

**FOR
AGENDA**

SM/05/43
Correction 1

February 17, 2005

To: Members of the Executive Board
From: The Secretary
Subject: **Cyprus—Selected Issues and Statistical Appendix**

The attached factual corrections to SM/05/43 (2/3/05) have been provided by the staff:

Page 5, para. 4, line 2: remove "(except for the banking sector)"
para. 6, line 2: for "80" read "65"

Page 6, para. 8, line 4: for "Social Security Committee," read "Social Insurance Board,"

Page 7, footnote 9, line 2: for "remuneration of all employees."
read "remuneration of almost all employees."

Page 8, para. 14, line 12: for "and the Industrial Relations Code imposes"
read "and most sectors impose"
para. 15, line 6: for "from government offices to stores and schools,"
read "from government offices to schools,"
para. 15, line 8: remove ", and not allowing for shopping after working hours"

Page 10, para. 21, line 4: for "2001," read "2010,"

Page 12, para. 24, line 2: for "approval" read "agreement"

Page 14, para. 24, line 2: for " they have" read "one union has"

Page 19, para. 39, line 7: for "the Employers and Industrialists Federation,"
read " one employer organization,"

Questions may be referred to Ms. Westin (ext. 39746) and Mr. Hatanpaa (ext. 35484) in EUR.

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associations, bargain collectively, and strike (or lock out). Meanwhile, voluntary norms, such as collective agreements and codes of conduct, determine the procedural framework for the bargaining process and the guidelines for labor relations.³

4. **The Industrial Relations Code of 1977 sets the framework for collective bargaining in the private sector and for the semi-government organizations (public enterprises).**⁴ The code asserts the rights to organize and to bargain collectively, and defines the proper issues for collective bargaining. It affirms the strict adherence to the provisions of international labor conventions ratified by the government, contains limitations regarding the right to resort to industrial actions, and assigns the government the function of mediator in labor disputes. In 2004, the code was extended with a voluntary agreement on the provision of essential services during labor disputes.

5. **The government's philosophy behind the promotion of a voluntary system has been the fostering of strong employer and employee organizations,** with a view to maintaining a balance of power between the two sides. The focus of the government has been on assisting the two sides in reaching agreement, thereby safeguarding peaceful labor relations and preventing the outbreak of labor actions. All in all, the system has contributed to maintaining good industrial relations and labor peace in Cyprus and reducing the number of labor disputes and work days lost to conflicts, in particular in the sectors covered by the Industrial Relations Code.⁵

Unionization and Tripartism

6. **A second characteristic of the Cypriot labor market is its high degree of centralization.** On average, some 65 percent of all workers belong to industry-based trade unions, which are organized in a small number of closely coordinated national federations. If one excludes the retail trade sector, union membership is even higher. Public sector employees, teachers, and bank employees have separate unions that are not affiliated with the national federations but which cooperate with them on issues of common interest. Despite the high degree of unionization, trade union membership is not a condition for employment in any sector.

³ In contrast to this tradition of voluntary agreements, since EU accession the trade unions have been lobbying for legalizing the existing collective agreements as well as fringe benefits, hours worked etc., possibly fearing waning influence given the expected inflow of workers from other EU countries. The employer organizations, meanwhile, have so far successfully opposed any changes to the current voluntary framework.

⁴ The code was signed by the Cyprus Employers' Federation and the two largest trade union confederations, and countersigned by the Ministry of Labor and Social Insurance (Republic of Cyprus, 1977).

⁵ The proven ability of the Cypriot economy to weather storms and act in a unified manner when faced by adverse circumstances may be linked to the strong relationships among the social partners and the sense of consensus achieved during more peaceful times.

7. **The strength and importance of unions differ.** The three large private sector unions, PEO, SEK, and DEOK, are divided along more or less politically-driven lines, with each union associated with one or more of the large political parties. Workers in the semi-government companies are also mainly organized in SEK and PEO, by far the two largest unions in Cyprus. While SEK is mainly a white-collar union, allied with the right-wing DYSY party, PEO is a blue-collar left-of-center trade union that is closely allied with the socialist ruling coalition member AKEL party. Private sector unions are generally seen as less “driven,” in part reflecting the dispersion of private sector employees across a large number of small firms. In fact, parts of the private sector, in particular the retail sector, have basically no unionization. Meanwhile, the banking and insurance sectors are dominated by one strong union, ETYK, which enjoys virtually 100 percent membership. Over the years, ETYK has acquired a role, rights, and status that, according to Messios (2004), in many cases reach into fields that typically are considered management prerogatives.⁶ The public sector is represented by one strong union, PASYDY, which enjoys effectively a 100 percent unionization rate. Membership rates also reach 100 percent in case of the teachers union.

8. **Most employers are members of industrial associations, in particular Cyprus Employers and Industrialists Federation, and the Chamber of Commerce and Industry.** Both organizations have equal representation in the various tripartite bodies, such as the Labor Advisory Board, the Economic Consultative Committee, the Social Insurance Board, and others.

9. **The existence of highly concentrated representative organizations of labor and employers facilitates the process of tripartism.** This process, which also includes the government, has become the main mechanism for discussion not only of a wide range of labor issues but also economic issues more generally. For example, the recently published medium-term Convergence Program has been the subject of an extensive discussion between the government and the social partners.⁷

⁶ Messios (2004), p. 13.

⁷ Still, the social partners have raised concerns that the Convergence Program was prepared without adequate consultation.

Wages

10. **The common process in which the terms and conditions of employment, including wage setting, are determined is collective bargaining.**⁸ Negotiations are usually first conducted at a broad sectoral level and then concluded at the branch level. At times, negotiations take place at the national level, either to define a framework for the sectoral discussion, or when issues of broader impact are being negotiated, such as the indexation of wages, and the length of the work week. Furthermore, the organization of unions into main federations ensures that agreements reached at the different sector and branch levels do not deviate greatly from a “national target.” Most collective agreements last two years although in some cases sectoral collective agreements are signed for a 3-year period.

11. **One important part of the wage determination process in Cyprus is the cost-of-living allowance (COLA).** Through the COLA, wages are indexed to average CPI inflation in the preceding six months twice a year, on January 1 and on July 1.⁹ The COLA is strongly supported by the trade unions and has remained a non-negotiable issue at the time of collective wage bargaining. Only minor changes to the system have been accepted in the last few years, in particular the exclusion of excise tax increases since the second half of 1999. In turn, the existence of the COLA has facilitated achieving long-term contracts and private sector wage increases in line with average productivity growth.¹⁰ Meanwhile, employer organizations have increasingly expressed concerns that the system undermines flexibility and competitiveness, and that it does not respond to real increases in productivity in specific sectors or individual enterprises.

12. **Minimum wages in Cyprus remain relatively low and do not constitute effective constraints on employment.** The legal minimum wage applies only to a few non-unionized occupations like clerks, salespersons, and day care and elderly care personnel, and is increased annually roughly in line with the minimum wage set in collective agreements.

13. **While minimum wages so far have been effectively non-binding, a recent government decision may change that.** According to this decision, which was taken in October 2004, minimum wages, which currently are about 42–43 percent of the national

⁸ Given the limited scope of labor market legislation, the range of topics covered in collective agreements is wide, including—in addition to wages—overtime pay, distribution of working hours during the week, holidays, sickness pay, and retirement benefits.

⁹ The COLA was first introduced as a war bonus to civil servants in 1941 but its use was gradually extended and since 1951 it has been a regular part of the remuneration of almost all employees.

¹⁰ The COLA does not only enjoy the support of the unions. Also various government officials, including the president, have expressed their support of the system. Only in times of real crisis, such as after the military conflict in 1974, have a temporary suspension of the COLA been accepted by the unions.

median wage, will be raised to 50 percent of the national median by 2008, implying some 10 percent increase a year. As a result, the legal monthly minimum wage was increased by 8 percent to €C 345 upon hiring, and by 6 percent to €C 367 after six months of employment.

Entry, Exit, and Working Hours

14. **Hiring and firing remains quite flexible in Cyprus.** There are no hiring quotas in the private sector, except for employees dismissed due to redundancy, which according to law shall have priority for rehiring within eight months of dismissal. Also, termination of employment in Cyprus is less restrictive than in most other European countries, both in case of redundancies and dismissals for other reasons. Employees that are laid off due to redundancy reasons are not entitled to compensation directly from the employer but instead receive a lump-sum payment from a central redundancy fund financed by regular employer contributions. Employers are also required to notify the Ministry of Labor and Social Insurance at least four weeks in advance of planned redundancy layoffs. In case of dismissal for other reasons, the employee receives severance pay of up to two years' salary depending on the cause of dismissal and the length of service. There are specific rules regarding advance notices and paid leave during the notice period and most sectors impose a "first in first out" rule for such dismissals. In contrast to many OECD countries, there are virtually no legal restrictions on the cause of dismissal. Still, sectors dominated by very strong unions, in particular the banking sector, in reality experience very few dismissals, e.g. in connection with mergers.

15. **With a few exceptions, working hours are set through collective agreements.** In line with the 1992 national collective agreement, the then 40-hour work week was gradually reduced to 38 hours as of 1998. Recent efforts by the employer organization to return to 40 hours a week have been thwarted by the unions. One curious aspect of the Cypriot labor market is the uniformity as to which hours are worked. Literally all work places, ranging from government offices to schools, are open almost exactly the same hours, from around 7:30 in the morning to around 2:30 in the afternoon, resulting in bunching of traffic, parents dropping off their children at school consistently being late for work.

16. **While part-time employment has long been permitted without any special restrictions, it remains rare.** In particular, though such employment now is safeguarded through EU harmonized legislation, it still faces strong resistance by the unions, which worry that part-time employment takes place outside the negotiated collective agreements. In 2003, only 8.9 percent of the gainfully employed population was working on a part-time basis, compared with over 17 percent in EU25. Mostly women work part time, or 13.2 percent of employed Cypriot women in 2003 compared with 30 percent of women in employment in EU25, and compared with 5.5 percent of employed Cypriot men. Still, part-time employment is increasing, rising by 7.2 percent between 2002 and 2003.¹¹

¹¹ The Ministry of Labor and Social Insurance, and the Planning Bureau; and the European Commission (2004).

Labor Market Programs

17. Unemployment benefits are relatively less generous than in most other EU countries, with a high earnings' replacement rate offset by shorter duration of benefits.

Benefits are paid from the fourth day of unemployment and for a maximum of 156 days, which is relatively short compared with EU standards. Also, in order for unemployment benefits to be renewed, the individual needs to be reemployed for at least 26 weeks. However, replacement rates are relatively high, amounting to about 70 percent of previous gross earnings in 2003.¹² The short duration of benefits is mainly meant to encourage efficient job search and reflects the situation of the Cypriot labor market, which is functioning at or near full employment with mainly frictional unemployment. Generally, the unemployment benefits system has not been tested since the early 1980s, as high growth and a limited supply of labor have contributed to a constant decline in the now very low unemployment rate. Furthermore, international labor mobility has functioned as a safety valve at the margin, with Cypriots emigrating initially, and since the early 1990s the recruitment of foreign labor.

18. In total, spending on labor market programs remains limited in Cyprus compared with other European countries. In 2002, spending on unemployment compensation amounted to only 0.4 percent of GDP, while spending on labor market policies, such as measures for public employment services and labor market training, amounted to 0.75 percent.¹³ Meanwhile, spending on unemployment benefits averaged 1.2 percent of GDP in EU-15 in 2001 while spending on labor market programs averaged 0.9 percent.¹⁴

¹² In 2003, unemployment benefits for a skilled industrial worker with three dependants amounted to 69.2 percent of gross earning prior to unemployment.

¹³ Ministry of Labor and Social Insurance and the Planning Bureau.

¹⁴ OECD (2004).

Employment by Sector, Gender, and Age¹⁵

19. **As in most other rich industrialized economies, primary and secondary sectors in Cyprus have become less important while the tertiary sector has gained in importance over the last decades.** In particular, between 1980 and 2003, service sector employment increased from 46 percent to 71 percent of total employment, while employment in agriculture and industry declined from 20 percent and 34 percent, respectively, to 8 percent and 21 percent, respectively. For comparison, industry accounted for 28 percent of total employment in EU-15 in 2003 while the services sector accounted for 68 percent.¹⁶

20. **The economically active population has increased dramatically since independence.** The total labor force participation rate has risen from approximately 40 percent in 1960 (Kontolemis, 1994) to 72.2 percent in 2003, mainly reflecting an increase in female labor market participation. However, there is still a large difference between male and female participation rates, with the former at 82.1 percent and the latter at 63.1 percent in 2003.

21. **Cyprus also fares well with respect to employment rates.** Between 2000 and 2003, the overall employment rate in Cyprus rose by 3.5 percentage points to 69.2 percent while the employment rate for women rose by almost 7 percentage points to 60.4 percent. This measures well both compared with the Stockholm/Lisbon criteria for 2005 and 2010, and the EU15 and EU25 averages. In fact, within EU25, only three countries, Cyprus, Hungary, and Latvia, have seen increases in overall employment rates over the last five years, and by 2003, only Cyprus and the Czech Republic among the new EU members had employment rates above the EU15 average.

Cyprus and the Stockholm/Lisbon Employment Criteria 1/
(in percent)

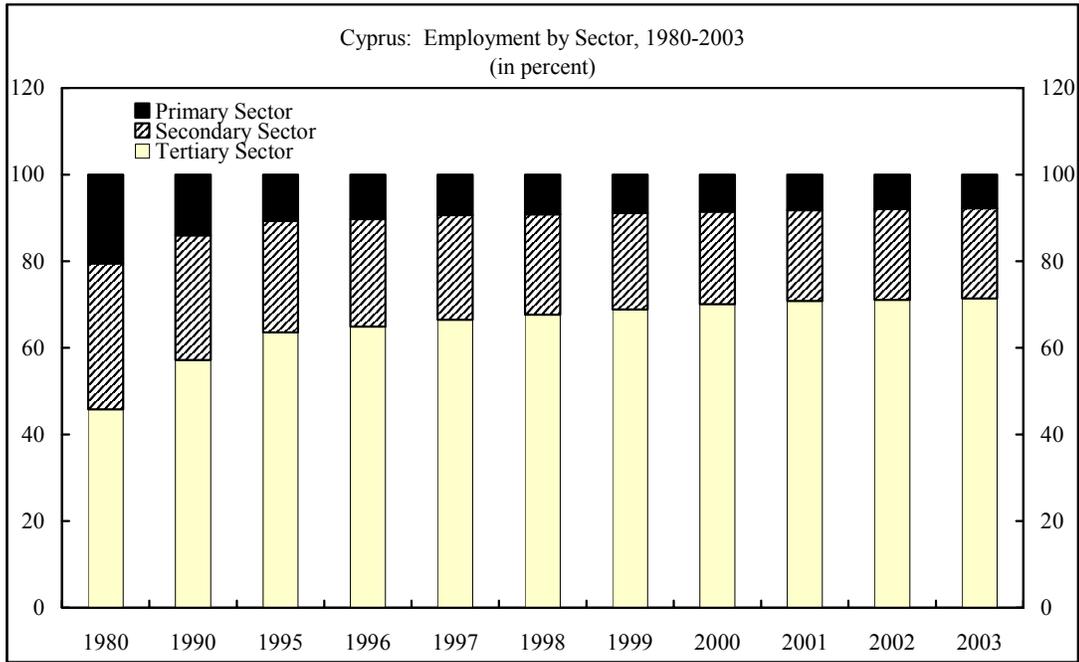
	2005 target	2010 target	EU15 2003	EU25 2003	Cyprus 2003	Cyprus 2006 target
Overall employment rate	67	70	64.3	62.9	69.2	70
Female employment rate	57	>60	56	55	60.4	62
Elderly employment rate		50	41.7	40.2	50.4	52

Sources: European Commission, *Employment in Europe 2004 - Recent Trends and Prospects*; and Republic of Cyprus, *National Action Plan for Employment 2004-06*.

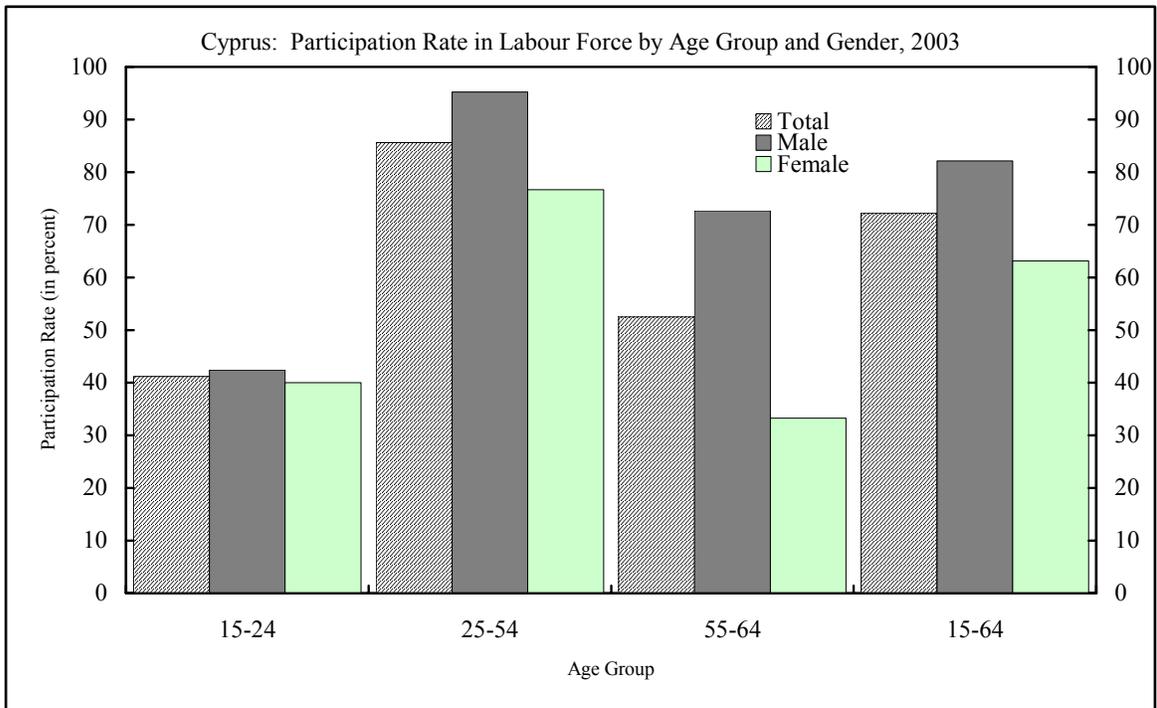
1/ The Lisbon European Council of 2000 set strategic goals for 2010 for the EU overall and female employment rates. The Stockholm Council of 2001 set intermediate targets for 2005 and added a new target for 2010 for the EU elderly employment rate. Denmark, Sweden, and the United Kingdom had reached the Lisbon employment rate criteria by 2003.

¹⁵ This section draws mainly on information provided by the Ministry of Labor and Social Insurance and the Planning Bureau, unless otherwise indicated.

¹⁶ European Commission (2004).



Source: Ministry of Labor and Social Insurance; Planning Bureau.



Source: Ministry of Labor and Social Insurance; Planning Bureau.

Foreign Labor¹⁷

22. **In 1991 working permits were issued for the first time to foreign workers and since 1992 there have been large-scale inflows.** Foreign workers now constitute some 13 percent of the labor force. Foreign workers receive wages according to the collective agreements, just as comparable Cypriot workers, although apparently often at lower starting wages, and they are entitled to the same social benefits and health insurance.¹⁸

23. **While foreign workers are active in most sectors of the Cypriot economy, most are found in the services sector.** In 2003, half of all foreign workers were employed in private households (30 percent of foreign workers) and in restaurant and hotels (20 percent); another 42 percent were evenly distributed among the agriculture, manufacturing, construction, retail trade, and international business sectors. As shares of total employment in Cyprus, foreign workers constituted 15 percent of the employed population in the agriculture, forestry, and fishing sector in 2003, 13 percent in the trade, hotel and restaurant sector, 11 percent in the construction sector, and 10 percent in the manufacturing sector.

Cyprus: Foreign Workers by Sector, 1998-2003

	1998	1999	2000	2001	2002	2003	Average annual	Distribution	
							percentage	in percent	
							change	of total	
							1999-2003	1998	2003
Total	20,713	23,879	25,766	30,215	35,276	40,702	14.5	100	100
<i>of which:</i>									
Agriculture and Hunting	1,675	1,958	2,061	2,487	2,958	3,417	15.3	8.1	8.4
Manufacturing	2,018	2,128	2,102	2,313	2,749	3,380	10.9	9.7	8.3
Construction	1,464	1,589	1,555	1,828	2,492	3,450	18.7	7.1	8.5
Wholesale and Retail Trade	1,475	1,588	1,685	2,079	2,749	3,394	18.1	7.1	8.3
Restaurants and Hotels	3,288	3,986	4,423	5,874	7,045	7,994	19.4	15.9	19.6
Private Households with Employed persons	5,952	6,713	7,717	9,278	10,537	12,041	15.1	28.7	29.6
International Business (former offshore)	2,787	3,803	3,803	3,495	3,496	3,375	3.9	13.5	8.3

Source: Ministry of Labor and Social Insurance, and the Planning Bureau

24. **Work permits are required for foreign workers.** Until May 1, 2004, the issuance of work permits to foreign workers needed the agreement of the unions, and permits were only to be issued in case no eligible Cypriot workers were available. However, since EU accession on May 1, 2004, EU nationals are treated in the same manner as Cypriots as to employment and no work permits are needed for workers from EU countries. Instead, employers now need to “prove” that there are no EU workers available in order for working permits to be issued to

¹⁷ This section draws in large part on information provided by the Ministry of Labor and Social Insurance and the Planning Bureau.

¹⁸ The Social Insurance Scheme is financed by equal contributions by employers and employees of 6.3 percent, respectively, of earnings, and by the state of 4 percent.

Cyprus: Share of Foreign Workers in Total Employment by Sector, 2003

Agriculture, Forestry, and Fishing



Manufacturing



Construction



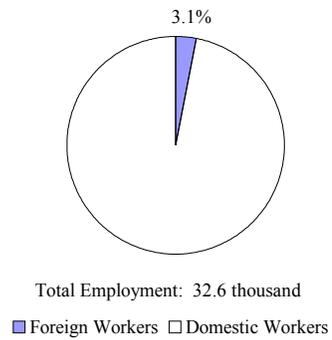
Trade, Restaurant, Hotels



Transport and Communications



Finance, Insurance, Real Estate



Source: Cyprus Statistical Service.

non-EU workers. The unions have expressed some consternation over these developments, fearing the waning of their control over the Cypriot labor market. As a result, one union has been lobbying to legalize the existing voluntary collective agreements and fringe benefits. The unions are also supporting recent government proposals to limit the inflows of workers from non-EU countries, which currently constitute the majority of foreign workers in Cyprus. Meanwhile, the employer organizations have expressed deep concerns regarding any further restrictions on the inflow of foreign workers in light of the severe labor shortages characterizing the Cypriot economy.¹⁹

Turkish-Cypriot Workers

25. **In the last few years, Turkish-Cypriot (T/C) workers have started to become an important source of labor for the Greek-Cypriot economy.** In April 2003, restrictions on movement across the “green line” dividing the government controlled areas from the Turkish-Cypriot community in the north were partially removed, immediately leading to a large increase in the flow of T/C workers to the government controlled areas. While some 700 T/C workers were already commuting to work in the government controlled areas before the removal of restrictions, this number had increased to at least 2,300 as of August 2004, according to data from the Department of Social Insurance (based on social security contributions—as Cypriot citizens, T/C workers are entitled to the same social security and health benefits as residents in the government controlled areas²⁰). In addition to the officially registered T/C workers, there is also a large number of T/C workers unofficially employed in the government controlled areas, possibly bringing the total number of T/C workers currently employed in the south to 10,000.

26. **Most T/C workers are found in industry.** More than half of the 2,300 T/C workers registered in August 2004 were employed in the construction sector while 12 percent were employed in the manufacturing sector; 5 percent were employed in the trade sector.²¹

27. **While a further inflow of T/C workers could ease the problem of labor shortages in the south, there are also concerns that inflows will start to taper off.** In particular, there are concerns that the current construction boom in the north, in part triggered by the Annan Plan of last spring and mainly financed by European (in particular British)

¹⁹ Ireland recently introduced similar rules in light of the latest EU expansion, now only issuing working permits to non-EU workers that constitute highly qualified or highly specific personnel for which there is also a demonstrable and verified shortage in the Irish labor market (Republic of Ireland, 2004).

²⁰ E.g., from January 2003 to August 2004, €C 5.8 million was paid out in the form of pensions to some 4,400 Turkish Cypriots, of which about 900 reside abroad. Also, in August 2004, some 1,400 Turkish Cypriots were treated at medical institutions in the government controlled areas, compared with about 200 in April 2003. (Department of Social Insurance Services)

²¹ Department of Social Insurance Services.

39. **Even current “zero wage-increase” agreements in the public sector may turn out to be very costly and further widen the wage gap versus the private sector.** Under the Convergence Program, the government and social partners have reached preliminary agreement on a zero percent increase in public sector salaries in 2004–05 and a 2 percent “negotiated” wage increase in 2006. Under this arrangement, the increase in total wage costs for the 50,000 public servants will still reach €C 80 million (around 1 percent of GDP) a year according to calculations by one employer organization, taking into account also the estimated 4 percent increase each year due to the automatic seniority-based “increments,” as well as the COLA. Such developments make for a widening wage differential between the public (including the semi-government organizations) and the private sectors, where there are no “increments” and where negotiated wage increases typically average productivity, i.e. around 1.5 percent.

40. **The achieved labor peace may have proven too costly.** Arguably, the COLA has contributed to long-term contracts and labor market peace. However, this can be contrasted with, say, Ireland, where the social partnerships have not only allowed for labor peace and fewer disputes but also a moderation in wage demands and a significant decline in wages as a share of GDP. This in turn has contributed to the steady increase in competitiveness experienced in Ireland during the 1990s. Meanwhile, it could be argued that labor peace in Cyprus has been mainly achieved through wage agreements that are too expensive. Box 1 outlines briefly the wage setting mechanisms in selected European countries.

41. **The rigidity of the COLA may be exacerbated in a low-growth environment.** It may be argued that the COLA worked better in a high-growth economy, where the downward stickiness in real wages did not constitute an effective constraint on the wage determination process, as real wages increased with productivity and workers released from industries unable to pay the rising wages were absorbed by other sectors in the expanding economy. However, in an environment characterized by less robust growth, this rigidity may become an impediment to the economy’s ability to weather negative shocks. In particular, in the presence of long-duration wage contracts in some industries, the COLA mechanism constrains the markets’ ability to correct an overshooting of wages that may result from too optimistic an outlook at the time of the contract’s inception.

Box 1. Wage Setting in Selected European Countries

Belgium: Wages are indexed to CPI excluding energy items. The actual implementation of the indexation is negotiated and varies across years and sectors, i.e., forward or backward looking indexation, and the number of months to include. In its concluding statement following its most recent Article IV consultation, the Fund suggested that the system be abolished over the medium term.

Greece: For years, indexation of wages to the CPI has been the normal practice, although it has always been negotiated. However, in the wage negotiations of June 2004, wage indexation was excluded.

Ireland: Broad social partnerships that include some 18 umbrella organizations cover a wide array of issues ranging from the macroeconomic environment to income distribution and supply side measures such as tax changes. In the 2003–05 agreements, many volunteer organizations were also involved. Social partnerships have been a source of strength in times of crises, allowing for a more long-term view and helping to build consensus for difficult but necessary reforms. The resulting broadened perspective has not only allowed for labor peace and fewer disputes, but also for moderation in wage demands and a significant decline in wages as a share of GDP, hence contributing to the steady increase in competitiveness experienced during the 1990s. There is no wage indexation mechanism, although the 2000–2002 wage contract was opened for renegotiation due to an inflation adjustment. There are now concerns that the 3-year agreements do not allow for sufficient wage flexibility, that they may not have delivered the wage restraint they have been credited with, that they have become too broad in scope and in the number of partners involved, and, hence, that they place inappropriate constraints on public policy.

Norway: The centralized bargaining system, which in part has been justified in recent years by allowing for a fairer sharing of Norway's oil wealth, has been instrumental to the relatively tranquil labor market relations, strong employment growth, and record-low unemployment. However, the compressed wage scale, a nominal wage growth that has exceeded that of key trading partners, and anemic productivity growth have all contributed to the public sector increasingly becoming the source of net employment gain.

Spain: Collective wage bargaining covers the bulk of workers. Wages are typically indexed to the previous 12 months of headline CPI. Wage indexation remains a contentious issue during the collective bargaining process, but has become more frequent in recent years. Negotiated wage increases are based on both an inflation component (2 percent) and on productivity gains, while ex-post, wages are adjusted upward if actual inflation deviates (beyond a certain threshold for many contracts) from the initial inflation component. The IMF has advised the abolition of the system, arguing that the increasing recourse to wage indexation contract clauses contributes to the persistence of inflation shocks.

Sources: Horváth (2001); Hunt (2004); IMF (2004a and b).