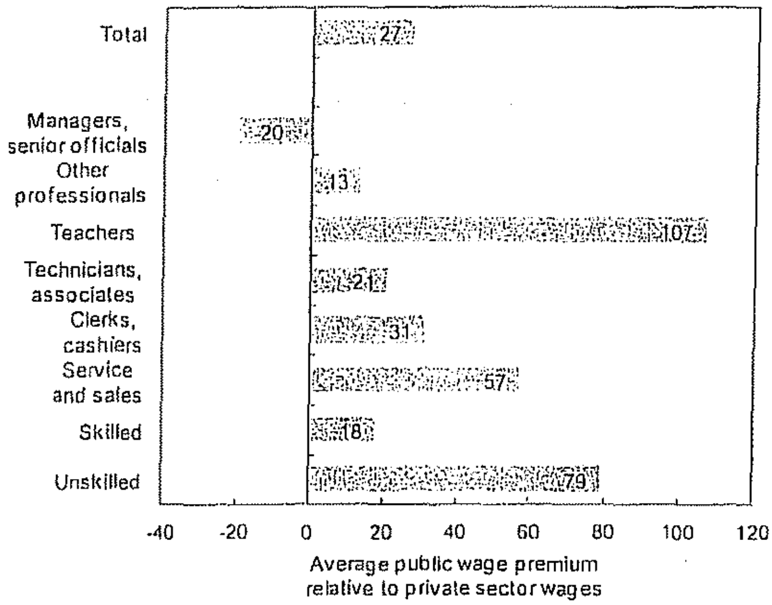
[7]These calculations do not take into account recent measures. However, these are likely to reduce average the public-private premium by just a fraction, to the extent that private wages do not fall as much as public wages. See Pashardes, Panos, 2011, "Government Payroll: Harsh Truths and Policy Dilemmas," Cyprus University Economics Research Centre, available at: http://bit.ly/WqpAj2.

[8]Sixteen scales (A1 to A16) apply to administrative and professional staff and ten scales (E1-E10) to hourly workers. Within each scale, there are a number of steps reflecting seniority—one for each year of service. Employees typically follow a career path depending on the occupation. For example, professional staff typically follows the A8-A10-A11 path: entering the civil service at A8, moving to A10 after 12 steps (years) in A8, and finally moving to A11 after 9 more steps in A10.

Figure 2.3. Public-Private Pay Differential, 2009



Source: Pashardes (2011).

- The pay structure includes components that are unrelated to performance. Public pay has been traditionally composed of the basic wage (depending on the scale and grade of the worker), COLA, general wage increases, and other allowances.

- Advancement through the career path happens automatically, depending solely on seniority. Compensation increases as individuals move along the steps and between the scales not necessarily requiring increases in performance or responsibilities. The compensation structure provides a very large premium to seniority—the average increase for each year of seniority is 3.7 percent.

- The appraisal system fails to promote employee competencies and performance. Currently, annual appraisals are conducted by evaluating employees according to 8 criteria with four ratings (ranging from excellent to non-satisfactory). These appraisals are taken into account for promotion purposes (by the Public Service Commission).[9] However, several agencies across the government seem to attach little value to these evaluations. The common perception is that managers rather give an "excellent" rating to nearly all of the employees, that these forms do not take into account individual or

[9] The criteria include: training and qualifications, fulfillment of duties in quantity and quality, interest and effort on the job, responsibility and seriousness, initiative, team work, civil attitudes, and managerial skills. The evaluation forms also allow workers to describe their duties and managers to explain their ratings in more detail.

organizational objectives, and that promotions are largely based on seniority with little regard to the appraisals.[10]

13. **Legal constraints on mobility across and within government entities impede the reallocation of employees toward higher priority activities.** Only limited categories of workers can be transferred across and within ministries and departments of the government. These include some support workers (including general clerical/administrative staff, cleaners, messengers who are contractually "interchangeable"), and entry level employees (through "duty assignment"). Recent laws have allowed these workers to be reallocated within ministries without central-level approval. However, reallocations across ministries and departments still require the approval of the Public Administration and Personnel Department of the Ministry of Finance (PAPD). In addition, severe limitations exist in reallocating non-interchangeable staff (including hourly-paid workers and technical staff). For the remainder of the civil service, the only option available currently is through temporary secondments, which require approval of the two entities involved in the secondment, as well as of the Ministry of Finance, and the Public Service Commission.[11]

14. **Temporary employment arrangements have been used to respond to permanent needs.** About 14 percent of the central government workforce is classified as casual (fixed term). The use of casual workers is particularly widespread in the ministries of Commerce, Education, and Health (Figure 2.4). While employment of many of these workers might address a genuine temporary need, up until recently temporary contracts seem to have been used to address permanent needs—temporary contracts have been traditionally converted to open-ended after 30 months, after which they are labeled "casual-indefinite".[12] However, these workers have not gone through the stringent process to enter the civil service (including the civil service exam and interviews). Casual workers are equivalent to other civil servants in many respects, except that they do not qualify for civil service pensions and are excluded from promotions to management positions.

15. **Little oversight exists for the wage bill outside the central government.** Non-profit organizations and local governments together spend about 2 percent of GDP in compensation. More importantly, the payroll of state-owned enterprises, which are part of the wider public sector, amounts to some 3 percent of GDP. While the Ministry of Finance approves their budgets, there seems to be a relatively weak central government oversight of the wage bill of these organizations.

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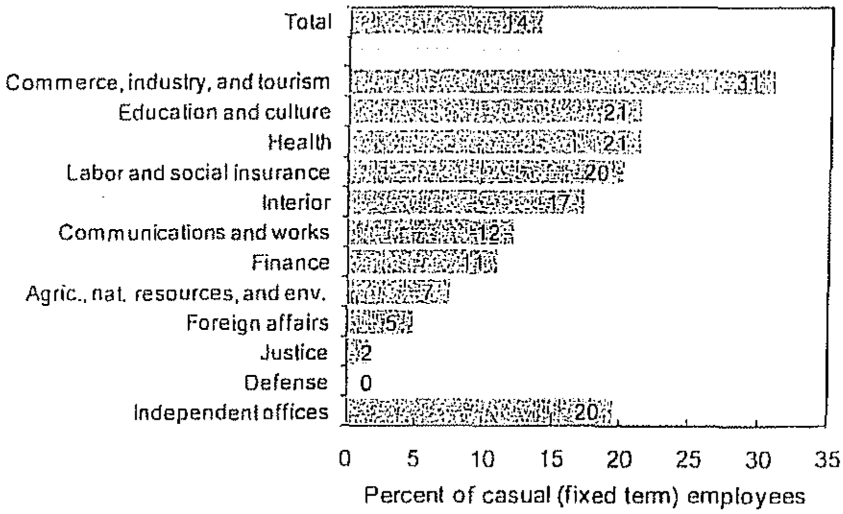
[10] In reality, about 70 percent of the employees receive an "excellent" grading in all of the eight criteria, 23 percent receive and excellent in 7 criteria, 5 percent in 4-6 criteria, and 2 percent in less than 4 criteria.
[11] According to the Public Service Commission, about 180 civil servants were in secondment in 2012.
[12] See laws No. 98(I)/2003 (http://bit.ly/YPrOF9), and Soumeli (2008) (http://bit.ly/14kzzV1).

Figure 2.4. Casual (Fixed-Term) Employment in the Central Government, 2009



Source: Ministry of Finance.

C. Reform Options

16. **In the context of fiscal consolidation, it is imperative to continue to address the issue of relatively high public sector compensation.** The public wage and employment measures taken so far will reduce the government wage bill by 2 percentage points to about 14½ percent of GDP in 2016. This level would still be considerably above international standards—only Denmark and Iceland have higher levels of spending among European economies. Furthermore, average public compensation is expected to decline by nearly 10.5 percent over 2013-2016, equivalent to only a fraction of the adjustment needed to bring public compensation more in line with that in the private sector. These remaining disparities are indicative of the potentially sizeable fiscal savings in the wage bill, which could be achieved without much adverse impact in terms of equity (government salaries are well above the poverty line) or efficiency (better aligning wages to the private sector is unlikely to disrupt the provision of public services).

17. **The starting point for reforms could include further reductions in compensation.** These reductions could aim to deliver fiscal savings while improving the compensation system to, for example, making it less dependent on seniority. Options for reform include a mix of across-the-board reductions and a more targeted approach:

- One option is to increase the flat reduction planned for 2014 from 3 percent to 5 percent. This could deliver savings of 0.3 percentage points of GDP. This type of across-the-board reduction might be preferable to progressive reductions, to the extent that they help to address the relatively large public-private wage premium for unskilled workers.

- An additional option includes eliminating the 13th wage payment for all workers. This could save up to 1.1 percentage points of GDP per year. This could be more palatable if, instead of fully eliminating the 13th payment, it is replaced by a flat amount. For example, introducing a €500 allowance would cost 0.2 percentage points of GDP.

18. **A more targeted approach could address the high seniority premium in the public wage grid.** Under the current wage grid, the average increase per year of service is 3.6 percent, so that a worker with 11 years of service receives a pay about 36 percent higher than a worker in the same scale with only 1 year of service. These increases have been awarded automatically and do not reflect productivity or performance. In the short term, this could be addressed by replacing the current wage grid with one that provides a flat 2 percent seniority premium. This would keep the initial compensation level of each pay scale fixed—protecting the lowest earners in each scale—but reducing it for those with higher seniority. For example, a worker with 11 years of service would experience an average pay reduction of 16 percent.[13] This measure could generate savings of up to 1.2 percentage points of GDP.

19. **In the medium term, the compensation grid should be tightened to better link compensation and performance.** For example, the average seniority premium could be kept at 2 percent but allocated depending on performance—those with higher performance rating would receive more than 2 percent and those with lower performance would receive less than 2 percent. However, this would require an improvement of the performance assessment system. In addition, the initial steps of each scale should be adjusted periodically reflecting comparable jobs in the private sector. A careful study of these issues could be included in the planned public administration review.

20. **Further targeted reductions of personnel could also be considered, particularly for education.** Although the overall level of public employment is not among the highest relative to other countries, there are certain pockets that might have excess personnel. For example, in the educational sector there seem to be room to reduce the number of casual workers without compromising educational outcomes by raising the number of teaching hours (see Chapter III). This could generate savings of up to 0.4 percentage points of GDP, provided that the number of casual workers is gradually reduced by about 2,000 individuals. Other areas of the public service could also aim to reduce the number of casual workers—a feasible target is a gradual reduction of about 500 casual workers over 2013-2016 (out of a total of 4,500 non-education casual workers) in 2012. This could deliver savings of up to 0.1 percentage points of GDP.

[13] 3.6 percent per year (current grid)-2.0 percent per year (proposed grid) x 10 years= 16 percent.

21. **Furloughs (mandatory leave without pay) could also be considered as a human resource tool in the short term.** To address pockets of excess labor capacity in certain ministries, it might be useful to establish targets for required unpaid leave or furlough. For example, in low priority areas with excess employment, managers could require workers to take an unpaid day off every month. Setting a target at each ministry, at say an average ½ hour of furlough per worker per week, could deliver savings of up to 0.2 percentage points of GDP.

22. **Greater mobility could be required to ensure the proper delivery of public services.** In the short term, the available options for mobility—including secondments and duty assignments—could be used more widely. In the medium term, most restrictions to mobility across- and within government entities could be lifted. This could be addressed in more detail by the upcoming public administration review.

23. **These reform options could also generate savings in SOE compensation.** The compensation of SOE employees is generally determined by the same compensation grid used by the government. Thus, these measures should be mirrored by the SOE sector. This could save up to 0.5 percentage points in SOE payrolls.

Table 2.5. Impact of Options for Further Wage Bill Consolidation, 2013-2016

(Savings in percentage points of GDP)

	2013	2014	2015	2016
Wage measures	1.0	2.5	2.4	2.4
Increase flat reduction from 3 to 5 percent	0.0	0.3	0.3	0.3
Elimination of the 13th wage payment	1.2	1.1	1.1	1.1
Introduce 13th payment, flat €500	-0.2	-0.2	-0.2	-0.2
Adjust step increases to 2 percent for all scales	0.0	1.2	1.2	1.2
Employment measures	0.0	0.3	0.5	0.6
Reduce employment in education by 2,000	0.0	0.1	0.3	0.4
Reduce casual staff in public service by 500	0.0	0.0	0.1	0.1
Establish furlough targets	0.0	0.2	0.2	0.1
Total options for further wage bill consolidation	1.0	2.8	2.9	3.0

Source: IMF staff calculations.

III. Education

A. Background

24. **Cyprus' education system is highly centralized and several bodies are involved in policy making and its implementation at the central level.** The Ministry of Education has the overall responsibility for education including the administration of education, the enforcement of education laws, and the construction of schools. However, a small number of vocational and post-secondary institutions come under the Ministries of Labor and Social Insurance, Agriculture and Health. The Education Service Commission, a body appointed by the President of the Republic, is responsible for appointments, secondments, transfers, promotions and discipline of the teaching personnel and the inspectorate. The local School Boards undertake, in collaboration with the Technical Services of the Ministry of Education, the maintenance of school buildings and are also responsible for their equipment.

25. **The public education system offers largely free access to education at all levels.** Public education is mainly financed by the government either directly or through budget transfers to local authorities or School Boards. Access to free public pre-primary education is based on admission criteria, including annual income, number of children and family status (e.g., single parents). Primary and lower-secondary education is compulsory and, for the public sector, government financing covers the cost of education including the free provision of books. Public technical and vocational secondary schools, including the majority of the textbooks, are also financed by the government. For public tertiary education and undergraduate studies at public universities, Cypriot and EU students pay fees of between €1,700 and €3,500 per year. The government provides a grant to cover these fees to the school or university so that students effectively do not pay tuition fees. For non-EU international students, these tuition fees vary but can be twice as high and they do not receive government grants. The fees, paid by the government or students, cover only a small portion of the universities budget and the remainder is covered by a block transfer from the government budget.

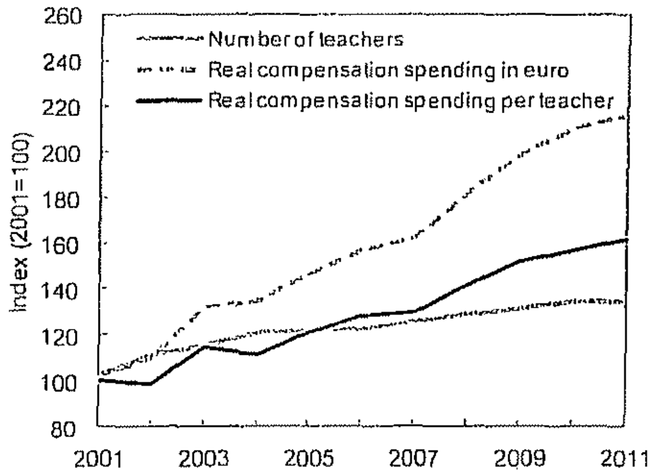
26. **The public education system is complemented by private sector providers, which are also catering for international students.** Private education is financed by individuals and foundations, and several private foreign language schools are assisted by affiliated overseas authorities and organizations. Private schools are subject to supervision and inspection by the Ministry of Education. There are several bodies that certify minimum quality standards for different levels of private sector education providers. Education services have been identified as an export sector with growth potential.

B. Key Issues

27. **Driven by a combination of rising wages and employment, public spending on education has risen rapidly in recent years.** Since 2001, education spending has increased by over 1.5 percentage points of GDP and per student spending has more than doubled. As a

result, at around 7.5 percent of GDP in 2011, Cyprus' education spending far exceeded the EU average of 5.7 percent of GDP and was the second highest in the EU. Compensation spending for education more than doubled between 2001 and 2011, mostly due to a 60 percent increase in the wage levels (Figure 3.1). Both the minimum and maximum statutory salaries (measured in terms of per capita GDP) of teachers in Cyprus are very high by EU standards.[14] Teachers' salaries increase faster with seniority in Cyprus than in other EU countries and are on average 100 percent higher in the public sector than in the private sector (Chapter 2). An increase in the number of teachers by 30 percent also contributed to the rise in total education spending. The increase was spread across all levels of education, with a higher increase in tertiary education reflecting the creation of two new public universities.

Figure 3.1. Compensation and Employment in Public Education, 2001-2011



Source: IMF staff calculations.

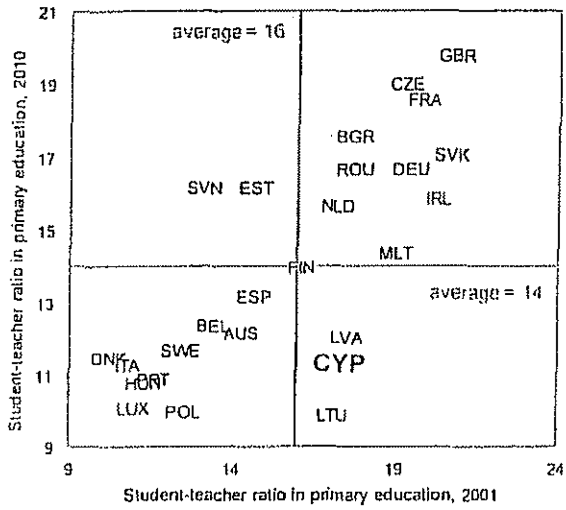
Primary and secondary education

28. **Teaching staff have increased while student numbers have declined, resulting in very favorable teaching conditions for teachers.** This is reflected in a large reduction in student-teacher ratios. While student-teacher ratios have fallen in most EU countries, they have fallen much more in Cyprus so that they are now among the lowest in the EU (Figure 3.2). Low limits on maximum class sizes feed the need for teachers. For all levels of primary and secondary education, Cyprus limits the class size to a maximum of 25 students. For those EU countries that apply class size restrictions, the average maximum class size is 27 for

[14] European Commission, 2012, "Teachers' and School Heads' Salaries and Allowances in Europe," 2011/12, available at: http://bit.ly/XyyA4j.

primary, 28 for lower secondary, and 29 for higher secondary.[15] In addition, Cypriot teachers have a low teaching load compared to other EU countries and they are among the very few in the EU for which the teaching load is reduced with seniority. For the majority of EU countries, average weekly teaching hours, both at primary and secondary level, are between 20 and 25 hours and teaching hours at different career stages vary only slightly.[16]

Figure 3.2. Student-teacher Ratio in Primary Education, 2001-2010



Source: IMF staff calculations.

29. **The quality of teaching staff in primary and secondary education is compromised by several practices related to working hours, and the hiring, evaluation and promotion processes for teachers.**

- *Working hours.* The working hours for teachers, and thus instructing hours for children, are limited by the working hour arrangements of the public sector. Teachers commonly use the after-work hours to provide homework support and tutorials to students that can pay for such services. The limited working hours also impact the time that children are looked after at school, affecting the possibilities for parents to take up full time work.

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[15] Recent studies have shown little impact of lower class sizes on pupil achievement. Value for money in raising attainment in schools is better achieved through interventions other than lowering class sizes, including increasing teacher effectiveness (e.g., by assigning the most effective teacher to the largest class). For a discussion and overview of recent studies see Department of Education, UK Government, 2011, *Class Size and Education in England Evidence Report*, available at: http://bit.ly/14GXD4P.

[16] See Galgóczi and Glassner, 2008, "Comparative study of teachers' pay in Europe," available at: http://bit.ly/Y0HAPj.

- *Hiring of permanent teachers.* Teachers are hired from a "waiting list" based on a first-in-first-hired rule. Given the attractive working conditions and remuneration in the education sector, the supply of teachers is high and the waiting lists for teacher positions are long. Reportedly, for certain specialties, more than 5,000 candidates are on the list (compared to about 12,000 total public sector teaching staff across all specialties). As a consequence, candidates wait for a long time to get to the top of the list and are often in their 50s once they are hired. There is therefore a risk that the training of teachers is outdated when they finally start teaching in the public sector. In addition, older hires have only limited time to gain and make use of experience before retiring.

- *Hiring of casual teachers.* In the past, causal teaching staff were hired to accommodate last minute uncertainties regarding the need for teachers due to higher or lower than expected registrations for public schools at the beginning of the school year. In recent years, however, the hiring freeze has led to a decline in permanent teachers in the education sector and these have been replaced by casual staff. Causal staff is hired through the same waiting list process as permanent. In contrast to casual staff in other areas of the public sector, contracts for casual teaching staff are not converted into "indefinite casual" contracts since teaching staff are only hired for part of the year. Casual contracts are assigned for the academic year and not necessarily renewed the following academic year since the hiring has to be done every year based on the list. This procedure does not seem to have caused serious disruption in the teaching practice in the past as in practice many of the casual teachers seem to be re-hired. Note that, to the extent that education policy is not changed and teaching staff is not reduced but permanent staff replaced with casual staff, the employment reduction targets aimed for under the 1 for 4 attrition rule will not be achieved.

- *High spending is not reflected in education outcomes.* Cyprus has only recently participated in its first PISA assessment and the results are not yet available. However, judged by outputs, Cyprus falls behind EU averages, for example in terms of upper secondary education attainment.

- *Evaluation and promotion.* Since teacher evaluations apparently improve automatically with seniority, rather than being based on performance or additional qualifications, promotions are allocated to the most senior teachers. This does not provide incentives for improved teacher performance.

Tertiary education

30. **Public spending on tertiary education is high in absolute and relative terms, reflecting very large salaries and allowances.** Tertiary education spending increased more rapidly in Cyprus than in other EU countries. Consequently, Cyprus' tertiary education spending per student is by far the highest in the EU. Salaries at public universities are in line

with civil service wage grids and the wage of an assistant professor (including basic salary and general increase) amounts to between €53,256 and €71,826 per year (Scale A13-A14). On top of the wage, an "incentive" allowance of between €7,000 and €12,000 can be granted. The allowance is supposed to be provided for outstanding performance and intended as an incentive for high performance. However, after the allowance was introduced it was basically granted to every professor, becoming an additional salary rather than a reward for good performance.

Administration / management of schools

31. **Schools are managed through what seems to be a cumbersome and inefficient structure of local school boards.** The school boards are elected for a three-year period and are responsible for managing school facilities as well as activities not directly related to teaching. The work on a school board is not remunerated. The school boards do, however, manage significant budgets for the schools, which gives them limited decision power over how to use public resources. Since the boards are elected every three years, there is a risk of a lack of continuity and experience in the management of budgets. In addition, the capacity of a school board to address problems, such as the need for repairs, can be disruptive to the day-to-day school life. The Ministry of Education has tried to channel part of the resources currently handled by the school boards directly to the schools but the headmasters are not used to taking this responsibility and were reluctant to do so.

C. Reform Options

Short-term reforms

32. **The high cost of the education system can only be reduced by addressing the high wage bill.** This can be achieved through a combination of the following short-term measures:

- The **statutory teaching time** for senior teachers could be increased from 19 hours in primary schools and 18 hours in secondary schools to up to 25 hours in both primary and secondary schools. This measure would reduce the need for teaching staff at the primary and secondary level by between 10 and 30 percent. This measure could allow for a reduction of teaching staff by between 900 and 3,800 persons. Reducing the teaching staff by 2,000 individuals could deliver up to 0.4 percentage points of GDP in savings (Chapter 2).

- Increasing the **average class size** will require merging classes and might require closing or merging schools that are relatively small but independent. While the merging of classes can help reduce the cost for teacher's wages, the closing or merging of schools might have a fiscal cost if schools needed to be renovated or built to accommodate larger classes. On the other hand, closed school buildings could eventually be sold to raise funds.

- **Extend school schedules** so that teachers teach both in the morning and the afternoon. This measure can improve education outcomes and help to contain private spending on education.

- **Adjust wages for public sector teachers.** The wages should be immediately adjusted downwards to be brought more in line with private sector remuneration. This would require a divergence from, or a relative adjustment of, the wage grid for teachers and, while a rough cut can be enacted immediately, further refinements should be part of the public administration review. The wage bill would decline depending on the design of the cut (Chapter 2).

- **Enhance mobility of teaching staff.** To address shortages and oversupply of teachers in particular districts in the context of consolidation and restructuring, teacher should be required to move within the public education sector across districts.

33. **Introduce fees for tertiary education and eliminate the "incentive" allowance for university professors.** In 2011, the government spent €2 million these allowances. Since most of the benefit of third-level education accrues to the individual student as higher future wages (as opposed to society more generally), students should pay full tuition fees at public universities. To compensate for access problems caused by the tuition fee, the government can provide a strictly income-tested student loan program and possibly income-tested grants. It could consider providing such a program through private sector banks. Gross revenues from tuition fees paid by Cypriot and EU students could amount to €40-80 million (0.2 to 0.5 percent of GDP) (Table 3.1). The cost for subsidizing interest payment for loan to low income student could amount to €12-25 million per year (assuming a 2 percent subsidy for a 20 year loan with students studying for 4 years).

Medium-term improvement of quality and efficiency of the education system

34. **To ensure and improve the quality of education, teachers should be selected and promoted based on merit and not according to waiting lists.** The Ministry of Education has a plan to reform the hiring, evaluation and promotion system for teachers gradually. The implementation of this plan should be accelerated.

35. **The responsibility for school budgets could be moved gradually from school boards to schools.** The headmasters and appropriate administrative staff in the schools would have to be trained and could be supported by the local administration as needed. The responsibility for the budget gives the school more accountability and would thereby improve the incentives for efficient use and management of public resources. In this context, the school board could assume an advisory role that ensures that public resources are used well. Under the current system, the supervisory and executive functions seem to be mixed in the school boards, risking conflicts of interest.

36. **Issues related to education grants and benefits will be discussed in the social welfare chapter**. As a principle, all education benefits should be means tested and, as much as possible, tertiary education should be financed by the students and financing can be supported via a student loan ranted by private bank with some government guarantee and possibly with some interest subsidy.

Table 3.1. Impact of Options for Education Consolidation Measures, 2013-2016

(Savings in percentage points of GDP)

	2013	2014	2015	2016
Education measures				
Increase statutory teaching time	+	+	+	+
Increase average class size	+/-	+	+	+
Extent school schedule	+	+	+	+
Adjust for public sector teachers	+	+	+	+
Enhance mobility of teaching staff	+	+	+	+
Introduce fees for tertiary education	0.2-0.5	0.2-0.5	0.2-0.5	0.2-0.5
Eliminate incentive allowance for professors	+	+	+	+

Source: IMF staff calculations.

Note: Savings from most education measures result from adjustments in employment and wages (included in Chapter 2 and denoted by + in this table).

IV. Health Care

A. Background

37. **Cyprus' healthcare system is fragmented with health services delivered by public and private providers in a largely uncoordinated manner.** The public health system provides services through six hospitals, four specialist centers, three small rural hospitals, 38 health centers, and many primary care sub-centers. The public system is largely tax financed and the Ministry of Health pays the salaries of all health professionals (government employees), consumables, medical devices, pharmaceuticals and the everyday costs of running hospitals and health centers. The private sector comprises for-profit hospitals, polyclinics, clinics, diagnostic centers and independent practices. Private healthcare services are mostly paid for through out-of-pocket expenditure since private insurance coverage is very limited (less than 8 percent of the population).

38. **Access to free public health services is not universal, with some groups eligible for subsidized prices and others charged on a fee-for-service basis.** The population is categorized by income, family and health status, and categorical classifications. Those entitled to free access regardless of income include: families with three or more children; people with disabilities or some chronic life-threatening diseases; all full-time civil servants, including police; military personnel and their families; those serving in the National Forces; students at all Cypriot universities; and political officials and diplomats. For the remainder of the population access to free or reduced-rate public health care is means tested (Table 4.1) Under the current criteria, about 85 percent of the population are eligible for free or reduced rate (50 percent of list prices) access to public health services. Those not entitled to free or reduced-rate access must pay for public sector health services according to a fee schedule set by the Ministry of Health. The out-of pocket expenditure of beneficiaries for hospital care is limited in terms of percent of annual income based on a progressive scale.

Table 4.1. Eligibility Criteria for Free and Reduced Access to Public Health Care

Free access to most public health care services	Reduced rate access to most public health care services
• individual with annual income under €15,380	• individual with annual income €15,380-20,000
• two-member families with annual income under €30,750	• two-member families with annual income €30,750-37,590
• increased by €1,700 for each dependent child	• increased by €1,700 for each dependent child

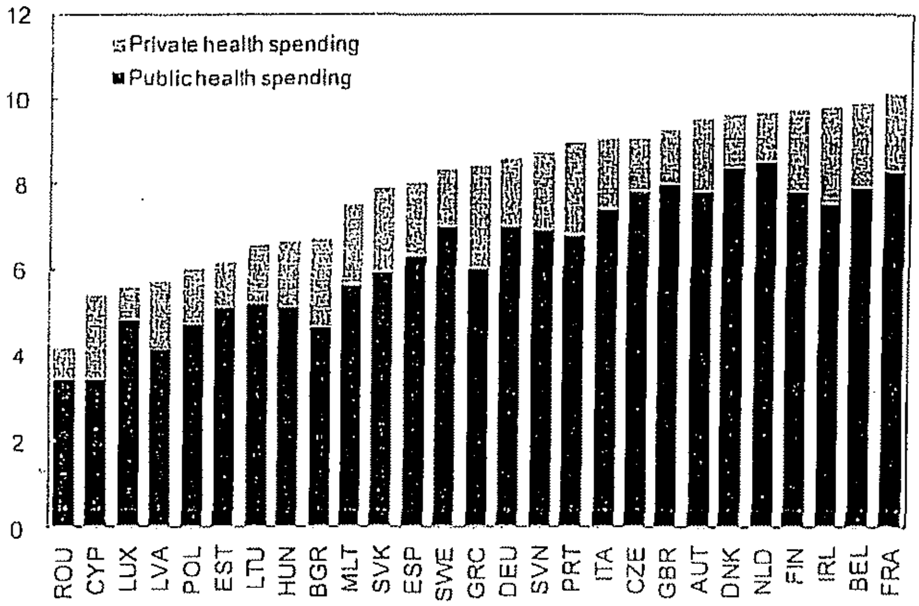
Source: Theodorou, et al., 2012, "Cyprus Health System Review," *Health Systems in Transition*, Vol. 14 No. 6.

B. Key Issues

39. **Cypruş' healthcare spending is low by international standards, with a large part of the spending is covered by out-of pocket spending, thus raising affordability and equity concerns.** Total and public health care spending amount to about 5½ and 3½ percent of GDP, respectively, compared to EU averages of 9 and 6.5 percent of GDP (Figure 4.1). According to a recent study, the public healthcare system suffers from long waiting lists for many services, a situation that has been worsened by the recent economic crisis. At the same time, the private sector has overcapacity resulting in underutilized expensive medical technology.[17] Many patients use private sector providers to avoid long waiting times and to gain access to services that are not provided by the public sector (including long-term care, rehabilitation care and palliative care). As a result, only about half of the healthcare needs are covered by the public sector, raising concerns about equity of access and affordability.

Figure 4.1. Public and Private Health Care Spending, 2011

(Percent of GDP)



Source: Eurostat and WHO.

40. **The current setup of the health care system has caused inefficiencies in terms of management and cost controls in the public health sector and coordination with private sector providers.** The Ministry of Health simultaneously assumes the roles of policy maker,

[17]See Theodorou, et al, 2012, Cyprus Health System Review, Health Systems in Transition, Vol. 14 No. 6.

supervisor, and monopoly service provider and service purchaser. This structure causes several inefficiencies:

- Public sector health care providers are not exposed to competition, and tools for performance monitoring and performance management of public sector health care providers (in particular hospitals, clinics and laboratories) have not been introduced.
- The Ministry of Health has put in place regulations largely in line with EU requirements, which ensures that private sector providers comply with certain requirements regarding technical equipment and staffing. However, rules and regulations to ensure minimum standards for the quality of health services are missing and the private sector remains largely unregulated with respect to service quality and pricing.
- The effectiveness of healthcare for patients moving between public and private providers is at risk due to a lack of integration and coordination of these providers.

41. **Although the government has been working on the implementation of a General Health Insurance System (GHIS) to address the problems of the current health system, progress has been slow.** The process of putting in place a GHIS started in 2001, when the GHIS law was passed and the Health Insurance Organization (HIO), which is responsible for the implementation of GHIS, was established.[18] Once in place, the system would provide universal health care through both public and private healthcare providers. The providers of primary, specialist, and inpatient-care services will be paid by the HIO based on capitation, agreed global budgets, and DRG systems, respectively. The GHIS will be financed through a combination of contributions on the payroll or other income, and budget transfers. The implementation of the GHIS has been held back by concerns over the systems' costs, and progress in preparing the administrative structures for the system (including IT infrastructure and programming of DRGs) has been slow. An update of the 2008 *Estimation of National Health Insurance System Expenditure Phase 1 Report* is expected to be available in the second quarter of 2013. Based on this report, the financing of the system and a timetable for its implementation could be discussed.

C. Reform Options

Short-term measures

42. **There is no room for reducing the level of public health spending under the current system.** The public health sector currently cannot answer to the needs of all eligible beneficiaries in a timely manner. Ultimately, this issue will be addressed by introducing an effective universal healthcare system. However, given the already experienced delay in the

[18] An amendment bill is pending parliamentary approval since 2007.

implementation of the system, the government could take some intermediate steps to take some pressure of the system.

43. **The pressure on the public healthcare system can be reduced by limiting eligibility for free healthcare and/or by increasing supply for free healthcare.** The former can be achieved by introducing stricter eligibility criteria for access to free healthcare. Making a greater share of the population pay for the consumption of public sector health services would provide financial resources for expanding services. The expansion of services should be done in coordination with the private sector to use available idle capacity.

- *Tighten eligibility criteria* by limiting access to free public health care to low-income households and patients with chronic diseases. The income thresholds should be set in line with the eligibility criteria for social assistance, i.e., based on the poverty line.

- *Make all others pay for services* provided by the public health system. The current fee schedule for public sector health services probably does not fully reflect cost as information on actual cost is limited due to the lack of a universal IT system. The fee schedule should thus be updated as cost information becomes available or is refined with the introduction of data management systems across service providers.

- *Introduce an income-related ceiling for out-of-pocket healthcare spending* to public sector providers. Such a ceiling would limit the risk of financial exposure in case of extraordinary healthcare needs. For public sector healthcare over and above the ceiling, the cost would be covered by the government budget. This would be in line with current practice for those beneficiaries that are eligible to access public health care at reduced rates.

- *Purchase additional services from the private sector* to address selected bottlenecks in public health services, using the additional income from fees and the savings from tightening the eligibility criteria. To ensure fiscal neutrality, only additional revenues should be used for purchasing additional services.

- *Improve the efficiency of public sector health services* provision to provide more and higher quality services through the public sector health care providers within the current resource envelope. In this regard, a focus should be on the reorganization and restructuring of the public health care sector and the Ministry of Health, separating policy and supervisory function from service delivery, with the decentralization of health services. In preparation for the GHIS, public hospitals and clinics could be transformed in semi-government entities with more managerial independence, but within hard budget constraints. As part of this effort, the recommendations of the 2009 *Roadmap for advance the competitiveness of public hospitals* should be implemented as much as possible under the current system and within the existing budget envelope.

Medium-term measures

44. **The full implementation of the GHIS can address the equity and financing issues but correct costing and functional financing arrangements are key to safeguarding the system's fiscal sustainability.** During the process of implementing the GHIS the following aspects should be closely monitored:

- The *GHIS has to be fiscally neutral.* The government contribution to the scheme should be fixed as a share of GDP up front and the remainder of the financing required to cover the cost of the system needs to come from contributions on payroll or other income. In this way, the exposure of government finances to future cost increases would be contained. The government could target to keep public health spending, including spending on the system's administration through the Ministry of Health and the contribution to the HIO, at the level of health spending under the current system.

- Proper *ex-ante costing of the GHIS* is key to ensuring the system's fiscal viability. The forthcoming update of the 2008 Mercer study should provide a basis for the costing. However, the lack of reliable, comprehensive and timely information on actual costs from public healthcare providers, also due to the lack of proper IT systems, could put the quality of the assessment at risk.

- The *financing of the GHIS* has to be established before any benefits are granted under the system. If the initial financing arrangements for the system turn out to be insufficient once benefits are in place, it will then be difficult to increase contributions from beneficiaries. Therefore, financing arrangements have to be set to an appropriate level and need to be introduced in parallel with benefits.

- To move forward, the *payment systems to reimburse healthcare providers* have to be put in place. The HIO is working on the programming of DRGs. While it is expected that the programming will be finalized by end-2013, the costing of the base unit, a crucial step in translating service costs into payments, is outstanding. The HIO has also taken first steps to prepare for the negotiation of contracts with service providers under capitation and universal budget agreements.

V. Pensions

A. Background

45. **The pension system of Cyprus aims to provide universal coverage.** The General Social Insurance Scheme (GSIS) covers all private and public sector workers, providing long-term benefits (old age, survivor and invalidity pensions), temporary benefits (unemployment, sickness and maternity) and various one-off grants. GSIS is augmented by occupational schemes, most importantly the Government Employees Pension Scheme. Since GSIS is a universal scheme, occupational schemes function as supplementary layers of insurance. Private sector employees can also be covered by occupational provident funds; however, these funds pay a lump-sum benefit at the termination of a labor contract without portability and without mandatory conversion to an annuity. People who fail to meet the minimum qualifying conditions for a GSIS pension are eligible for a social pension or a lump-sum payment (old age settlement). In addition to pension benefits, various untargeted and means-tested supplements and allowances are available to the elderly (these are discussed further in Chapter VI). GSIS and social pensions are administered by the Ministry of Labor while GEPS falls under the jurisdiction of the Ministry of Finance. Pension benefits are subject to the same progressive income tax regime as other personal income.

46. **Financing arrangements differ across the three public pension schemes.** GSIS is a contributory pension system with a contribution rate of 13.6 percent of gross wages. In the case of government employees, the employee contribution is 3.45 percent and the employer contribution is 10.15 percent.[19] For all other contributors, total contributions are shared equally between the employee and the employer. GSIS also receives additional contributions from the government, equal to 4.3 of insured wages. GSIS has accumulated a reserve fund valued at €7.5 billion (end-2012), 99 percent of which is invested in government bonds. GEPS, on the other hand, is a noncontributory scheme as far as old-age pensions are concerned, but members contribute 2 percent of their wages towards survivor benefits.[20] Social pensions are also financed from GSIS revenues (approximately one-third) and from the budget (two thirds).

47. **GSIS is a defined benefit, earnings-related scheme, divided into a basic and supplementary benefit.** Eligibility for a GSIS pension is conditional on age, service history and "contribution performance". Contribution performance is measured in points where the value of a point is equal to the ratio of the individual's insured earnings to the Basic Insurable Earning (BIE), which is a wage indexed benchmark defined by a government decree. The standard retirement age is 65 years, the minimum service history is 15 years (of

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[19] As part of the 2011 reforms, government employees joining GEPS after 2011 pay the general 6.8 percent employee contribution to GSIS.

[20] This contribution was, until recently, reimbursable if the person had no household members potentially eligible for a survivor pension.

which 10 have to be covered by paid contributions) and the minimum points required is 10 (gradually increasing to 15, in line with the minimum service time requirement).[21] Early retirement on a full pension is available at 63, provided that the applicant meets the minimum service time criteria and has insurance points equal to at least 70 percent of the number of years since turning 16 (33 points at 63). The basic pension equals 60 percent of BIE if the average of insurance points is 1. An average insurance point in excess of 1 accrues supplementary benefits at 1.5 percent per year, while an average insurance point below unity leads to a proportionately reduced basic pension with a floor (minimum) of 85 percent of the BIE. If a person accrues total insurance points between 6 and the minimum required for a GSIS pension and is ineligible (on residency grounds) for a social pension, then a lump-sum (old-age settlement) equal to 15 percent of the BIE for every insurance point is paid at the age 68. GSIS also pays survivor (widows, widowers and orphans) pensions, based on the deceased person's service history and insurance points.

48. **GEPS is an earnings-related final-salary scheme, providing supplementary old age and survivor pensions as well as a gratuity payment to government employees.** Eligibility for a GEPS pension is based on age and service time: government employees' statutory retirement age is 63, although early retirement is available from 58, with an unreduced benefit, provided that the applicant has completed at least 5 years of service. Pension entitlements accrue at 1.5 percent per year and cannot exceed 50 percent of the affiliate's highest salary in service which, in most cases, is their final salary. No additional pension rights accrue after 400 months of service, but a longer career implies a higher final salary and provides incentives to work longer. Since GEPS affiliates participate in both GSIS and GEPS, only the portion of the GEPS benefits which exceeds the GSIS supplementary pension is paid to retirees. At the same time, if a government employee retires from GEPS prior to becoming eligible for a GSIS pension, the person receives the full GEPS pension until pension payment from GSIS commences. A gratuity is payable at resignation from service but no sooner than 48 years of age.

49. **Permanent, hourly-paid central government employees participate in a contributory provident fund which is underfunded and requires budget subsidies.** The scheme collects a 4 percent employee contribution and a 5.5 percent employer contribution, which are credited to affiliates' individual accounts. The accumulated reserves are invested in private equity and fixed-income instruments (27 percent) and in bank deposits (73 percent). The benefit received is a defined benefit gratuity, equal to 14.5 percent of the last month's pensionable remuneration for every month of employment. The scheme is regulated by government decree, governed by a tri-partite board, and is explicitly guaranteed by the government.

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[21]This is legislated to increase by one year every year, staring in 2013, until it reaches 15 years. By 2017, all 15 years will have to be covered by contributions, eliminating noncontributory service time (apart from time spent at home with children).

50. **A social pension is payable to those who are ineligible for a pension from any other source and meet the residency criteria.** The social pension is set at 81 percent of the BIE and is, therefore, wage indexed. The residency criterion is 20 years residence in Cyprus after age 40 or 35 years' residence since age 18.

51. **Public pension spending is currently low relative to other EU member states and its growth has been curtailed by recent reforms.** Public pension expenditures reached 7.6 of GDP in 2010. Under a no policy change scenario, these expenditures are expected to increase to 8.7 percent of GDP in 2015 and to nearly 14 percent of GDP by 2050. The current favorable situation is explained by the country's low old-age dependency ratio: the ratio of the elderly (65 and older) to the working age population (15-64) is low, at 0.19. However, by 2050 this old age dependency ratio is expected to worsen to 0.5 as a result of a 5-year improvement in life expectancy at retirement and a low fertility rate. One of the key long-term challenges is approximating the system dependency ratio (beneficiaries to contributors) to the old age dependency ratio through controlling benefit uptake and promoting employment while slowing down the deterioration of the latter through parametric adjustments.

B. Key Issues

52. **Although recent reforms have improved the system's long-term prospects, they leave short-term expenditures largely unaffected.** The reforms introduced in GSIS represent good practice and have mostly exhausted the options available (Box 5.1 and Table 5.1). These reforms increase the retirement age in manner ensuring that life expectancy at retirement remains constant, expand service histories in order to foster longer contributory periods, and reduce benefit rates (average replacement rates) through revised indexation rules. GEPS has been turned into a career average scheme, gratuity payments are taxable, and the age at which a pension benefit can be claimed is also increasing, although only with respect to entitlements accruing after 2012 in the case of contributors born before 1964. In addition to these parametric reforms, benefits in service are frozen in nominal terms at their 2012 levels until 2015. However, because of the slow attrition of the beneficiary stock and the grandfathering of accrued rights (especially in GEPS), the only changes generating short-term savings are the temporary benefit freeze and the retirement age increase.

53. **Because of the slow attrition of the existing stock of beneficiaries, short-term fiscal savings are only achievable through the revaluation of earned rights of people close to retirement and reducing benefits already in service.** In the design of pension reforms, the further a cohort is from retirement, the more their past and future accruals may be revalued: younger cohorts have a longer time to adjust to the new rules and alter their labor market strategies to cope with the consequences of a reform. People close to retirement are usually "grandfathered", that is, both their past and expected futures accruals remain unaffected because they have little time to make up for any loss suffered. Benefits in service are rarely subjected to downward adjustment: typically, it is the rate at which nominal

benefits grow (indexation) which changes but no level shifts are introduced. These systemic and legal traditions limit the potential size and the timing of expenditure reductions. However, it is not possible to protect entitlements and realize sizeable short-term savings. Thus, if the government wishes to realize short-term savings on pension expenditures, politically difficult decisions regarding the treatment of past entitlements and benefits in service will be required. Given that (a) GSIS reforms already cover all GSIS entitlements and contributors, (b) across-the-board benefit reductions would have a negative effect on poverty among pensioners and (c) the fact the GEPS pension benefits–both promised and in service–remain generous, reduction of existing and promised GEPS benefits is the most equitable path to expenditure reductions in this sector. Benefit cuts could also be progressive based on total pension benefits.

Box 5.1. Recent Reforms

Retirement age increases

- The statutory retirement age is gradually increased to 65 for both GSIS and GEPS.
- Automatic further retirement age increases legislated to keep life expectancy at retirement constant.
- Early retirement remains possible. However, the earliest age at which an unreduced full-career pension can be drawn is increased, in 6 month steps, from 63 to 65.
- Actuarially fair benefit reductions (0.5 percent per month) are applied to pensioners who desire to retire early.

Tighter eligibility criteria

- In GSIS, the minimum service time with paid contributions is increased from 10 to 15 years, in one-year steps, over a period of five years.
- Further changes limit the increments enjoyed on the basis of dependent but working spouses, and the treatment of multiple survivors.

Controlling benefit levels

- In terms of GEPS benefits, price indexation replaced wage indexation (although this measure is rendered ineffective by the temporary measure of freezing benefits at 2012 level).
- In terms of new assessments, GEPS benefits accruing after 2012 will be calculated on the basis of full career earnings (while the pro-rated pre-2013 benefits will continue to be base on final salaries).
- For cohorts born before 1964, GEPS gratuities earned after 2012 are income tax liable. For younger affiliates, the whole gratuity is tax liable.
- Benefits were reduced progressively in several steps since 2011.
- As a temporary measure, GSIS, GEPS and social pensions are fixed at their 2012 values while the BIE is frozen as well.

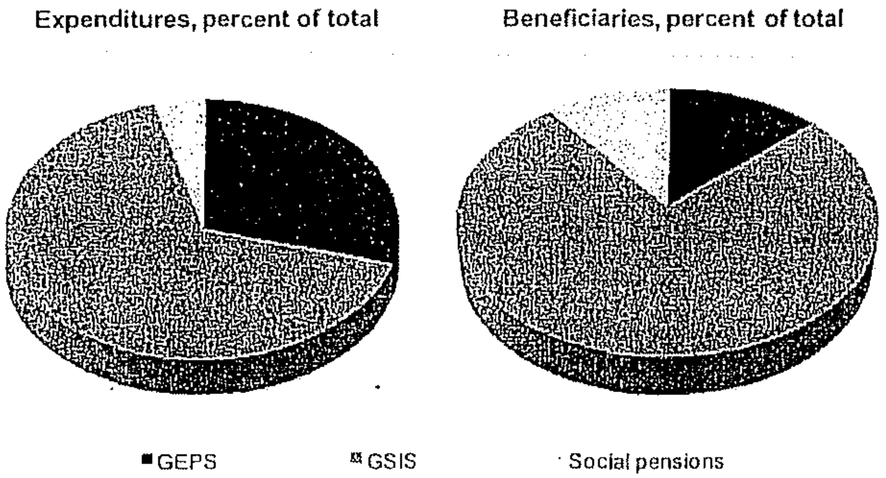
54. **Currently, approximately 75 percent of pension expenditures is indexed to prices, with the remaining 25 percent is indexed to wages.** It is not a composite indexation, however, but a system where the share of wage and price indexation depends on the type and size of benefits received: the basic part of the GSIS pension and the social pension grow in line with the BIE both in terms of newly assessed benefits and those already in service. Price indexation of the lower layer of benefits is in line with the practices of most

developed countries and better suits the social policy objective of protecting even those people with low lifetime earnings or short work histories against old age poverty. It should be emphasized that while a shift to full price indexation reduces the level of pensions relative to wages, it maintains these benefits' purchasing power. It is also important to recognize, however, that – for historic reasons and as a consequence of earlier reforms – there is a negative correlation between age and average GSIS old age pensions. Therefore, while keeping absolute poverty levels unchanged, price indexation of benefits would increase relative poverty more among older pensioners compared to younger ones. This can be better addressed through means-tested transfers rather than keeping the default indexation above the rate of inflation. Given that pensions are frozen between 2013 and 2015, full price indexation would result in savings only starting in 2016.

55. **Although GEPS has been closed to new entrants, it continues to generate large outlays in the coming decades.** GEPS benefit expenditures represented 2.6 percent of GPD in 2011, out of which gratuity payments accounted for 0.7 percent of GDP. Reforms introduced are gradual, with new assessment, eligibility and taxation rules only applicable to entitlements earned after 2012 in case of affiliates born before 1964. Given that service time beyond 400 months earns no additional pension rights in this scheme, benefit calculations based on career-average earnings will have little effect on new assessments in the next 3 to 5 years. Similarly, the taxation of the gratuity payments earned after 2012 will only start to reduce net benefits gradually, with a 3 to 5 year delay (since most GEPS affiliates 3 to 5 years from the retirement age have already accrued 400 months of service time).

56. **Benefits under GEPS are substantially more generous than under GSIS.** While GSIS is a career average scheme, GEPS is a final salary one. Given the steep seniority-driven career earnings profile of public employees, this results in vastly different average annuities across schemes: the average old-age benefit of a GEPS pensioner in 2011 was €26,500 per year while a person receiving only a GSIS old-age benefit was paid €8,200 on average. The difference would be substantially higher if gratuity payments were translated into an annuity flow. Since public sector wages, adjusted for differences in educational attainment, were on average 27 percent higher than private sector wages, the remaining difference is explained by the different assessment rules. Retirement age provisions also vary: whereas private sector (GSIS) workers can retire no earlier than 63 on a full (unreduced) pension, GEPS members can start drawing their pension at the age of 58. Government employees, in addition to higher wages and a final salary scheme, also enjoy a generous retirement gratuity, on average equal to 5 years of gross GEPS pensions, and amounting to 0.6 of GDP in 2011. As a consequence of higher wages and more generous benefit rules, the share of GEPS benefits within total expenditures is substantially higher than the share of pensioner eligible for a GEPS pension (Figure 5.1).

Figure 5.1. Share of Expenditures and Beneficiaries, by Pension System



Source: IMF staff calculations.

57. **The earliest age of eligibility for a gratuity and for a pension remains low in GEPS.** The earliest age government employees can start drawing a GEPS pension is gradually increasing from 58 to 60 but is only applicable to people born after 1964. A similar rule of applicability limits the use of actuarial reductions: for people born before 1964, actuarial reductions only effect entitlements earned after 2012. Eligibility to a gratuity is granted at the time of resigning from government employment, which may or may not coincide with reaching the retirement age. Indeed, the gratuity can be paid to anyone older than 48 if the person resigns from government employment. The fact that the effective retirement age is only 2 years lower in GEPS than in GSIS (61.5 vs. 63.5) is attributable to incentives to continue working and not the retirement age regulations which are relaxed. It also means that if the incentives weaken because of public sector wage controls or reduction in public employment, retirement probabilities will likely increase and applications for gratuity payment will be brought forward unless further regulatory amendments are introduced.

58. **The provident Fund of the Hourly Paid Government Staff is underfunded and requires regular government subsidies.** The scheme, by definition, is underfunded: a 9.5 percent contribution levied on salaries cannot produce an account balance equal to 14.5 percent of the final salary, unless net investment returns are exceedingly high and the affiliates' earnings follow a flat profile. Over the past years, individual accounts covered between 40 to 60 percent of gratuity payments, with the shortfall financed by a government subsidy. Given that the problem is largely due to the scheme's design shortcomings (and much less to poor investment performance), the government's continuing subsidies can only be reduced if the scheme is overhauled.

C. Reform Options

59. **Limit the possibility and the incentives to receive gratuities and pensions prior to the statutory retirement age.** Currently, government employees can retire at a full pension at 58 (to be gradually raised to 60) and can request gratuity payments as early as 48 (to increase to 60), provided that they meet the minimum service time criteria. Actuarial reductions for early retirement (years between the statutory retirement and 60) apply only to entitlements earned after 2012 in the case of employees above 48 years of age. The options proposed above are only viable if these retirement rules are tightened, otherwise the prospect of curtailing pensions and gratuity rights will incentivize government employees to bring forth their retirement, which may result in increasing rather than decreasing pension expenditures over the short run. From an equity point of view, it is also important to equalize retirement ages and access to gratuity payments. It is recommended that the earliest age of eligibility for a GEPS pension is increased to 63 in one step and then continues increasing in line with GSIS retirement ages. It is also recommended that the earliest age of eligibility to a gratuity payment is increased, also in one step, to the uniform statutory retirement age, regardless of cohort and length of service. Conceptually, this measure will separate retirement *from* government employment from retirement *into* the pension system. It will also forestall an increased inflow of GEPS retirees in response to changing conditions of retirement and result in lowering the stock of GEPS beneficiaries.

60. **Assess all new GEPS pensions on the basis of career average earnings, irrespective of the individual's age and the time when the entitlement was accrued.** Government employees' earnings profiles are very steep because of cost-of-living adjustments and automatic progression within grades. Therefore, the use of final salary rules makes benefits very generous. While career average assessment rules leave the relative value of past earnings unchanged, final salary schemes can be construed as average earnings schemes which revalue all past earnings by a factor equal to the relative earnings position of the individual just before retirement.[22] For example, if, on the last day of employment, an individual's wage is twice as high as the average economy-wide wage, a final salary scheme will upscale previous earnings' relative value to the same extent. A final salary scheme, therefore, introduces an automatic, retroactive upward adjustment of pensionable earnings. It is estimated that an immediate and full shift to career assessment would result in savings reaching 0.1 percent of GDP in 3 years and 0.5 percent of GDP in 10 years, resulting from lower pension and lower gratuity expenditures.

61. **Reduce lump-sum gratuity payments to government employees.** In recent years, end-of-employment gratuity payments accounted for 0.5-0.7 percent of GDP, depending on the number of new GEPS retirees and their work history. Gratuity payments average 5 times the gross annual entry pension of the recipient and are tax free. The average gratuity payment

[22] These schemes take past earnings into account after valorizing past earnings according to wage growth.

in 2011 was €115,000, over 14 times the average GSIS old age pensions. In other words, the gratuity received by newly retired government employees was close to the amount which the average GSIS pensioner would receive during his entire retirement. There are various options to reduce the fiscal cost of gratuities, expected to result in annual savings ranging between 0.1 percent to 0.6 percent of GDP.

- *Option 1 – Full termination of gratuity payments.* This option will result in the elimination of the liability attributable to gratuity entitlements and would result in savings of 0.6 percentage points of GDP between 2014 and 2016, respectively if implemented immediately and with universal applicability. Given that immediate and full effectiveness (as opposed to a gradual or partial reduction of entitlements) introduces a sharp discontinuity in benefit levels that solely depends on the calendar date of retirement, an alternative solution is the termination of the gratuity payment in steps, over a period of 4 years, with each new cohort of retirees subjected to an equal (1/4) reduction of their expected gratuity. A graduated termination would reduce savings, however, which would only reach 0.6 percentage points of GDP in the fourth year of the reform.

- *Option 2 – Reduction and mandatory annuitization of gratuities at retirement.* A gratuity payment is not a pension insofar as it does not directly provide lifetime protection against poverty or smooth consumption patterns through ensuring a sufficiently high replacement rate. Both from a social policy and a short-term fiscal perspective, an annuity is preferable to a lump-sum payment. Given current life expectancies at the effective retirement age, mandatory annuitization, while leaving the net present value of gratuities unchanged, would result in short-term savings of between 0.5-0.6 percentage points of GDP, gradually diminishing over time as more new cohorts become eligible for the annuity. Mandatory annuitization would however translate into approximately a 35 percent increase of GEPS benefits, and would not address, in present value terms, the inequality across private sector and government employees. It is recommended, therefore, that if gratuities are not terminated as per option 1 then a discount of at least 50 percent is applied to accrued gratuities before they are translated into annuities. While this measure would still result in short-term savings similar to those of option 1, the steepness of the build-up of future annuity payments would be proportionately reduced.

- *Option 3 – Taxation of the full gratuity.* Currently, gratuities are exempt from personal income tax and, according to recent legal changes, only the portion earned after 2012 would be tax-liable. This approach fails to produce short-term fiscal savings and creates unnecessary complications in terms of record keeping and tax administration. Subjecting gratuity payments to personal income tax would imply on effective tax rate of 26 percent on lump-sum payments, resulting in fiscal savings of 0.1-0.2 percentage points of GDP, depending on the distribution of gratuities. In addition to fiscal savings, taxing gratuities would give incentives to voluntary annuitization since annuities would typically fall into a lower tax bracket than a lump sum.

62. **As regards introducing a more uniform treatment of gratuities paid by the GEPS pension scheme and the private sector provident funds, the government has two alternative options**: either re-categorize gratuities as part of the employees' last salary, which by definition would be taxable or, preferably, subject all gratuity payments to personal income tax. This latter approach would ensure that all labor income, regardless of being immediate or deferred remuneration, receive uniform tax treatment and would also limit the use of occupational provident funds as instruments of tax optimization. Furthermore, taxation, if coupled with portability rules and limitations on the use of funds (permitting access to funds only at the time of retirement) may promote annuitization and help achieve the pension system's social policy objective of life-long income replacement.

63. **Reduce all pension benefits paid to former government employees and state officials.** This measure, while politically and legally difficult, will still maintain former government employees' benefits above the pension received by private sector employees of a similar earnings career. The reduction will limit the difference between the benefits of those retirees whose pensions are assessed according to the new rules (as per the above reform proposals) and those who started drawing a pension shortly before the new, stricter rules become applicable. In administering the reduction, equity considerations would suggest that any cut in pension benefits be applied progressively, with higher pensions bearing a larger share of the total benefits reduction.[23] A 20 percent reduction in benefits would decrease public pension spending by between 0.2 and 0.4 percent of GDP in the next four years. It is also advisable that an absolute ceiling is placed on pension benefits and that retired state officials' pension benefits are subjected to the same—preferably progressive reductions—as the pension of former government employees.

64. **Transform the Provident Fund of the Hourly Paid Government Staff into a defined contribution scheme with mandatory annuitization at retirement.** In defined benefit schemes, the risk of a funding gap (resulting, for instance, from poor investment results or poorly designed scheme rules) rests with the scheme sponsor, while in defined contribution schemes both the upside and downside investment risk is borne by scheme members. Gradually transforming the current scheme into a defined contribution arrangement may be performed in two steps: first, by a tapered reduction of the gratuity accrual rate and re-interpreting it as the minimum level of gratuity and, second, introducing a minimal rate-of-return guarantee (e.g. a zero percent real return guarantee). In order to achieve higher replacement rates in retirement and to limit the government's social assistance

[23] At the time of the mission, no distribution data was available regarding GEPS benefits, therefore no alternative, fiscally neutral reduction schedules could be compared.

expenditures, restricting the use of account balances to mandatory annuitization at retirement is advisable.

65. **Introduce structural reforms to simplify the system to ensure fiscally responsible protection against old-age income poverty and to separate poverty alleviation objectives from consumption smoothing objectives.** The government is considering a structural reform which would entail replacing the social pension, the minimum GSIS pension, and (potentially) the various supplements and cash social assistance programs available to the elderly, with a general revenue financed flat basic pension based on age and residency but independent of contribution performance and service time. The proposal has a number of attractions. The current system already provides some form of old-age income to everyone. At the same time, the various minima and other benefits makes it difficult to provide clear incentives for contribution compliance, especially in the lower regions of the wage distribution. The two basic functions of the pension system, protection against (absolute) poverty in old age and ensuring a smooth consumption pattern over one's life cycle, require different levels of redistribution and cannot, therefore, be easily accommodated in a single social insurance scheme. It is important to separate these two functions into different legal-institutional arrangements and to separate their objectives. Creating a basic citizens' pension is also a precondition to enforcing an inter-temporal budget constraint on the remaining earnings-related segment of the pension system: unless a basic income is available to all elderly persons and its (real or relative) value is maintained, it is difficult to curtail accruals (future pension liabilities) or current benefits in the face of fiscal constraints or competing social objectives.

66. **A detailed study needs to be produced analyzing the fiscal and welfare impacts of the above reforms.** A flat rate basic pension cannot be financed out of earnings-related insurance premia because of the compliance disincentives created. Thus, the current tax revenues financing pension expenditure will need to be re-arranged, with the portion required to finance the basic pension incorporated into other taxes. It is important that the impact of the required changes in tax policy is examined, in view of the capacity to levy and collect taxes and the objective of avoiding growing informality. The direct cost of the above structural reform also needs to be considered. It is important to make the statutory retirement age binding in case of the basic pension (without early retirement provisions) and also to carefully calibrate its level so that it can fulfill its purpose (covering the cost of living at or around the subsistence minimum) and avoid generating additional expenditures. It is recommended that long-term projections and sensitivity analyses with respect to the main characteristics of the proposed system are conducted as soon as possible.

Table 5.1. Impact of Options for Public Pension Consolidation, 2013-2016

(Savings in percentage points of GDP)

	2013	2014	2015	2016
Measures introduced recently	**0.2**	**0.5**	**0.7**	**0.8**
Of which: Freezing benefits	0.2	0.4	0.6	0.6
Retirement age increase and actuarial deductions	0	0.1	0.2	0.2
Price indexation of GEPS benefits	0	0	0	0
Limit on gratuities accrued after 2012	0	0	0	0
Taxation of gratuities accrued after 2012	0	0	0	0
Further options for reform (maximum savings)	**0.6**	**1.0**	**1.2**	**1.3**
Of which:				
Reduction of GEPS benefits in service	0.2	0.3	0.4	0.4
Reduction of GEPS gratuities				
via immediate termination	0.3	0.6	0.6	0.6
via mandatory annuitization	0.3	0.6	0.5	0.5
via full income tax liability	0.2	0.2	0.2	0.2
Career average assessment for all new retirees, for all accruals				
if lumpsum gratuity remains unchanged	0.1	0.2	0.2	0.3
if lumpsum gratuity is terminated or annuitized	0	0.1	0.1	0.1
Increasing the eligibility age for gratuity and unreduced pension	0	0.1	0.1	0.1
Price indexation of the GSIS basic pension and the social pension	0	0	0	0.1

Source: IMF staff calculations.

VI. Other Social Protection Benefits

A. Background

67. **Social protection benefits are provided through a large number of programs.** Existing benefits fall into three groups in terms of organization and financing (Table 6.1).

a) *Short-term benefits connected with the work status of the beneficiary*, mostly financed by social insurance contributions, are administered by the Ministry of Labor and Social Protection (MLSP). The most important benefit in this group is unemployment benefit. These benefits are financed by general social insurance contributions and typically consist of a basic flat rate component and an earnings-related component. Two different pension-like benefits, reassessed annually, deal with old-age poverty among those with low pensions or without adequate pension rights. Public employment services and active labor market policies are administered independently of unemployment benefits.

b) *A group of benefits provided to the general population and financed directly through general taxation.* These benefits were originally universal, but since 2005 the gradual introduction of means tests has begun excluding the top end of the income distribution. The Ministry of Finance (Grants and Benefits Department) administers the largest programs, namely child benefit and student grants. Housing-related benefits for the purchase or improvement of a house are administered separately by the Ministry of the Interior and by other bodies. The special needs faced by refugees and displaced persons are addressed by a separate scheme.

c) *A variety of benefits provide the remaining last-resort social safety net.* The largest programs rely on an individualized approach to claimants and are administered by the Department of Social Welfare of the MLSP.[24] Public assistance comprises a minimum income scheme for basic needs (including rent subsidies) for people of working age, subject to a strict income and property means test and an obligation to participate in activation and rehabilitation. Separate schemes exist for long-term care. Persons with disabilities are eligible for two separate cash benefit schemes.

68. **Unemployment benefits offer a constant replacement rate of work income and last for six months.** Social insurance contributors acquire the right to benefits after six months of contributions. The unemployment benefit is composed of a flat rate component equal to a minimum of €410 per month (which increases with the number of dependents) and an earnings-related component; together these lead to replacement rates varying from 50-70

[24]The legal framework governing these benefits is due to be consolidated in a series of linked draft legislative proposals prepared in the course of 2012. These proposals rationalize the framework in place since 2006. The description of the approach offered in this report is based on that of the draft laws.

percent. The benefit has a ceiling corresponding to earnings of €4,000 per month. If the unemployment spell lasts beyond six months, the unemployed person can become eligible for public assistance benefits subject to a strict means test. All registered unemployed are entitled to participate in activation measures promoted by the Human Resource Development Authority or the Public Employment Services of the MLSP. The unemployment arrangements thus leave gaps in the case of those with an insufficient insurance record – chiefly the young unemployed – and those who have exhausted their rights to unemployment benefits.

Table 6.1. Non-pension Social Protection Benefits

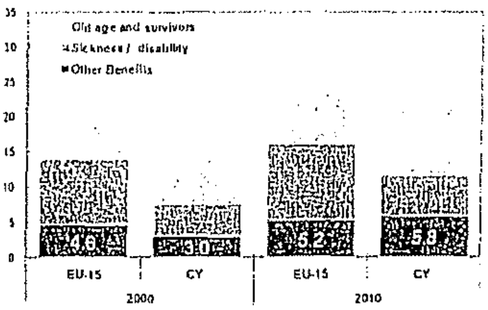
	Type of Coverage	Who Is Eligible?	Agency	Source of Finance
Social Insurance and other work-related benefits	Unemployment benefit	Employees	Ministry of Labour, Social Insurance	Financed by general social insurance contribution
	Sickness Benefit Maternity allowance and maternity grant Funeral grant	employees, self employed dependants		
	Work injury (work)	employees, self employed		
	Holiday fund, redundancy fund, Social cohesion	Contributing employees	Ministry of Labour, Social Insurance	Social insurance contribution supplement
	Social pension	Individuals over 65 with no pension entitlement		Government budget
	Grants to pensioners households with low income	Pensioners in households below poverty line, on application	Ministry of Finance Grants and Benefits	Government budget
Non-work related Categorical (formerly universal) benefits	Child benefit Student grant	Generous means test (excludes top earners)	Ministry of Finance Grants and Benefits	Government budget
	War and affected persons Pensions	Universal		
	Housing benefits for refugees (purchase and rent) Housing benefits for non-refugees	Generous means test	Ministry of Interior	
	Loan guarantees and interest subsidies for house acquisition, student loans, and enterprise loans	Citizens who have property in the occuppied territories	Committee for the Equalisation of burden	Interest free loans from the Government
Social Safety Net – Income guarantees	Public Assistance	Strict means test; counselling and integration	Ministry of Labour, Dept. of Social welfare; to be regulated by draft public assistance law	Government budget
	Rent subsidies for public assistance beneficiaries			
	Long term Care recipients	Coupons		
	Asylum seekers	Strict means test		
	Disability benefits	Basic benefit universal; services means tested	Ministry of Labour, Dept. for social inclusion of people with disabilities	
	Disability universal cash benefits and Aids	Universal benefits, little counselling		

69. **The benefits comprising the social safety net are to be subject to consolidation and reorganization.** The drafting of this plan is at an advanced stage of preparation and could be implemented in early 2013. According to the draft legislation, the original function of public assistance as the ultimate (or "last resort") safety net is to be restored—a series of

amendments to the preexisting framework had greatly diluted this function by expanding recipients to include asylum seekers, disabled, and single-parent families, irrespective of income tests. In its new form, public assistance is to be a strictly means-tested program targeted to families that cannot meet specified basic needs (nutrition, clothing etc); if the family income is insufficient to meet those needs as ascertained on a case-by-case basis by welfare services, the difference will be paid to the family in the form of a cash benefit. Public assistance thus relies on an individualized approach and extensive counseling, reflecting its origins as a social inclusion instrument. Programs for persons with disabilities, asylum seekers, persons needing long-term care, and for rent support will still be pursued by the same department in an individualized and selective approach.

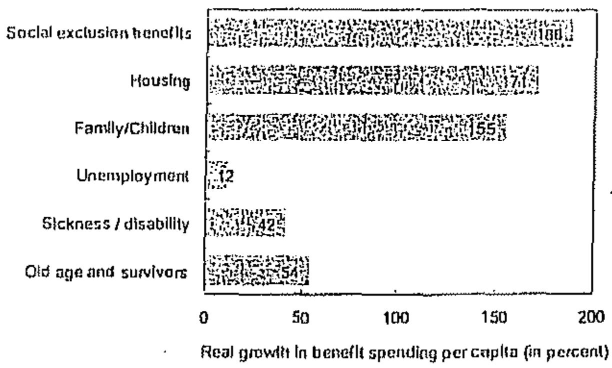
70. **Though social protection spending in Cyprus in 2010 is still below the EU average, this is chiefly due to lower expenditures on sickness and disability benefits.** Benefit spending other than for old age and sickness (i.e. chiefly devoted towards family, unemployment and social exclusion) reached 5.8 percent of GDP in 2010, exceeding the EU average of 5.0 percent (Figure 6.1). This reflected increases after 2007 chiefly due to a sharp increase in the housing and the social exclusion benefits. In contrast, spending on unemployment and for family benefits was more restrained (Figure 6.2).

Figure 6.1. Public Expenditure in Social Expenditure Programs, 2000-2010
(Percent of GDP)



Source : Eurostat.

Figure 6.2. Real Growth in Selected Social Expenditure Programs, 2000-2010
(Percent of GDP)

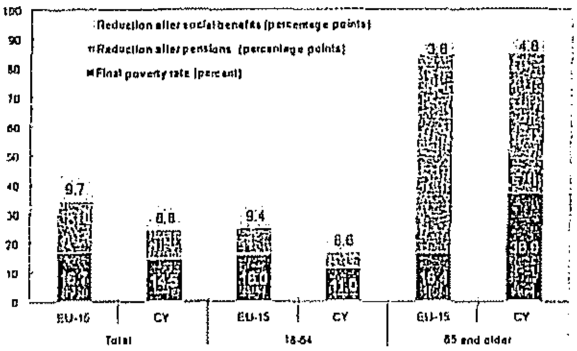


Source: Eurostat.

71. **The effectiveness of social transfers in reducing the risk of poverty is close to the EU average and superior to most southern EU states.** The risk of poverty is reduced by social transfers (other than pensions) by 8.8 percentage points, when in the EU27 the equivalent is 9.2, including Italy at 4.8 and Portugal at 7.4 (Figure 6.3). Partly as a result, the poverty rate in Cyprus is considerably below the EU average, especially for individuals of working age (15-64 years). However, although the risk of poverty for the over-65 group has fallen dramatically from 50.6 percent in 2007 to 36.9 percent in 2011, there is no equivalent trend for individuals of working age. On the contrary, between 2007 and 2011 there was a small rise in the risk of poverty by one percentage point. Thus, the increased expenditure in

non-pension social expenditure since 2007 does not appear to have had an impact on reducing poverty of those of working age. Finally, it is important to note that the poverty statistics are based on 2010 incomes (surveyed in 2011) and have yet to include the effects of the crisis.

Figure 6.3. Poverty Rate Before and After Social Benefits, by Age Group
(Percent of Population)



Source: Eurostat.

72. **Proposed reforms for 2013 and 2014.** A number of consolidation measures have already been legislated or are being proposed for implementation in 2013 and 2014; the savings projected for these measures are estimated at €113 million for 2013 (Table 6.2). These include the discontinuation of some benefits, the introduction of more stringent means tests, and reductions in generosity of others; they include a non-itemized commitment for savings of €35 million from housing programs.

Table 6.2. Impact of Social Protection Measures Proposed by Authorities for 2013

Measure	Percent of GDP
Abolition of the subsidisation scheme of large families for the acquisition of motor vehicles	0.01
Abolition of the easter allowance granted to social welfare beneficiaries	0.02
Streamline the christmas allowance granted to social welfare beneficiaries by 20 percent	0.01
Abolition of the Social Cohesion Scheme for Pensioners	0.00
Abolition of the dietary allowance	0.02
Reduction of other welfare benefits	0.01
Abolition of the heating allowance of the social welfare beneficiaries	0.02
Streamline the easter allowance granted to pensioners by 26 percent	0.03
Abolition of the Special Grant to Pensioners	0.06
Abolition of the mother's allowance	0.13
Abolition of the subsidisation scheme for the purchase of labtop computers	0.02
Reduction of the Student's Welfare Scheme	0.01
Streamline of Housing Schemes	0.20
Abolition of Wedding Allowance	0.01
Reduction of child benefit allowances by 9 percent	0.07
Streamline the funeral allowance by 30 percent	0.00
Reduction of maternity allowance	0.01
Reduction of the subsidisation scheme for purchasing car for disable	0.01
Abolition vacation allowance for persons with disabilities	0.00
Total	0.64

Source: IMF staff calculations.

B. Key Issues

73. **The social protection system, which was developed during a time of low unemployment and steady economic growth, must be adapted to cope with the crisis.** It must now adapt to an altered environment, characterized by high and rising unemployment and coinciding with a tighter fiscal environment. In this environment, increasing demands are placed on social protection. Some programs will inevitably expand, but others must also be transformed to take account of the changed nature of social problems during a crisis. For example, the rise in unemployment typically leads to a larger share of youth unemployment as well as to more people who have exhausted their unemployment benefit rights, while the demand for workers by employers is curtailed. These changed circumstances in the labor market imply that the type of interventions that are effective also changes. The change in priorities means that other programs have to 'make way' for emergency crisis-related actions. In such an environment, social protection acquires a heightened strategic significance and must demonstrate that the burdens of adjustment are distributed equitably with more help directed towards those worst hit and least able to cope. As the crisis impacts disproportionately on the young, there is a particular need for programs to help these groups.

74. **The economic downturn also increases the need for a unified overall social governance structure addressing system fragmentation.** Times of crisis require proactive policy, clear priorities and a need for consensus. However, currently the administration of the system is fragmented amongst various departments of the MLSP, the Ministry of Finance, the Ministry of the Interior and some other independent bodies. This fragmentation raises concerns of planning coordination, as there is no single government centre to monitor, coordinate and direct social policy. Coordination issues were exacerbated until recently by the fact that information referring to benefits themselves was not shared by different administrations, giving rise to the possibility of the same need being subsidized more than once, or the possibility of dependency traps arising through the accumulation of multiple benefits in the same family or household. Unity in planning is further hampered by structures exclusively dedicated to one category of need (e.g., the greater needs of displaced families).

75. **Non-pension transfers are widely distributed across the population with considerable leakage to richer groups.** The proportion of the population receiving some benefits is roughly constant across income groups (Table 6.3). The means tests employed for non-work-related benefits (and first introduced in 2005) are high enough to only exclude individuals at the top of the income distribution. Nevertheless, there was a larger than expected reduction of claimants in 2012, possibly due to aversion to submitting income information.

- Student grants (given to families of students registered for tertiary education in Cyprus or abroad -excluding doctorates) are the least targeted benefits.

- Child benefits have an important part in reducing poverty reflecting their size (1 per cent of GDP), and near universality.

- Unemployment benefit only plays a small role in poverty reduction. In the pre-crisis period, unemployment benefit claimants tended to be in the middle of the income distribution. The unemployed living in households exposed to poverty risk were individuals not eligible for benefit, due to insufficient contributions or lengthy unemployment spells. As the crisis unfolds it is reasonable to expect unemployment to become more closely associated with poverty.

- Public assistance is the benefit most closely targeted towards the poorest. The number of potential beneficiaries who do not take up their public assistance is not known, but is likely to be concentrated in cases of shorter-term need, as for unemployment.

Table 6.3. Targeting Efficiency of Social Protection Benefits

	Family benefit	Child benefit	Student grant	Public assistance	Unemployment benefits	Other benefits	Total benefits
Distribution of beneficiaries, by quintile of income							
1(poorest)	22.8	14	9.1	44.5	20.7	19	15.9
2	22.3	21.5	23.6	26	25.5	22.4	21.2
3	15.8	22.9	25	14.5	29.5	19.5	22.3
4	19.6	22.2	24.3	8.7	14.9	21.3	21.5
5 (richest)	19.4	19.3	18	6.3	9.3	17.8	19
All	100	100	100	100	100	100	100
Reduction of at risk of poverty (percentage points)	-1.6	-6.4	-0.1	-4.0	-0.8	-2.2	-13.8

Source: Koutsampelas (2011).

76. **There appears to be some duplication of effort, chiefly in the areas of pensions but also in housing.** At least two benefits (the social pension and grants to low-income pensioners' households) are assessed annually and are paid to pensioners in addition to their state pensions. There are similar issues with disability payments, addressed by two separate departments of the MLSP. A number of different bodies serve different needs of the unemployed including unemployment benefit, public assistance, job search, and activation measures. Housing-related benefits are given by many bodies, some dedicated to the needs of families of displaced persons.

77. **Different types of benefits employ different income thresholds for means test, different definitions of income, and identify the household in different ways.** In the last two years there has been an acknowledgment of the need for consolidation and for the comparability of means tests across different benefits. However, for most of the formerly universal cash benefits the income and wealth limits introduced, even those due to be implemented in 2014, would still exempt only the very well off. The reduction of claimants for student grants and child benefits noted in 2012 may prove short lived, as potential

beneficiaries become familiar with the new system. The crisis, and the greater needs it creates, require greater selectivity for eligibility to child benefits and especially for student grant eligibility.

78. **Housing-related benefits are disproportionately large given the generally satisfactory housing conditions.** Housing benefits (grants and loans for the purchase, building, or home repairs, as well as rent subsidies) were designed to deal with problems unrelated to the crisis; they thus can play little role in crisis alleviation. For example, while not denying that belonging to a family of displaced persons gives rise to disadvantages, the current financial status of beneficiaries (second or third generation of displaced persons) justifies a reexamination of the urgency of their claims. In addition, as seen in other countries, the crisis may lead to new categories of housing-related needs not covered by the current system—such as over-indebtedness of recent house buyers unable to meet their interest payments in a depreciating housing market.[25] In any case, the good housing conditions in Cyprus—one of the highest owner occupancy and lowest overcrowding rates amongst the EU27 (EU Joint Social Protection Report, 2012)—imply that economizing in this field will create fewer problems than retrenchment elsewhere.

79. **The rise of unemployment and its longer duration during the crisis will give rise to challenges for which the system appears ill prepared.** As the crisis persists (and perhaps deepens), new needs are appearing. This is happening in three ways: (i) a larger number of young unemployed not eligible to benefits; (ii) benefit claimants exhausting their six month entitlements and faced with a sharp drop in entitlements as the strict means-tested public assistance benefit is the only replacement;[26] and (iii) a larger number of jobless households where no one has access to work income.[27] These greater needs will imply greater strain on the available infrastructure, which was designed to deal with problems very different in scale and in nature from the emerging ones. The length of unemployment spells is likely to rise, implying the needs of unemployed people who have remained jobless for a given length of time will be different. The type of activation and active labor marker program appropriate to a recession differs from programs designed to deal with labor placement in a tight labor market. In a similar vein, the kind of support, and individualized approach to claimants that existing public assistance services entail, will come under strain in times of mass and prolonged unemployment. Finally, services complementary to women's employment – such as child care or care services for the old and the disabled—need to be

[25]In the case of Cyprus, the degree of household indebtedness is among the highest in the EU although it is covered by substantial assets, leading to a positive net asset position.
http://ec.europa.eu/economy_finance/publications/occasional_paper/2012/pdf/ocp101_en.pdf

[26]The short maximum duration of unemployment implies that fears of benefit dependence are justified only in isolated cases. One such is EU nationals from low-wage countries who work in Cyprus; compared to wages in their home country, unemployment followed by public assistance benefits may compare favorably.

[27]The definition of jobless households is derived from survey practice and includes everyone co-habiting; it is thus wider than the nuclear family concept used in most programs.

maintained as many women seek to make up for the loss of family income.[28] In all three cases mentioned, the greater need for services during the crisis implies that extra resources may be needed in particular areas; a policy of horizontal cuts would be doubly harmful.

80. **The balance between family benefits in cash and in kind needs to be reassessed.** In many countries family benefits are seen as an instrument to support women's employment by allowing women to combine family duties with work responsibilities. In this way, there is a shift in emphasis from cash benefits towards services that allow mothers directly to combine work and family. This implies coordinating services with benefit claims, quality child care (for preschool age children) as well as ensuring that the school timetable conforms to mothers' private sector responsibilities, chiefly through longer school hours.

81. **There is a need to reconsider the easy availability and generosity of student grants.** These were generous in Cyprus mainly due to the late arrival of tertiary education. However, the existence of free local public university removes much of the original rationale of their design. Their generosity can be seen in the following respects: (a) the inclusion of postgraduate education (other than doctorates); (b) the subsidization of academic fees whilst public universities are free; (c) the setting of means tests to exclude only individuals at the top of the income distribution; and (d) the inclusion of study abroad on an equal basis to study in Cyprus. Compared to their contemporaries, graduates will face fewer problems in the labor market, while their lifetime incomes are likely to be higher. Such considerations have led countries such as Norway, the US and the UK to move from grants to subsidized student loans.

82. **Disability grants could also be means tested.** The position of the proposed new law on public assistance on disabilities takes the view that, as disability affects individuals of different income levels, the intervention—if seen as compensating for a handicap—should not vary with income. In this way, the law under consideration has a universal cash component based on the severity of disability, but then allocates auxiliary services under a means test. The introduction of universality to public assistance further blurs the distinction with disability benefits given by the Department of Social Inclusion of the Disabled. The argument of universality in disability grants, however, can be challenged in favor of applying some kind of means tests to all benefits—provided this can be done in a way that does not inordinately increase the cost of administering the benefits. The means test could allow for the special circumstances of disability by being less stringent than in other cases, and can encompass consideration of wider family solidarity.

83. **Benefits are not subject to taxation.** Taxing benefits introduces an automatic solidarity component, but also generates much information that is valuable for social policy

[28] In Cyprus, there is evidence of the 'added worker effect' for women, who seek work to a greater extent to compensate for the loss of family income due to labor market pressures.

by allowing easier matching of income and needs. One such important piece of information would be the ability to measure the accumulation of benefits in the same family and the ability to improve on the design of many benefits.

84. **Even after the reforms of 2013, some of the real increase of some benefits since 2007 may be hard to justify**. The rise in expenditure in many programs since 2007 is due to increased expenditure per beneficiary, caused largely by discretionary increases. This is partly acknowledged by the decision to reduce non-work related benefits by 9 per cent for 2013. However, even after taking this into account, this leaves a pattern of real increases in benefit levels since 2007 not entirely consistent with the need for fiscal consolidation and addressing the adverse impacts of the crisis.

C. Reform Options

85. **Create consensus to rebalance social protection and actively promote equity**. The crisis is a time for decisions and for setting priorities. Policy should plan for expansion and improvement of programs that are related to the crisis, such as labor market activation or the social safety net. To make way for them, other programs will need to be curtailed for the duration of the crisis or even abandoned. Similarly the unavoidable fact that some individuals will face dramatic challenges increases the need to actively promote equity; this means greater solidarity by those who are better off. Greater selectivity in program design to deal with equity issues needs to be complemented by a concern for intergenerational equity to aid the younger generation. The implementation of this overall project requires certain governance initiatives:

- *An urgent need to promote consolidation in planning, followed by action to produce a unified information base.* To base the rebalancing on consensus, it is imperative to have an overall view of the challenge to social policy and how the existing fragmented programs can best rise to it. Consolidation implies actions in three directions: First, and most urgently, consolidation in strategic planning. Second, consolidation of *administrative* structures, assigning delivery to a single ministry. And third, consolidation of the information base. The latter is due to come about with the swift activation of the Data Warehouse, which must be followed by its utilization as a planning tool.

- *Clarify the division of social insurance and welfare*. Social insurance schemes should be clearly delineated from social assistance schemes. Short-term benefits such as unemployment and sickness benefits should be distinguished from longer term benefits such as pensions and survivor protection. Benefits related to pensions (such as the social pension or perhaps the benefit to pensioners' households) should be administered by the pension system.

- *The needs of an unemployed person at different times of their unemployment spells should be addressed by a single agency.* All aspects of dealing with unemployment – unemployment social insurance benefits, means-tested benefits for the unemployed, job search and activation services, the young unemployed – should be subject to much greater coordination by being gradually integrated into a unified structure

86. **The new public assistance law should be passed as a matter of priority.** Disability benefits should be also means tested using the income criteria no more generous than those used for child benefits. The individualized approach to public assistance should be retained and adapted to the needs of the long-term unemployed, especially in the period following the cessation of all unemployment-related payments. The performance of the new arrangements must be closely monitored in order to intervene, if needs be, in a timely manner.

87. **The family benefits and student grants means test should be further tightened and should be coordinated across all benefits.** In order for selectivity to be effective, the income threshold must be set as to exclude a greater proportion of high earners, in order to allow greater attention to the bottom of the income distribution. In order not to overburden the administration of benefits, the handling of the means test and utilization of supplementary tax data should be undertaken centrally. The definition of a household and household income should be harmonized to the extent possible (e.g. by using consistent household equivalence scales) and must include all income from benefits. The use of supplementary information such as ownership of property or other categorical information may also be considered. Self-employment income should allow for the possibility of under-declaration by specifying a lower threshold.

88. **There should be a major reexamination of housing benefits to realign them with real housing needs.** There should be unification of the separate plans for refugees with that of the general population; though the identity of refugee can still be used as discriminating factor, it can be considered together with other indicators of needs. The budget consolidation agreed for 2013 includes a global (not yet itemized) target for streamlining of €35 million (0.2 percent of GDP). The precise actions corresponding to this streamlining must be specified urgently; these actions could be extended until at least 2016. This can be the first step of a more thorough reassessment encompassing all housing programs. A more drastic option to be considered can be to suspend all programs involving new grants or subsidization of new loans (e.g. housing schemes run by the Interior Ministry or the Special Grant for buying and building a house run by the Ministry of Finance) for the period to 2016. Rent subsidization can be made available subject to a means test at least equivalent to that applied to child benefit.

89. **Reexamine the rationale and consolidate the administration of smaller benefits.** For example, the operation of the holiday fund adds to non-wage costs and does not confer commensurate benefits. Free public transport for pensioners is already due to be replaced

with concessionary rates for a monthly bus pass. Abolition of other programs directed towards students (purchase of PC, grants to students other than the special grant).

90. **All social protection benefits should be liable to tax.** Tax can be deducted at source and, if there is no tax liability, tax deductions should be returned. Though this can lead to extra revenue chiefly in the formerly universal benefits, it will generate information which can be used to plan social policy better. All benefits should be included in tax declarations. Knowledge of the distribution of benefits across households could allow consideration of the desirability of a cap on total benefits, as well as moves towards consolidation of benefits.

91. **Consider introducing a new unemployment assistance benefit for those exhausting their six month entitlement to unemployment insurance.** The basic structure of unemployment benefit does not require adjustment. To respond to the lengthening of the duration of unemployment and the change in its nature, during the course of 2013 active consideration could be given to an extension of payments to unemployment benefit claimants after the exhaustion of their unemployment insurance entitlements (six months) in the form of a new unemployment *assistance* benefit. This new benefit:

- could be drawn by those claiming unemployed benefit if their unemployment spell extends beyond six months. A trial period of extending it to nine months will allow consideration of extension to twelve months, which will bring it in line with most EU countries.

- could be considerably lower than unemployment insurance. The minimum could be the basic part of the unemployment benefit without family supplements (currently €410 per month).

- could be subject to a means test, though less strict than the current public assistance level.

- could be combined with increased focused activation measures, such as longer training programs, job subsidization and short time working programs (which will also cover for the young unemployed).

- could be financed from general revenue independently of the insurance component.

The new benefit combined with strengthened activation programs would relieve the pressure on public assistance services, and will prevent the lengthening of unemployment spells from creating new entrenched social problems as well as avoiding rising structural unemployment

92. **There must be an expansion of active labor market measures to accommodate the needs for the young and the long-term unemployed.** The increase of unemployment implies that the programs offered must be greater in volume but also in nature. In particular, in times of crisis time-intensive programs can be more effective, while there is a need for

programs tailored to the needs of younger jobseekers, such as short-time work schemes or hiring subsidies. A projection of expenditure must wait upon the proposal of suitable programs; however, a considerable net expansion of expenditure should be planned for.

93. **Though in the context of the crisis there are considerable uncertainties in projecting needs in social protection, there exist options that can secure developments remain fiscally neutral.** Rapidly rising unemployment is creating large automatic rises in expenditure; to these could be added the costs of implementing unemployment assistance and of expanding active labor market policies. Yet, this expenditure could be financed by redirecting expenditure from other, less pressing programs in social protection (Table 6.3). This change in priorities can draw on initiatives in housing and in less generous means testing for student grants and child benefits.

Table 6.4. Options for Social Protection Expenditure Rebalancing, 2013-2016

(Savings in percentage points of GDP)

	2013	2014	2015	2016
1. Unemployment assistance scheme for 12 months, benefit at current basic amount for one person (€410)				
-Assume *all* in LFS between 6-11 months eligible	..	..	-0.3	-0.2
-Assume means test *excludes 30%*	..	..	-0.2	-0.2
(Scheme for 9 months)				
-Assume *all* in LFS between 6-11 months eligible.	-0.1	-0.2		
-Assume means test *excludes 30*	-0.1	-0.1		
2. Expand Active Labour Market programs				
- Increase by 0,2 percentage points of GDP	-0.1	-0.2	-0.2	-0.2
3. Child (and single parent) benefits: tighter means testing				
- set income at 39 thousand (30% excluded)	0.0	0.0	0.0	0.0
- set income at 19 thousand (70% excluded)	-0.1	0.3	0.3	0.3
4. Student grants.				
- set income at 49 thousand (34% excluded)	0.0	0.1	0.1	0.1
- set income at 39 thousand (47% excluded)	0.0	0.1	0.1	0.1
- set income at 19 thousand (73% excluded)	0.0	0.2	0.2	0.2
5. Taxation of all benefits as income				
- Social insurance benefits @ 3%		0.0	0.0	0.0
- non-work related benefits @ 5%		0.1	0.1	0.1
- public assistance @ 2%		0.0	0.0	0.0
6. Rationalization of housing benefits				
- extend agreed streamlining	0.0	0.2	0.2	0.2
- Suspend grants; - means test rent subsidies	0.5	0.5	0.5	0.5

Source: IMF staff calculations.