MUTUAL LEARNING PROGRAMME:

PEER COUNTRY COMMENTS PAPER – THE REPUBLIC OF CYPRUS

The international crisis and its impact on Cyprus: Severity and employment measures to deal with it

Peer Review on "Employment measures to tackle the economic downturn: Short time working arrangements/partial activity schemes"

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1 LABOUR MARKET SITUATION IN THE PEER COUNTRY

This paper has been prepared for a Peer Review within the framework of the Mutual Learning Programme. It provides information on Cyprus's comments on the policy example of the Host Country for the Peer Review. For information on the policy example, please refer to the Host Country Discussion Paper.

In Cyprus, the international crisis that began in the latter half of 2008 did not directly involve the banking sector because it is fairly conservatively run and closely supervised by the central bank. The crisis reached Cyprus through the decline in international demand, especially for tourist services and for winter/holiday homes. The initial shocks in the tourist and construction sectors spread to other areas of the economy and unemployment rose broadly. The government moved cautiously within the parameters of the European Economic Recovery Plan (EERP) by attempting to stimulate the sectors that were badly affected, i.e. tourism and construction, through temporary measures (EERP Pillar I) and by emphasizing general infrastructural projects (Pillar II). It also increased liquidity in the banking sector and sought to affect market psychology positively.

Whether and by how much these measures have stimulated the economy is difficult to say. Part time work is not favoured and only 8% or so of employment is of this form. There has been no appreciable impact of the recession or of the measures to combat it on this incidence. Despite them, real GDP growth turned from 5.1% and 3.6% in 2007 and 2008 respectively to -1.7% in 2009. While this was the first negative growth for 35 years, it was a milder recession than what was experienced in the Euro zone (-4.1%) and France (-2.5%) in 2009. However, because the crisis reached Cyprus with some delay, the recovery that started in France and elsewhere in 2009Q2-Q3 has not been strongly felt in Cyprus. The 2010Q1 and 2010Q2 figures for quarter-to-quarter growth in real GDP were 0.3% and 0.4% for Cyprus and 0.2% and 1% for the Euro area respectively. The analogous figures for year-to-year changes show more clearly the divide between the recovery in Cyprus and the Euro area. The 2010Q1 and 2010Q2 year-to-year changes were -1.4% and -0.2% for Cyprus and 0.6% and 1.7% for the Euro zone respectively. Thus, while the recession in Cyprus is technically over, its recovery lags behind that of its Euro partners. The LFS unemployment rate was 4% in 2007, 3.8% in 2008, but rose to 5.4% in 2009 and was 7.5% in 2010Q1 (up from 4.7% in 2009Q1). Registered unemployment rose in all sectors, all educational categories and for all duration groups. Although the Cyprus unemployment rate is lower than that of France (the Host Country Discussion Paper, Figure 1, reports an ILO definition rate of 10% in early 2010), it must be remembered that Cyprus is traditionally a low unemployment country which employs large numbers of EU and third country workers, representing over 20% of the total workforce. Recent levels of unemployment in Cyprus are historically high and pose new and unfamiliar challenges.

As the crisis deepened, the 3.4% of GDP fiscal surplus of 2007 (mainly the result of land transfer fees related to a housing bubble) declined to a 0.9% surplus in 2008 and a 6.1% deficit in 2009. Absent any action, the 2010 deficit was expected to exceed that of 2009 and this against a background of unfavourable implications from population ageing relative to the EU-27. On 14 May 2010, measures to reverse the deficit were announced. A EUR 80 million reduction in government expenditure for 2010 and a 1000 person reduction in employment in the civil service were announced. Particularly relevant is the reduction in the support for tertiary education institutions and research (EUR 9.3 million out of a EUR 131 million budget, or a reduction of 7%).

Other measures to contain the fiscal deficit were also announced but they required legislative changes which could not be pushed through by the minority government. These measures included targeting the child and student subsidy programmes toward those on lower incomes (thereby sustaining social support to those in need while containing the deficit), a bill to strengthen the tax authorities' capacity to fight tax evasion (thereby increasing needed revenue) and a bill to raise revenue through a zoning violation amnesty. Attempts are continuing to forge a political consensus with respect to further fiscal austerity measures that might be taken. This discussion will begin again in earnest this autumn as political leaders re-assemble, particularly if scrutinising agencies begin to express further concerns about the budget deficit which is probably approaching 7%.

2 ASSESSMENT OF THE POLICY MEASURE

Possibly because of the presence of undesirable unemployment, France has had a long tradition of some use of partial activity programmes in its arsenal against this problem. Interest in these measures covers a variety of sectors, though it is especially intense in the automotive and supply chain. The link of partial activity programmes to training programmes, which had been of questionable legal status prior to the crisis, was strengthened in November 2009, clarifying that the employment contract can be suspended to allow for training. The generosity of the measures was also increased. As a result, the number of authorised hours increased during the recession to a peak in 2009Q2, though the use of these hours appears to be below the levels observed in the past (Host Country Discussion Paper, pp. 12-14). The link between these hours and training appears to be unclear as of yet (Host Country Discussion Paper, pp. 15-16).

By contrast, Cyprus has been a country of low unemployment, employing large numbers of workers from abroad (initially third country but now the EU as well). The mechanism of partial activity has, therefore, not been one that has attracted a lot of attention traditionally. The significance of training has always been recognised and the tripartite Human Resources Development Authority (HRDA), levying a payroll charge of 0.5% on employers, has run a wide variety of initial and subsequent training programmes for many groups, including the unemployed. These have generally not been linked to partial employment as a means of combating unemployment until recently. The Higher Hotel Institute of Cyprus (HHIC) and the Cyprus Productivity Centre (CPC) are also involved in a number of training programmes.

As the crisis took hold in Cyprus, two programmes (see the National Reform Programme, NRP, of the Republic of Cyprus, October 2009, p. 112) that resemble partial activity programmes were promoted. One measure promotes training for persons employed in hotels which interrupt their operation during the winter, off-peak, months. Under this scheme, overseen by the HHIC, companies in this sector that temporarily suspend their operations (partially or wholly) have the opportunity to place their employees into training programmes. While these employees are undergoing training, their employers receive government grants to cover the cost of their salaries. This scheme operates within the framework of an existing programme which provides incentives to employers in the hotel industry to temporarily suspend employees instead of laying them off (subsidizing 55% of the monthly salary from the Social Insurance Unemployment Fund). The budget of the scheme is approximately €1,142,000 (for the period 2009-2013) and it is financed by the European Social Fund (ESF) and national sources.

The second programme mentioned in the NRP concerns in-company/on-the-job training programmes for employees faced with the risk of lay-offs and it is run by the HRDA as a preventive measure against unemployment but also as a means of improving vocational qualifications. The HRDA provides a subsidy to employers who choose the training rather than the layoff option. These in-house training programmes focus on the sectors of the economy which are most affected by the recession, namely Hotel and Catering, Retail Trade and Construction. The content of training is determined by the enterprises themselves based on their needs and it is delivered according to training specifications approved by HRDA.

These HRDA measures are now being promoted more broadly with the intention of covering all sectors which might benefit from them. The size of the funding commitment is, now, quite substantial. The scheme falls within the programming period January 1, 2009 to December 31, 2014 and has a budget that may reach Euro 10 million annually, may cover up to 5000 beneficiaries annually and may be continued to 2014 if needed. The programme now offers training subsidies on a competitive basis to firms for both *general* and *specific* training. It differentiates the proportion of costs covered by the size of firm and whether the training is general or specific to the firm. In the case of general training, the proportions are 60% for large, 70% for medium and 80% for small firms; when specific training is offered, the proportions of costs covered are 25%, 35% and 45% for the three sizes respectively. The programme aims specifically to preserve employment positions through a reduction of the cost of employment (while employees train) and the simultaneous enhancement of general or specific skills.

Beginning March 26, 2010, a scheme administered by the CPC, which comes under the umbrella of the ESF co-funded programme Employment, Human Capital and Social Cohesion 2007-2013, aims to preserve and enhance employment by supporting business plans which enhance productivity. A competitive procedure ranks proposals from enterprises in all sectors. The budget for 2010 is approximately Euro 8m and the programme aims to preserve 600 positions and to increase employment by a further 300 positions. Though not explicitly a partial activity programme, the business plan will generally involve training for employees and the time cost of this involvement is eligible for support. The programme may be renewed beyond 2010 if it is deemed successful and necessary.

In general, ‘adverse selection’ and ‘moral hazard’ issues are at stake in all programmes of the type described in the Host Country Discussion Paper for France and above for Cyprus. Adverse selection refers to the nature of the participating companies. In the worse possible scenario, participating companies may be ones that would go under anyway but manage, through some programme, to buy themselves some time. Eventually, however, they close. Moral hazard refers to actions taken by companies and workers once these training and business plan improvement programmes become available. It is possible that they may stop doing any of their own (scheduled) training and rely on these programmes instead.

More information on these issues in the case of France would be useful. Are these problems real or do the programmes contain provisions that minimize them? In Cyprus, a number of points are worth making. In the case of the first programme mentioned that is directed at hotel winter closures, there is strong temptation for companies to use this programme to coast through to another year. This may be particularly the case in an industry which has been in a secular decline. The HRDA programme may avoid the adverse selection and moral hazard programmes because, in a sense, it acts as the training agent of paying firms. It is understood that firms will make use of the 0.5% payroll contribution that they make to the HRDA and, in many cases, they rely on the HRDA to offer all training. The CPC programme tries to deal with the adverse selection problem by requiring that applicant companies have a sound record of employment for 6 months prior to the programme and maintain employment for 5 months after the programme. Also, a substantial proportion of the funds involved are paid after the end of the programme and its assessment. The moral hazard problem is more difficult to guard against: there seem to be no provisions which require companies to maintain earlier patterns effort to improve their business plans and productivity.

An assessment of these programmes (take up, continuance of employment following training, possible unemployment despite training, the nature of the training programmes pursued and satisfaction with them, the nature of companies that take advantage of these programmes, the fate of participating companies following participation in these programmes) has not been undertaken in Cyprus and as far as it is known there is no plan in place to do so in the future. It is probably too soon to do so and, in any case, the counterfactual scenario of what would have happened without these programmes is not easy to determine. No details are available at this point on the number of individuals and companies that have been taking up the provisions of these programmes and subsidies involved.

The impression given in the Host Discussion Paper is that the information available for France is not very different from what is available in Cyprus. In these respects, the admittedly limited experience of Cyprus with partial activity programmes is similar to that of France for its explicit programmes. In both cases, we would like to know more.

What is different, however, is the scale of governmental involvement in these programmes and their scope in France. The programme in France is, indeed, very much more extensive and complicated.

A more concrete difference between the programmes is that, in France, the scheme is applicable to large, established and sophisticated, manufacturing industries (Host Country Discussion Paper Figure 8) that may be going through a temporarily hard time due to the world decline in liquidity and demand. The possibilities for retraining and the subsequent impact of such training on productivity are plausibly high. The earliest two schemes in Cyprus applied to the hospitality and construction industries. In general, these industries employ low-skill workers. The scope for benefiting from training in these sectors and for these skill levels is limited. A related issue is that neither the hospitality nor the construction industries are likely to recover to their former levels. Tourism is undergoing a secular but continual decline in numbers and revenues, despite Herculean efforts by many officials and organisations and much support by the government. So it is not clear that retraining with the view to re-employing workers in that sector is the answer. In the case of construction, it underwent the bubble felt in a number of countries and it is doubtful that it will return to its former size. There is a feeling that the future of the country lies in other directions, namely in high value added businesses and medical services, tertiary education and research. The larger schemes run by the HRDA and the CPC are, in principle, not restricted to any sector(s). However, they are not used as an instrument to promote new strategic directions either.

3 ASSESSMENT OF THE SUCCESS FACTORS AND TRANSFERABILITY

The partial employment programme in France has a long-standing history and, through the recent enhancements to the programme, it has been made considerably more attractive. Authorised hours have increased substantially (258 million hours in 2009 as opposed to 28 million hours in 2008) but the actual use of hours in 2009 was 30% lower than in previous years. Considerable uncertainty appears to exist as to the questions raised in the section below. This information would be needed in order to feel confident that the programme was a success. Clearly, funds were injected into firms that took up the programme and many of these firms were in the manufacturing sector, in areas which are undoubtedly highly placed in France's strategic planning.

The experience of Cyprus in this area is very recent. The programmes were strengthened or even created in response to the international crisis and they have not, in the past, been thought of as measures in the arsenal against unemployment. The measures were initially directed to areas that were hard-hit by the recession. These areas (tourism and construction) are important sectors to the economy of Cyprus. Nevertheless, they are probably areas which are either in secular decline (tourism) or have undergone a bubble (construction), rather than new strategic directions that the government wishes to stimulate in the long-run. The new versions of the programmes have a broader coverage, larger budgets and aim to involve more individuals and save more employment positions. In principle they can be used to support the reorientation of the economy but detailed information on the take up rates by sector is not available at this time.

The early support given through these new measures in Cyprus was modest, showing a willingness to respond to the adverse shocks without investing enormous amounts of resources in this way. Nevertheless, in the context of declining revenues and an increasing budget deficit, these resources have an opportunity cost. The government has had to cut funding for strategically important areas such as tertiary education and research. To that extent, changes in course were put into effect for which the government was criticised by the sectors that were adversely affected. From this point of view, France has tried, through these programmes, to maintain its manufacturing capability, while Cyprus initially propped up sectors which were either in decline or going through a bubble. Recent data on the proportion of GDP devoted to research and development show that this proportion continues to hover around 0.43% despite the substantial investment increases that have been made in this area by the government (private sector involvement is modest). The new versions of the programmes in Cyprus are, at least in principle, aimed at all sectors of the economy and have provisions which guard against some adverse selection and moral hazard problems. Whether the coverage of the new HRDA and CPC programmes is broader, remains to be seen. The provision in the HRDA programme that both general and specific training is covered would help ameliorate problems of subsequent unemployment when, despite the programmes, companies lay off workers or fold.

The evaluation of programmes is made difficult by the lack of quantitative information collected on take-up rates, the nature of companies and the characteristics of the trainees, the kind of training received and whether productivity has, in fact, increased. Also useful would be knowledge of the value of general programmes (in terms of facilitating re-employment) if the trainee becomes unemployed. On all these issues, less information is available than in France.

4 QUESTIONS

1. What kind of companies take up these programmes?
2. Does France have planned changes in strategic directions that might suggest directing partial activity programmes to new areas rather than old areas of strength?
3. Is there a budget tension between devoting resources to partial activity and to infrastructural projects? What are the attitudes towards infrastructure investments as an alternative to partial activity programmes?
4. Do companies that can genuinely benefit from improved training take up these programmes or is it companies that would have folded, cushioning their exit?
5. Does the programme slow down scheduled training by the companies themselves?
6. What are the features of the training programmes implemented? Does training improve productivity?
7. What about the workers trained, do they remain employed in the same company?
8. Do some workers who have received training become unemployed anyway?

ANNEX 1: SUMMARY TABLE

Labour market situation in the Peer Country
• The recession arrived in Cyprus with a lag and indirectly, through a decline of tourism flows and construction, rather than the banking sector. • Nevertheless, unemployment increased in all sectors and all educational categories. The LFS reached 7.5% in 2010Q1, up from 4.7% in 2009Q1. • The budget deficit increased to around 6% of GDP, making it more difficult for the government to stick to its long-term strategic directions. • Political consensus for fiscal tightening could not be achieved but more efforts will be made this coming autumn.
Assessment of the policy measure
• Partial activity a long-standing measure in French arsenal against unemployment and in character with how labour market is structured. • Changes to these programmes occasioned by the recession increased authorised hours tenfold, though actual hours remained at 30% - lower than in the past. • Questions at the micro level limit confidence in the assessment of the programme.
Assessment of success factors and transferability
• Partial activity programmes are recession driven, new to Cyprus, and outside the culture of measures that are typically called for in a low unemployment environment. • They are generally directed at sectors (tourism and construction) that have been hard hit by the recession and so have an ameliorative, short-run, character. • They have directed resources, which are scarce in a recession, to old engines of growth rather than new directions.
Questions
• Have governments in France planned changes in strategic directions that might suggest directing partial activity programmes to new areas of strength? • Is there a budget tension between devoting resources to partial activity and to infrastructural projects? What are the attitudes towards infrastructure investments as an alternative to partial activity programmes? • Do companies that can genuinely benefit from improved training take up these programmes or is it companies that would have folded, cushioning their exit? • Does the programme slow down scheduled training by the companies themselves? Does training increase productivity? • What about the workers trained, do they remain employed in the same company? Do some workers who have received training become unemployed anyway?