

Discussion on Cyprus Economy: Reform or Shrink

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1. Introduction

In this presentation I will put forward my analysis about today's structural weaknesses of the economy, by concentrating on the structural problems of the public sector, which I feel represent the Achilles heel of the economy. By this, I do not wish to diminish other competitiveness issues such as: financing social insurance, structural problems of the banking sector, excessive bank lending and the enormous current account deficits, all of which are also unsustainable. In addition, I would like to emphasize that I believe, that Cyprus, irrespective of the effects of the world economic crisis, would eventually have gone through an economic crisis of its own, because of the endemic nature of the current structural weaknesses.

2. The wider public Sector and earnings growth

What are the urgent issues that I believe need immediate attention by the policy makers?

2.1 Overall undermining of the competitiveness, through excessive growth in employee earnings

The major factor undermining competitiveness is the long-term rate of annual growth of earnings much in excess of the annual rate of improvement of labour productivity. Since 1980, the average annual rate of growth of real, earnings has been 3.5%, and exceeds the equivalent annualized rate of improvement of productivity (2.0%) by an annual factor of 1.5%. By the term labour productivity I simply refer to overall productivity as measured by the simple ratio of total GDP at constant prices with the number of gainfully employed people. The cumulative growth of earnings compared to the equivalent improvement in

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productivity, over this 29-year period, has resulted in a cumulative difference of the two indices of 98 percentage points (Figure 1 and Table 1).

TABLE 1

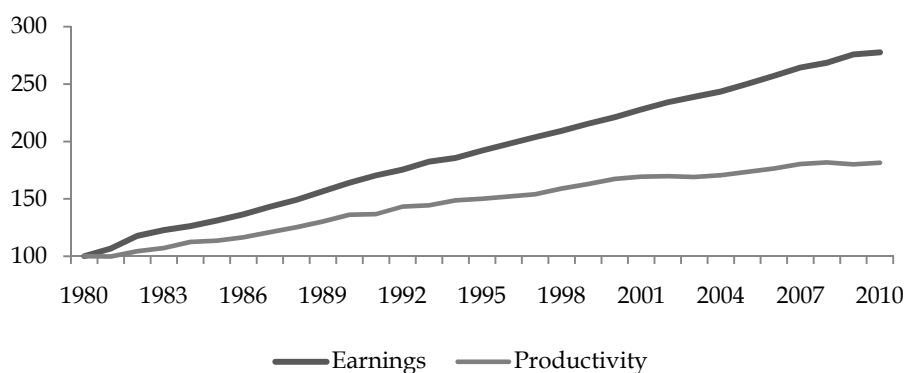
Average Real rate of growth of earning and productivity 1980-2009

	Indices (1980=100)	Average rate of growth (%)
Real Earnings	278.5	3.5
Productivity	180.5	2.0

Source: Personal calculations based on published data of Labour Statistics 2009 and National Accounts, Department of Statistics and department's website: www.mof.gov.cy/mof/cystat/

FIGURE 1

Indices of real earnings and productivity 1980-2009 (1980=100)



Source: Labour Statistics 2009 and National Accounts, various years, Department of Statistics and department's website www.mof.gov.cy/mof/cystat/

2.2 The gradual loss of competitiveness is nowadays reflected in relative price developments

Figure 2 represents, in my opinion, the proof of this gradual loss of competitiveness. Between 1997 and 2010 the index of locally produced goods shows that prices have increased by 60.2%, or on an annual average rate of 3.7%, during a period when international commodity prices have declined by some -14.5%, or annually by -1.2%. At the same time, prices of locally produced services increased by a total factor of 52.2% or by an annual factor of 3.3%, also much above imported inflation. These figures reveal the extent of the ongoing deterioration of competitiveness of the

non-tradable sector, which is important for Cyprus given the reliance on tourism. It should be noted that imported commodities have experienced a lower rate of inflation for much longer period, extending to the beginning of the 1980's and late 1970's.

2.3 The major factors leading to the deterioration of competitiveness

What are the factors behind these adverse long-term developments? The simple answer is that the main culprits are the banking and the wider public sectors, where earnings soared during the past three decades. The long-term trend increase of nominal and real earnings, by broad sectors of the economy, based on the published data of the Department of Statistics (Table 2) are very revealing: during the same period the highest percentage annual increase in earnings were recorded by the banking sector followed by the wider public sector, that is civil servants, workers in local authorities and employees of semi government organizations (telecommunications, electricity, water and sewerage disposal organizations). Table 2 reveals that only in these sectors the trend rate of annual increase of earnings exceeded the average of the economy. Therefore it is the banking and wider public sectors that led the excessive rate of growth of earnings.

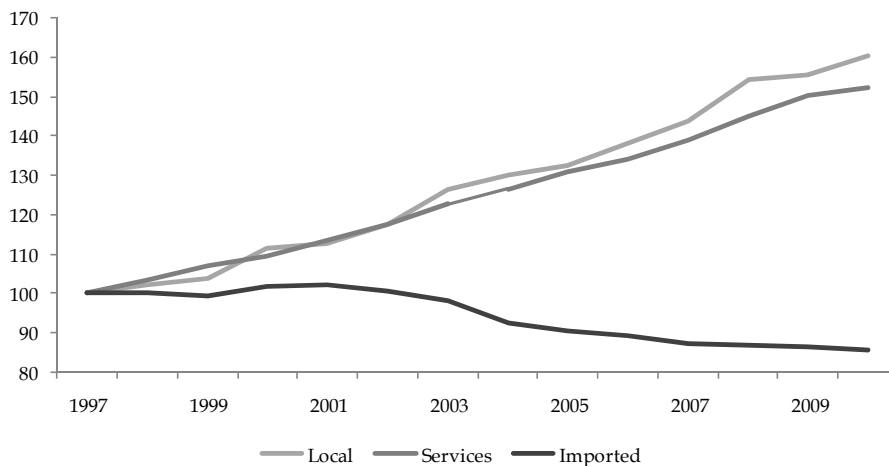
TABLE 2
Rate of increase of earnings by broad sector 1980-2009

	Indices 1980 = 100		Average rate of increase (%)	
	Nominal	Real	Nominal	Real
Banks	1148.6	388.5	8.9	4.8
Government	952.1	322.1	8.1	4.1
Local authorities	876.7	296.6	7.8	3.8
Electricity etc.	871.4	294.8	7.8	3.8
Transport and communications	835.1	282.5	7.6	3.6
Other services	820.3	277.5	7.5	3.6
Trade and tourism	802.8	271.6	7.4	3.5
Construction	728.5	246.4	7.1	3.2
Quarrying	709.2	239.9	7.0	3.1
Manufacturing	690.7	233.7	6.9	3.0
Agriculture	640.9	216.8	6.6	2.7
Total employees	815.9	276.0	7.5	3.6

Source: Tables VI and VII pages 128 and 129 of Labour Statistics 2009, Department of Statistics and own calculations and department's website www.mof.gov.cy/mof/cystat/

FIGURE 2

Indices of locally produced services and imported goods 1997-2010



Source: Personal calculations based on published data of Labour Statistics 2009, Department of Statistics and department's website www.mof.gov.cy/mof/cystat/

2.4 How wages increased in the public sector

The privileged conditions of employment in the public sector represented a very strong incentive for entry into the civil service for the majority of the population. The high remunerations and the development of strong-party affiliations in political life, created the culture of paternalism and "favourism", which in turn led to the demands for larger public sector (Table 3). The average rate of expansion of employment in the public sector has been measured at 2.5% per annum between 1981 and 2010. As a result the number of employees in the wider public sector grew by 37.300 people reaching a total of 71.300 in 2010 or 18.9% of gainfully employed population, representing a sizeable increase in the share of the wider public sector in total gainful employment from 13.8% in 1981 (Table 3).

2.5 The role of salary scales

It is also very revealing to observe how the government wage bill grew over the years. One way was obviously the expansion in numbers. The second was the high wage increases awarded through negotiations. But the real reason was one other aspect that affects total wages and salaries in the public sector. This refers to the system of combined salary scales, which are used widely, and which led to the explosion of the public sector wage bill in recent years. The system of salary scales presents a number of

unacceptable elements which added to the overall cost of the public sector. In summarized form these are the following:

TABLE 3

Employment by the wider public sector 1981 -2010

	Central government	Organizations directly dependent on the government	Local authorities on	Semi government organizations	Total	%Total gainful employment
1981	26.645	n.a.	1.729	5.584	33.958	13.8
1990	31.126	n.a.	2.710	7.231	41.067	16.2
2000	40.972	1.639	3.649	9.742	56.002	18.1
2005	46.480	2.588	3.976	10.281	63.325	18.1
2010	51.818	4.430	4.677	10.307	71.232	18.9
Average yearly rate of expansion 1981- 2010					2.5%	

Source: Labour Statistics various years, Department of Statistics and department's website www.mof.gov.cy/mof/cystat/

2.5.1 The large number of scales and combinations of scales

The number of salary scales used in the public sector expanded considerably. It is important to remember that in late 1970's there was a well-received initiative for reforming the salary scale system. At that time, the whole structure was reformed and the total number of scales was reduced to 16 plus 5 fixed salaries, and a small number of personal scales. These personal scales were retained because of complications built into the previous system. However, over the following years, the actual number of scales increased from 16 to 39 plus 9 fixed salaries (website of the Treasury Department of the Ministry of Finance): gradually, through a piecemeal approach, salary scales were extended and renamed; for instance scale A5 I was added by giving one more increment at the top of scale A5, i.e. extending the number of years the holder would continue to receive automatic increments and also scale A5 II, extending a further increment at the top of scale A5 I. The reality is even more unsettling and complicated, because the Treasury Department of the Ministry of Finance recognizes a much larger number of scales on its payroll. The actual number of salary scales, combined salary scales and fixed salaries is 96, on the basis of information supplied to parliament by the Ministry of Finance. This is an unacceptably large number far beyond any measure of logic or efficient

and fair public administration. So the first unacceptable element of the wider public sector salary system is the enormous number of scales, clearly an element of inefficiency and paternalism.

2.5.2 Number of annual increments in each scale

The second illogical aspect of this system of salary scales is the number of increments, within each salary scale. The low scales, from A1 to A8 II, provide automatic annual increments for around 10 – 15 years. That is, one newly appointed civil servant on the salary scale of A5 will be receiving increments for 12 years, since the total number of steps of the salary scale is 13. Scales at the higher end of the system that is higher than A9 provide for a smaller number of increments between 5 and 11, because these are promotion posts. This is the second unreasonable element of the public sector salary scale system because it reduces incentives for efficiency and betterment.

2.5.3 The average annual rate of growth of the salary scales

The third unsustainable element is the average rate of annual increment of the salary scales. With the exception of the lower scales (A1 to A3) which provide for annual increases measuring only 1.9%, in all other cases the rate of annual increment incorporated, ranges from 3.4% to 4.4%. This is beyond any reasonable expectation, given that the overall average rate of improvement of productivity, over the last 15 years (1995-2010) has not exceeded 1.3% per year. These annual increases do not include the six monthly COLA adjustments or the general increases that every two or three years the trade unions negotiate with the government. This is clearly a disincentive to productivity improvement since any civil servant is assured of large average annual increments in salary for so many years. Therefore this is the third unreasonable and untenable element of the public sector salary scale system.

2.5.4 The combined scales

There is a fourth distorting element in the government structure of salary scales: this refers to a peculiar system of so-called “combined scales”. In the 1980’s this applied to limited special cases such as doctors and engineers, specializations that were in short supply. It also applied to technical staff and sub-professionals. Combined scales ensure that civil servants receive increments for more years than it is allowed under one scale. This is now the prevalent practice and almost all firstly appointed civil servants are placed on a combined system of 3 scales enjoying annual increments for more than 20 years, further reducing any incentive for

improvement and efficiency enhancement. It is this system of combined scales, which expands the total number of scales recognized by the Treasury as a lower level scale is combined with a higher one, and the holder receives automatic increments, without the need of promotion. To illustrate, Table 4 contains a specific example of triple combination, the case of A8, A10 και A11 +II. This is the widely used scale for appointing all university graduates in the civil service such as teachers for preprimary, primary, secondary education, economists, town planners, agronomists, etc and there were more than 11.600 persons holding such combined scales in 2009. These combined scales provide the employee with an annual increase of 4% for 20 years without promotion. A person appointed in 2009, on this post, would have had, his or her salary, grow from an annual level of €25.500 at first appointment to €55.800, 20 years later (Table 4) without any promotion and not including COLA adjustments or general negotiated increases. Therefore the proliferation of the use of the system of combined salary scales is the fourth unreasonable and unsustainable element of the public sector salary scale system. The end result is a system of salary scales that can be considered a “complicated maze” for the outsider but a convenient vehicle for the insiders to receive automatic salary increases over many years. It was build gradually with many arbitrary decisions, taken without regard to fairness or efficiency.

It should be emphasized that in addition to the combined salary scales for first appointment there are other combined scales to which a very small number of persons are appointed (Table 5). Indeed, Table 5 illustrates the salary scale maze, by showing one single scale (A8) and its “combinations”. This is an irrational approach and its extensive use is evidence of the arbitrary nature of the salary scale system in the public sector. What is certain is that it is not a system geared to serve fairness or efficiency. I believe that it represents the means by which individual favours are being handed to civil servants behind closed doors.

TABLE 4

An example of combined salary scales in the wider public sector 2009

Combination A8, A10 and A11 +2	Total annual emoluments of employee (€)		Number of increments in the scale	Average annual increment (%)
	First year salary	Final year salary		
A8	25.467	39.157	11	4.4%
A10	35.637	49.271	8	4.1%
A11 +2	42.125	55.759	8	3.9%
A8-A11+2	25.467	55.759	20	4.0%
Number of persons holding posts under the this specific 3 scale combination in 2009				11.616

Source: Government Budget 2009.

Note: This refers to the level of remuneration and the scales in 2009.

TABLE 5

Examples of the combinations of scale A8

Combinations of A8 scale with lower level ones	A8	Extensions of scale A8 With higher level scales
A2-A5-A7-A8+1(137)	A8 (895)	A8+1 (1175)
A5-A7-A8+1(1520)		A8+2 (45)
A5-A7-A8+2(942)		A8-A10 (25)
A7-A8+1 (30)		A8-A10-A11 (11616)
A7-A8+2 (3)		A8-A10-A12 (7)
		A8-A9 (5)
		A8-A9+1 (969)
		A8-A9-A10 (1)
		A8-A9-A10+1 (75)
		A8 + (1)

Source: Table of Ministry of Finance given to parliament.

Note: In parentheses are found the number of persons appointed in the relevant scales and their combinations as of 2009.

2.5.5 The ratio of first entry posts to higher promotion posts

Finally, there is a further unreasonable element in the government wage bill. This refers to the existence of high percentage of promotion posts vis a vis the first entry posts of the civil service. In most services and departments there is one promotion post for less than two first entry posts. In practice it means that almost all civil servants will eventually enjoy promotion. Therefore, this is the fifth unreasonable and untenable element of the public sector structure and salary scale system.

2.6 The government wage and pension bill

The combination of high wage growth, expansion of employment, large number of annual increments in salary scales, the system of combined scales, the extremely high incremental rates applied in each scale and the high ratio of promotion posts to first-entry posts, have created an explosive cocktail of factors, which pushed the government wage bill, including pensions, to soar. Unfortunately there are two sets of figures regarding the total public sector wage bill (Table 6) but what I believe is a more representative set of figures reveals the following:⁴

1. The first is that the true size of the public sector wage bill is very large. According to the data published by the Ministry of Finance total public expenditure accounts for 45.6% of GDP.
2. The size of the government increased substantially from around 30% of GDP in the early 1980's to more than 46% in 2010, mainly due to the explosion of the government wage bill, which from 33% of total government expenditures in 1980 in 2010 it accounts for 45.6%. Such high percentage of total public expenditures means that any attempt to reduce fiscal deficit must deal decisively with the wage bill. All different sources reveal this upward trend observed over the past three decades
3. The wage bill, which stands around 20% of GDP, places Cyprus in the first place amongst EU member states; Denmark is second at 16.7% and third is Sweden at about 15% of GDP (Figures 3 and 4).

⁴ There are strong reasons to believe that the true size of the wage bill is given by the numbers published by the Ministry of Finance, because they translate grants, to local authorities and organizations, fully dependent on government, to their components in terms of the type of expenditures they finance. That is, the data of the ministry, includes the wage bill of the organizations directly depended on the state for funding (i.e. the University of Cyprus, Open University, TEPAK, School Committees, THOK, KOA, CTO, National Orchestra etc.) and ever growing number of local authorities.

TABLE 6

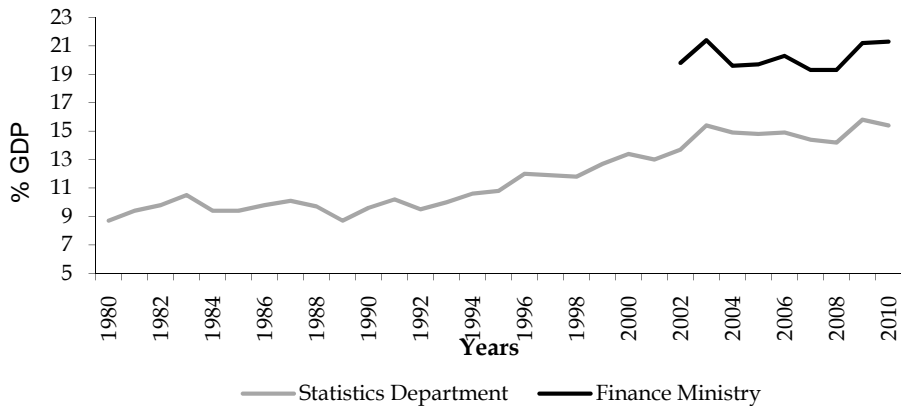
Total public expenditures and public sector salaries and pensions 2002 – 2010

Year	Total Public expend.	Salaries and Pensions		Salaries and pensions (%)			
		Statistics Department (α)	Finance Ministry (β)	Total public expend. (α)	GDP (α)	Total public expend. (b)	GDP (b)
2002	4357.3	1500.3	2178.6	34.4	13.7	50.0	19.8
2003	5182.4	1809.7	2520.3	34.9	15.4	48.6	21.4
2004	5311.3	1884.5	2474.1	35.5	14.9	46.6	19.6
2005	5779.1	1997.2	2658.4	34.6	14.8	46.0	19.7
2006	6144.6	2155.0	2933.4	35.1	14.9	47.7	20.3
2007	6548.4	2279.1	3058.6	34.8	14.4	46.7	19.3
2008	7206.8	2450.7	3336.6	34.0	14.2	46.3	19.3
2009	7754.0	2669.4	3588.3	34.4	15.8	46.3	21.2
2010	8139.1	2686.7	3715.1	33.0	15.4	45.6	21.3

Sources: (α) Fiscal Magnitudes, 11.April, 2011, Department of Statistics and department's website www.mof.gov.cy/mof/cystat/. (β) Page 5 Tables on Economic Indicators 2002-2013 April 2010, website Ministry of Finance www.mof.gov.cy/

FIGURE 3

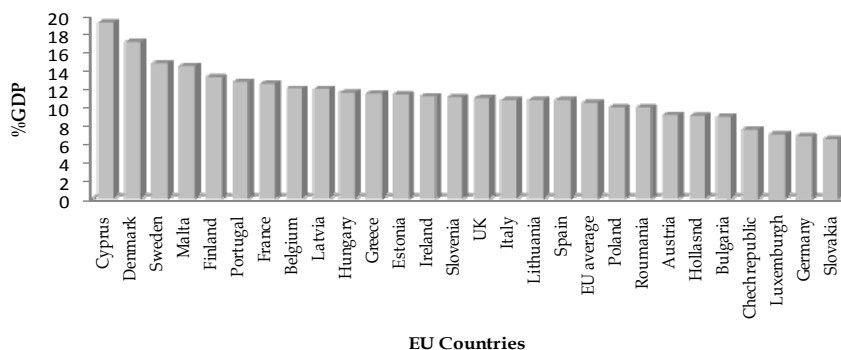
Public sector salaries as % of GDP 1980-2010



Sources: (α) Fiscal Magnitudes, 11.April 2011, Department of Statistics and department's website www.mof.gov.cy/mof/cystat/. (β) Page 5 Tables on Economic Indicators 2002-2013, April 2010, website Ministry of Finance www.mof.gov.cy/

FIGURE 4

Public sector salaries as % of GDP in EU countries (2008)



Source: Eurostat www.europa.eu/ for 26 member states and website of Ministry of Finance (www.mof.gov.cy/) for Cyprus.

3. Some concluding remarks and policy recommendations

The preceding analysis reveals that these structural problems of the public sector wage bill pose a huge threat to the viability of the Cyprus economy and its long term survival. They require decisive measures if we are to overcome and ensure that the economy returns to full employment and reasonable levels of fiscal deficits, public debt and current account deficits. To return to the path of growth and full employment only radical solutions should be applied. Some of these radical solutions for public sector wage bill should include the following measures:

- Gradual reduction in the number of civil servants in the wider public sector excluding semi government organizations: I believe that a target of 55.000 appears to be reasonable to ensure adequate numbers and good delivery of services.
- Reduction in the number of salary scales: I believe that the total number of scales should be reduced to a manageable number of 16 and 5 fixed salaries. In addition there should be a professional evaluation of the scales so as to ensure that the various professions are placed on the appropriate scale, within this simplified salary structure. The only salaries that could deviate from this rule are in the health sector specifically to doctors and dentists etc.
- Abolition of the combined scales: The system of combined scales leads to passivity. It does not allow for efficiency, internal competition and does not provide incentives for improvement after appointment.

- Radical reduction in the number of increments contained within each salary scale: The suggestion is that each scale provides for a maximum of 8 increments, which appears to be a reasonable number. Certainly it could not remain 12 and 15 because it is a system that blunts all incentives for improvement.
- Radical reduction of the rate of the annual increment. The present rate of almost 4% is unreasonably high and bears no relationship to economic reality and level of average annual productivity improvement. So the suggestion is for an annual increment of 1%.
- Reduction of the openings for promotion: The civil service structure should be re-examined and more reasonable ratios should be adopted on the basis of expert advice. The government should set up a Commission for public sector reform and commit to adopt its main recommendations.