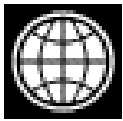


**Sustainability and Sources of Economic Growth in the
Northern Part of Cyprus
Volume I: Economic Assessment**

June 8, 2006

**Poverty Reduction and Economic Management Unit
Europe and Central Asia Region**



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CURRENCY AND EQUIVALENT UNITS

Exchange Rate Effective as of January 1, 2005

Currency Unit = New Turkish Lira

Currency Unit = Turkish Lira

US\$1 = NTL 1.36

1 NTL = 1,000,000 TL

(as of November 21, 2005)

FISCAL YEAR

January 1 – December 31

ACRONYMS AND ABBREVIATIONS

bl	billion
EC	European Commission
EU	European Union
FDI	Foreign Direct Investment
GDP	Gross Domestic Product
GNI	Gross National Income
IT	Information technology
MIC	Middle income countries
ml	million
MNC	Multinational corporation
NTL	New Turkish Lira
PPP	Purchasing Power Parity
TL	Turkish Lira
tr	trillion
OECD	Organisation of Economic Co-Operation and Development
SME	Small and medium enterprise
UNDP	United Nations Development Programme
USAID	United States Agency for International Development
WDI	World Development Indicators

ACRONYMS AND ABBREVIATIONS OF INSTITUTIONS IN THE NORTHERN PART OF CYPRUS

The use of the acronyms and abbreviations listed below refer to the agencies that take responsibility for these activities for the Turkish Cypriot community. Reference to these agencies, the terms “public sector” and “administration”, and other designations and terminology used in this report, do not imply official endorsement or acceptance by the United Nations of boundaries, territories, or the administration of the northern part of Cyprus as the government of an independent state.

CB	Central Bank
CSPF	Civil Servants Pension Fund
MOAF	Ministry of Agriculture and Forestry
MOEAC	Ministry of Education and Culture
MOF	Ministry of Finance
SIF	Social Insurance Fund
SPO	State Planning Office

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EXECUTIVE SUMMARY

Though Cyprus is a member of the European Union (EU), it entered as a divided country with unresolved political problems that continue to this day. Because the *acquis communautaire* does not extend to the portion of Cyprus not under the effective control of the Republic of Cyprus, the benefits of membership have yet to reach the Turkish Cypriot community living in the northern part of Cyprus. In the absence of a political accommodation, efforts by the European Commission to provide assistance have so far not yielded the hoped for results of opening up the economy of the northern part of Cyprus to Europe.

Despite its isolation over the past two decades, the Turkish Cypriot community has made remarkable **progress**. It has established functioning institutions and educated its population. Moreover, the living standards achieved by the population are high for a middle income economy. Social indicators are comparable to those of the Central and Eastern European new member states of the EU. And though its nominal income per capita is only about 44 percent of that of the Greek Cypriot community, its purchasing power parity-corrected income per capita is about 67 percent indicating that income convergence between the two parts of Cyprus is achievable by 2020 with sustained levels of moderate growth.

The two biggest **constraints** on the economic development prospects of the northern part of Cyprus stem from the lack of resolution of the political problem. The *first* problem is the absence of preferential access to EU markets for all exports from the northern part of Cyprus using the least expensive transportation service providers. The Green Line regulations allow only for the export of goods that either originated or were mostly processed in the northern part of Cyprus to the EU on preferential terms but trade must take place using southern trucks and through southern ports. Few Turkish Cypriot goods are exported through this avenue. The *second* constraint is the unresolved property issue. This increases uncertainty and shortens the time horizon of local businessmen and deters foreign direct investment. The consequences of these are subtle but pernicious—institutional structures have not evolved significantly over the past 20 years, technological change has been limited, and the population and private enterprises have become heavily dependent upon the public sector for financial support.

Even though the timetable for reunification is uncertain, the Cypriot community faces a **strategic choice**. The Turkish Cypriot community can prepare for that eventuality by aligning its institutions and policies to the EU even as the formal non-application of the *acquis* continues. Or, it can continue its past policies and wait for the negotiation process to resume before embarking on a reform program. Neither choice is easy as reform will imply significant short-term sacrifices and inaction will imply continued economic dependence on Turkey and an ever growing disparity between its structure and that of the southern part of Cyprus. This is also the same choice that faces the authorities of the Republic of Cyprus. They must decide whether to facilitate the modernization of the economy in the northern part of Cyprus in order to help it converge to the southern part of Cyprus or to delay their support for strengthening the economy in the northern part of Cyprus to cope with competitive pressures and to effectively apply the EU's rules and policies.

The major components of an economic **reform agenda** for the northern part of Cyprus are (1) decreasing the *fiscal* deficit and managing public debt, (2) expanding the *private sector* through replacing universal subsidies with targeted transportation subsidies, improving physical infrastructure, privatizing public enterprises, and removing the anti-export bias, and (3) reforming the *education* sector by improving the quality of secondary schooling and universities, developing vocational and technical education programs, and improving the efficiency of education expenditures. In order to tackle these problems, there are multiple steps that need to be taken—priorities within these areas need to be selected, sequenced, and paced to be politically and socially acceptable to the population. The biggest hurdle will be in convincing various stakeholders—some who are economically powerful—to sacrifice private gains for the Turkish Cypriot community's medium- and long-term welfare.

CHAPTER 1

OPPORTUNITIES AND CHALLENGES FOR CYPRUS—AN INTRODUCTION

1.1. Cyprus became part of the European Union (EU) in May 2004 as a divided island. Though the whole of Cyprus is considered to be part of the EU, the *acquis communautaire* is suspended in the northern part of the island. Consequently, many of the economic advantages of EU membership have not benefited the Turkish Cypriot community which has lived in isolation in the northern part of the island since 1974. Though the Turkish Cypriot community's administration remains unrecognized by the international community (with the exception of Turkey), its policies and actions have had far reaching consequences for the economic development of the northern part of Cyprus and the people who live there. The Turkish Cypriot administration and community have had close ties with Turkey for the last three decades, but barriers to trade and the movement of persons resulting from the economic isolation has impeded its economic development and integration into world markets.

1.2. The EU is taking steps to help facilitate the economic development of the Turkish Cypriot community, the economic integration of the island, and its ultimate reunification. In this context, a proposal by the European Commission has been adopted by the Council whereby the EU will provide substantial amounts of financial assistance.¹ The aim of these funds is to provide financial support for encouraging the economic development of the Turkish Cypriot community.² Concurrent to these efforts to provide financial assistance, the EU has adopted the "Green Line Regulations" which allows for the free movement of persons (Cypriots and EU citizens) and of selected goods across the island. An additional effort underway since July 7, 2004 is a proposal by the Commission for a Council Regulation on special conditions for trade with those areas of the Republic of Cyprus in which the Government of the Republic of Cyprus does not exercise effective control.

1.3. In order to prepare the stage for the programming of the EU financial assistance to the northern part of Cyprus, the European Commission entrusted the United Nations Development Programme (UNDP), through the program "Partnership for the Future", with the execution and implementation of the action entitled "Feasibility Studies for Economic Development Projects." The main purpose of the project is to provide technical studies and strategies for the economic development of the northern part of Cyprus. Thus far, four studies on the northern part of Cyprus have been made under the umbrella of the project, namely in the areas of rural development, the energy/electricity sector, solid waste management, and the water and wastewater sector.

1.4. This report is an additional study under the EU-funded "Feasibility Studies" initiative. It is meant to complement the work already carried out by the UNDP program. Also, due to budget considerations, the range of topics covered is limited to those priority areas for economic growth and leave aside some important areas such as infrastructure, health, and safety nets. Moreover,

¹ See GAERC Conclusions of 26th April 2004.

² See the Draft Council Regulation.

certain issues—such as land—were not covered in depth as the decision on how to address property rights will be addressed in a political settlement.

1.5. The report hopes to inform the dialogue on strategies for economic development of the northern part of Cyprus such that it facilitates the reunification of the island and promotes its integration into the EU. We attempt to identify the major economic obstacles—including the impact of the isolation—that presently hinders or will potentially skew its economic development in the medium- to long-term. We also suggest various options for reforming economic and sectoral policies though we make no attempt to be prescriptive. The vision for the economy of the northern part of Cyprus is one that has the ability to grow in a sustainable manner since this alone can guarantee improvements in living standards of the Turkish Cypriot community. Moreover, growth in the northern part of Cyprus is of critical importance to the future of the Greek Cypriot community since in a unified Cyprus stability and prosperity for all will go hand-in-hand.

A. ACHIEVEMENTS

1.6. The Turkish Cypriot community has made significant progress in the economic and social spheres despite living in isolation for almost three decades. Key institutions and systems have been developed, policies and regulations have been instituted to ensure economic order, the society has a large stock of human capital (i.e., educated and/or skilled labor), and a culture which respects the rule of law. An understanding and appreciation of the accomplishments of the Turkish Cypriot community are necessary because they ultimately provide the foundation upon which the full integration of Cyprus with the EU will rest. The reforms proposed in this report are based upon the understanding that the Turkish Cypriot community has the capacity to implement necessary changes to institutions and policies to be consistent with the *acquis communautaire*.

1.7. Prior to emphasizing some important aspects of development that have occurred in the Turkish Cypriot community, it is important to place where the community stands in relation to the Greek Cypriot community and the EU. As seen in Table 1.1, the northern part of Cyprus's income per capita is comparable to the new EU member states as a group. Its gross national income³ (GNI) per capita of \$8,094 appears similar to that of Estonia. But why does income matter? It is indicative to a certain degree that the economy has the resources and the level of development necessary for embarking on the process of integration into and achieving compatibility with the European family of nations. Moreover, the economy of the northern part of Cyprus where the public sector currently plays an important role will be able to learn from these new member states that were only recently classified as “transition economies” following the breakup of the Soviet Union.

1.8. Any economic reform agenda—especially one which requires changes to the allocation of public resources or modification of incentives and laws that guide the actions of Turkish Cypriots—will need to work with and strengthen the existing public institutions even if some degree of institutional consolidation could lie in the future of a reunified Cyprus. Over the past decades, a series of institutions have developed which are in charge of planning, policy setting, service delivery, resource allocation, investment, and monitoring of activities in various sectors. Several of these institutions are responsible for the allocation and/or distribution of large amounts of financial resources. Consequently, these institutions have acquired substantial experience on what works and what does not as well as on the interests and needs of various stakeholders. Even

³ This was formerly referred to as gross national product (GNP).

private institutions' (such as commercial banks) ability to function well is dependent on the oversight provided by public institutions.

Table 1.1: A Comparison of Income of New European Union Member Countries, 2004

	GNI per capita (in US\$ nominal)	GNI (in US\$ bl nominal)	Population (in ml persons)	GDP Growth /1 (in %, 2002-2004)
Cyprus	16,090	17	1.0	...
Northern part	8,094	2	0.2	10.3
Southern part	18,201	15	0.8	2.6
Other New EU Member States				
Czech Republic	9,943	102	10.2	3.0
Estonia	7,802	11	1.3	7.2
Hungary	9,361	95	10.1	4.0
Latvia	5,950	14	2.3	7.3
Lithuania	6,275	22	3.4	7.7
Malta	13,053	5	0.4	-0.2
Poland	6,226	238	38.2	3.5
Slovak Republic	7,559	41	5.4	4.9
Slovenia	16,029	32	2.0	3.5
Average EU-9 /2	9,133	62	8.2	4.5
<i>Memorandum item</i>				
Turkey	4,206	302	71.7	7.6

Source: World Development Indicators and SPO.

1. Average of three year growth rates. 2. Unweighted average of new EU member states excluding Cyprus.

1.9. One of the key factors behind the success of the institutions that have arisen in the northern part of Cyprus is the relatively high level of education of the people that lead and staff them. The Turkish Cypriot community has invested heavily in education over the years and the payoff can be seen in the quality of public institutions and an understanding of the complexity and inter-linkages of various issues. Though the staff of these organizations may not have all the essential skills or knowledge of international experience, they have the most important skill which is the ability to acquire knowledge and incorporate lessons into policies and other activities.

1.10. A third element that has been important to the ability of the Turkish Cypriot community to develop a functioning economy is the rule of law. In the northern part of Cyprus, generally laws are respected by the population and pervasive corruption among public sector employees does not appear to be present. Moreover, though the judicial system appears to be slow, it is not viewed as defunct or responding only to influence. But there are three main areas that need to be addressed and these include (i) the ownership of land, (ii) "state capture" by various interest groups including unions and producer associations—that is, that a few gain undue influence and hence benefits to the detriment of the welfare of the population, and (iii) lack of full disclosure of private activity by businesses (ranging from employment of unregistered workers to the activities of off-shore banks and casinos) and individuals (especially reporting of income from informal labor market activity).

1.11. A strong policy framework is important for economic development in addition to functioning institutions, human capital, and the rule of law. A set of policies are needed which support macroeconomic stability as well as those which promote the development of private sector activity. This is one area requires the attention of the administration of the Turkish Cypriot community. In some spheres, the economy of the northern part of Cyprus has been influenced

heavily by developments in Turkey due in part to their currency union. But in other areas, significant progress has been made (e.g., supervision of the banking sector). However, there are many decisions that have been influenced by the concern of the impact of isolation. And though the set of policies have allowed the economy to function, a large gap remains between what has been achieved and the potential of the Turkish Cypriot community.

B. ISOLATION

1.12. The current legal status of the northern part of Cyprus has resulted in far reaching problems for the Turkish Cypriot community. Property rights are insecure and the public (as well as many private) institutions of the Turkish Cypriot community are not recognized by the Government of the Republic of Cyprus. Three of the main problems that stem from this situation for the Turkish Cypriots are restrictions on the movement of people and goods into and out of the northern part of Cyprus, and limited avenues for knowledge transfer. Thus, despite the enviable location of the island of Cyprus, the Turkish Cypriot community is largely unable to take advantage of its proximity to the major markets of Europe and the Middle East.

1.13. The restriction of **movement of persons** results primarily from the prohibition of entry and exit of vessels and persons from airports and maritime ports in the northern part of Cyprus.⁴ Though Turkish Cypriots have traveled off the island, it has been through the use of airports and maritime ports in the northern part of Cyprus which link with Turkey. (With the exception of Turkish and Azerbaijan airlines, no other foreign carriers use the airports in the northern part of Cyprus.) The use of these ports in the northern part of Cyprus is considered illegal by the Government of the Republic of Cyprus. In terms of the “legal” movement of Turkish Cypriots, prior to 2003 it was confined to the northern part of Cyprus. However, beginning in April 2003 they were free to move across the island though international travel through the airports and maritime ports in the southern part of Cyprus could only be undertaken with the possession of a passport issued by the Republic of Cyprus.⁵ Once obtained, these passports allow Turkish Cypriots to travel freely within the European Union.

1.14. With regard to the free **movement of non-Cypriots**, foreign citizens (mostly of Turkish nationality) traveled to the northern part of Cyprus through the use of the ports in the north. After the Green Line regulations went into affect, persons holding EU passports were allowed to travel freely throughout the island and cross between the southern and northern parts through two checkpoints. As the Republic of Cyprus does not recognize the Green Line as an external border, this freedom of movement has been extended to all visitors who enter through the ports in the southern part of island. The current policy of the Government of the Republic of Cyprus is not clear on whether foreign citizens eligible for travel to the Republic of Cyprus but who enter

⁴ Beginning in April 2003, two of the four checkpoints at the Green Line were opened that allowed for the movement of Cypriots across the island.

⁵ The Government of the Republic of Cyprus’s definition of a Turkish Cypriot is a person whose lingua franca is Turkish and (i) was born on the island prior to 1974, (ii) is born of (both) parents in the first category, or (iii) is born of parents who met abroad (but not on the island of Cyprus) and one parent falls into one of the first two categories. Length of residency on the island or being born on the island does not qualify a person for Cypriot nationality. Consequently, Turkish Cypriots who are “citizens” according to the central administration in the northern part of Cyprus are not recognized as Turkish Cypriots by the Republic of Cyprus and are not eligible to be legally resident on the island or to travel freely across the island. Thus, the estimate of the Turkish Cypriot population by the Government of the Republic of Cyprus and the Turkish Cypriot community differs by a factor of two.

through the ports in the northern part of Cyprus can have legal action brought against them. The ability of visitors to travel freely on the island can potentially have important implications for tourism activity in the northern part of Cyprus.

1.15. The **movement of goods** into and out of the northern part of Cyprus also faces restrictions due to the prohibition of the use of the ports in the north. Consequently, prior to the adoption of the Green Line Regulations, legally the Turkish Cypriots were not allowed to engage in any trading activity either with foreign countries (or even with their fellow Greek Cypriots). Though the use of these ports—including for the purposes of trade—is deemed illegal by the Republic of Cyprus, maritime ports in particular have been instrumental in preventing a potential embargo on the Turkish Cypriots by allowing them to import and export merchandise necessary for consumption and investment purposes. The use of the maritime ports is not restricted only to Turkish ships since some other foreign ships do appear to use the ports in the northern part.⁶ However, shipping costs are higher compared to the southern ports in part due to the comparatively low volume of trade in the north. Most maritime traffic is between the northern part of Cyprus and Turkey and consequently many exports are transshipped through Turkey.

1.16. The unresolved status of the Turkish Cypriot community has led to their exclusion from membership in many international organizations such as the International Air Transport Association, the International Civil Aviation Organization, the Interpol, and the Universal Postal Union. The Republic of Cyprus has also discouraged the extension of private activity (e.g., SWIFT) to Turkish Cypriot banking institutions. This combined with the (recently lifted) legal ban on travel to and from the northern part of Cyprus has resulted in limited interaction between the Turkish Cypriot community and its institutions with foreign and international organizations. The end result for the Turkish Cypriots extends beyond their inability to benefit from important services to having far fewer opportunities to benefit from the experience of others through **knowledge transfers** in the areas of good practice (other than through Turkey).

C. REUNIFICATION

1.17. The reunification of Cyprus remains a hope that many still have. Others might worry that it will mean sacrifices with few benefits for themselves or their children. But the reunification of the island of Cyprus has the potential of achieving many of the same benefits that resulted from the enlargement of the European Union. Reunification—like accession—is not a zero sum game where some gain at the expense of others. Rather if done fairly, it can increase the welfare of all Cypriots. The presence of the *acquis communautaire* offers not only a package of non-negotiable rules to help both sides converge to European norms—and consequently to each other—but also an instrument to help set into motion the steps necessary for integration.

1.18. What will reunification mean in practice? And where will the benefits flow from? There are many areas of potential gain, but among the more important ones are:

- Productivity growth. The removal of restrictions on the movements of persons, goods, services, and capital across the Green Line will translate into output expansion driven by investment, lower unemployment, and real incomes growth. It will also give opportunities for

⁶ Ships that have stopped at any of the ports in the northern part of Cyprus are then not allowed to enter in the waters under the control of the Republic of Cyprus without facing heavy fines for breaking national laws.

the Cypriot economy to diversify and to take advantage of economies of scale and specialization with the larger labor force.

- Environmental protection. Cyprus is an island dependent upon tourism yet where water supply is inadequate and irregular. It must address issues on how best to sustain its few water resources as well as to dispose of solid waste so not to degrade the very environment that attracts tourists and makes the island habitable. This can only be done in a comprehensive manner taking into account the competing demands from various sectors including agriculture.
- Business environment. The Cyprus problem remains unresolved setting it apart from the other countries in the EU. The *acquis communautaire* is suspended across over one-third of the territory and one-fifth of its residents. In the eyes of foreign investors, reunification will represent a situation where the rule of law applies to all and political harmony pervades thus, increasing the attractiveness of Cyprus as a destination for new investment with upgraded technologies.

1.19. Though there may be many paths to reunification, lessons from the EU accession process and the experience of enlargement offers valuable guidance on economic integration. The EU emphasizes two economic criteria that candidate countries must meet in order to ensure their own welfare but also that of the incumbent Member States. These are: (i) “a functioning market economy and the capacity to cope with competitive pressures” and (ii) “the ability to take on the obligations of membership (in other words, to apply effectively the EU’s rules and policies)”.⁷ Moreover, in reference to the economic analyses that show that benefits of enlargement exceed the costs, the EU states that “future members, already exposed to the challenge of globalisation, will help the Union to surmount [the costs].”⁸

1.20. Are these criteria relevant to the reunification process of Cyprus and if so, how? It should be self-evident that unification of the two parts of Cyprus that are economically stable and growing is better for all than a unification process where one side enters with economic distortions that undermines its ability to withstand competitive pressures. Thus, these two criteria for developing a strong market economy and strengthening institutions which facilitate the rapid adoption of EU rules and policies will serve to lay a solid foundation for reunification and prosperity. Furthermore, the EU view that prospective members’ exposure to globalization serves to help mitigate potential costs of enlargement is noteworthy as it underlines the importance of trade and openness in the accession process—something that is particularly important for the northern part of Cyprus which faces many trade restrictions.

D. CROSS-CUTTING THEMES

1.21. The assessment of the economy of the northern part of Cyprus undertaken for this report is broad based and cuts across many sectors and issues. However, a few major themes run through this report and they are worth highlighting from the beginning.

- *First*, the economy of the Turkish Cypriot community is relatively affluent and has substantial own resources for economic development. The “national accounts” underestimate economic activity of the private sector and consequently gross national income (GNI) per

⁷ As stated on the European Commission website at europa.eu.int/comm/enlargement/arguments/index.htm.

⁸ See above footnote.

capita may be higher than what is reported. However, even more important than income, the Turkish Cypriot community has substantial financial, human capital, and institutional assets that are presently under-utilized and would benefit from re-orientation.

- *Second*, though the restrictions on movement of goods and people imposed on the Turkish Cypriots inhibit economic development, in order to improve the welfare of the community, economic policies should facilitate private sector expansion and a retrenchment of the public sector.
- *Third*, the Turkish Cypriot community should consider unilaterally adopting key features of the *acquis communautaire* since the reunification of the island and integration into the EU lie in its future. This strategy will help to modernize institutions, update regulations, and improve the environment for private sector activities.

1.22. Though the next decade offers significant opportunities to the Turkish Cypriot community, it also demands significant changes. Moreover, realization of this future potential will not be a smooth process. Three factors that will make the process more difficult are as follows:

- *First*, the lack of a shared vision for economic development combined with a soft budget constraint (due to generous financing from Turkey) has led to large transfers to various economic actors, expansion of public sector employment, and high wages and benefits for public sector employees. This has diverted attention away from quality of services or accountability in the distribution and use of funds.
- *Second*, uncertain property rights increase the risk of investment for businesses as well as individuals. Due to the movement of a significant share of the Cypriot population in 1974, land and assets owned by Greek Cypriots and Turkish Cypriots in the northern and southern parts of the island respectively were unwillingly abandoned. However, in the interim three decades, a significant share of private land and assets were expropriated (and not infrequently “sold” to others). Consequently, the property issue creates uncertainties in terms of economic development and the terms of compensation in any settlement.
- *Third*, uncertainty about whether the past difficult relations between the Greek Cypriots and Turkish Cypriots will allow for the proper implementation of the Green Line Regulations, free and fair competition on the island, and business relations to develop between firms in the northern and southern parts of Cyprus. *Ad hoc* public sector interference on north-south economic integration efforts increases transactions costs of doing business and consequently, will negatively impact cross-island economic activity and consumers.

1.23. These factors pose significant hurdles to the development process though they may not necessarily be intractable. Shared visions can be developed and sacrifices can be made with a greater understanding of the problems and potential long-term rewards. Property right risks could be minimized with use of public guarantees and leasing arrangements rather than outright sales. And it is possible that any lack of trust that inhibits integration may be overcome by market forces.

1.24. However, political environments have a strong impact on economic development as they are an important factor in determining the investment climate. Research by the World Bank has shown systematically that without a favorable investment climate, businesses will go elsewhere to the detriment of a country’s population. In the case of Cyprus, an unsupportive political environment could have two main consequences. First, it could undermine integration of the

island and create further incentives for the Turkish Cypriot private sector to increase their reliance on Turkey and other countries. Second, it could eventually have spill-over effects and undermine prosperity on the island as it becomes apparent to foreign investors that Cyprus has unresolved governance issues.

E. OUTLINE OF THE REPORT

1.25. Given the opportunities available to and the challenges facing the northern part of Cyprus, the remainder of this report focuses on how to achieve sustainable growth. Since economic prosperity has seldom, if ever, been achieved in public sector led economies, we concentrate on what changes in policies are needed to develop the private sector to generate jobs and improve living standards of population. Furthermore, in a unified Cyprus, it is an open question whether Turkey and other providers of assistance will continue to offer such generous levels of external grant financing to a country whose income per capita will soon exceed its own by almost a factor of four. Consequently, the report also analyzes public finances with the aim of understanding what are the main causes driving the fiscal deficit and what can be done to reign in public expenditures and to increase revenues. In this context, we address the policy areas of public finance, pensions, private sector development, trade, financial sector, and labor markets. We also look at policies in one important area of the economy – agriculture – and in the critical policy area of education.

1.26. Rather than being comprehensive, this economic report presents an analysis of those issues that are considered essential to understanding the Turkish Cypriots' growth prospects. The report is structured as follows. The first volume has an additional three chapters that (i) includes benchmarking the northern part of Cyprus against other EU economies along selected key economic and social indicators; (ii) identifies key obstacles to achieving macroeconomic sustainability and private sector expansion; and (iii) discusses options for reform. The second volume presents detailed descriptions, assessments, and possible reform agendas for individual topics and sectors. The scope of this volume takes into account other agencies' contributions to the analysis of the economy of the northern part of Cyprus. These stand alone chapters target audiences that work specifically on these issues and would benefit from a more detailed discussion of the topic. One of this report's main contributions hopes to be in bringing together an integrated picture of the economy of the northern part of Cyprus and identifying those policy reforms that need to be made concomitantly in order to yield a significant payoff in the medium-term.

CHAPTER 2

BENCHMARKING CYPRUS

2.1 The isolation of the northern part of Cyprus has led to comparatively little knowledge or analysis of its economy. This chapter provides an overview of some key indicators of economic development relative to the southern part of Cyprus (when available) or with other economies. However, benchmarking Cyprus is not straightforward since it has some characteristics which are unique to small island economies. Thus, when looking at economic characteristics such as trade or industrial development, it is worthwhile bearing in mind that Cyprus has had to follow a different development path than any of the other new member states of the European Union (EU) with the possible exception of Malta.

2.2 The Turkish Cypriot community has developed its own set of policies and institutions to regulate the economic and social affairs of the population. To what extent they have been successful in terms of producing outcomes which are sustainable and increase the long-term welfare of the community needs to be better understood and will be discussed in the subsequent chapters of this report. However, as a first step, comparing some relevant indicators will provide a sense on how similar or dissimilar the northern part of Cyprus is to other places. And in those cases where it is an outlier—lying well beyond the average, this may very well be an indicator that steps need to be taken to bring it into line with other economies.

2.3 The remainder of this chapter is organized as follows. Any benchmarking exercise must begin with a comparison of income per capita. This discussion is followed by an overview of the structure of the economy (both sectoral and expenditure composition) and a description of the openness of the economy. The next section discusses macroeconomic conditions and looks at the key macroeconomic indicators, public finance, aid dependency, and selected financial indicators. We close with a short discussion of health and education indicators. Where possible, the northern and southern parts of Cyprus are compared with comparator countries and the other new EU member states.

2.4 Some key findings of the benchmarking exercise are as follows:

- Though in 2004 the nominal income per capita of the Turkish Cypriot community is 44 percent of the Greek Cypriot community's, this increases to 67 percent when taking into account purchasing power parity.
- The economies of the northern and southern parts of Cyprus have more in common with each other than they do with either the other new EU member states or small island economies.
- The northern part of Cyprus's macroeconomic performance diverges the most from any other European economy. In particular, the composition of public finances is very different.
- The Turkish Cypriot community has significant resources available for investment which are presently underutilized.

Table 2.1: Gross National Income Per Capita Estimates Using Different Methodologies, 2004

	Gross National Income per capita		
	Nominal	Atlas /1	PPP-corrected /2
	(in current \$)		
Cyprus /3	16,090	14,569	20,695
Northern part	8,094	7,217	14,864
Southern part	18,201	16,510	22,234
Cyprus /3	16,323	14,777	21,124
Northern part - Revised Base /4	9,212	8,214	16,918
Southern part	18,201	16,510	22,234
	(in percent)		
GNI of Northern to Southern part (in percent)			
Northern part (Original) / Southern part	44	44	67
Northern part (Revised Base) / Southern part	51	50	76
<i>Memorandum item (in current \$)</i>			
Turkey	4,206	3,750	7,724

Source: World Bank estimates based on data from WDI and SPO.

1. Atlas conversion factor for Turkey is applied to the northern part of Cyprus. 2. 1996 PPP conversion factor for Turkey is applied to the northern part of Cyprus. 3. Weighted by population. 4. Revised base for GNI is from input-output table, 1998 (SPO).

A. INCOME PER CAPITA

2.5 The average income per capita of the Turkish Cypriot community in 2004 is estimated at US\$ 8,094. Though widely cited, this figure is not necessarily the most appropriate for comparisons to other economies or even to the southern part of Cyprus. Income per capita in U.S. dollars can be indicative at best since it does not control for the variation which results from large movements in exchange rates and inflation differentials over the short- and medium- term nor does it capture the differences in purchasing power of a dollar across countries. In order to compare income per capita across economies, the World Bank has devised two different methodologies—“Atlas” and “Purchasing Power Parity” (PPP). The application of these methodologies can have a substantial impact on income per capita estimates in some cases.

2.6 The World Bank Atlas method for computing gross national income¹ (GNI) was adopted for the purpose of allowing for cross-country comparison of national incomes. This methodology was established to reduce the impact of nominal exchange rate fluctuations.² An alternative methodology, PPP, measures the relative purchasing power of different countries’ currencies over the same types of goods and services. Since goods and services may cost more in one place than in another, PPP allows for more accurate comparisons of standards of living across economies (see Box 2.1). However, the World Bank does not collect PPP information for the northern part of Cyprus; consequently, we use as a proxy the PPP conversion factor for Turkey.

¹ This was formerly referred to as gross national product (GNP).

² The Atlas method of conversion is used by the World Bank in order to smooth fluctuations in prices and exchange rates. A conversion factor is applied that averages the exchange rate for a given year and the two preceding years, adjusted for differences in rates of inflation between the economy and the Euro Zone, Japan, the U.K. and the U.S.

Box 2.1: The Value of Purchasing Power Parity

What is the best way of comparing output, income, or consumption across economies? Though many people use exchange rates, most realize that \$100 spent in the United States does not buy as much as \$100 spent in China, Egypt, or Poland. And a person living on \$10,000 in the U.S. may have difficulty buying food and paying for housing while that same income would buy an affluent life style in many countries of the world. The reason why \$100 dollars are “worth” more in some countries than in others is a reflection of the lower cost structure and lower prices of goods and services in the non-tradable sector in most developing countries. Exchange rates fail to capture this difference.

As a result, the World Bank uses the “Purchasing Power Parity” (PPP) methodology to compare incomes and output across economies. This methodology allows us to compare the volume of goods and services between countries at a given point in time. PPPs can be considered “virtual exchange rates” as they allow the quantity of food and services produced and consumed in different economies to be compared using a common set of relative prices.

The PPP conversion factor shows the number of units of an economy’s currency required to buy the same amount of goods and services in the domestic market as one dollar would buy in the United States. By applying this conversion factor, we convert an economy’s nominal GNI per capita (expressed in U.S. dollars in accordance with the market exchange rate of the local currency) into its PPP-corrected GNI per capita (an indicator adjusted for the difference in prices for the same goods and services between this country and the United States, and independent of the fluctuations of the national currency exchange rate).

PPPs are a valuable tool for assessing welfare, but they have two major drawbacks which are that they are irregularly collected and their accuracy over time is undermined if relative price structures or people’s consumption habits within a country change significantly. The last comprehensive collection was in 1996 and another collection is underway and will be completed by late 2006. Thus, the PPP-corrected income per capita computations for high-inflation economies (such as Turkey) should be revisited upon availability of the new data as their accuracy may have diminished over time.

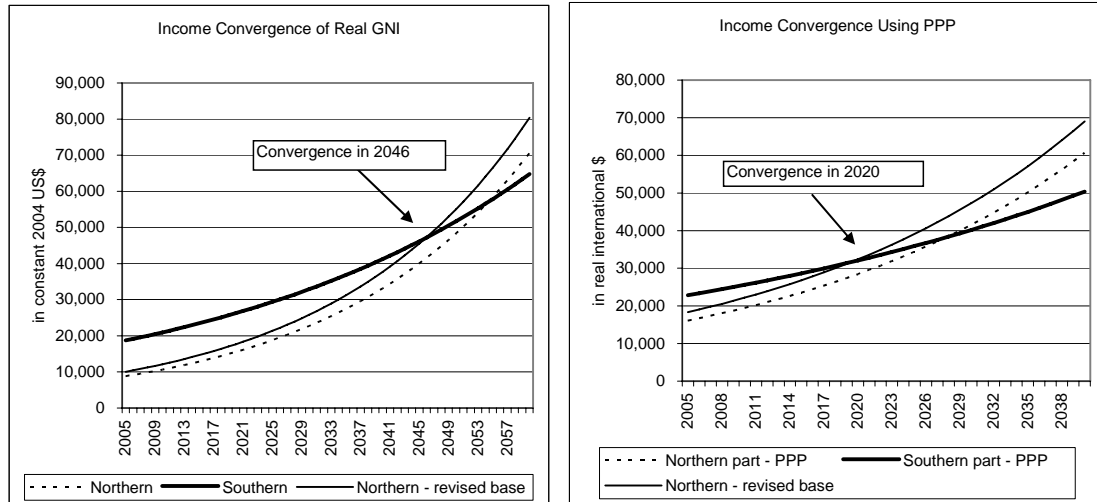
2.7 The results of the application of these different methodologies are presented in Table 2.1. We see that when we apply the Atlas methodology, GNI per capita declines for both northern and southern parts of Cyprus leaving the ratio between their incomes per capita comparable at 44 percent. However, the PPP-corrected income per capita increases significantly for the northern part of Cyprus (US\$ 14,864) compared to the southern part (US\$ 22,234) indicating the relatively stronger buying power of the local currency, i.e., the Turkish lira. With the latter methodology, the ratio of income per capita of the northern part to the southern part increases to 66 percent. (However, as a small island economy, prices in the northern part of Cyprus may be higher than in Turkey on average; consequently, the PPP-corrected GNI per capita for the Turkish Cypriot community represents an *upper bound* for comparing income across the northern and southern parts of Cyprus.)

2.8 An additional issue that has important implications for income per capita is whether the “national accounts” data for the northern part of Cyprus adequately capture economic activity. The methodology for computing national accounts by the “State Planning Organization” (SPO) was developed in 1977 and since then has not been overhauled. However, in 1998, the statistics unit did undertake a series of extensive surveys including of private businesses. It developed an input-output matrix to revise the “national accounts” methodology while continuing to use the old method as well. There were two interesting results. First, in comparing the gross national income computations from both of these methodologies, GDP was 14 percent higher using the new methodology.³ Second, it showed that the value added ratios had changed significantly indicating

³ The revision of the methodology does not ensure that the “informal” sector was adequately captured. The surveys extended coverage of the private sector but the problems of inadequate coverage of firms that remain under the radar screen (especially micro enterprises) as well as under-reporting of output may still

in several cases higher efficiency rates as would be expected with the adoption of more modern techniques of production.

Figure 2.1: Income Convergence Using Real and PPP-corrected GNI per capita



Source: World Bank staff estimates using 2005 figures as the base year.

2.9 This under-reporting of the GNI has important implications regarding convergence of incomes between the northern and southern parts of Cyprus. If we apply the growth rate to the revised base of 1998 and use the same growth rates for the period 1999 - 2004, this translates into a GNI per capita (Atlas) of US\$ 8,214 in 2004. It also increases the PPP-corrected GNI per capita to US\$ 16,918 which raises the ratio of north to south to 76 percent indicating that in terms of income per capita, the gap is smaller than indicated by the use of unadjusted data. Interestingly, the adoption of a higher base for northern part of Cyprus does not significantly affect its comparator economies in the EU. Its income per capita (whether using Atlas or PPP adjustments) ranks it closer to the more prosperous new central and east European members of EU such as Hungary and the Czech Republic.

2.10 Any discussion of future convergence of income between the northern and the southern parts of Cyprus has to first determine the most suitable indicator of income per capita. The discussion above has shown that depending upon the methodology adopted for adjusting for the variation in exchange rates, inflation, and purchasing power, the income gap between the northern and southern parts of Cyprus changes significantly. It also flags the issue that comparing nominal income per capita figures may not be the most relevant for a discussion of income convergence. Furthermore, any forward looking exercise on income convergence will also be affected by the benchmark as well as by the assumptions on growth rates. For example, assuming 5 and 3 percent average economic growth rates in the northern and southern parts of Cyprus respectively and the no change in current population growth rates, using the PPP-adjusted GNI per capita indicators convergence will occur in 2020 whereas based upon nominal GNI per capita it will not be until 2046 earliest (as seen in Figure 2.1 above).

have remained. Full coverage of the informal economy would increase the GNI per capita. Estimates of the informal economy range between 20-35 percent of the economy (see Volume 2, Chapter 5).

Table 2.2: Island Economies – Sectoral Composition of GDP, 2004 /1

	GNI per capita (in US\$, Atlas method)	Agriculture (in % of GDP)	Industry (in % of GDP)	Services (in % of GDP)
Cyprus	14,569	4	19	76
Northern part	7,217	10	15	74
Southern part	16,510	4	20	76
Average for Island				
Upper-MIC /1, 2	6,662	5	27	68
Memorandum				
Turkey	3,750	12	27	61

Source: World Development Indicators and SPO.

1. GNI per capita for upper middle-income-countries (MIC) is between \$3,256 - \$10,066. 2. Unweighted average of eleven upper-middle income (island) countries for which data are available.

B. STRUCTURE OF THE ECONOMY

2.11 Small states have their own special development challenges due to their small domestic labor forces and internal markets.⁴ They share many similar characteristics though their income levels may vary dramatically. Their economies are usually open, suffer from limited diversification, and have comparatively lower public and private sector capacities. Firms are generally small and cannot easily realize economies of scale. Furthermore, their public sector as a share of the economy tends to be higher compared to larger developing countries since, despite the small population sizes, certain basic services still need to be provided. Examples of public services where unit costs fall dramatically by achieving economies of scale are potable water, electricity, and schooling. Many small states are remote and isolated since three out of four are islands and these ones in particular face high transaction costs for foreign trade operations.

2.12 Though the northern part of Cyprus faces unique adverse circumstances due to the economic isolation, at the same time its geography and small size have also impacted its development path and will continue to do so irrespective of the political environment. Thus, in terms of a growth strategy, it is worthwhile understanding these constraints since some activities may never be viable on the island and some costs will always be higher than those faced by other non-island or larger countries. For example, access to fresh water, proper disposal of solid waste, and limitations of space particularly affect island populations. Because of the more limited avenues for development and higher cost structure, it is all the more important that investment is channeled into profitable and self-sustainable activities—and that the administration not support unprofitable private activities. Not only would this be a poor use of public money but also—and perhaps more importantly—it diverts precious labor and capital resources away from more productive and sustainable activities.

⁴ See *Small States: Meeting Challenges in the Global Economy*, (Commonwealth Secretariat and World Bank, 2000). The report defines a “small state” as a country with a population of 1.5 million or less persons.

Table 2.3: Components of Gross Domestic Product, 2004

	<i>(in percent of GDP)</i>			
	Consumption			Investment
	Total	Private	Public	
Cyprus				
Northern part /1	94	70	24	21
Southern part	82	64	18	18
Average for EU-15	78	58	21	20
Average for EU-9	79	59	20	26
<i>Memorandum items</i>				
Cyprus (northern part) computed by SPO	83	58	24	21
Turkey	78	65	13	23

Sources: World Development Indicators, Eurostat, and SPO.

1. World Bank staff estimates based upon SNA methodology which classifies net transfers differently than the SPO.

2.13 This section will compare three important economic aspects of the northern part of Cyprus to other economies. We will look at the sectoral distribution of value-added, the openness of the economy, and the expenditure components of GDP. This comparison will be between Cyprus and other small states and/or other EU members with a disaggregation between the northern and southern parts of the island.

2.14 The sectoral distribution of the northern part of Cyprus is comparable in some important aspects to the southern part—more so than to other island economies. The economic structure as measured by the sectoral contributions to GDP for the northern part of Cyprus shows an economy that is dominated by services—which contributes three-quarters of the economy with much smaller contributions from the industrial sector (15 percent) and agriculture (10 percent). In comparison to other island economies, the dominance of the services sector and the importance of agriculture are similar though in the upper range while the industrial sector's value-added is in the lower range. In terms of the services sector, the economic structure of the northern and southern parts are comparable but agriculture plays a much smaller role in the southern part and the industrial sector plays a larger role. However, the high share of agriculture in the economy in the northern part of Cyprus may be driven by policies that subsidize and encourage agriculture production beyond what is consistent with its climate and water resource availability.

2.15 Though at the aggregate level, the importance of various sectors appears relatively comparable between the northern and southern parts of Cyprus, subsectors of their economies differ significantly. Tourism and the related sectors of restaurants and transportation play an important role in both economies though more so in the southern part than in the northern part of Cyprus. However, in the northern part of Cyprus, education and the civil service contribute significantly to GDP while in the southern part of Cyprus, financial services are important and manufacturing is likely to be a growth area. Though structural improvements will need to take place, the economy of the island when taken as a whole is relatively diversified indicating that upon reunification, it may be better placed to withstand economic shocks than the two parts of the island can individually do so at present. Furthermore, there may be substantial gains achieved in the delivery of public services due to economies of scale.

Table 2.4: Island Economies: Economic Openness /1*(in percent of GDP, unless noted otherwise)*

Countries	GNI per capita /2 (in US\$ nominal)	Trade Openness /3		Exports		Imports	
		Goods	All /4	Goods	Services	Goods	Services
High Income Countries							
Cyprus	14,569	43	98	7	40	35	16
Northern part	7,217	54	98	4	37	50	7
Southern part	16,510	41	98	8	40	34	17
Malta	12,050	116	159	50	26	66	18
Iceland	37,920	47	74	23	13	25	14
Upper Middle Income Countries							
Antigua and Barbuda	9,482	52	130	6	54	46	24
Barbados	9,270	51	115	10	44	41	20
Trinidad and Tobago	8,730	86	97	44	7	42	4
Seychelles	8,190	88	160	34	44	54	29
St. Kitts and Nevis	6,980	68	116	18	25	50	22
Mauritius	4,640	79	121	37	24	42	17
St. Lucia	4,180	52	110	11	39	42	19
Average /5	7,353	68	121	23	34	45	19
Memorandum items							
EU-7 Average /6	8,527	60	126	45	15	56	10
Turkey	3,750	52	64	22	8	30	4

Source: World Development Indicators and SPO.

1. Latest available data 2002 - 2004. 2. Data for 2004 with the exception of Barbados and St. Kitts and Nevis which are from 2003. 3. The sum of exports and imports. 4. Total refers to both goods and services. 5. Unweighted average of upper middle income (island) countries. 6. Unweighted average for the ten new EU members excluding Cyprus, the Czech Republic, and the Slovak Republic.

2.16 Another way to analyze the structure of the economy is to look at the expenditure side. The feature of the “national accounts” which stands out in the northern part of Cyprus is the high share of total consumption compared to the rest of Europe and even to the southern part of Cyprus. This is due to above average public and private consumption. Public expenditures are higher by 4 percentage points of GDP than the new EU-member states while private consumption is 11 percentage points higher—both reflecting the impact of large external transfers on the economy. Investment at 21 percent of GDP is lower than the EU-9 average of 26 percent of GDP. Given the large infrastructure needs of the northern part of Cyprus—which are at a comparable level of development to many of the EU-9 countries—the lower investment ratio is probably indicative of inadequate resources being devoted to this area.

2.17 Despite its isolation, the northern part of Cyprus has high trade levels relative to the size of its economy with trade in goods estimated at about 54 percent of GDP in 2004—though driven almost exclusively by imports. The majority of the relatively small volume of goods exports (74 percent) is unprocessed agricultural products. However, another—and arguably better—indicator of openness is the trade in both goods and services. The relevant indicator for this is 98 percent of GDP which is the same as that of the southern part of Cyprus.⁵ Key service exports of the northern part of Cyprus are tourism, higher education, and entertainment (casinos). However, given the small size of its domestic market and labor force, the openness exhibited by the northern part of Cyprus may still be suboptimal. Other small island upper middle income

⁵ The trade in services was estimated based upon available sectoral information. SPO reports only net invisibles and does not disaggregate the trade in services.

economies have an average openness index of 120 percent of GDP. Presently, due to the political situation the northern part of Cyprus has a high geographical concentration in trade with Turkey.⁶

2.18 Though the Turkish Cypriot economy appears to be an open economy in terms of imports, it lags significantly in terms of foreign direct investment (FDI). Though data on the total investment by Turkish businesses are not available, no other country undertakes FDI in the northern part of Cyprus due in part to the lack of assurance from the Government of the Republic of Cyprus that no legal action will be taken against them. Consequently, though the average net FDI inflows to the EU-9 is estimated to be between 3 – 4 percent of GDP in 2004 and for the southern part of Cyprus it was 8 percent of GDP, non-Turkish FDI in the northern part of Cyprus was nil.

C. MACROECONOMIC CONDITIONS

2.19 Historically, macroeconomic conditions in the northern part of Cyprus have been volatile and driven by both external and internal factors. Economic developments in Turkey and the isolation have been especially important. On the domestic front, the choices of Turkish Cypriot policy makers as well as domestic institutional features such as the strong public sector trade unions have shaped the structure of the economy as well as its overall competitiveness. How any particular element has impacted economic growth is difficult to isolate and is not the purpose of this report though such an analysis could indeed inform future reform options.

2.20 Moreover the situation is unusual because the northern part of Cyprus uses the Turkish lira for most financial transactions. Thus, interest rates and inflation are driven by economic developments in Turkey and the northern part of Cyprus has no independent monetary policy. Furthermore, the lack of one's own currency also means no fiscal income from seignorage. Consequently, fiscal policy is the only means at the command of the administration to smooth out short-term business cycle fluctuations. In addition, fiscal policy is critical for influencing economic development in conjunction with sector policies, a good business environment, and human capital development.

2.21 This section focuses on whether the aggregate economic outcomes are within the norms observed among other new European Union members. We take two separate approaches to making a comparison of macroeconomic conditions. First, we look at the historical growth trends in the northern part of Cyprus. Then, we assess five main indicators which are GDP growth, inflation, unemployment, the fiscal balance, and the current account balance against benchmark economies. Second, we look at the main components of public expenditures and revenues, followed by a discussion of the importance of foreign aid for the Turkish Cypriot economy.

⁶ In 2004, 47 percent of total exports from the northern part of Cyprus were destined for Turkey and 60 percent of all imports came from Turkey. See Volume II, Chapter 6.

Table 2.5: A Comparison of Macroeconomic Indicators of New EU Member States, 2004

	<i>(in % per annum)</i>		<i>(balance as % of GDP)</i>		<i>(in % of labor force)</i>
	GDP growth	Inflation	Fiscal /1	Current account	Unemployment
Cyprus /2	4.8	3.0	-5.2	-5.4	4.0
Northern part /3	14.6	9.1	-8.8	-0.6	9.4
Southern part	3.7	2.3	-4.8	-5.9	3.4
<i>New EU Member States</i>					
Czech Republic	4.4	2.8	-4.0	-5.2	8.3
Estonia	7.8	3.0	1.7	-12.7	9.7
Hungary	4.0	6.8	-5.4	-8.9	6.1
Latvia	8.5	6.2	-1.1	-12.3	10.4
Lithuania	6.7	1.2	-1.7	-7.7	11.3
Malta	0.4	2.8	-5.2	-10.3	7.3
Poland	5.4	3.5	-6.1	-1.5	19.1
Slovak Republic	5.5	7.5	-4.0	-3.5	18.1
Slovenia	4.6	3.6	-1.4	-0.9	6.4
Average for EU-9	5.3	4.2	-3.0	-7.0	10.7
<i>Memorandum items</i>					
Turkey	8.9	8.6	-6.1	-5.1	10.3

Sources: IMF Article IV staff reports, World Development Indicators, and SPO.

1. The computation for the fiscal balance is total revenues plus grants minus total expenditures. 2. The fiscal deficit for the whole of Cyprus excluding foreign grants to the northern part of Cyprus is 6.1 percent of GDP. 3. The fiscal deficit for the northern part of Cyprus without foreign grants is 17.4 percent of GDP.

Benchmarking Macroeconomic Indicators

2.23 At the aggregate level, the macroeconomic situation in the northern part of Cyprus differs markedly in some respects from both the southern part of Cyprus as well as that of the average of the new EU members as seen in Table 2.5. The three main areas in which the northern part of Cyprus is atypical compared to the EU-9 are (i) the GDP growth rate, (ii) the fiscal balance, and (iii) the inflation rate. The economy of the northern part of Cyprus grew by 14.6 percent in 2004 which was almost three times the EU-9 average and 11 percentage points higher than that of the southern part of Cyprus. On the negative side, the fiscal balance of the north is -8.8 percent of GDP (or -17.4 percent of GDP without the inclusion of foreign grants) which is much higher than the average of the -3.0 percent of the EU-9 though within range of those countries that are at the upper end of the distribution (e.g., Poland and Hungary). The fiscal deficit for the southern part of Cyprus for 2004 was -4.8 percent of GDP which is also above average for the EU-9 and beyond the 3 percent of GDP ratio required for joining the European Monetary Union. Moreover, the inflation rate in the northern part is also high especially compared to the southern part. This higher inflation rate is a reflection of the rapid rise in prices in Turkey that impact the Turkish Cypriot economy due the currency union between the two entities.

2.24 In other respects, such as the current account balance and the unemployment rate, the Turkish Cypriot economy has lower rates than the average of the new EU members. The current account balance was -0.6 percent of GDP compared to -7.0 percent for the EU-9 and -5.9 percent of GDP for the southern part of Cyprus. However, before reaching any conclusions about whether

the current account deficit in the new EU economies indicated worse performance, it is important to determine whether their current account deficits were the result of an inflow of foreign capital, especially foreign direct investment, into the country. Furthermore, in the case of the northern part of Cyprus, the low current account deficit is a result of international transfers.

2.25 The unemployment rate which stood at 9.4 percent of the labor force in 2004 (based on survey data rather than registration data) was below the 10.7 percent average for the new member states but well above the 3.4 percent of the south. The robust economic growth in the north did not reduce the high rate of unemployment. Though high growth unaccompanied by employment generation is not unusual in countries where structural rigidities adversely impacting firm creation and expansion, the case of the northern part of Cyprus is different. Here the lack of employment creation and firm development stems from the lower uptake of investment opportunities because of the political and economic uncertainty, disputed property rights, trade and travel restrictions, and the public sector's heavy involvement in the economy.

Table 2.6: A Comparison of Revenues and Public Expenditures, 2004

	<i>(in percent of GDP)</i>						
	Revenues excluding grants			Expenditures			
	Total	Taxes /1	Social contributions	Total	Current	Wages /2	Capital
Cyprus							
Northern part /3	42	36	4	60	53	15	7
Southern part	39	34	7	44	41	11	2
Average EU-9 /4, 5	37	30	...	42	37	9	5
<i>Memorandum item</i>							
Turkey /6	25	24	...	20	18	8	2

Sources: World Development Indicators, IMF Article IV staff reports, and SPO.

1. Taxes including social contributions unless noted otherwise. 2. Wages are a component of current expenditures. 3. Total revenues including grants are 51 percent of GDP for the northern part of Cyprus. 4. Unweighted average for new EU member states excluding Cyprus. 5. Figure for wages not available for the Czech Republic, Poland, and Malta. 6. Preliminary data for 2003.

2.26 In addition to the overall macroeconomic indicators, it is also useful to compare the structure of public finances as it provides an idea of how extensive the role of the public sector is in the economy (see Table 2.6). In the northern part of Cyprus, the central administration raises the equivalent of 42 percent of GDP in revenues (excluding grants) of which 36 percent of GDP are from taxes including social security taxes. The tax burden in the northern part of Cyprus is very high, especially if we look at taxes excluding social security taxes. Tax revenue net of social taxes is about 32 percent of GDP in the northern part of Cyprus and the comparable figure for the EU-9 would probably be between 18 – 22 percent of GDP.⁸ Furthermore, given that the administration believes that there is a large informal sector, the ability to collect such high taxes is indicative that the formal sector is heavily taxed which of course leads to strong incentives for activity to remain informal. Finally, social tax collection in GDP is low compared to the southern part of Cyprus and the rest of Europe as well. As discussed later, this explains the under-funding of the pension system in the northern part of Cyprus.

2.27 Public expenditures in the northern part of Cyprus are exceptionally high in comparison to the average of the EU-9 countries as well as to the southern part of Cyprus and the difference is

⁸ Data on social contributions for EU-9 are not included in the table since their consistent classification is not carried out for the majority of countries. However, 18 – 22 percent using different sources of data provides a reasonable estimated range for the share of tax revenues excluding social taxes in GDP.

driven by the recurrent budget. The share of GDP spent on public sector wages is 15 percent compared to 9 percent of GDP for the EU-9. Though not shown in Table 2.6, goods and services account for about 9 percent of GDP for the EU-9 and only 3 percent for the southern part of Cyprus which seems to indicate under-spending on this important category by the central administration. The biggest difference is in the transfers and subsidy component of current spending. For the EU-9, about 19 percent of GDP is spent on this category compared to 32 percent of GDP in the northern part of Cyprus. Public capital expenditures are much higher in the northern part of Cyprus than elsewhere. However, it is not clear whether this large difference is because of how public sector accounts are organized. For example, if in the EU-9, public investments are financed predominantly by local governments rather than the central government, this will not be captured in the spending shown in our table.

Table 2.7: A Comparison of Pension Indicators

	<u>Pension Expenditures</u> percent to GDP	<u>Gross Replacement Rates /1</u> (in percent)	<u>Retirement Age to Qualify /2</u> (in years)	<u>Contribution Rate /3</u> (in percent)
Cyprus				
Northern part	12.2	78	55	35
Southern part	8.0	60	65	16
EU-15	10.4	69	65	23
EU-10	8.1	...	...	25

Source: World Bank and OECD.

1. Gross replacement rate are defined as the ratio of the benefits for a new pensioner to the salary at the end of the career.
2. Average retirement age for EU-15 is given for males. Average female retirement age is 63 years to qualify for a pension.
3. Social security contribution as a share of gross wage.

Pensions

2.28 One of the main components of public transfers across Europe is social transfers, especially social security payments. With the aging of the European population, the generous pension schemes have begun to comprise a significant share of GDP in many EU member countries. Moreover, many of the systems are not fully-funded and several (especially in the former transition economies of Europe) were originally designed to be government financed. Hence, government financial transfers for pensions are common in these countries. The key features of a well-designed pension system are one that (i) provides *adequate benefits* to prevent old-age poverty and a means for consumption smoothing, (ii) is *affordable* and does not exceed the financing capacity of individuals, nor jeopardizes other economic objectives or fiscal sustainability, (iii) is *sustainable* by being financially sound well into the foreseeable future, and (iv) is *robust* so that it withstands major exogenous shocks.⁹

2.29 Pension expenditures account for 12 percent of GDP in the northern part of Cyprus, a considerably higher figure in comparison to the new EU member states as seen in Table 2.7. Since total pension contribution revenues are only 4.0 percent of GDP, the pension system runs a deficit of 8.2 percent of GDP and the central administration budget helps to cover the gap for the

⁹ See *Old Age Income Support in the 21st Century*, (World Bank, 2005).

northern part of Cyprus.¹⁰ (Though data are not available for the EU-9 regarding the extent of the fiscal deficit resulting from the pension system, steps are indeed being taken by the new member states to address their pension problems.)

2.30 The generosity of the system in the northern part of Cyprus is apparent from the gross replacement rate and the low retirement age – thus, Turkish Cypriots get relatively more money compared to their last salary and for a longer time than pensioners in Europe. The pension system in the northern part of Cyprus covers only 42 percent of the labor force which is less than the 68 percent average for the EU-9. Unless family networks remain strong in the Turkish Cypriot community, this could be a signal a future where old age poverty could be far more prevalent than what exists today. But what this also signals is that relatively fewer people pay into the social security system. The reason this probably occurs is apparent from the high contribution rate of 35 percent compared to 26 percent for the EU-9. When labor taxes are high, either job growth occurs only slowly or economic activity takes place mostly in the informal sector.

Table 2.8: Aid Dependency, 2003

	GNI per capita (in US\$, Atlas method)	Aid per capita (in US\$)	Aid in GDP (in percent)
Cyprus			
Northern part	4,938	1,348	22.7
Southern part	14,230	24	0.1
All aid recipients /1	2,824	79	8.6
Small country aid recipients /2	3,535	337	13.3
EU-9 /3	6,873	149	0.7
<i>Memorandum items</i>			
Cyprus (northern part), 2004 /4	7,230	1,102	15.3
Turkey	2,800	2	0.1

Sources: World Development Indicators and SPO.

1. Based upon data for 148 countries. 2. All aid recipients with populations below 1 million in 2003. 3. New EU member states excluding Cyprus. 4. The large difference between 2003 and 2004 Atlas GNI per capita is due to exchange rate developments in the Turkish lira after the economic crisis.

Resources for Development: Foreign Aid

2.31 Aid dependency remains a controversial issue on the international agenda. Foreign aid is used by many countries to assist poorer countries but also to “buy” reforms that are hoped to lead to higher growth and better living conditions especially for the society’s most vulnerable. The track record on aid yields two important findings. First, aid can indeed be effective in raising economic growth *but only in a good policy environment*. Second, foreign aid cannot “buy” a good policy environment – it must be owned by the recipient itself.¹¹ When a society is committed to economic reform, aid can be used to strengthen institutions, improve policies, and transfer knowledge. However, when a government is not committed to extensive economic reform, the result of aid dependency is a public sector with a soft budget constraint and associated lax planning and resource management, over-staffed public agencies, and high pay and benefits for the civil service.

¹⁰ See Volume 2, Chapter 2 which discusses the pension system in detail.

¹¹ *Assessing Aid: What Works, What Doesn't, and Why*. World Bank (1998).

2.32 But, small countries—especially low-income ones—have an additional problem which is that they, like large countries, have to provide certain essential services to their citizens such as core administrative services, schools, and infrastructure. However, their small size not only proscribes them from achieving economies of scale but also their smaller (and usually poorer) tax base makes it more difficult to obtain revenues. Thus, some smaller recipients have experienced aid dependency for a longer period of time as they need foreign support to provide their citizens with adequate levels of essential services.

2.33 The northern part of Cyprus is among the places with a small population that is heavily dependent on aid which may have begun as a result of its political and eventual economic isolation. With an estimated population of about 218,000 persons, it is among the smaller economies in the world though by no means the most geographically isolated when compared to the islands in the Pacific.¹² On a per capita basis, it received \$1,348 per person in 2003 compared to the average of \$337 for small country aid recipients. It is also among the few economies (in addition to New Caledonia and French Polynesia) that received substantial foreign assistance despite having a relatively affluent population.¹³ The share of aid in GNI for the northern part of Cyprus was 23 percent and 15 percent in 2003 and 2004 respectively.¹⁴

Table 2.9: A Comparison of Selected Banking Sector Indicators

	<i>(in % of GDP)</i>			<i>(Credit in % of net domestic credit)</i>	
	Bank assets	Deposits	Net domestic credit	Public	Private
Cyprus					
Northern part	164	139	59	42	58
Southern part	...	...	...	...	...
EU-15	253	84	141	20	80
Selected new EU member states					
Czech Republic	94	69	56	41	59
Hungary	67	40	56	22	78
Poland	55	39	43	29	71

Source: World Bank and "Central Bank" of the northern part of Cyprus.

¹² A definition of who is included in an estimate of population differs across countries. Some use *de facto* estimates – everyone who is within their territory on a certain date, irrespective of nationality, duration, or purpose, is included. Others use *de jure* estimates, and include only nationals (frequently, those living outside the country). Increasingly, census bureaus have been using the "usual resident" concept for censuses and population estimates, but the meaning of "usual" is not standardized. All census bureaus exclude temporary visitors, such as tourists, but the treatment of such categories as longer-term residents, foreign military and diplomatic personnel, and guest workers is not standardized. The SPO in the northern part of Cyprus employs the *de facto* population definition as a basis for their estimates.

¹³ New Caledonia and French Polynesia, which have similar size populations of less than 250,000 received \$2,022 and \$2,134 per capita respectively in 2003. Their GNI per capita (Atlas methodology) was \$14,060 and \$16,150 in 2000 (latest available data) respectively. **These countries are former colonies of France and continue to maintain close relations with France after their independence.**

¹⁴ There are indeed some countries – islands – that receive a much higher portion of their GNI comes from aid – Solomon Islands (41 percent), St. Kitts and Nevis (41 percent), St. Lucia (47 percent), and St. Vincent and the Grenadines (67 percent).

Resources for Development: Financial Sector

2.34 The northern part of Cyprus does not lack for investible resources. In 2004, it had 24 commercial banks—17 private domestic banks, 1 public bank, and 6 foreign bank branches. Total assets and deposits of the banking system are high in the northern part of Cyprus at 164 percent and 139 percent of GDP respectively. Both of these indicators exceed those of the selected new EU member states for which data were available. The high deposit ratio is also indicative of the excess liquidity of the banking system which may be a reaction to the recent banking crisis (2000-01) as well as uncertainty about the future economic prospects for the Turkish Cypriot community. However, the relatively modest share of credit in the economy indicates that resources are being underutilized (and invested in liquid securities in Turkey), though the share is similar to the three new EU member countries for which data are available. But, though net domestic credit in GDP is comparable between the northern part of Cyprus and selected new EU members, it is biased towards the public sector indicating relatively modest resource allocation towards the private sector.

Table 2.10: A Comparison of Social Indicators

	Infant mortality rate (deaths per 1000 live births)	Life expectancy (in years)	Population growth (in % per annum)	Gross Enrollment rates	
				Secondary school (in percent)	Higher education (in percent)
Cyprus					
Northern part	10	73	1.1	95	72
Southern part	4	78	0.7	98	32
Average for EU-9	7	74	-0.2	100	54
Memorandum Item					
Turkey	33	69	1.4	79	28

Sources: World Development Indicators and SPO. Latest data available for 2002-2004.

D. HEALTH AND EDUCATION INDICATORS

2.35 Health indicators of the northern part of Cyprus are comparable to those of the EU-9 in many cases. Life expectancy at birth which is perhaps the best indicator of the overall health situation is 73 years compared to 74 for the EU-9. Interestingly, the two health indicators provided in the table above show that the southern part of the Cyprus is closer to the richer countries of the EU-15. However, it is not clear from the available information whether the difference in the life expectancy between the majority Greek Cypriot and Turkish Cypriot populations are driven by the infant mortality rate differential rather than differences in adult mortality. The comparatively high infant mortality rate in the northern part of Cyprus should be something that could be addressed through a combination of health awareness campaigns and improvements in infant care by the health care system.

2.36 The population of the island of Cyprus is growing (though slowly) unlike the rest of the EU which is contracting. Population growth in the northern part of Cyprus is 1.1 percent though it is uncertain to what extent this is driven by low fertility or Turkish Cypriot out migration in the face of unfavorable political and economic circumstances that have affected the region for the past three decades. Low population growth rates combined with a small population carries its own problems. In particular, for the northern part of Cyprus this is likely to have significant

implications for the sustainability of the pension system since with an aging population, there are fewer workers supporting a growing number of retirees. Another problem that results from slow population growth is the negative implication for the growth of the labor force and ultimately for economic growth. There are two ways to get around this problem. First, an economy can import labor – which is what both parts of the island are presently doing. Second, it can adopt economic and human capital policies which increase the productivity of labor so that the same pool of workers over time is able to produce higher valued output.

Table 2.11: Weeks and Days of Instruction and Net Teaching Time

	<i>(number of)</i>		<i>(number of hours)</i>
	Weeks	Instruction days	Net teaching time
Cyprus			
Northern part	31	155	415
Southern part	...	...	840
EU Average	...	187	...
Selected EU Member Countries			
Austria	38	184	622
Denmark	42	200	640
England	38	190	...
Finland	38	190	599
Germany	40	189	735
Hungary	37	185	555
Italy	33	165	594
<i>Memorandum items</i>			
Average for OECD	38	186	701
Turkey	38	180	600
United States	36	180	1,127

Source: SPO and *Education at a Glance* (OECD, 2005).

2.37 The Turkish Cypriot community has made great strides in education, which is valued by the population, and children are encouraged to continue through secondary school. Gross secondary enrollment rates at 95 percent are comparable to that seen in the southern part of Cyprus and just a little below the EU-9 average. Though the educational system does indeed seem to be able to provide education services to the population, the quality and quantity of education remains a very real concern. One way to measure it is by analyzing inputs – in this case, weeks of instruction and teaching time. Compared to their EU peers, Turkish Cypriot students completing 8 years of education have actually completed only the equivalent of 6.6 years of education in Europe based upon the number of instruction days they have had. (The average length of a school year in the EU is 20 percent longer compared to that of the northern part of Cyprus.) Moreover, if the length of the school day were to be taken into account, the number of equivalent “years” of education would fall even further.

2.38 Tertiary education enrollments rate of 72 percent of Turkish Cypriot secondary school graduates are exceedingly high (compared even to the EU-15’s average of 59 percent) indicating that admission standards may not be sufficiently rigorous. Too many unqualified young Turkish Cypriot adults are continuing onto universities when they should have been screened out and

diverted to another type of educational stream such as technical training. The reasons for their high enrollment rates in universities are manifold but one strong incentive is that a higher education degree is a necessary qualification for obtaining a public sector job in the northern part of Cyprus. Consequently, young adults in search of these well paying, secure jobs try to obtain the necessary pre-requisites in order to join the queue for public sector employment.

CHAPTER 3

CHALLENGES FACING THE SUSTAINABILITY OF GROWTH IN THE NORTHERN PART OF CYPRUS

3.1 Membership of Cyprus into the European Union (EU) has changed the course of development for the Turkish Cypriot community. Though the EU has presently suspended the *acquis communautaire* in the northern part of Cyprus, the Turkish Cypriot community can begin to unilaterally implement the regulations thus ensuring more rapid consistency of Turkish Cypriot institutions and policies with its important trading partners of the EU (such as the United Kingdom) as well as EU candidate countries such as Turkey. However, for the Turkish Cypriot community to benefit from the growing openness of its economy and the consistency of economic policies between itself and the rest of Europe, several fundamental changes need to be made to the structure of the economy which is presently being maintained through existing policies, selected institutions, and financial incentives provided by the central administration. These changes when taken together would translate into a modernization of the economy and a reduction in the dominance of the public sector. Furthermore, it will ease any future reunification as it will strengthen and enrich the Turkish Cypriot private sector.

3.2 Any economic reform program in the northern part of Cyprus has to be based upon the objective of encouraging private sector development in a sustainable way – which means a policy environment that facilitates its expansion without supporting those economic activities, firms, or sectors that are loss making or exhibit low productivity. The development model that was adopted in the past is one where the public sector has been the main driver of growth not only through its administrative activities but also in productive activities through public enterprises and banks. However, this trend of public sector dominance has begun to reverse itself and the quicker this reversal occurs, the better it will be for living standards of Turkish Cypriots whether before or after a unified state.

3.3 Many of the economic problems facing the northern part of Cyprus are exacerbated by its aid dependency. Though this assistance in the past was critical to the welfare of the Turkish Cypriot community in the early years of their isolation, its continuation at generous levels impedes the northern part of Cyprus's economic development. The reason for this is apparent as most funds are allocated by the public sector to various activities and interest groups. The availability of these funds and the effective "soft budget constraint" faced by the administration has led to the expansion of the public sector and greater reliance of individuals and businesses on "handouts" (or unearned benefits) and creating market distortions and perverse incentives (for example, to invest in low productivity sectors). Thus, rather than investing the resources for the long-term benefit of the Turkish Cypriot community in such areas as better infrastructure or higher quality education, much of the aid is consumed for short-term income gains.

3.4 Against this backdrop, this section will try to answer the question of whether the current high standards of living are sustainable. The goal is to highlight those areas for which reform is critical for growth – especially private sector led growth – and which currently act as obstacles to

the modernization of the economy and related institutions and policies. The findings of this chapter draw upon the individual technical papers presented in the second volume of this report.

A. EXTERNAL ECONOMIC CONSTRAINTS

3.5 The restrictions on the movement of goods and persons in the northern part of Cyprus have created external constraints to the Turkish Cypriot community's economic development prospects and options. The Green Line Regulations adopted in 2003 are a milestone in the process of the integration of the Turkish Cypriot community into Europe Union. They set the groundwork for the opening of trade between the two parts of Cyprus as well as providing for free movement of people. The Regulations also open EU markets to goods exports originating in the northern part of Cyprus provided they transit through the southern part of Cyprus.

3.6 The Green Line framework has had the greatest impact through the lifting of restrictions on the **movement of persons**.¹ As a result of the opening of the Green Line, about 5,000 Turkish Cypriots work in the southern part of the island. The remittances from these workers make a significant contribution to the economy and are estimated at about US\$ 50 million for 2004. In addition, there was an increase in the number of foreign tourists from the EU as well as from the southern part of Cyprus which helped to boost the hotel, restaurant, and entertainment subsectors. However, though tourism and related industries grew, the hotel industry still suffers from low utilization rates.

3.7 In terms of facilitating the **growth of trade**, the Green Line framework has been more successful in promoting intra-island trade than international trade between the northern part of Cyprus and the EU. Though the Regulations provide for preferential access of Turkish Cypriot exports to the EU as long as they are shipped through the southern ports, other restrictions exist which undermine their implementation. Three of the main weaknesses with the framework are as follows:

- First, the Green Line regulations specify that only goods originating in the northern part of Cyprus that are either "wholly obtained" or have "undergone their last substantial, economically justified processing or working in an undertaking equipped for that purpose" can enter the southern part of Cyprus. Considerable bureaucratic discretion is left to the relevant authorities in the Republic of Cyprus in determining whether the product meets the criteria. Three main consequences of this requirement are (a) it limits the export offer of the northern part of Cyprus as it is a resource poor region with limited manufacturing capacity, especially of intermediate products; (b) it limits the development of local manufacturing based on inputs imported from the most competitive sources of supply; and (c) it prevents the northern part of Cyprus as being a base for wholesale distribution center for the island for imported goods.
- Second, the constraints on the use of Turkish Cypriot trucks and ports in the northern part of Cyprus not only raise transportation costs for Turkish Cypriot exporters but adversely affect the transportation providers in the northern part of Cyprus. At present, the Republic of

¹ The Green Line framework refers to the Council regulations, policies that are within the purview of the Republic of Cyprus as noted in the regulations and policies of the Turkish Cypriot community as they pertain to the movements of goods and persons across the Green Line.

Cyprus limits entry of Turkish Cypriot trucks;² goods have to be reloaded on trucks from the southern part at the Green Line. And by compelling potential exporters to EU-wide markets to ship their products through the southern part of Cyprus to gain the preferential access to the EU Internal Market, the current framework discriminates against and potentially undercuts the services sector in the northern part of Cyprus while offering southern service providers rents at the expense of the former. Firms from the northern part cannot export on the same market access conditions to the EU as they do to the EU member state, the Republic of Cyprus, and they have to use transportation services, e.g., the trucking and ports subsectors of the southern part, if they want to do so.

- Third, development of the tourism sector is stymied because of restrictions on the movement of persons and the use of airports in the northern part of Cyprus. Since the Green Line framework does not open up the use of airports in the northern part of Cyprus to foreign airlines, few foreign tourists (with the exception of Turkish visitors) enter from there. However, another aspect of the problem is that the Green Line framework is ambiguous about the legality of movement of persons—including EU citizens—who have entered the island through ports of entry in the northern part of Cyprus.³

3.8 The current framework governing movement of persons and goods is not a panacea to the economic restrictions facing the economy in the northern part of Cyprus nor an effective instrument for promoting exports of the Turkish Cypriot community to the EU. Furthermore, there are two other mechanisms missing in the Green Line framework.

- First, although there are other non-trade-related impediments to investment, foreign direct investments—critical to an economy’s participation in a more sophisticated division of labor organized around global supply chains—are unlikely to flow in an environment given the legal uncertainties resulting from the political situation.
- Second, the northern part of Cyprus has no direct access to a single Pan-European market for industrial products based on the Pan-European Agreement on Cumulation of the Rules of Origin. The Agreement has provided strong incentive to multinational corporations to establish production facilities in new EU member states.⁴

² The present arrangements allow entry of trucks not to exceed 7.5 tons and operated by a driver with a license issued by the Republic of Cyprus.

³ Article 2 of the Corrigendum allows for entry into the southern part of Cyprus if two conditions are met. (i) A person has a residence permit issued by the Republic of Cyprus or a valid travel permit with a visa, if required; and (ii) he or she is not deemed a threat to public policy or public security. The preamble of the Corrigendum to Council Regulation (EC) No. 866/2004 of April 29, 2004 which informs about the policies of the Government regarding ‘crossing the line’ and provisions of Article 2 restricts entry only to third-country nationals and EU citizens who entered Cyprus “through the Government Controlled Area.” The implication of this is that persons using the ports of entry in the northern part of Cyprus may not cross the Green Line and also that not all residents of the northern part of Cyprus may cross the Green Line.

⁴ The Agreement had paved the way for establishment by 2002 of a single European trading bloc for industrial products, encompassing the EU-25, EFTA, Bulgaria, Romania and Turkey. Under the Pan Euro-Mediterranean Protocol on Cumulation of Rules of Origin, it has been extended to include countries with which the EU has Euro- Mediterranean Partnership Agreements: Tunisia (signed in 1995), Morocco (1995), Jordan (1997), the Palestinian Authority (an interim agreement was signed in 1997), Israel (2000), Algeria (2001), Egypt (2001), and Lebanon (2002). Negotiations with Syria were concluded at the end of 2003, but final approval has been delayed.

Box 3.1: Technological change in the northern part of Cyprus

The sources of private sector growth in the northern part of Cyprus, as in other economies, have been capital accumulation, growth in the quantity and quality of labor and productivity growth. In the years 1990-2004, the average annual growth rate of real GNI was 3.7 percent, real private fixed capital investment grew at an estimated rate of 3.5 percent, the labor force increased at a rate of 1 percent, and labor productivity rose at an annual rate of 2.7 percent. Clearly, capital accumulation and labor productivity growth have been important growth drivers over the period, while labor force growth played a minor role. But how much did technological change—innovation—contribute to growth?

The growth rate of labor productivity gives us only a partial indication of the contribution of technological change to growth. Labor productivity growth is brought about by both capital accumulation (increases in the capital/labor ratio) and technical change. The growth rate of labor productivity is also driven by increases in labor quality and gains from the reallocation of labor to higher productivity activities through the years. Taking account of these factors suggests that the contribution of technological advance may have been a rather small component of the 2.7 percent rate of labor productivity growth.

- First, technological change is often embodied in new types of machinery and equipment. In the northern part of Cyprus, an exceedingly large fraction of capital accumulation, roughly one-third, has gone into residential dwellings rather than machinery and equipment, reducing the potential for technological advance in production.
- Second, data on enrollments in higher education indicate that labor quality must have increased significantly over the period. The number of Turkish Cypriot students in higher education expanded at an annual average rate of 20 percent from 1990-2004. Even if we allow for the fact that the quality of education was not up to EU standards, rising enrollment rates in higher education surely had a positive impact on labor's cognitive ability.
- Third, an important part of labor productivity growth has come from reallocation of labor to higher productivity private sector activities.

3.9 The absence of these two mechanisms makes it difficult for Turkish Cypriot businesses to participate in the most rapidly expanding segment of trade, based on production fragmentation, driven now mostly by multinational corporations (MNC).⁵ By the same token, it significantly curtails transfer of new technologies of which MNCs have been the main vehicle in the new global economy. In consequence, the existing arrangements, albeit an improvement over the situation before 2003, still relegate the territory of northern part of Cyprus to the status of an international economic outsider.

3.10 Consequently, it is not clear whether on balance the Green Line framework will promote the trade in goods of the northern part of Cyprus. First, high transaction costs undermine the potential competitiveness of Turkish Cypriot exports to the EU market thereby not having the beneficial effects hoped for—but also not necessarily reducing existing exports. Second, the *de*

⁵ The empirical evidence on links between FDI and trade point not only to the complementary relationship between FDI and exports but also to increasingly stronger links due to the growing fragmentation of production combined with the creation of distribution networks spanning across continents. Global diffusion of productive activity leads to an increased international trade in both final goods and parts and components. Thus, about one-third of world trade consists of intra-firm trade, that is trade among various parts of a single corporation, and the importance of intra-firm trade has been growing over time. Estimates also suggest that about two-thirds of world trade in the latter half of the 1990s involved multinational corporations, including both intra-firm trade and arms-length transactions (UNCTAD. 2002. *World Investment Report: Transnational Corporations and Export Competitiveness*. United Nations: New York and Geneva.).

facto ban on movement of products through the Green Line imported from other EU member states and their Customs Union partner, Turkey, significantly reduces benefits to producers, services providers and consumers in both parts of the island. One suspects that economies of scale might be reaped from, for instance, consolidating wholesale operations or establishing final stage assembly lines in one or other part of the island. The current arrangements effectively remove this option.

3.11 In conclusion, the Green Line Regulations have been instrumental in lifting some of the restrictions on the movement of goods, services, and labor into and out of the northern part of Cyprus. However, their success (and their mandate) has only been partial and there is a question of whether the outcomes represent a better or possibly worse situation for the economic development of the northern part of Cyprus. A problem could arise from the mobility of labor in an environment where investment—whether domestic or foreign—is low due to the uncertain political situation. Labor migration to the high wage economy of the southern part of Cyprus will put upward pressure on wages in the northern part of Cyprus. Due to the constraints in exports and the lack of any increase in labor productivity domestically, investment in the tradable sector will fall and resources will shift into the non-tradable (and non-competing) sector of the economy. How likely this scenario is will depend upon the degree of labor migration as well as the wage gap between the northern and southern parts of Cyprus.

B. MACROECONOMIC STABILITY

3.12 A policy agenda which results in low volatility of key macroeconomic variables (that is, growth, inflation, and the current account balance) improves the predictability of the domestic macroeconomic environment. This predictability is critical for proper resource allocation decisions, investment, and economic growth. It is also important for individuals since predictable growth in income and consumption enhance welfare. Macroeconomic *instability* impedes businesses' ability and willingness to undertake investment opportunities. The consequences of this are serious as it has negative implications not only for private sector expansion but also for sustainability of economic growth in the medium- to long-term. However, good macroeconomic outcomes must be accompanied with the reform of rules and institutions governing the formulation of macro policies to be long-lasting and not overturned or abandoned by the next political leadership.

3.13 The northern part of Cyprus has experienced high macroeconomic volatility as seen by the annual changes in the economic growth, inflation, and the current account balance. Even in the last five years (2000 – 2005), the economic growth has been volatile ranging between -5.3 percent (2001) and 14.6 percent per annum (2004). Figure 3.2 shows the sharp swings in GDP growth rates which have indeed been extraordinary in their frequency as well as their highs and lows. Inflation has also been relatively high since 1977 during which time it averaged 60 percent per annum. It is only in the last year (2004) that for the first time it has come down to less than 10 percent. Finally, the current account has displayed similar volatility, though in the last five years it has performed well in terms of being in either (relatively) modest deficit of 3 percent of GDP or in surplus.

3.14 The levers available to the Turkish Cypriot community for improving macroeconomic stability are limited to fiscal policy as monetary policy is out of its hands due to the currency union with Turkey. Thus, the instability of inflation and, by the same token, a large share of the

swings in GDP is caused by developments in Turkey's economic performance and its interest rate policies. Consequently, the importance of getting fiscal policy right increases.

Box 3.2: Sources of Economic Growth

Growth Rates and Contributions to Growth						
	Growth rates (in % per annum)			Contribution to growth (in % of total)		
	2002	2003	2004	1990-2000	2000-2004	1977 - 2004
Agriculture	18.9	7.3	8.5	5	26	9
Industry	5	7.7	10.6	11	9	13
Manufacturing	5.7	7.3	10.2	..	..	..
Construction	15.9	30.8	2.3	20	10	9
Services	2.8	6.4	14.1	64	55	70
Trade & Tourism	13.9	12.5	25.5	..	..	..
Public Services	-0.5	4.1	5.2	..	..	..

Source: World Bank staff calculations based on SPO data.

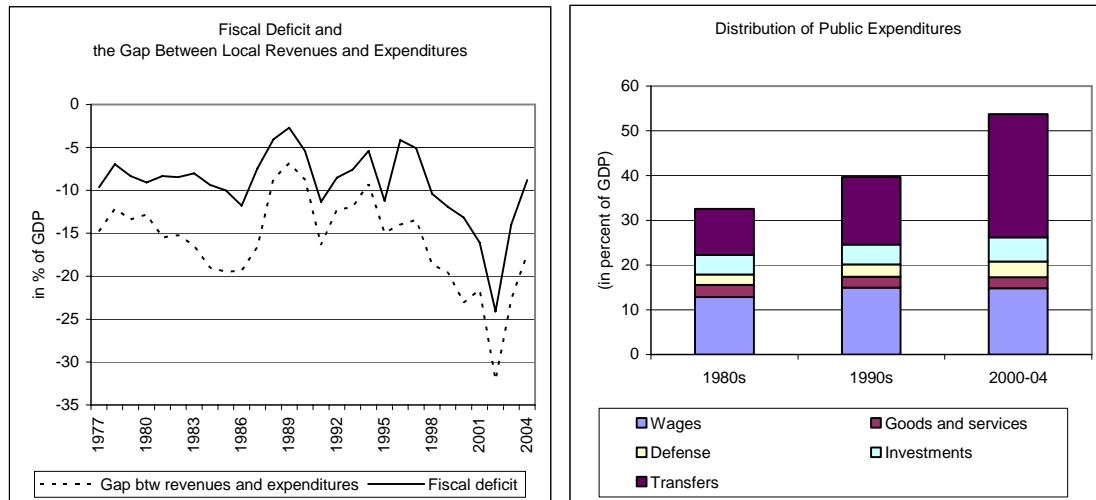
What have been the main sources of growth over time in northern Cyprus, in particular in recent years? Because of its mere size, the services sector has been the main engine of growth over time. It contributed to 70 percent of total output growth between 1977 and 2004. But average growth rates in the services sector (3.8 percent) were nonetheless significantly lower than in construction (7.6 percent) or industry (4.3 percent). Because of lower growth rates, the services sector's contribution has actually diminished over time, which is contrary to what one would expect from an expanding economy. The construction sector saw particularly high growth rates in the 1990s, when it contributed some 20 percent of total growth, and came to a halt only in 2004. The industrial sector has been contributing less to growth over time, accounting for around ten percent of all growth in the 1990s and 2000s. As would be expected, agriculture has seen its share of the economy fall over time.

On the expenditure side, more recently, investments registered a stronger growth rate, predominantly due to a housing boom created by foreign demand and strong public sector investments in infrastructure. Foreign housing demand was curtailed by political factors in 2004, and consumption regained its role as the main driver of growth. Spending by the central administration has spiraled to excessive levels, growing at double digit rates and reaching above 60 percent of GDP.

These developments were reflected in the production side. Following the boom-bust in investments and a surge in consumption by the central administration, construction grew rapidly in 2002 and 2003 but came to an abrupt halt in 2004. Agriculture showed a strong performance, growing by an average of 11.6 percent between 2002 and 2004, while industry and services also registered solid growth rates of close to 8 percent in the same period. Most of the growth in services originated in trade and tourism; these sectors benefited from the opening of the Green Line and strong growth in Turkey. Other service sectors seem to be growing at a slower, though still strong pace. Slowest growth was registered in the financial intermediation sector as it is apparently consolidating following the financial turmoil in the previous period.

3.15 What exactly is the “right” fiscal policy? In general, there are three main characteristics of ideal fiscal management. *First*, fiscal policy should ensure that the administration is “self-financing” so as to avoid uncertainties related to varying tax burdens. *Second*, fiscal policy needs to be flexible in order to smooth out short-term business cycle effects including those triggered by events in Turkey due to the close real and monetary links between the two economies. *Third*, good fiscal management is also characterized by efficiency and effectiveness of the use of public resources as well as good governance and accountability in spending and revenue collection.

Figure 3.1: The Fiscal Deficit and Its Drivers



Source: World Bank staff estimates based on SPO data.

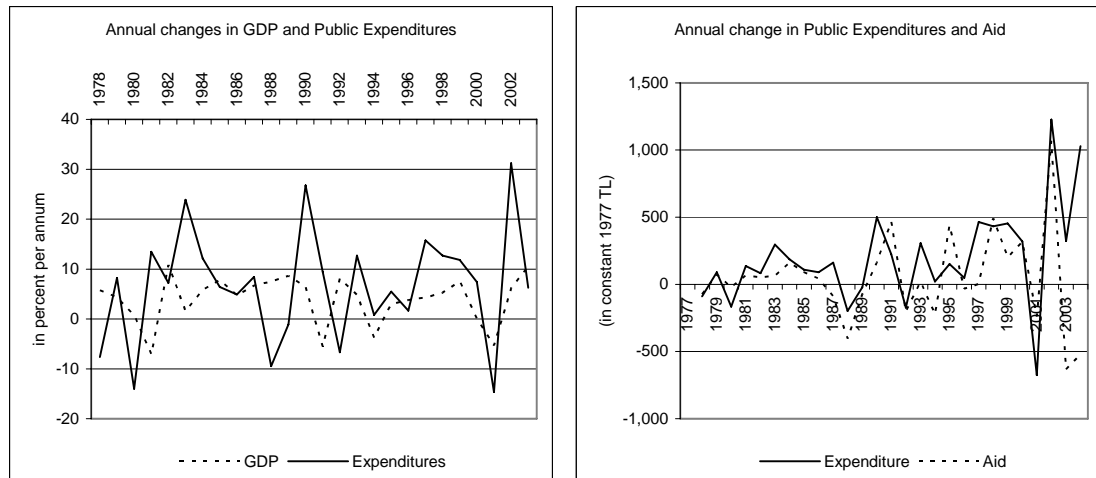
Note: Fiscal deficit is equal to revenues plus foreign grants minus expenditures.

3.16 Large **fiscal deficits** have characterized the central budget of the northern part of Cyprus over the past three decades. In 2004 the fiscal balance of the central administration was -8.8 percent of GDP (or 17.4 percent of GDP excluding foreign grants).⁶ These large structural deficits have occurred mainly because of the availability of cheap financing from the Republic of Turkey. With the support of Turkey, the Turkish Cypriots have been able to close the gap though at the expense of increasing their dependency upon financial aid as well as increasing the economy's vulnerability to the removal of foreign financing. In addition, the central administration and the public enterprise sector have borrowed from the pension funds as well (and pension funds continue to lend them money at high interest rates). In the absence of knowing the total amount of public (domestic and foreign) debt, it is difficult to determine whether the accumulated debt is repayable or not and whether the fiscal situation is sustainable in the long-run.

3.17 One of the fastest growing components of public expenditures is transfers which have been a main factor behind the pushing the share of total expenditures in GDP to 60 percent in the northern part of Cyprus when the average for the new EU member states is 40 percent of GDP. What exactly are these transfers? A large share of the transfers is indeed social insurance transfers whether to civil servants or to finance the bankrupt (private) Social Insurance Fund. These aggregates mask more than 30 different types of transfers heavily dominated by social transfers (pensions and a dozen other smaller transfers) that have surged in recent years. This increase in transfers makes substantial fiscal adjustments more difficult because it increases longer-term liabilities affecting larger and potentially strong interest groups. In 2004, social insurance transfers were an estimated 14.7 percent of GDP while other transfers were 17.4 percent of GDP. Transfers are given to such entities as public enterprises, marketing boards, and municipalities. In addition, this category includes some arrears that are being paid to depositors who lost their savings in the 2001 financial sector crisis as well as to the central bank in repayment for loans taken before it was made independent.

⁶ This figure covers only the central administration and not the public enterprise sector. This figure is preliminary as it does not include information on debt service payments to the Provident Fund.

Figure 3.2: Countercyclicality of Fiscal Policy – Public Expenditures and Aid



3.18 Fiscal policy has also not strived to be **countercyclical**—meaning that public sector (central administration) spending did not fall when economic growth was high. If anything, there is a modest positive correlation between the growth in expenditures and GDP indicating *procyclicality* that increased from 1990 onwards as seen in Figure 3.2. What is also apparent is that expenditures and aid moved in tandem. But it is difficult to ascertain whether aid drove expenditures or the other way around. Whichever way the causality ran, it is important to understand that the same way that more public sector expenditure is not better nor is more aid better for the Turkish Cypriot community. High inflows of aid can lead to problems with long-term consequences if aid has not been well used to institute reforms. In the context of our particular discussion now, excessive aid inflows that are determined independent of the consequences for economic growth can over-stimulate the economy, distort markets, and exacerbate macroeconomic volatility. Also, aid inflows that are themselves large as a share of GDP and change significantly from year to year can trigger economic volatility.

3.19 Finally, in the northern part of Cyprus, the **formulation of fiscal policy and budget management** is improving through the adoption of various instruments that will facilitate fiscal discipline. These are (i) comprehensiveness of the budget, (ii) three-year budgetary framework, and (iii) accrual-based accounting instead of cash budgeting. (Though not yet under consideration, integration of the recurrent and capital budgets will also help to provide a better understanding of future financial obligations.) These tools will be important in answering such questions as “where do our finances in total stand now”, “how much are we spending”, and “what do our future financial obligations look like”?

3.20 The greatest concern at present is the lack of comprehensiveness of the fiscal stance. The “Ministry of Finance” (MOF) may itself not be aware of the extent of public sector obligations as it narrowly focuses on the central budget. Though, steps are underway to improve comprehensiveness by bringing off-budget items on-budget, this is not being extended to the public enterprise sector. Little is still known about public enterprises in terms of their profitability, their borrowing from the commercial banking sector, the pension, and Provident Funds, and any build-up of arrears. Though the central administration no longer provides a public guarantee on any debt assumed by public enterprises, these firms continue to borrow. Depending upon how much they borrow, the central administration may have to assume their debts in order to avoid systemic risk to the financial sector. Also, public enterprises have been used to expand employment opportunities for Turkish Cypriots, thus the pension obligations which are being

racked up as a result of overstaffing of these firms will need to be covered ultimately by the central administration—through higher taxation of the Turkish Cypriot public or by greater dependence on Turkish assistance—neither being a favorable prospect.

Box 3.3: Currency Unions: Costs and Benefits

A currency union (CU) is a geographical area within which a single currency is used. There are a growing number of examples of CUs involving several countries holding the same currency. The Euro zone is an example of one version, where a group of countries relinquish their national currencies and jointly adopt a new one. The adoption of the U.S. dollar by Ecuador is another version of CUs, where a small area adopts the currency of a large anchor country. This latter is similar to the case of the northern part of Cyprus, which has a currency union with Turkey—whose economy is almost twenty times the size of that of the northern part of Cyprus.

Benefits... Why would countries wish to renounce their national currency? A common currency reduces transaction costs for trade and investment between member areas as no currency exchange needs to take place. It reduces the costs associated with risks of trade and investment abroad because currencies do not fluctuate to influence prices and profits, and increases efficiency because information about relative prices in different areas is clearer. Thus, it may encourage further economic integration between the members. And perhaps most importantly, it enforces policy credibility and macro-economic stability for two inter-related reasons: because inflation cannot be used as a means of reducing e.g., the real cost of public debt or stimulate the economy in a recession, and because the exchange rate cannot be used as a means of increasing competitiveness by devaluation (in the case of fixed exchange rates) or managed depreciation (floating). Countries can thus “buy” externally fiscal and monetary discipline by joining a currency union. This has been the main argument behind e.g., dollarization in some historically volatile Latin American countries.

... And costs. But like all coins, the common currency has two sides. Giving up currency is tantamount to giving up monetary policy as a tool for smoothing business cycles. Interest rates cannot be lowered to boost economic activity in a recession that is hitting only one part of the currency union. If prices do not adjust and labor and capital are not free or willing to move across areas to compensate for such asymmetric shocks, unemployment and inflation may result in different parts of the CU. Alternatively, adopting the currency of a large country which floats against other major currencies may at times mean unduly large fluctuations because of economic or political developments in the anchor country, that are unrelated to economic fundamentals in the smaller country.

Given these pros and cons, **the benefits for a country joining a currency area are likely to be larger** if the country has a history of high inflation (and thus, is combating a credibility problem), if it is geographically and/or culturally close to a larger currency area as proven in trade and investment ties and if it wishes to further integration with that area, if economic shocks (e.g., in terms of trade) tend to affect the country in similar ways as the larger currency areas and their business cycle fluctuations are more aligned, and if the larger currency area is monetarily stable.

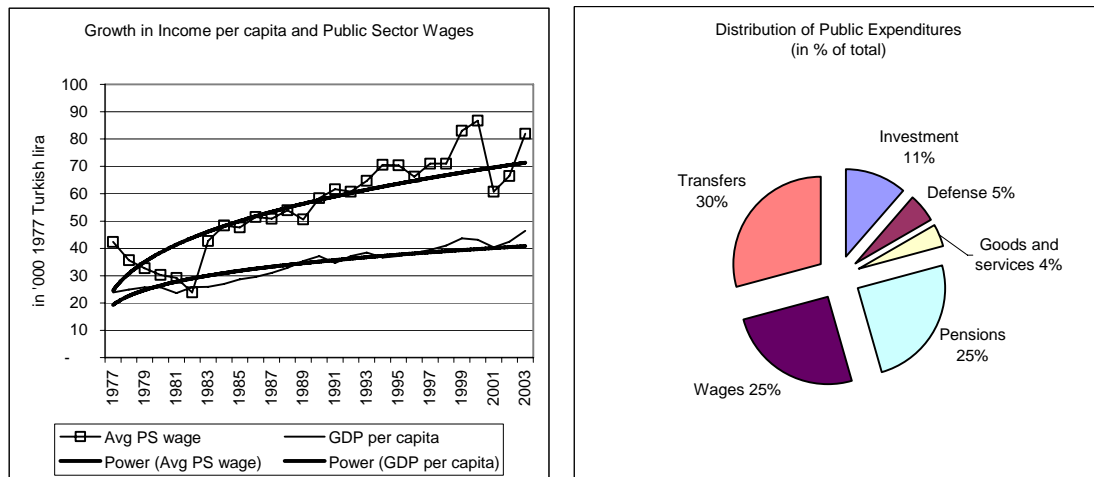
Source: Adapted from Alesina, Barro and Tenreyro (2002), “Optimal Currency Areas”, NBER Working Paper No. W9027.

C. THE CENTRAL BUDGET AND SUSTAINABILITY OF PENSION OUTLAYS

3.21 The importance of the public sector in the northern part of Cyprus cannot be overstated. Total central administration expenditures as a share of GDP are 60 percent of GDP, which is well above the average for new EU member states and with the addition of expenditures by the municipalities and public enterprises will be even higher. A government’s role should be to finance the provision of services that are “public goods” (such as primary and secondary

education, primary health care, basic infrastructure, and defense) and taking care of the poor in society. However, the delivery of public goods should be done efficiently since the resources used to finance them are public monies that should be used for the benefit of all rather than for private gain. Thus, provision of services by civil servants who are paid relatively high wages compared to the private sector indicates a waste of public monies and the capture of “rents” by narrow (though powerful) interest groups.

Figure 3.3: Public Sector Wages and the Distribution of Public Expenditures in 2004



Source: World Bank staff calculations based on SPO data.

3.22 In order to understand whether the allocation of public expenditures in the northern part of Cyprus is appropriate, a deeper understanding of the Turkish Cypriot community’s objectives and priorities is necessary. This information would need to be complemented by a more thorough and disaggregated understanding of public expenditures than what has been captured in this report. However, even aggregate and rough information can point out where some major problems lie. Table 3.1 presents some estimates for expenditures and revenues for 2004. These numbers are at best preliminary and should be seen as indicative rather than correct in absolute terms.

3.23 It is useful to begin by putting public expenditures into perspective by analyzing it in per capita terms, that is, how much each Turkish Cypriot man, woman, and child has to pay. On a gross average basis, for total (central administration) public expenditures, each person paid a total of \$4,727. Of this amount, \$1,204 is paid for net wages and salaries of public employees, \$1,159 is paid for social security payments and public sector pension payments (pre-1987), \$1,374 is paid for various types of transfers, \$542 was paid for investment projects, and \$197 is paid for non-wage goods and services (e.g., textbooks, libraries, laboratory equipment, and office supplies). How were these expenditures financed? The administration raised on average \$3,346 from each Turkish Cypriot. Since only \$486 was raised through personal income taxes, the perception of the tax burden may be biased. Most of the funds were raised indirectly (\$1,759) through VAT and excise taxes which increase the price level of consumables. And as already mentioned, Turkish aid financed \$1,206.

Table 3.1: Consolidated Central Budget, 2004

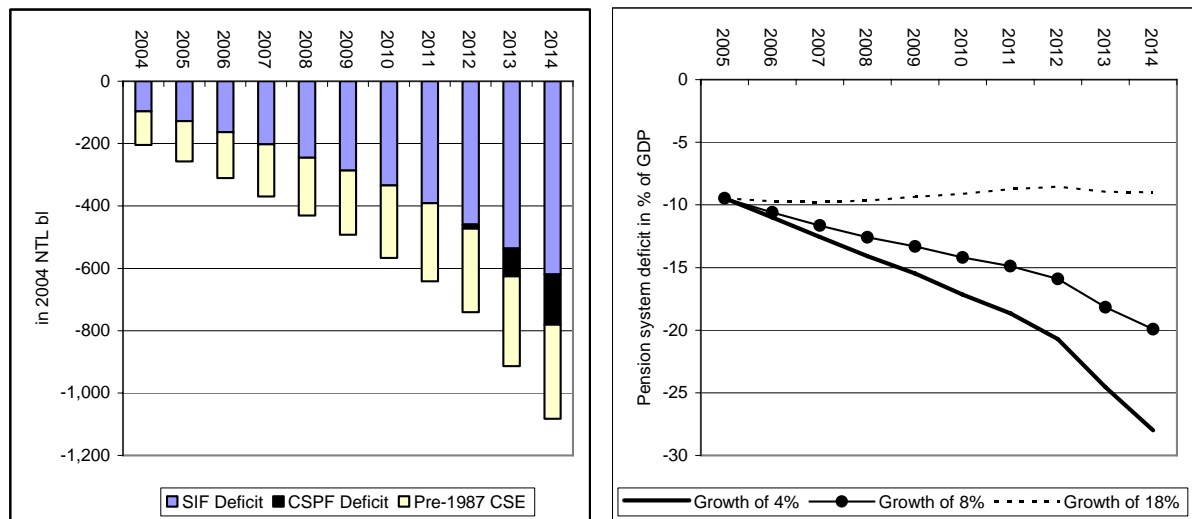
	(in TL trillion) /1	in % of GDP	in US\$ per capita
TOTAL REVENUES AND GRANTS	1,253	51.0	4,024
Revenues	1,042	42.4	3,346
Direct taxes	236	9.6	758
Personal income	151	6.2	486
Corporate income	23	0.9	72
Income and corporate tax (previous year)	16	0.6	50
Motor vehicles and licenses	36	1.5	117
Fees and Duties	10	0.4	32
Other	2	0.1	5
Pension contributions	107	4.3	342
Social security contributions	105	4.3	337
Public sector pension contributions (pre-1987 employees)	2	0.1	5
Indirect taxes	548	22.3	1,759
VAT	223	9.1	717
Excise /2	277	11.3	890
Import duties	18	0.7	59
Import, export and wharf fees	19	0.8	62
Bank and insurance transactions tax	8	0.3	26
Other	2	0.1	5
Non-tax and capital revenues	152	6.2	487
Foreign Grants /3	211	8.6	678
TOTAL EXPENDITURES	1,472	59.9	4,727
Recurrent expenditures	1,303	53.0	4,185
Wages and salaries	375	15.3	1,204
Goods and services	61	2.5	197
Transfers	789	32.1	2,534
Social security payments & other expenditures	207	8.4	664
Public sector pensions payments (pre-1987)	154	6.3	496
Social welfare transfers /4	92	3.7	294
Contribution to municipalities & other local inst.	41	1.7	130
Public enterprises /5	70	2.8	224
Other /6	226	9.2	725
Defense	78	3.2	250
Capital expenditures and transfers	169	6.9	542
Investment financed by Turkey /7	133	5.4	427
Investment financed by northern Cyprus	33	1.3	105
Capital formation and expropriation	3	0.1	10
Overall Fiscal Balance	-219	-8.9	-703
excluding foreign grants	-430	-17.5	-1,381
NEW LOANS	164	6.7	528
Foreign loans from Turkey	164	6.7	528
STATISTICAL ERROR /8	-55	-2.2	-175
<i>Memorandum items</i>			
GDP	2,457	100.0	7,890
Total Financial Assistance (loans and grants) from Turkey	375	15.3	1,206
Turkish lira per US\$ = 1,428,058			

Source: MOF and SPO.

1. Latest actual figures available as of October 2005. 2. Price Stability Fund revenues. 3. Includes Turkish grants for investment projects that do not go through the MOF but are reported to SPO. 4. Categorized as social transfers by MOF but this figure excludes transfers for pension payments and Social Insurance Fund. 5. Funds provided by Turkey; these items are off-budget. 6. These are categorized by MOF into "financial and "economic" transfers and excludes transfers to the Social Insurance Fund. These transfer categories also include transfers to public enterprises and repayment of arrears. 7. Includes public investment projects which are off-budget. 8. Information on loans from the pension funds is not included.

3.24 The general profile of expenditures indicates too many resources allocated to wages, pensions, and transfers and too little to goods and services. The high personnel costs (i.e., wages and salaries) at 15 percent of GDP are much higher than that of the EU-10 indicating either that wages are too high or the number of public employees is too great—or both. From the data available, it appears that wages are indeed trending upwards at a faster pace than GDP per capita which may indicate that public sector employees are garnering advantages in excess of their contribution to the economy (see Figure 3.3). And as already discussed earlier, transfers (especially so called “financial and economic” transfers) are an equally huge absorber of public monies with no clear public benefit to the Turkish Cypriot community. When the benefit of public funds accrues to a few, questions could be raised about the legitimacy of these allocations and whether they take the Turkish Cypriot community as a whole in the direction they wish—including greater self-reliance.

Figure 3.4: The Growing Financial Burden of Pensions



Source: World Bank staff estimates based upon information provided by SIF, MOF, and CSPF.

1. These graphs provide the base case scenario with the system’s current parameters retained.

Pensions

3.25 One of the largest drains on public finances in the northern part of Cyprus is the pension system. Pension systems are forced savings and are supposed to be self-financing by transferring income between generations. Thus, the people who will benefit from the system should be the ones that contribute to it. When pension funds begin to draw upon the financial resources of the government—that is, ultimately the general population—they are no longer self-financing, but rather use public funds for providing private income to a few. When the public funds being drawn upon are relatively modest, payment of private pensions may be seen as acceptable by tax paying citizens. But when they are large and growing, whether or not the population is willing to fund these obligations, they may not have adequate resources to do so—ultimately leading to serious consequences for economic growth and old age poverty simultaneously.

3.26 The current pension system in the northern part of Cyprus has two important strengths that provide a good basis for reform. It is a modern multi-pillar system and it has a well-organized social insurance administration. The whole system has about 39,000 contributors and 22,000 pensioners. It consists of two main parallel schemes: the general public scheme which covers

mostly the private sector and the civil servants scheme.⁷ The Social Insurance Fund (SIF) administers the first pillar of the general public scheme while the Provident Fund administers the second pillar. The Provident Fund provides a lump sum payment to the worker upon retirement. The civil servants can be split into two groups based upon whether they joined the civil service before or after 1987. Responsibility for covering the pensions of civil servants who joined before 1987 belongs to the central administration and will be financed solely through taxes (or aid). Civil servants employed after 1987 will be covered by the Civil Servants Pension Fund (CSPF). Also, comparable to the lump-sum benefit provided by the Provident Fund, civil servants receive a lump-sum gratuity upon retiring after 25 years.

3.27 Though the institutional set-up of the pension system is appropriate, with its current parameters, it is not sustainable. Already, the system as a whole is costly—its annual outlays in 2004 were more than 12 percent of GDP. It is also in deficit with payments exceeding contributions by an estimated 8.2 percent of GDP in 2004 (more or less equally resulting from the SIF and the pre-1987 employees' pensions). The high pension expenditure burden is a consequence of overly generous pension benefits in relation to contributions. These benefits include an early retirement age, a high replacement rate for wages, and a high minimum pension. Contributions in comparison to payments are low and legislation has been drafted such that the central administration is supposed to contribute not only to the pensions of public sector employees but also to that of private sector employees. (However, this latter issue is a moot point given that the SIF's deficit is already being covered by the central administration.) However, the contribution rates are very high (35 percent of gross wages) which raises the cost of labor and ultimately either stymies employment growth or encourages the expansion of informality.

3.28 The future pension obligations of the social security system in the northern part of Cyprus will balloon over the next ten years. Neither the SIF nor the CSPF are sustainable, consequently, they would run large deficits in the absence of reforms which the central administration would likely cover (see Figure 3.4)—if it had the necessary fiscal resources to do so. Though hopes may exist that high economic growth will “save the system”, the second chart in Figure 3.4 shows that this is unlikely. Unless economic growth reaches 18 percent per annum, the deficit of the pension system that will need to be covered through general taxation will grow. Even with robust 8 percent growth (which is more than twice the average growth rate for the northern part of Cyprus during the last 30 years), the deficit would grow from 10 percent of GDP to 20 percent over the next decade.

3.29 Another little appreciated problem is with the asset structure of the Provident Fund—that is, where it invests contributors' long-term savings. In August 2005, the total value of the Fund's assets was NTL 538 billion or about 20 percent of GDP. These represent substantial long term savings available for economic development, if appropriate channels were available. At present, 68 percent is lent to the public sector—60 percent to the central administration and 8 percent to public enterprises. The high budget deficit and the volatility of aid flows to the central administration would seem to make it a high risk investment—not an appropriate recipient for long-term savings. Moreover, there are no legal barriers to the Provident Fund investing abroad which would be an important way to diversify the portfolio, but this is presently unexploited perhaps with the exception of some Government of Turkey bonds.

⁷ The general public scheme (also known as the Social Insurance Fund) covers employers (business owners), private sector workers, the self-employed, public non-civil servants workers, and civil servants during the two-year probation period.

D. ECONOMIC OBSTACLES TO PRIVATE SECTOR GROWTH

3.30 The ability of the public sector to be the engine of growth in the northern part of Cyprus is unlikely to continue as it is a strategy dependent upon generous aid from Turkey. Though foreign aid may continue at high levels, it will not necessarily finance the expansion of the public sector – if only because of the growing pension obligations faced by the central administration and the need to reduce the high fiscal deficit. Furthermore, the Turkish Cypriot community itself appears to desire to reduce its dependency upon Turkey and gain greater autonomy in setting its own economic agenda. And perhaps most importantly, the Turkish Cypriot community may have no choice in the matter since the external environment is changing – whether because of Cyprus’s accession to the EU, the Green Line regulations, or Turkey’s Customs Union with the new EU member states. Thus, the economic reality that will face the Turkish Cypriot community in the future is one where the private sector – whether in the northern or southern part of the island – will be looked upon to provide job opportunities and income growth to the population.

3.31 What are some of the problems that impede the expansion of the private sector in the northern part of Cyprus? Part of the answer of course lies in the political situation facing the Turkish Cypriot community and the resulting trade isolation and the higher cost of exporting through Turkey. Though the problems resulting from the political isolation may be large – and possibly overwhelming, there are other economic impediments to the expansion of the private sector that the Turkish Cypriot community can address. By removing those impediments, the administration may provide a strong impetus to private sector growth in the short- and medium-terms. For the long-term welfare of the Turkish Cypriot community, especially in the context of a unified state, unless Turkish Cypriots can become successful businessmen, professionals, or skilled workers, their future will be in low wage, low productivity jobs.

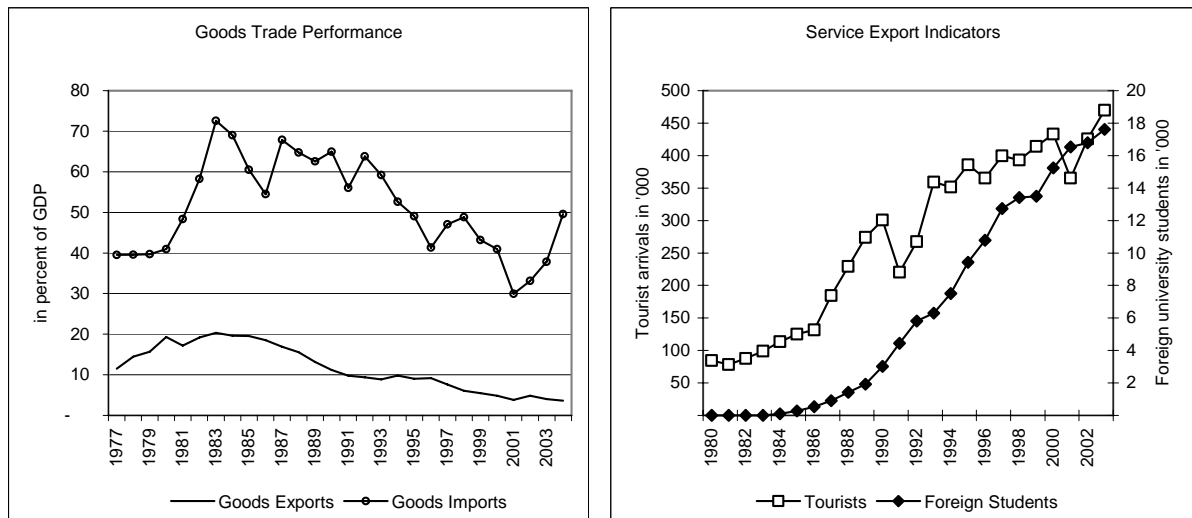
3.32 This section will discuss some of the main economic and sectoral obstacles to private sector expansion in the northern part of Cyprus. The sources of private sector growth are capital accumulation, growth in the quantity and quality of labor, and productivity growth. This translates into the policy areas of international trade, the financial sector, and the investment climate.

Trade Openness

3.33 Though the trade story for the Turkish Cypriot community is rapidly evolving into one on service exports, specifically higher education, tourism, and entertainment (e.g., casinos), the quality of data on these categories is not good. We estimate that for 2004, total service exports were about \$642 ml and service imports were \$114 million.⁸ Though there are no robust data on the evolution of revenues from service exports, the trends in tourist arrivals and foreign students are instructive (see Figure 3.6). In 2004, the majority of all tourist arrivals were Turkish and though their numbers continue to grow in absolute terms, their share has fallen from 80 percent to 72 percent in the period 1999 – 2003. In the last few years, growth in the number of non-Turkish tourists has been high; total arrivals of this category increased by 49 percent in 2001-2003. However, foreign students are seen to be “higher value” service exports since their expenditures span a much longer period of time and they also attract complementary tourism (i.e., parents and other family members). Their numbers are also increasing which bodes well for the service exports at least in the medium-term.

⁸ These should be seen as indicative and in no way accurate estimates of exports and imports of services. The SPO does not provide disaggregated data and consequently these estimates were made on the basis of sectoral level information.

Figure 3.5: Trade Performance



Source: SPO.

3.34 The export of goods is traditionally seen as one of the major ways to stimulate economic growth and generate employment. Even in small island economies it appears that goods exports do indeed play an important role contributing about 20 – 25 percent of GDP. Total goods exports of the northern part of Cyprus were only 4 percent of GDP in 2004. Of the total \$62 ml in export revenues, the main categories were agriculture products (\$21 ml), processed agricultural products (\$17 ml), and other industrial products (\$13 ml). The export offer of the northern part of Cyprus is primarily in low value added goods, reflective of the low level of industrialization of the economy. Furthermore, its trade partners are relatively undiversified with Turkey (47 percent), United Kingdom (22 percent), and Russia (15 percent) together providing 84 percent of total goods export revenues.

3.35 Goods imports have been growing rapidly in the last few years with an increase in 2003-2004 by 78 percent. Total imports in 2004 were \$853 ml dollars or 50 percent of GDP. This growth was driven by the increase in imports of construction materials and luxury consumption goods – reflective of the trends at the aggregate level of high private consumption and heavy private investment in the residential sector. Goods imports are even less diversified than exports with 60 percent of total imports coming from Turkey, 11 percent from the United Kingdom, 10 percent from the EU (excluding UK). Though the northern part of Cyprus should be a high import economy given its small size, for private sector led growth to occur, a significant share of imports should be in machinery and equipment for private capital formation (which should be about 10 – 15 percent of GDP). In 2004, only 8 percent of GDP was spent on “machinery and transportation equipment” which includes the importation of cars, thus very little was spent on private capital formation and probably only marginal amounts on non-construction related industrial activities.⁹

3.36 Though the geographical location, small size, and political constraints facing the northern part of Cyprus have been major determinants of its poor merchandise trade performance, the foreign trade regime has not helped. The administration has taken many steps to improve the trade regime (such as bringing in line the tariff schedule on industrial products with that of the EU), but other – less transparent – policies undermine these advances in trade openness.

⁹ [Note: Need to double check that cars for personal use are included in this category.]

Consequently, protectionism still remains a problem. The three main modalities of exercising protection in the northern part of Cyprus are (i) quantitative controls of both exports and imports, (ii) excise taxes levied almost exclusively on imported products, and (iii) different VAT rates on foreign and domestically produced goods. They raise domestic prices, transaction costs of foreign trade operations and also institute significant uncertainty over the longer term fulfillment of contracts. (Excise taxes provide an important source of funds for the administration hence trade and fiscal reforms are intricately linked.)

Box 3.4: Tourism – Its Potential and Obstacles

In 2004, the northern part of Cyprus had about 600,000 tourist arrivals compared to 2.3 million for the southern part of Cyprus. Almost two-thirds of tourists to the northern part of Cyprus are from Turkey. Net tourism revenues of \$288 million far exceed the \$62 million merchandise export revenues. The contribution of trade and tourism to GDP is 18 percent with the share of hotels and restaurants estimated at 3 percent of GDP.

Despite being an important source of foreign exchange for the Turkish Cypriot community, this sector is under developed especially when compared to the southern part of the island. There are an estimated 128 hotels and guest houses in the northern part of Cyprus that report employing about 2,400 persons. In addition, the tourist industry includes restaurants, travel agencies, and casinos. This sector obtains less than 1 percent of bank loans.

The tourism sector in the northern part of Cyprus faces several obstacles which hinders its expansion. One problem is that travel time to the northern part of Cyprus is extended due to the lack of direct flights from European destinations (excluding Turkey). Second, due to unresolved land issues, investment in tourism facilities carries significant risk. Currently, only local and Turkish investments are being made in this sector. Third, the Turkish Cypriot tourism sector has difficulty in promoting and marketing internationally.

But the tourism sector also faces additional problems.

- Hotels operate at only a little more than 40 percent capacity and quality is variable in the areas of services, food safety standard compliance, and accommodation. There is limited ability to serve tourists in the areas of restaurants and transportation services (particularly buses to provide day sightseeing trips) and attractions, such as golf courses and other leisure activities. The northern part of Cyprus's natural and historical attractions have not been fully developed either and need significant upgrading.
- Infrastructure is inadequate and high-cost. To deal with electricity and water shortages and frequent outages, hotels must install their own generators and water treatment systems. Such costly infrastructure investments reduce their ability to compete on price with alternative destinations. Solid waste collection and disposal are also problems.
- Marketing is poor and there is a lack of public/private cooperation. There is no unified destination management program with input and commitment from both the public and private sectors and with high-quality marketing skills to implement it. There is insufficient professional marketing of the northern part of Cyprus as a tourist destination.
- Land use planning is poorly developed and zoning of land is currently largely absent leaving room for significant *ad hoc* intervention by the administration which creates uncertainty for developers. The lack of GIS capacity (to digitize the land and real estate cadastre) is an important drawback for the transparent setting and enforcement of zoning restrictions. This in turn is a limiting factor for the preservation of the attractiveness of the prime areas of historic and natural beauty which is a main driver of tourism.

Though tourism expansion faces many problems, this sector can indeed be an important driver of growth for the northern part of Cyprus. But the development of this sector needs to be done carefully with an understanding of which segment of the tourist market is being targeted and what strategy should be adopted to attract these persons. Thus, development of this sector requires a comprehensive plan—rather than a piece meal approach – inclusive of both public and private stakeholders.

3.37 One of the fundamental principles of export led growth is that it is dependent on open markets for imports. The reasons for this are two fold. First, imports allow “contestability” of markets. This means that local producers have to compete against international firms for domestic consumers and consequently they will strive for efficient production to keep prices low and good quality. If domestic producers do not have to compete for local consumers because they benefit from some form of protectionism, it also means that they will never be competitive in global markets. Second, exports – especially in small economies – can have a large import component to them. Thus, any policies which raise the price of imports make the country’s exports less competitive on the international market.

Table 3.2: Banking sector indicators for the northern part of Cyprus

<u>Financial sector indicator</u>	<u>Ratios</u>
Total loans / total deposits	39
Liquid assets / total deposits	58
Foreign currency deposits / total deposits	54
Pas-due loans / total loans	9
Public sector loans / total loans	42

Source: “Central Bank”.

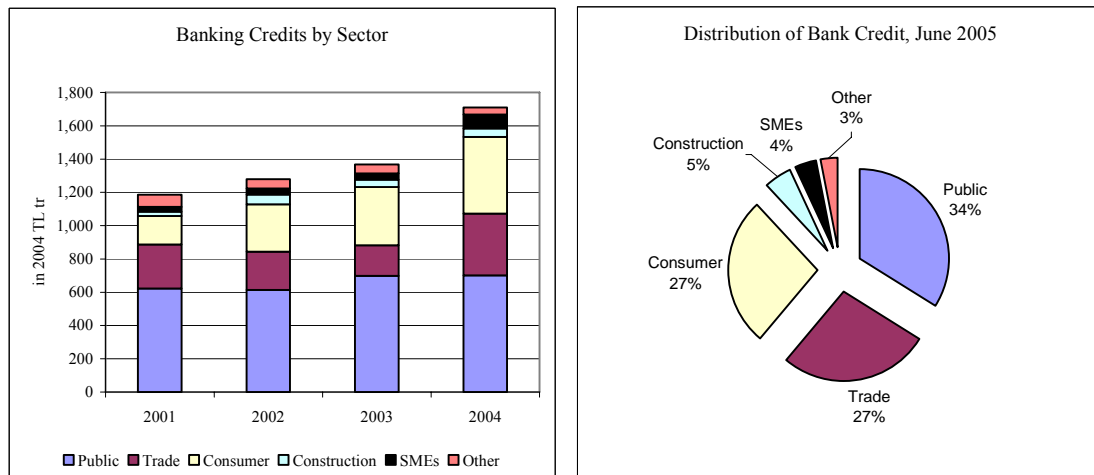
Financial Sector

3.38 The financial sector plays a critical role in economic development. Its soundness and performance are linked closely to macroeconomic and real sector developments. If it is well-functioning, it can spur economic development through channeling resources to the private sector and facilitating the expansion of production of goods and services. However, if it becomes unstable, it impedes economic growth and can cause major disruptions in both the economy and peoples’ standard of living. A financial system with different types of financial institutions also helps to improve the allocation of capital and can act to decrease the intensity of financial sector crises if they occur.

3.39 The financial sector of the northern part of Cyprus is surprisingly multi-dimensional given the small size of the population and the economy. It is comprised of commercial banks, cooperatives (i.e., credit unions), off-shore banks, the (public) Development Bank, insurance funds, pension funds, exchange bureaus, and a stock exchange. Though various institutions exist to intermediate savings in the economy, not all are well developed (e.g., the stock exchange) or exhibit the same level of competence in fulfilling their respective functions. Commercial banking is the most developed component of the system and can potentially play an important role in stimulating private investment. Moreover, this is also the only part of the financial sector which is properly supervised as it falls under the “Central Bank”.¹⁰

¹⁰ The “Central Bank” in the northern part of Cyprus functions primarily as a banking supervision agency since the northern part of Cyprus does not have its own currency and, therefore, no monetary policy.

Figure 3.6: Distribution of Bank Credits by Sector



Source: “Central Bank” of the northern part of Cyprus.

3.40 Though the banking sector has bounced back from the 2000-01 banking crisis, problems still remain with regard to its ability to fulfill its intermediation role in the economy (see Table 3.2). The main ones are (i) relatively modest financial intermediation activity and (ii) the unresolved potential of systemic risk due to the greening of public sector loans. These problems act as a bottleneck to the ability of the economy to exploit for purposes of economic development the US\$ 3 billion deposits (140 percent of GDP) sitting in the commercial banks. Interestingly, it is actually the foreign (Turkish) bank branches which engage the least in lending activities. They hold 32 percent of total deposits and make only 4 percent of all loans. Whereas the private commercial Turkish Cypriot banks hold 53 percent of total deposits and are responsible for making 81 percent of all loans.

3.41 Low financial intermediation by the banking sector may be explained by several factors such as risk aversion in the aftermath of the banking crisis, a wait-and-see attitude given the unresolved political situation with no clear signals on the resolution of the land problem, or simply the availability of high interest-low risk investment opportunities in the Turkish treasury market. And on the demand side, the problem of high interest rates on Turkish lira denominated loans and short maturities may curtail the desire for loans by investors in particular. But the ultimate consequence for the Turkish Cypriot economy is banks hold back giving loans and the new loans that are given are skewed away from productive sectors. During 2001-2004, the distribution of bank credit as a share of total credits remains in favor of the public sector, foreign and domestic trade, and consumers as seen in Figure 3.7. These types of loans are characterized by collateral backing and short maturities – and hence carry relatively lower risk for the banks. However, surprisingly, the highest growth over this period has come from lending to SMEs though from a very low basis (of only 2 percent of total credits). In constant Turkish lira, the growth in credit to SMEs increased by almost 200 percent compared to 44 percent for total credit. Negligible lending is done to the non-SME productive enterprises such as tourism, manufacturing, and agriculture.¹¹

¹¹ This statement should be qualified as there could be potential overlap in lending to these sectors and in SMEs and trade lending. Furthermore, it is not clear how much lending is undertaken by the cooperative

3.42 The issue of systemic risk to the bank sector remains a concern for Turkish Cypriot owned banks primarily because of past lending by private banks to the central administration and public enterprises. Total public sector debt to the private commercial banking sector is 27 percent of GDP. The commercial bank exposure to the public sector is high (34 percent of total lending in mid-2005) and the absolute value continues to grow at an average of 4 percent per annum over the last 3 years. The reasons behind this are that much of the lending to public sector entities occurred in the years leading up to the banking crisis and banks continue the capitalization of interest and extension of maturities on a number of these exposures rather than categorizing them as non-performing loans. (In addition, banks continue to lend to public sector enterprises and municipalities though no “government” guarantee is given on these loans.) The rationale behind this strategy is that the banks believe that the central authority debt obligations will indeed be honored – eventually. And the central administration (in its transfers) is indeed repaying a small portion of the public debt on an annual basis. However, whether this is a viable strategy in the medium-term is not clear given the large obligations of the public sector to the Provident Fund as well as the high fiscal deficit.

Investment Climate

3.43 The investment climate in the northern part of Cyprus is marked by considerable economic and political uncertainty, trade restrictions to Turkish Cypriot goods in global markets, and heavy public sector influence on economic activity. These overarching problems dampen investor expectations about the future, increase investment risk, and weaken incentives for investment, innovation, and technical learning. In addition to these overarching problems, there are other elements of the investment environment that affect the ease of doing business in the northern part of Cyprus and the cost and competitiveness of investments. We highlight some of the more significant investment climate issues in this section.

3.44 **Economic and political uncertainty** in the northern part of Cyprus is high. Macroeconomic instability (resulting from the close linkage with the Turkey’s economy) has served to increase investor uncertainty and caused lenders to factor in higher risk premiums in interest rates and to reduce loan maturities. Thus, investment will tend to gravitate towards those activities where there is a quick payoff (e.g., construction, casinos, and restaurants) rather than in such activities as agriculture or industrial production. Political uncertainty about the timing and conditions of reunification of the island has been another factor in the climate of insecurity. One of the central issues of reunification is the property question. The fact that a significant proportion of land in the northern part of Cyprus may be contested creates significant investor uncertainty (see Box 3.5). The property issue continues to be a problem for local investors in tourism and agriculture, and for infrastructure development, and for foreign investors in residential housing. The current situation as regards property also reduces the amount of collateral available for loans, an important issue in an economy where most of the firms are SMEs and banks require as much as 200 percent collateral for business loans.

3.45 **Travel and trade restrictions** in the EU limit opportunities for exporters and tourism operators in the northern parts of Cyprus. Trade with the southern part of Cyprus via the new Green Line Regulations is also currently constrained by psychological barriers and extra costs due to the imposed conditions of trade. These restrictions on trade limit the size of the market and raise transport cost. High transport costs and constrained production capacity utilization

banks based in the rural areas. Some of their loans may be given for agriculture activities given their proximity to their customers and their businesses (for example, farms). Lending activities by these institutions are not supervised by the “Central Bank” and consequently data are not collected.

negatively affect the competitiveness of many products in the northern part of Cyprus. Perhaps most importantly, isolation from global markets reduces incentives for firms to invest in upgrading technologies and product quality and limits the channels through which transfer of new ideas and technologies take place.

Box 3.5: Land and Real Estate Ownership

Property rights on the island of Cyprus are uncertain due to political events over the last three decades. A description of the three phases in the shifts of ownership of land and real estate over the past sixty years can provide an understanding of some the challenges facing the island in the resolution of the property issue.

- In 1946 with the promulgation of a Cadastral Law by the British government, there began a fairly complete registration of land and real estate belonging to private individuals and juridical persons throughout Cyprus, though titling of state-owned land lagged considerably. Estimates exist that by the late 1950s, between 25 to 50 percent of privately-owned land area was held by Turkish Cypriots. An estimated 90 percent of the property area owned by Turkish Cypriots was in the southern part of Cyprus.
- In the early 1960s, a second phase began with the escalation of political tensions. Within settlements and cantons (regions) greater segregation of the two groups occurred, and leasing out of land developed significantly. In the mid to late 1960s, leasing out developed into selling and many Turkish Cypriots sold their properties, with some leaving Cyprus altogether. By the early 1970s, over 95 percent of Turkish Cypriots now lived in the north and their share of property had fallen to about 30 percent. However, an estimated 85 percent of this property was in the southern part, so Turkish Cypriots were minority owners in the northern part.
- After 1974, much of the citrus and potato areas in Guzelyurt (Morphou) which had been left by Greek Cypriots remained uncultivated, as there was not an intention at the time among Turkish Cypriots to take up new permanent residence there. Many were non-farm employment oriented and preferred not to cultivate agricultural land. However, after 1977, with the issuance of the “Land Allocation Act” by the Turkish Cypriot administration, Greek Cypriot lands in the northern part of Cyprus were allocated to Turkish Cypriots and immigrants from Turkey, many of whom now took up agriculture and expanded land use. In 1984, titles to land were distributed to these beneficiaries by the administration in the north.

Over the past thirty years, the title registration system has been maintained in four offices at the district level. Changes of ownership are visible in the system, and it is possible to go back into the records and identify the earlier Greek Cypriot owners. In fact, during this period some Greek Cypriots with property in the north were able to arrange the sale and transfer of such property to Turkish Cypriots, often through exchanges for Turkish Cypriot property in the southern part of the island. This sale or exchange was banned by the Republic of Cyprus in 1992, but this ban was rescinded in September 2005.

Currently, there are 54,000 agricultural land parcels in the northern part of Cyprus (out of 250,000 in Cyprus altogether) and roughly 200,000 non-agricultural pieces of other real estate (again out of a total of roughly 1 million in Cyprus). All these plots are described on paper maps, but many have not been adequately updated for many years. A cadastral and mapping office in the northern part of Cyprus is currently working on the re-surveying and digitization of cadastral maps, and in the process adopting a new coordinate system (introduced internationally).

Resolution of the property issue in the island of Cyprus could continue piecemeal through the court system. However, the danger of this approach is that it prolongs uncertainty for an indefinite period, thus adversely impacting the investment climate. A better approach would be to resolve the property problem through a comprehensive settlement thereby avoiding lengthy and costly litigation procedures. This will not only reduce the aggregate time and financial cost, but will also serve to improve the investment climate on the island.

3.46 Expansion of public employment and the high growth of public sector wages have led to the development of distortions in the labor market. One of the main consequences of high wages and benefits and overstaffing in public agencies and enterprises is that the public sector has become a magnet for young jobseekers. Many of the country’s most educated and talented young people are attracted to public employment rather than becoming entrepreneurs or managers in the private sector. Firms complain about a lack of middle-level skilled labor, particularly technicians.

This public sector premium in pay and benefits not only exerts a pull on talent away from the private sector, it also puts upward pressure on the private sector wage level, reducing competitiveness.¹² Moreover, it undermines incentives for private sector training as many young employees upon receiving some skills seek jobs in the public sector—and the benefit of training employees is lost for the private firms.

Box 3.6: How the Public Sector Distorts Markets: The Case of Agriculture

Marketing of more than half of agricultural products (by value) is heavily influenced by public marketing boards or public enterprises: the Agricultural Products Marketing Board (TUK); the Milk Marketing Board (SUTEK); and Cypruvex. Since these companies are the main implementers of agricultural policy in the northern part of Cyprus and can pass on the high prices they pay to farmers to the processing sector, the losses which they incur are mainly generated as a result of overstaffing and other inflated administrative costs. More importantly, they are viewed by farmers as entities which can always absorb price reductions in the international market and to whom one can always sell sub-standard product. This reduces the incentives for farmers to increase the quality of their output and raise productivity. As a result, improvements to product quality (for example, in milk through the installation of cold chains) and to the timing of sales by farmers (for example, through fruit and vegetable cold storage) are only slowly being propagated.

Estimation for Change in the Value of Produce after Alignment with the EU, 2004

	Nominal Protection Coefficient		Cyprus (north)	
			Production Value Share	Change in Value of Produce with Alignment
	EU-25	Cyprus (north)		(in percent)
Durum Wheat	1.00	1.05	1	-5
Common Wheat	1.07	1.37	1	-22
Barley	1.09	1.19	24	-9
Cow Vetch	1.25	0.80	0	56
Tomatoes	1.17	1.11	3	6
Citrus	1.00	0.77	12	29
Potatoes	1.10	1.59	5	-31
Grapes	1.02	1.55	1	-34
Cow Milk	1.38	1.59	25	-13
Beef	1.99	0.97	4	105
Poultry	1.97	1.87	13	5
Sheep	1.33	0.81	9	65
Eggs	1.00	1.95	3	-49
Total	1.35	1.33		6.00

Source: World Bank staff estimates based upon OECD (2005) and MOA data.

Comparing market supports by major commodities with those of EU-25 in 2004, reveals that differentials between producer farm and reference world prices measured by the nominal protection coefficient are generally higher for grains and lower for livestock products in the northern part of Cyprus than in the EU. The main and important exception to this pattern is the higher support prices accorded to the dairy sector in the northern part of Cyprus. Egg production is granted even higher comparative support, but is it a smaller sector than dairy. In the crops sector, wheat, barley, potatoes, and grapes are being supported through market subsidies more than in the EU as seen in the table above

¹² The starting wage in public employment of 1,100 TL is 50 percent higher than the 720 TL minimum wage in the private sector. The public sector pension is 50 percent higher than the pension in the private sector.

3.47 The **involvement of the public sector in the productive sectors** has created a host of problems unfavorably impacting the investment climate. Public enterprises are present in many areas, for example they include marketing boards in agriculture (fruits and vegetables, dairy, other agricultural products), alcohol producing, tobacco processing, carob processing, olive oil processing, milk processing, flour production, slaughter houses, media, a shipping agency, petroleum processing, air transport, banking, and importing. There are two important negative consequences for the private sector from the existence of the large public enterprise sector. First, and perhaps least appreciated, is the fact that public enterprises curtail business opportunities for the private sector. It is difficult for a private sector firm to compete with a firm where profitability is not the bottom line (as losses are picked up by the central budget) and prices can be set below cost. Also, given the scarcity of skilled labor willing to work in productive enterprises, private firms cannot compete with the better compensation packages that public firms can offer. Second, the inefficiency of public enterprises hinders competitiveness of the private sector and impedes its ability to develop. Product quality of downstream food processors, for example, is hampered by the inefficiency of upstream marketing boards in agriculture (see the agricultural section of this report). Low quality service of public infrastructure providers is also a major impediment to competitiveness.

3.48 **Inadequate quality of infrastructure.** Private business activity in the northern part of Cyprus is hampered by inadequate development of infrastructure services. Infrastructure costs are higher (although utility rates are not full cost recovery rates) and quality of services lower than competitors, especially in the areas of water and electricity. Power outages are frequent and water shortages common. Many firms must run their own generators or operate their own water systems, which adds extra cost and reduces their competitiveness. Also, backbone infrastructure, such as telecommunications, broadband, and internet providers, which are necessary for global integration are under-developed in the northern part of Cyprus.

3.49 The business environment for private sector investment in the northern part of Cyprus has policies and practices that need to be improved and legislation that needs to be brought up to EU standards, but for the most part it is not remarkably restrictive compared with many transition economies. A 2004 study by Bearing Point, funded by USAID, compared the environment for doing business in the northern part of Cyprus with OECD countries and with emerging Asian economies.¹³ It found that the northern part of Cyprus compared favorably in many areas, including rule of law and courts and regulation, with some exceptions. Finally, it is important to mention that in surveys of enterprises in the northern part of Cyprus most firms do not cite institutional or regulatory barriers as their biggest constraints to future growth. They generally put political and trade isolation at the top of the list along with a host of commercial barriers. In a 2004 survey of 272 enterprises, conducted by UNOPS with EU support, firms ranked the following commercial problems as constraints to doing business: (i) credit (loans, working capital), (ii) market development (access to new markets, marketing techniques), (iii) compliance with EU legislation and standards (health, safety, environmental), (iv) product and process improvement (compliance with industrial standards, certification, quality control, procurement, packaging), (v) human resource development in IT (e-commerce, IT application training, hardware upgrading), and (vi) foreign language development (Greek, English).

¹³ BearingPoint, Inc, "Cyprus Partnership for Economic Growth: Analysis and Findings", submitted to USAID, January 2005.

E. HUMAN CAPITAL DEVELOPMENT

3.50 Education in the northern part of Cyprus has a dual purpose. On one hand, it is an essential vehicle for transforming human capital and building social cohesion in a community that has been isolated politically and economically and that is now seeking ways to integrate to the Europe and global markets. On the other hand, education plays a significant economic role in the northern part of the island due to the export of higher education services to non-Turkish Cypriot students. Achieving balance between these two purposes is essential since opportunities as well as dangers are often hidden in the fast growth of enrollments and fiscal revenues. Moreover, the continuous focus on improving quality of education services will only serve to enhance the income generating prospects of the tertiary education sector which plays a critical role in the economy and growth of the northern part of Cyprus.

3.51 Education authorities have an established goal of bringing education in the northern part of Cyprus close to European good practices and policies. Indeed, the education sector development has several elements that are compatible with the ongoing education reforms in Europe: extending the length of compulsory education from eight to nine years, revising curriculum content and methods to emphasize student-centered education, modernizing teacher pre-service training, designing new student assessment scheme for compulsory education and matriculation examination for the upper secondary school leavers, and strengthening learning of foreign languages throughout the education system. Work is also underway to make vocational secondary education a more attractive alternative for young people by harmonizing the vocational qualifications and programs with the current European standards.

3.52 In the northern part of Cyprus, the total number of students in the academic year 2004/2005 was about 64,000 of which almost half were studying at the tertiary level. The majority of primary and secondary students—92 percent—were in public schools though private schools are expanding rapidly. The public school system is bifurcated in that the best students are placed in elite secondary schools, “Maarif Colleges” with many of its students eventually obtaining the option to study at foreign universities financed by public monies. Few of these students return home to share the knowledge and skills acquired abroad.

Primary and Secondary Schools

3.53 Schools in the northern part of Cyprus have many positive features. They have committed and motivated teachers, reasonable student-teacher ratios, and public educational services are widely accessible throughout the northern area. The teaching profession is popular among secondary school leavers and admissions to teacher training programs are highly sought after. Parents are also committed to the education of their children and willing to devote extra resources for payment for certain textbooks and additional tutoring.

3.54 The main problems affecting primary and secondary schools in the northern part of Cyprus are (i) insufficient learning time in school, (ii) variability of educational quality across schools at the same level of education, (iii) teaching and learning do not adequately focus on skills needed in a democratic knowledge society, (iv) overly generous teacher salaries and benefits at the expense of investment in school supplies and technology, and (v) lack of labor market relevance of secondary education. These factors combined indicate that the value received by students is far less than what the public is paying.

3.55 **Insufficient learning time.** Turkish Cypriot students in secondary school receive much less instruction than their peers in OECD countries. Their school days are shorter and they have

far fewer instruction days in a year (155 versus 186 for OECD average). Less school-based learning time translates into less opportunity for teachers to teach and for children to learn what is expected. Consequently, Turkish Cypriot children are being short changed and leave school inadequately prepared unless they supplement their instruction with additional tutoring in after hours. At the lower secondary level, the net teaching time is about 60 percent of that in OECD countries in average which translates into about 3 years of less education by the end of 12th grade.

3.56 Variability of educational quality. The quality of education varies significantly between schools at the same level of education. Maarif Colleges offer high quality learning opportunities to their students. But some schools are in short supply of even basic learning facilities and teaching aids, and class-sizes are much higher than in other schools. Physical and human resource differences between private schools and average public schools are often striking. Private schools have smaller pupil-teacher ratios, better equipped classrooms, sports facilities and workshops, and their own operational budget to finance development activities during the school year.

3.57 Generous teacher compensation packages. Teachers' work loads are light with a maximum of 20 – 25 lessons per week and only 31 weeks of instruction per year. On average, in lower secondary school net teaching time is 415 hours per year compared to the OECD average of 701 hours and 840 hours for the southern part of Cyprus. However, teacher salaries in the northern part of Cyprus are exceedingly high in comparison to average income. Mid-career salaries of Turkish Cypriot teachers are 3.6 times average GDP per capita where the OECD average teacher salary was only 1.3 times income per capita.¹⁴ One interesting comparison is between the hourly compensation for Turkish Cypriot teachers versus teachers in the Republic of Turkey. The former earns about \$69 per teaching hour whereas a Turkish teacher earns only \$15 per hour.

3.58 Labor market relevance. Relevance to labor markets as well as to lifelong learning becomes a specific issue in secondary education. A considerable part of vocational and technical training takes place under irrelevant curriculum and in premises that have out-dated equipment that are not providing students with opportunities to acquire the skills they will need in the labor market. Vocational education programs are specialized in rather narrow professional domains which restrict creating flexible occupational competences that are increasingly required in the modern world of work. Currently new professional standards for vocational and technical education are being developed that will bring it closer to EU practices and to the needs of the labor markets in the Turkish Cypriot community. (See Box 3.6.)

Higher Education

3.59 There are six universities in the northern part of Cyprus that provide academic and semi-professional training programs. Five are private universities and one is a semi-public university. Of the 35,000 university students, two out of three are foreign, mostly from Turkey but also increasingly from the Middle East. Turkish Cypriot enrollment rates are high at all levels of the education system but excessively so at the university level. High tertiary gross enrollment rates (72 percent) of Turkish Cypriots in the northern part of Cyprus may be indicative that universities are not doing an adequate job of screening out secondary school graduates who do not have the abilities necessary for entering a rigorous educational program.

3.60 Quality issues in the education sector are especially significant at the higher education level. The number of students in higher education has risen almost tenfold in the last 15 years. At

¹⁴ The average salary of a lower secondary school teacher with 15 years experience was \$28,000 per annum. The average income per capita in the northern part of Cyprus is about \$8,094.

present, there are six higher education establishments in the northern part of Cyprus that provide various academic and semi-professional training programs for about 35,000 students in the 2004/05 academic year. Approximately 60 percent of them from Turkey. However, practically all Turkish Cypriot secondary school graduates are accepted to one of the six universities. This is a huge quality challenge given the mixed quality of secondary schools where the new entrants are currently coming from. Furthermore, this dominance of higher education has led to a situation in education policies where lower level tertiary education is practically replacing what is normally considered as non-academic secondary education in Europe.

Box 3.7: What Skills Should Students Acquire To Make Their Economy Competitive?

Education—in particular, upper secondary school—plays an important role in helping economies integrate into the world economy. Globalization, the skill-based nature of technological changes in the workplace and the increased importance of knowledge as a driving force in economic and social development, are putting additional incentives on national governments to critically evaluate and modernize their secondary education systems. The common aim is to produce graduates that are better prepared for work as well as for further learning.

According to research carried out by Levy and Murnane (2004) on the skills requirements for the tasks performed in the U.S. labor market, five categories of tasks performed by a labor force today were identified:

- *Expert thinking*: solving problems for which there are no rule-based solutions, e.g., diagnosing the illness of a patient whose symptoms seem strange.
- *Complex communication*: interacting with humans to acquire information, to explain it, or to persuade others of its implications for action, e.g., a *manager* motivating the people whose work she supervises.
- *Routine cognitive tasks*: mental tasks that are well described by logical rules, e.g., maintaining expense reports.
- *Routine manual tasks*: physical tasks that can be well described using rules, e.g., installing windshields on new vehicles in automobile assembly plants.
- *Non-routine manual tasks*: physical tasks that cannot be well described as following a set of If-Then-Do rules because they require optical recognition and fine muscle control that have proven difficult for computers to carry out, e.g., driving a truck.

There are different trends for each of these five types of tasks in the U.S. labor market. Tasks requiring expert thinking and complex communication have grown steadily since 1970. On the other hand, the proportion of the labor force employed in occupations that emphasize routine cognitive or routine manual tasks remained steady in the 1970s and then declined over the next two decades. The share of the labor force working in occupations that emphasize non-routine manual tasks declined throughout the period.

3.61 Expanding access always create a quality challenge in education. Some education specialists in the Turkish Cypriot community are quite correctly worried about the lowering standards in accepting Turkish Cypriot students to universities and also diminishing expectations from there local students on what is required to graduate. It was argued that practically anyone having some kind of secondary education diploma is able not only to enroll in university but also complete it. Since private universities have complete autonomy after being accredited by the Council of Higher Education of Turkey concerning their academic requirements and students pay for their tuition (and diplomas), there is little the administration can currently do to control the quality and to assure adequate level of expectations in the universities.

3.62 Another critical quality issue in higher education is its relatively weak emphasis on teaching scientific research as part of academic programs. Higher education quality is commonly determined by two main dimensions: teaching and research. Lack of appropriate preparation to understand and carry out research as part of university studies will in the long run jeopardize the

reputation of university institution. Indeed, many young Turkish Cypriots are leaving the island for foreign universities for this reason.

3.63 All universities with the exception of the Eastern Mediterranean University (EMU) are fully financed by private money. The EMU is partly financed from the public budget. Turkish students are subsidized by their Government, whereas only students (Cypriot and Turkish) at the EMU are subsidized by the public sector in the northern part of Cyprus. Moreover, financial discipline on part of the EMU appears to be lax and concerns have been raised about its salary structure and adequate attention to non-wage inputs (excluding buildings). As a consequence of its premier status, it is able to obtain funds to cover its deficit. However, this comes at the expense of Turkish Cypriot school children who lose out in the reallocation of their educational funds to the university.

CHAPTER 4

OPTIONS FOR REFORMING THE ECONOMY FOR SUSTAINABLE ECONOMIC GROWTH

4.1 This report attempts to provide an overview assessment of some of the key areas of the Turkish Cypriot economy in the northern part of Cyprus. The report was able to make a preliminary review of public finances, the pension system, private sector development, trade policies, the financial sector, labor markets, agriculture, and education. As noted earlier, no pretense is made that the assessment is comprehensive or even covers all critical areas of the economy. Indeed, many important issues were not discussed such as infrastructure, the environment, the health sector or the social safety net.¹

4.2 Any economic assessment is only useful if it helps to shed light on what are some key areas that need to be addressed in order to ensure prosperity for the population in the future. This broad assessment is useful in capturing some of the problem areas that need resolution in the short- to medium-term if the Turkish Cypriot community wishes reasonable levels of economic growth to continue and to begin to converge with the policies and institutions of the European Union (EU). Many specific sectoral recommendations are provided in the subsequent volume and they are targeted to the audience of policy makers and stakeholders who are deeply involved in specific areas.

4.3 In this volume, we discuss those reforms which are important for improving the growth prospects of the economy in the context of its future integration into the EU. There is no time horizon specified as to when this integration and reunification of Cyprus is believed will occur. The reason for this is that irrespective of whether or not the Turkish Cypriot community acquires the rights of other EU member citizens sooner or later, the process of integration with the EU has begun. Consequently, for the Turkish Cypriots to benefit from the process and to shape their own future in the context of a future unified Cyprus, it is imperative that they are active in shaping their institutions, policies, and regulatory framework to conform to the EU rather than allowing political developments to steer their economic reform agenda.

4.4 This chapter will discuss briefly the four areas that the central administration together with other stakeholders needs to address in order to initiate the process of economic reform. It should be noted that there is no single magic bullet that will help to modernize the Turkish Cypriot economy. However, by highlighting critical areas for reform, we hope that the complementary steps will be taken to upgrade the legislation, develop institutions, and invest the necessary resources to ensure that the reforms can be implemented comprehensively.

¹ Under the UNDP's "Feasibility Studies for Economic Projects", several infrastructure areas were covered already.

A. ACHIEVING FISCAL SUSTAINABILITY

4.5 The availability of foreign aid and access to a large pool of domestic savings provides an avenue for fiscal expansiveness, but it is not a sustainable strategy especially since most of the resources are consumed rather than invested. On the one hand, public sector expenditures are high and growing (especially pension obligations) while the tax burden is already high so as to encourage economic informality. On the other hand, the continued inflows of large sums of money into the economy distort various factors and product markets – that is, they increase wages and support business activities in areas that are not particularly profitable and consequently undermine balanced economic growth.

4.6 There are four main components of a strategy for achieving fiscal discipline in the northern part of Cyprus. They are (i) reform of the pension system, (ii) phasing out of most economic and financial transfers, (iii) debt management, and (iv) reduction of the share of public sector wages and salaries in the budget. These components are discussed below.

4.7 **Reform the pension system to achieve self-sustainability.** Although the current pension system of the northern part of Cyprus may exhibit some elements of a modern multi-pillar pension system and a well organized social insurance administration, its fiscal performance, with a deficit of 8 percent of GDP, has created a heavy burden on public finance. In addition, due to the generous benefits provided in the public pension scheme, a distorted incentive structure creates a labor market bias in favor of public sector employment. Without reforming both the general and civil servants' parts, primarily removing the unfunded promises and unsustainable benefit levels and retirement ages, the pension system would continue to slide into a deeper deficit. To bring the system to a sustainable path, the list of measures that can be considered by the policymakers includes:

- Balancing the general pension scheme (the SIF) by revising the system parameters (i.e., retirement age, calculation period, indexation, minimum pensions, pension formula compression) and, if needed, higher contribution rates (at least in the period until parametric reforms yield some results) and a temporary nominal pension freeze.
- Improving the actuarial balance of the civil servants pensions scheme (CSPF) by revising the parameters (i.e., retirement age, calculation period, formula, indexation), reducing or eliminating gratuity payments, and increasing the contribution rate.
- Reducing the deficit for pre-1987 civil servants by tightening the indexation pattern and other system parameters, increasing the contribution rate and if needed, a temporary nominal pension freeze.
- Starting to provide pension products from the Provident Fund instead of paying out only the lump sums.
- Removing pension system incentives for long term employment in the civil service.
- Gradually integrate the civil servants pension system into the general system.
- Diversifying the portfolios to minimize investment risks in both pension schemes, hiring a professional asset manager, and increasing transparency of these pension funds.
- Introducing legislative changes so as to prevent Provident Fund lending to the budget under the current setting.

4.8 **Phase out economic and financial transfers.** In 2004, economic and financial transfers (exclusive of any transfers to the SIF or local administrations) were an estimated 12 percent of GDP (see Table 3.1). Transfers to private and public enterprises as well as to small farmers and businesses serve only to support activities which may not be profitable in the medium- to long-term. The financial support uses taxpayer money to *discourage* businesses from leaving a loss-making activity for an activity which is more productive and has a higher payoff. Therefore, it is not only a poor use of money, but it hinders development of a competitive private sector. Though there is usually little economic justification for such transfers, once money is given, a sense of entitlement develops among the recipients as well as powerful political interests—so removing them is very difficult and can best be done under a broad reform program.

4.9 **Reduce the share of public sector wages and salaries.** Public sector wages and salaries² in the northern part of Cyprus account for 15 percent of GDP compared to 9 percent for the new EU member states. This difference is substantial and indicates an excessive amount of public resources being devoted to this category. Moreover, it appears that though the civil service has gradually been reducing the proportion of the labor force it employs, public wages—especially relative to the private sector—have increased rapidly. Thus, not only is there a financial cost, but the civil service’s higher wages, job security, and excellent benefits serve to attract the brightest away from the private sector.

4.10 But wage reform is always difficult especially in a context of strong trade unions that traditionally see their role as improving the welfare of their members through higher income and better benefits. And in the case of the northern part of Cyprus, since a significant portion of the budget is financed by Turkish taxpayers, Turkish Cypriots themselves do not protest the relatively high wages received by public employees. But unless the Turkish Cypriot community comes together to address the wage bill, the distortions in the labor market will continue, dependency upon Turkey will increase, and the debt owed to Turkey will continue to grow. Various measures for reducing the wage bill range from retrenchment and wage cuts to employee attrition, early retirement schemes, and wage increases below inflation.

4.11 **Manage public debt better.** There is little consolidated information on public debt available in the northern part of Cyprus.³ The central administration borrows domestically from the pension funds and internationally from the Republic of Turkey. Public enterprises and local administrations borrow from commercial banks (though no longer officially guaranteed). Moreover, there is a significant amount of old public debt with private commercial banks which was taken in the past decade that has yet to be fully repaid. In addition to questions about the amount of debt obligations held by the public sector, the terms of the debt—interest rates and maturities—are not easily available and there is no strategy for managing debt from the perspective of smoothing public consumption over time and ensuring solvency. Furthermore, there is no systematic reporting of debt servicing in the central budget.

4.12 Why is it a priority to track and manage public debt in the northern part of Cyprus? The reason is that the current approach by the public sector could adversely impact the stability of the economy through undermining the pension system and private commercial banks. Though that possibility may be remote, continued rapid build up of debt obligations without an appreciation of

² Here we refer only to the wages and salaries of workers in the central administration. However, the share of this category in GDP is likely to rise substantially with the inclusion of public enterprises and local administrations. Public enterprises are purported to be significantly overstaffed.

³ Public debt refers to the debt held by central administration, public enterprises, and local (municipal and district) administrations.

how much is being accumulated and the absence of a repayment strategy makes this approach unsustainable. Already the substantial portion of the (old) problem loans from the public sector on the balance sheets of commercial banks has made banks risk averse and unwilling to lend to the private enterprise sector which in turn has stymied the expansion of the private sector.

4.13 The objective of debt management should be to achieve the lowest possible borrowing costs at an acceptable level of risk *given* a policy framework which is consistent with a stable macroeconomic stance. Thus, a debt management strategy must go hand-in-hand with a common understanding of (i) the administration's fiscal targets for the coming year and in the medium-term and (ii) the funding rules for domestic and foreign borrowing. Moreover, for a debt strategy to work, it would be essential that the fiscal targets were genuine targets for which the leadership would be willing to expend its political capital in order to attain them. Finally, whatever framework is adopted, transparency is important and can be facilitated through timely reporting to ensure greater accountability of the administration to the public.

B. DEVELOPING THE PRIVATE SECTOR

4.14 By its very nature, any private sector development strategy must have multiple components given the many factors that influence its development. In the case of the northern part of Cyprus, some constraints are a unique result of the political situation and will likely only be resolved through political dialogue. Also due to its small size, a couple of subsectors—tourism and higher education—hold dominating positions in the economy. The expansion of these specific subsectors would best be served by obtaining the advice of international consulting firms in mapping out the short-, medium-, and long-term steps that should be taken to develop them strategically. In this section, we turn our attention to briefly highlight five areas where reform will benefit the private sector in general.

4.15 **Replace economic and financial transfers with targeted shipping subsidies.** Private sector competitiveness can only begin to be improved by removing the transfers (including those through the price stability fund) discussed in paragraph 4.8 above. However, one of the underlying reasons for having provided the subsidies in the first place may have been to compensate private businesses for the problems resulting from the political situation. But the impact of economic restrictions on business activities are mainly threefold: higher shipping costs, non-preferential access to EU markets, and longer time to destination markets. Though little can be done about the loss of business due to the extension of time needed to ship products via other countries, the administration could provide a subsidy for the higher transportation costs of using ships coming into the northern ports.⁴ However, this would only make economic sense if the belief is that the isolation is temporary and will be removed in the next three to five years. Otherwise, the private sector must adjust to the situation and pursue those activities that are profitable in the context of isolation.

4.16 **Improve physical infrastructure.** As noted in Chapter 3, infrastructure gaps hamper private sector development in the northern part of Cyprus. Though the Turkish Cypriot community devotes 7 percent of GDP to investment,⁵ the continued shortages in the supply of

⁴ As noted earlier, the use of these ports of entry and exit are deemed illegal by the Government of the Republic of Cyprus.

⁵ The World Bank estimates that financing needs of developing economies for infrastructure are 7 percent of GDP, though low-income countries may need up to 9 percent of GDP annually to increase access to quality infrastructure.

infrastructure services indicate that the money is not being allocated to priority areas, gross inefficiencies in the delivery of services exist, and/or inadequate resources are allocated towards operations and maintenance. Though an immediate step should be in improving service delivery in the context of a sector-wide review of the issues and constraints, in the medium- and longer-term as the Turkish Cypriot community embarks hopefully upon a fiscal adjustment program, the key will be to protect spending on public infrastructure. In addition, greater thought needs to be given to increasing the commercial orientation of public infrastructure entities including private participation in service provision (for example, through privatization as discussed in paragraph 4.17). This will entail designing effective regulatory and institutional arrangements, including credible (and independent) regulatory agencies.

4.17 Begin the privatization process. Expanding the private sector in the northern part of Cyprus will mean downsizing the public sector, especially in terms of its participation in commercial activities. Public enterprises are active in many different areas—from production of consumer goods to marketing boards to utilities. Privatization offers the Turkish Cypriot community ways to improve enterprise efficiency, lower the cost of production, and improve the quality of services. Also, it is an important vehicle for attracting new technology and know-how. Privatization (or at the very least, corporatization) needs to be put on a fast track, particularly in those areas where public enterprises impinge upon the productivity of the private sector or reduce opportunities for private entrepreneurial activity. Special attention should be paid to marketing boards in agriculture and enterprises in energy, water, and telecommunications. It should be noted that privatization can be carried out using many different methods (e.g., asset sales, cooperatives, and IPOs), but it requires strong political leadership and commitment, appropriate legislation to guide the process, and a decision-making framework to give legal authority to those responsible for program implementation.

4.18 Remove the anti-export bias of policies. Given the small size of the Turkish Cypriot economy, openness to trade is essential for its development. However, as discussed earlier in this report, the present political situation in conjunction with the existing trade policy regime in the northern part of Cyprus impedes the export of goods. Trade can best be promoted through a strategy with three components. *First*, the Turkish Cypriot administration should seek to achieve full harmonization of border measures with those of the EU external economic border. Alignment of border measures with the EU involves adoption of the EU customs procedures, Community's Common Customs Tariff (CCT), EU trade defense measures (for example, countervail, antidumping) and its bilateral preferential trade regime.

Second, the Turkish Cypriot community should remove measures which distort competition. In addition to the removal of the economic and financial transfers discussed above, three other actions are as follows:

- Suspension of foreign trade initiatives. For instance, the Turkish Cypriot authorities should not contemplate enacting antidumping legislation. This should be shelved, as the goal of the strategy is to execute the EU trade measures including the EU antidumping measures;
- Eliminating the trade-licensing regime. It can be done with the stroke of a pen for all products except for those for which licenses are not issued. For meat, milk and dairy products, these should be replaced with duties, i.e., border measures, set initially at high levels but subject to a transparent and decreasing schedule; and
- The removal of excise taxes levied solely on imports in two steps: (a) extending the preferential schedule to imports; and (b) the abolishment of excise on imports and applying those in place to both imported and domestically-produced goods

4.20 *Third*, the EU should incorporate the northern part of Cyprus within its customs union with common arrangements for imports from other countries and a common external tariff provided that the Turkish Cypriot community adopts the relevant provisions of the *acquis communautaire*. While the current arrangements concerning movement of persons could be maintained at the Green Line, the main difference would be (a) to eliminate current procedures on the movement of goods through the Green Line with some possible exceptions concerning products from the northern part of Cyprus that are subject to phyto-sanitary measures and mandatory technical standards and (b) to establish and execute the same rules and procedures regulating export and import activities as applied in other EU borders.

C. DEVELOPING THE EDUCATION SECTOR

4.21 The Turkish Cypriot community's future may very well turn on how successfully the education sector is managed and developed over the next few years. Education plays a large role in all societies as it is the vehicle for creating human capital and a channel for teaching the society's values to the next generation of citizens. In the case of the northern part of Cyprus, it is also important as a social industry which contributes significantly to the income of the community. However, it is imperative that the financial profitability of the higher education subsector does not overshadow and divert attention away from its main objective of educating young Turkish Cypriots.

4.22 The performance of the education system can be measured along three broad aspects—quality, efficiency, and relevance. Achieving these goals at the primary, secondary, and higher levels of education are not easy and require adequate political attention and commitment—otherwise the failure of any intended reform is assured. In addition to strong leadership and technical expertise in education systems, educational reforms require coordination between policy-makers, education institutions and business leaders—since this will not only enhance the relevance and quality of education, but will also broaden and strengthen the support for undertaking major reforms to the system. The remainder of this section provides some of the key steps that the Turkish Cypriot community can take to improve their educational system.

4.23 **Increase support to the ongoing education reform.** The ongoing education reform promises significant qualitative as well as structural changes that are closely connected to the economic and social development. The Turkish Cypriot community should (1) prepare a comprehensive education development plan with priorities, implementation schedule and targets; (2) seek technical assistance and advice to successfully implement and steer the development plan; (3) organize internal structures in the administration to strengthen leadership and coordination of reform activities; and (4) prepare annual work plan for the reform and secure sufficient funding in the education budget.

4.24 **Decentralize decision making and financial management to districts and schools.** The Turkish Cypriot administration is well aware of the main issues in the education sector and has made several policy decisions that will shift education gradually towards European practices as the reform proceeds. In order to keep this shift steady the Turkish Cypriot community should (1) clarify the management and administrative roles of the regions and schools; (2) improve the leadership and management capacities in schools; (3) gradually give schools more autonomy in terms of organizing work in school; and (4) make schools responsible for their incremental budgeting.

4.25 **Restructure secondary education.** Secondary education is fundamental in bridging basic education and labor markets on one hand, and further education on the other. Some reform measures are underway in vocational education. In order to make secondary education a dynamic element for quality improvement in the education sector, the Turkish Cypriot community should (1) prepare a specific strategy for medium- and longer term development of secondary education; (2) balance the ratio of general and vocational secondary education by investing in quality improvements (curriculum, teaching and learning aids, facilities, etc.) and thereby increase the attractiveness of vocational education; (3) decrease early specialization in vocational education and design occupational standards that are in coherence with labor market needs; (4) make the secondary school network more dynamic and efficient by having less operational units with better quality and responsiveness to external needs; and (5) prepare an external school leaving examination for upper secondary education.

4.26 **Prepare a long-term strategy for higher education.** Higher education has become the center of attention due to its size and economic significance. A loose regulatory framework and weak steering have created a situation where the quality of higher education is diverse and the sector growth is driven by quantitative demands rather than those of economy and society. In order to use higher education as an engine for sustainable economic growth the administration should (1) strengthen the planning and quality assurance functions within the central administration; (2) reform the financing of higher education towards results-based funding; (3) create incentives for the universities to enhance research and innovation activities in collaboration with business leaders; (4) introduce measures that will guarantee the transferability of degrees and credits in Europe and beyond.

4.27 **Improve the efficiency of the education system.** Education is an expensive service to provide yet in the Turkish Cypriot system does not adequately respond to the needs of the individuals or the labor market. Teachers' salaries and personnel costs in the administration are a burden for financing education in a sustainable way. In order to increase funding of education reform and capital investments in pre-tertiary level the administration should (1) carry out an economic analysis in the education sector to identify the efficiency gaps; (2) improve the efficiency of secondary education through rationalizing the service delivery and making the vocational and technical education units more cost-effective; (3) gradually change the teacher salary system by shifting the average workload and respective teacher pay closer to international standards; and (4) link higher education financing closely to the quality of teaching and research, in other words to performance and outcomes rather than inputs.

4.28 **Establish the policy for monitoring and evaluation education and mechanism for its implementation.** Information management in a small community is relatively easy to handle. Indeed, the basic statistical system is working well. However, the available education indicators are mostly referring to inputs to the system rather than outputs and outcomes. In order to properly manage the education service delivery and steer the ongoing sector reform the administration should (1) design a comprehensive plan for evaluation of education covering all levels; (2) implement the planned student assessment scheme for elementary and lower secondary education; (3) adopt the system of education indicators and benchmarks that is currently being used in the EU; and (4) strengthen the monitoring and evaluation capacities in the central administration.

D. INVESTING IN STATISTICS

4.29 Good statistics are essential for identifying the scope of the problem, benchmarking the current situation, and measuring progress. Close collaboration between the producers of data, policy makers, and technical experts in this area would result in significant benefits for the Turkish Cypriot community in producing statistics that could help guide any future reforms. Furthermore, use of foreign experts would help to ensure comparability with the EU and more importantly with the southern part of Cyprus, thus moving the Turkish Cypriot community one step closer in its integration process.

4.30 The analysis of the economy in the northern part of Cyprus undertaken for this report was hampered by the lack of detailed data and, in some cases—especially with regard to the fiscal and trade data, the lack of conformity with standard practices in reporting of “national accounts” and balance of payments data. If “harmonization” and “convergence” remain on the agenda of the Turkish Cypriot community, much more resources (both technical and financial) and additional trained staff need to be invested in strengthening the statistical capacity of the administration. The priority areas where data need to be strengthened to achieve internationally accepted methodologies are: (a) “national accounts”, (b) balance of payments, (c) fiscal data, and (d) public debt data.

CHAPTER 5

SOME CONCLUSIONS

5.1 The economy of the northern part of Cyprus has been deeply affected by its partial opening following the adoption of the Green Line Regulations. The movement of persons—especially, tourists and labor—between the northern and southern parts of the island has the potential to significantly change the pattern of economic development over the course of the next three to five years. However, in other ways, the economy has not changed at all—foreign direct investment remains negligible, exporting goods is almost as difficult today as before the Regulations went into affect, and the travel of Turkish Cypriots off the island remains restricted. Moreover, the future of Cyprus is uncertain—no clarity exists on the timeframe for reunification nor have any noteworthy steps been agreed upon to resolve the property issue between the two communities on the island.

5.2 Given the circumstances facing the Turkish Cypriots, the question arises as to what vision of the future should guide the choice of their economic development path. As a small economy on the southern periphery of Europe, the answer is that the future—whether near or distant—lies with Europe since no viable alternative exists to EU integration and reunification. Integration into global markets is essential for sustained economic growth since neither self-sufficiency nor long-term dependency are feasible or desirable options. Though at a very preliminary stage, the integration of the Turkish Cypriot community into the EU has indeed begun. The critical questions to be answered by the Turkish Cypriots are how to select, sequence, and pace economic reforms in preparation for integration at some uncertain future date. And what strategy to follow in the interim period.

5.3 One option that surprisingly remains on the table is that no fundamental change in course is needed until a political resolution to the Cyprus problem is found. Further opening of the economy or lifting of restrictions are seen as steps to be pursued either as part of final negotiations or after reunification. This view is shortsighted since without major reforms, the long-term welfare of Cypriots' is in jeopardy. For the Turkish Cypriot community, this could translate into a continuation of their isolation, variability of income, susceptibility to economic crises, and growing economic dependency. And for the Greek Cypriot community, maintaining the status quo could undermine their hard-earned prosperity and national harmony through the introduction of tensions resulting from income and asset inequality between the two groups. Thus, steps which ensure convergence of living standards, institutions, and policies sooner rather than later serve the interests of all Cypriots.