Professional Services

Driving jobs and growth in Cyprus

By Fiona Mullen, Director, Sapienta Economics Ltd & Marina Theodotou, Founder and Managing Director, Curveball Ltd

Reviewed by Stavros A. Zenios, Professor at the Department of Public and Business Administration, University of Cyprus, and Senior Fellow at the Wharton School, USA

A research report commissioned by PwC Cyprus

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Foreword

Evgenios C Evgeniou
CEO, PwC Cyprus

As Cyprus faces some of its toughest economic challenges in decades, it is important for business leaders to take a fresh and objective look at their own professions in order to devise plans for sustainable growth into the future.

I am therefore pleased that PwC has sponsored the publication of this research into the professional services sector at a time when the country requires both a basis for constructive dialogue and a clear plan of action.

This study analyses the contribution of the professional services sector to the Cyprus economy, highlighting how this sector, more than any other, has driven the economic prosperity of Cyprus during the past two decades. The study compares Cyprus with competitors in a selected peer group, then makes an honest examination of the sector's strengths, weaknesses, opportunities and threats facing the sector. It concludes with a plan of action for the key stakeholders: the regulators and policy makers, the private sector and the voice of the industry.

It is clear from this research that there are many opportunities to restart the engine of the Cyprus economy. As a key growth sector, the professional services business can and should have a leading role in shaping the debate for future economic growth. Opportunities examined in this paper include expanding capacity and expertise in new sectors of the economy, such as natural gas and renewables, empowering younger professionals to innovate and engaging the voice of the industry more closely in private-public partnerships to strengthen the communities we live in both locally and globally with the use of technology and social media.

The traditional ways of generating economic growth have changed rapidly during the past four years and will continue to do so. At such a critical juncture for our economy, it is imperative that Cyprus adapt to the new reality. The specific recommendations in this study provide a realistic starting point. I hope that the analysis and recommendations in this study will create the platform for constructive dialogue and action that will focus minds and reinvigorate the broader economy.

Evgenios C Evgeniou

CEO, PwC Cyprus

Commentary

By Stavros A. Zenios

Professor at the Department of Public and Business Administration, University of Cyprus, and Senior Fellow at the Wharton School, USA

It is much like the classic paintings of Russian forests by Ivan Ivanovich Shishkin (1832-1898).

Fiona Mullen and Marina Theodotou—with careful brushstrokes, a keen eye for details and an unusual perspective—help us, through the downpour and mist of current economic uncertainty, overfelled businesses, and past the wild behaviour of financial markets, to see the forest through the trees. And the forest has beauty and power and resilience.

The main message of this study is simple and clear. Professional services is a sunrise industry for Cyprus. This is where future growth will come from, this is where jobs are created and this is how we leverage one of the most important—and abundant—resources of the country: its human capital.

The authors compile an amazing array of data to make their point. They approach it from every imaginable angle—or, at least, imaginable by the authors or by this commentator. They support their analysis not only with a logical and coherent presentation of the data but also through the application of solid research methodology to extract information from the data. And then they still go on. They benchmark Cyprus at both the micro and macro level vis-à-vis peer countries (Ireland, Malta, Luxembourg) and "best in class" (Singapore).

The findings are striking:

- Professional services have been growing faster than what has been considered by many to be the food staple of the Cyprus economy.
- Professional services have been growing constantly right through the crisis, showing remarkable resilience in the face of adversity.
- Professional services create more jobs per unit contribution to economic growth than other sectors of the economy.

But the most remarkable of their findings, the one that emerges through benchmarking, is that services have been growing and are proving resilient and create jobs not because of the conditions of the country but in spite of these conditions. Across many indicators that measure the favourable environment for professional services, Cyprus lags its peer countries and has a long way to go to the "best in class".

And here lies the potential for action. Through a SWOT analysis the authors summarise the information they have amassed to tell us what we should improve, and how. The study offers a clear and practical roadmap to lead the Cyprus economy to the light at the end of the tunnel of the current recession and high unemployment.

This study took months to compile. The fact that it comes just in time for the debate on how to deal with Cyprus' request for international assistance from the Troika speaks well for the foresight of firms like PwC who commissioned the study.

Conventional wisdom in Cyprus wants wise old men as the only ones that can deal with the country's problems. The study proves this wrong. It was a new generation of CEOs who commissioned it and a new generation of women professionals who carried it out. Even in this subtle way the study challenges us to think towards more open, inclusive and bold strategies. Only then we can capitalise on our Strengths and bypass our Weaknesses to go beyond the Threats and grasp the Opportunities presented by the crisis. A crisis is a terrible thing to waste.

The findings of this study rhyme well with what I have been arguing since 2007 when I first talked about the Nicosia Knowledge Region. I knew then that this was the right thing to do following the lead of many successful countries. State of the art literature on economics and innovation tell us this is the way to move beyond the end of manufacturing and trade-based services. Mullen and Theodotou present compelling evidence to support that what is well known internationally applies to Cyprus as well.

And here they are not unlike Shishkin either. He drew great inspirations from his international travels and the beauty of the forests in foreign lands before he returned to his home country and brought to life the power and beauty of her scenery. Shishkin was reluctant to travel abroad and so are we in looking to the outside world. But his art flourished after he suffered the pain of separation from his motherland. And exactly so, what this study is telling us is that our economy will flourish only if we find the strength to see past the narrow confines of our little island.

I expect this study to be debated extensively. It should be debated extensively. I hope it will be debated extensively. And just like in every debate there will be those in favour and those against. Not every argument of the authors supports exclusively the main thesis of the study. Different interpretations can be made, data maybe questioned by alternative pieces of information, sound recommendations may surrender to special interest groups.

But here again the study is not unlike a Shishkin masterpiece. A tree here or there may not be quite right, the light maybe too much or too little through the mist and the downpour. But with all its imperfections the forest comes through with its majesty unblemished. This is what makes Shishkin classic. And this is what makes this study a must-read if we are going to start a journey of renewal towards a better and prosperous Cyprus.

About the authors

Fiona Mullen, Director, Sapienta Economics Ltd

Fiona Mullen has been providing economic analysis and research to an international audience for 20 years. She founded Sapienta Economics Ltd in 2006 to provide independent analysis on a range of European and Middle Eastern countries and co-founded Strata Insight in 2012 to provide political risk consultancy services to international oil and gas companies operating in Cyprus. She has been the Cyprus contributor for the Economist Intelligence Unit (EIU) since 2001 and has served as economy adviser to the UN's Special Adviser to the Secretary-General on Cyprus, Mr Alexander Downer, since 2008.

Mullen is the author of several publications on the economy of Cyprus, including Cyprus: An Island in Europe, by James Ker-Lindsay, Hubert Faustmann and Fiona Mullen (eds), published by I.B. Tauris in 2011, and the award-winning The Day After: Commercial Opportunities Following a Solution to the Cyprus Problem, by Fiona Mullen, Praxoula Antoniadou-Kyriacou and Özlem Oğuz, published by the Peace Research Institute Oslo (PRIO) in 2008.

Prior to living in Cyprus Mullen was Director of the flagship Country Reports and Country Profiles at the EIU and Senior Europe Analyst. She was the Senior Analyst from 2002 until 2006 at the Financial Mirror, Cyprus' only financial newspaper. Fiona Mullen has also produced in-depth economic analysis on a wide range of Middle Eastern countries.

Mullen holds an MSc in European Social Policy from LSE, a BA Joint Honours in German and Philosophy from King's College London and two Master's-level Individual Professional Courses in econometrics from SOAS's Centre For Financial Management Studies (CeFiMS).

Marina Theodotou, Founder and Managing Director, Curveball Ltd

Marina Theodotou is an economist with over 20 years' professional experience. In 2010 she founded Curveball Ltd (www.curveballlimited.com), a Cyprus based boutique consultancy. In 2007-2009, as Director of Business Development and Operations at the Cyprus Investment Promotion Agency, she led efforts to rank Cyprus in the World Bank Doing Business Report.

Between 2004-2007, as the Jordan office Country Director of the Financial Services Volunteer Corps, (www.fsvc.org) she focused on technical assistance for the Central Bank and the Association of Banks in Jordan. Between 1995 and 2004 at Bank of America (www.bankofamerica.com), she held roles in Trade Finance, Internal Audit, Corporate Treasury, Risk Management and Strategic Benchmarking in Charlotte, NC and NYC. In 2003 she earned a Six Sigma Black Belt.

In 2009 she was voted 23rd of the 100 most powerful businesswomen in Cyprus by InBusiness magazine. She is a member of Rotary International (www.rotary.org) and earned the Paul Harris Fellow Award in 2012. In Nov. 2011 she founded and curated TEDxNicosia (www.TEDxNicosia.com). She is one of ten EU Commission Women Ambassadors for Entrepreneurship in Cyprus. Marina speaks and writes extensively in her areas of expertise.

She holds a Bachelor's (with honors) and a Master's Degree in Economics from the University of South Carolina and the University's 1992 Outstanding Undergraduate Academic Award in Economics. She is an IEMA certified Climate Change Leader (2010). Since Feb. 2012 she is an invited blogger on Huffington Post (www.huffingtonpost.com). She speaks English, Greek, French, Italian, basic Spanish, reads and writes Arabic and is learning Turkish.

Acknowledgements and disclaimer

We first started exploring the idea of producing analysis on the professional business services sector of Cyprus in early 2011. The aim was not only to quantify the economic impact of the professional services sector in Cyprus but also to use our complementary skills and experience to devise recommendations for future growth.

However, it was not until we approached Evgenios C Evgeniou, CEO of PwC Cyprus, that the project came to life. His quick grasp of the concept turned an idea into a live project in the space of a few weeks. We would like to thank Mr. Evgeniou and all of the PwC team for the sponsorship, support and assistance throughout this project. We are particularly grateful to Chrysilios K Pelekanos, Partner, In charge of Indirect Tax Services, for acting as the focal point on the project and to Marios Andreou, Partner, Direct Tax Services, for his comments on various drafts. We would also like to thank Stavros A. Zenios, Professor of Finance and Management Science at the Department of Public and Business Administration, University of Cyprus, for reviewing the report.

In earlier stages of the project we received input from Chris Patsalides, Group Treasurer at Bank of Cyprus, and feedback and guidance on the macroeconomic and modelling sections from Alex Michaelides, Professor of Finance at the University of Cyprus.

We would like to thank all the professional services sector executives and staff for their input and perspective during discussions and research for our project.

Thanks are also due to Demetris Papaconstantinou, a former student of Marina at the University of Nicosia, who gathered from the Statistical Service much of the raw data used in the macroeconomic and modelling sections.

All opinions expressed in this report are those of the authors alone.

We would like to thank Julia Kalimeri for translating a long and challenging report and Christina Neophytidou for assistance in translating some of the charts and tables.

Fiona Mullen and
Marina Theodotou

Nicosia

October 2012

Executive summary

Cyprus is currently facing deep and unprecedented challenges. The economy is suffering its second recession since 1974, unemployment is soaring to record highs, especially among the young, a large part of the once solid banking sector is in need of recapitalisation and the government is unable to refinance its debt without external assistance. While the Cyprus economy has traditionally bounced back from difficulties, it is clear from this research that the traditional sectors of tourism, construction and manufacturing are unable to provide the jobs, growth and therefore lifestyle to which Cypriots have become accustomed. Our research shows that the newer sectors of professional business services and international financial services have been the most resilient sectors in the recent downturn and now contribute more to the economy than tourism. The sector also complements tourism by attracting higher-spending visitors and supporting tourism's long-term aim of raising the quality of the tourism product.

However, the professional services sector, too, has its own significant challenges. It is facing fierce competition from nimble challengers such as Malta and Ireland, as well as more traditional financial centres such as Luxembourg and Singapore.

According to Bloomberg, Malta has attracted 500 funds in five years with €8 billion under management, while the Ministry of Finance of Russia reports that Luxembourg and Russia have signed an attractive new double taxation agreement. One likely reason why these competitors are so adaptable and fast to respond, our research found, is because they are far better at innovating than Cyprus. While Cyprus is already generally behind its peers as a general place to do business, it is even further behind all of its key competitors for business services when it comes to innovation.

In a high valued-added service economy, innovation is the key to survival. Grasping the opportunity to help professional services to continue to drive economic growth and absorb highly skilled jobs, especially among the young, requires new thinking and fresh ideas, both by the sector itself as well as the policy-makers at government and regulatory level.

We therefore conclude our research with ten strategic-level recommendations: three for the government, three for the professionals in the sector and four for the professional representatives (voice of the industry). For each strategic-level recommendation, we also include between two and four specific targets to aim for within the next 12 to 24 months. We make our proposals with tight budgets in mind. If our recommendations are followed, our estimates suggest that the professional services sector, which has already played a strong part in offsetting the decline in tourism, could add 9,700 new jobs in five years, bringing in extra tax and social insurance revenue to the government of €13 million per year.

Achieving this requires keen focus at both government and sector level. We strongly believe that if our key recommendations are adopted, they will lay the foundation for dynamic, sustainable growth, not only for the professional services sector but also for the economy as a whole. More importantly, they will create a rising number of jobs for young talent in Cyprus.

Introduction and approach to research

If one were to ask a random group of people which is the largest sector of the Cyprus economy, the most common answer would be tourism. Certainly, it attracts more policy attention than other sectors (with the possible exception, these days, of natural gas) and a great deal more in terms of funding. Yet while the focus of attention has been on other sectors, a quiet revolution has been taking place in another sector, namely professional services—the accountants and lawyers who serve a large international business community. Armed with the lowest corporate tax rate in the EU, more than 45 double taxation treaties, a trusted common-law legal system and an educated, English-speaking workforce, this sector has continued to grow, even during the recent downturn.

But how much does this sector contribute to the economy, exactly? Is its contribution to the economy smaller or bigger than tourism? How does the sector compare with its peers in other countries? What risks and opportunities do the sector face in the coming period and how much more could the sector contribute to jobs if it innovated and received the right support? Last, but not least, what can the government and the professionals do to grasp these opportunities, fill the jobs gap for skilled graduates left by the public sector and contribute more to the country's growth in these difficult times? These are the key questions which we seek to explore, analyse and answer in this study.

Section 1 is entitled "Professional services: Current impact on jobs and growth". In view of concerns about soaring unemployment, we start the section by examining the contribution of legal, accounting and financial services to jobs. We then calculate how much revenue these sectors bring into the country in terms of exports of services as measured in the balance of payments. Finally, we consider the contribution of the professional and services sector to the economy both in terms of size and growth. Since financial services are closely linked to business services, we also analyse their contribution, in particular the contribution of financial services serving international clients. By combining these, we come to an estimate of the contribution of what we term "international services" and compare it with the contribution of tourism. The analysis would not be complete without considering the contribution of the companies which are served by professional and financial services. In particular, using available data, we shall estimate inflows of Foreign Direct Investment (FDI) by entities resident in Cyprus without a physical presence in Cyprus (EWPPs).

Section 2 is entitled "Macro benchmarking: Cyprus as a place to do business". Here, we benchmark Cyprus as a place to do business at the general level against other competitor countries for international business services, namely Ireland, Luxembourg, Malta and Singapore.

In Section 3, "Micro benchmarking: Cyprus as an innovator", we take a different approach to benchmarking. Since the key to growth in an advanced economy is how well its people can innovate, we also compare Cyprus as an innovator with the same peer group.

Section 4 is entitled "SWOT analysis: Strengths, Weaknesses, Opportunities, Threats". Here we examine both exogenous factors and endogenous factors to pinpoint areas in which strengths need to be enhanced, opportunities grasped and risks mitigated. This analysis is based on extensive research already conducted by the sector as well as interviews with those active in the legal and accounting professions.

Section 5 is entitled "Additional jobs potential if opportunities are grasped". Using an econometric model that analyses the historical relationship between growth and jobs, we estimate how many more jobs the professional services could create if the opportunities identified

in the SWOT analysis and the recommendations are grasped by the policy-makers, the sector itself and its "voice of the industry" representatives.

We conclude our analysis with a series of recommendations in Section 6, entitled "Adopt and adapt: A blueprint for sustainable growth". Here we take lessons learned from the "best in class" and devise how best to adapt them to Cyprus. This section includes ten strategic-level recommendations for critical actions required by the government, the sector and the voice of the industry, as well as specific recommendations for the next 12 to 24 months, made with the current difficult economic environment in mind.

Since we see this research as a practical tool for a wide audience, we have deliberately written this report in a plain style, moving detailed technical explanations, for example, to the appendix. Our aim is that our recommendations can easily be understood and adopted both by policy makers and by the professionals themselves.

Finally, we hope that this research helps not only to raise the profile of a dynamic and job-creating sector but also brings fresh ideas that will keep Cyprus nimble and competitive for the future.

Section 1
Professional services: Current impact on jobs and growth

1.1 Approach to the analysis

In this section we compare the contribution of the professional and financial services sectors with that of tourism. We do this for two reasons. First, to put our analysis in context and second, to compare with a sector that has traditionally been considered to be the mainstay of the Cyprus economy. It is worth noting that professional services should not be viewed as a competitor to tourism, but, as will be argued, as a sector that complements and supports the tourism industry.

1.2 The macroeconomic context

Before analysing the specific sectors under review, it is worth putting the analysis into context. The Cyprus economy is currently in recession, with real growth of Gross Domestic Product (GDP) expected by the IMF, in its October 2012 World Economic Outlook, as well as locally based economists in the 10 October 2012 edition of the Financial Mirror, to record an annual decline in both 2012 and 2013. This is a highly unusual situation for Cyprus, which until 2009 had not recorded a single recession since the period immediately after Turkish invasion in 1974 that caused a mass dislocation of people and a large loss of productive capacity. Unemployment has also reached historical highs. The unemployment rate has shot up from just 4.7% when Cyprus joined the EU in 2004 to 11.1% in the first quarter of 2012. Even more worryingly, youth unemployment has climbed even higher, reaching 26.7% in the first quarter of 2012, from just 10% in the first quarter of 2009. These trends were well under way even before the write-off of Greek government debt negatively affected the capital ratios of the two major banks and led to a serious loss of business confidence. In February 2012, the European Commission, as part of its new Alert Mechanism Report, identified Cyprus as having "very serious macroeconomic imbalances".

At the same time as economic activity has weakened, the public finances have also deteriorated. The budget surplus peaked, partly owing to property-related revenue, at 3.5% of GDP in 2008 but by 2011 there was a budget deficit of 6.3% of GDP. The combination of deteriorating public finances and concerns about the exposure of local banks to Greek government debt led to a series of downgrades by the international rating agencies and by June 2012 Cyprus was rated "speculative" (junk) by all three main agencies, Standard & Poor's, Moody's Investor Service and Fitch Ratings. As a result, the government was shut out of international markets and currently finds itself unable to refinance its debt.

In sum, the Cyprus economy faces new and unprecedented challenges, which are unlikely to be overcome without fresh thinking and innovative solutions.

1.3 Contribution of professional services to jobs

The contribution of a particular sector to the economy can be measured in a number of different ways: the contribution to jobs, to exports and to Gross Domestic Product (GDP), or strictly speaking, to Gross Value-Added (GVA).

While we have become accustomed to measuring progress in terms of real GDP growth, the contribution of an economic sector is more meaningful to policy makers and the general public if it creates jobs. For this reason, we have chosen to examine the contribution of the professional and international financial services sectors to employment before we measure its contribution to exports and GDP. This approach is also taken with a view to the growing literature on the shortcomings of GDP growth as an economic development measure (Stiglitz et al 2010).

Within employment data, the business services offered by lawyers and accountants are captured at the broad level by the sector called "professional, scientific and technical activities". Banking and other financial services, which benefit from Cyprus' position as an international business centre, are captured under "financial and insurance activities", while tourism is mainly captured under "accommodation and food-service activities", as well as to a small degree under air transport.

Data from the Statistical Service of the Republic of Cyprus (Cystat) show that employment in the two sectors under consideration has grown considerably in the past ten years. Figure 1.01 shows that the broad sector of professional, scientific and technical activities employed 17,200 people in 2011, which is 59% higher than the 10,800 people employed in 2001. Financial and insurance activities employed 18,100 in 2011, which is 11.3% more than the 16,000 employed in 2001.

Accommodation and food services, meanwhile, employed 35,900 people in 2011, only 5.6% more than the 34,000 employed in 2001.

Professional, scientific and technical activities together with banking and other financial services employed 35,300 people in 2011. This is at par with the 35,900 people employed by accommodation and food services.

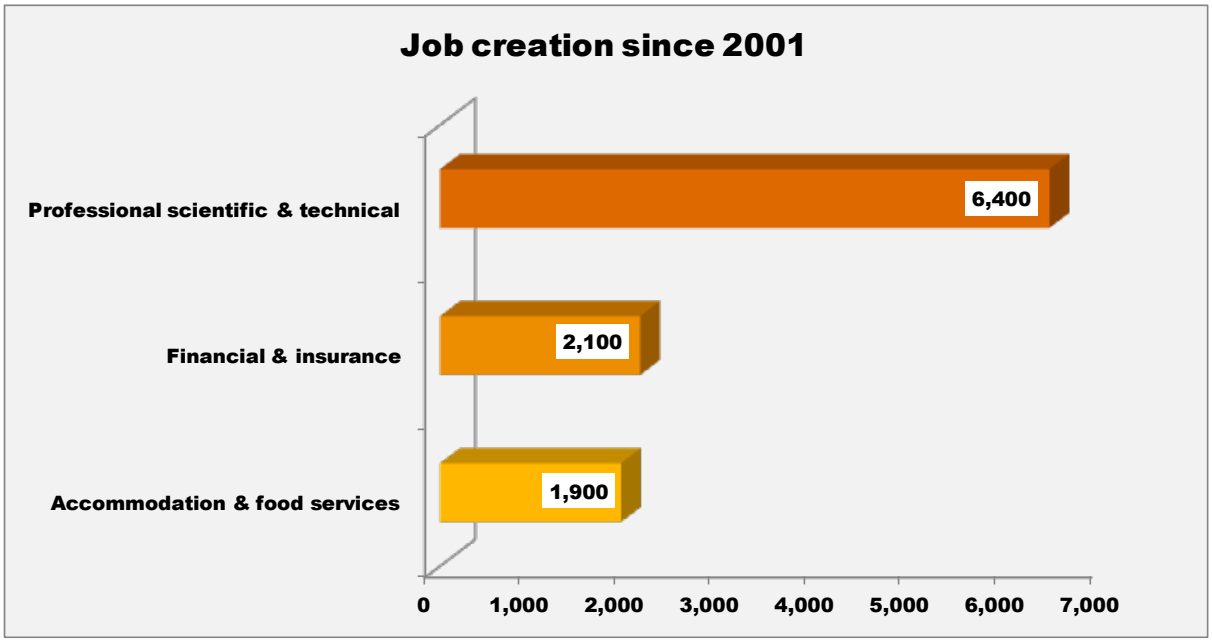
Figure 1.01

Employment in broad sectors	2001 '000	2011 '000	% of total
Professional scientific & technical activities	10.8	17.2	4.4%
Financial & insurance activities	16.0	18.1	4.7%
Professional & financial services	***26.8***	***35.3***	***9.1%***
Accommodation & food services	34.0	35.9	9.2%
Total employment inc other sectors	***330.4***	***388.7***	***100.0%***

Source: Cystat

However, professional services added 6,400 to employment in 2001-2011, financial and insurance activities added 2,100, while accommodation and food services added only 1,900 (see Figure 1.02). Moreover, in the difficult period since 2008, accommodation and food services have actually shed 1,100 jobs, falling from 37,000 in 2008 to 35,900 in 2011. By contrast, the broad professional services sector added 1,800 jobs and financial and insurance activities added another 1,000.

Figure 1.02



Source: Cystat

Job creation at the specific sector level

To get a real sense of employment generated by the specific sectors under review—legal and accounting services, financial services serving international clients, and tourism—we must look at disaggregated data. This poses some challenges, as not all of the sectors we are considering are available in disaggregated form. For example, Cystat separates employment in financial services from employment in insurance services, but it does not isolate local financial services from those serving international clients. Similarly, there are no employment statistics on air transport, as opposed to overall transport. We must therefore make our own employment estimates for international financial services and air transport by inferring from other available data, such as non-resident deposits and GVA. A full explanation of methodology can be found in the appendix.

In 2011, Cystat data show that the subsector of legal and accounting services employed 8,900 people (Figure 1.03). According to our estimates, financial services serving international clients employed 4,900. Together, therefore, the sector that we are calling "international services" employed 13,800 people in 2011.

The subsector of accommodation employed 16,700 in 2011. We estimate, based on the methodology explained in the appendix, that air transport employed 1,200 people in the same year. Thus, the sector that we are calling "tourism and related transport" employed an estimated 17,900 people in 2011.

Figure 1.03

Employment in specific sectors	2001 '000	2008 '000	2011 '000	% of total in 2011	Ave. growth in 2007-11
A. Professional scientific & technical activities	10.8	15.4	17.2	4.4%	4.5%
B. Legal & accounting	5.5	7.9	8.9	2.3%	4.7%
C. Financial & insurance activities	16.0	17.1	18.1	4.7%	2.5%
D. Financial services exc insurance & pensions	12.0	12.8	13.5	3.5%	2.5%
E. *Financial services serving international clients*	3.2	3.8	4.9	1.3%	2.5%
Employment in "international services" (B+E)	***8.7***	***11.7***	***13.8***	***3.6%***	***3.9%***
F. Accommodation & food services	34.0	37.0	35.9	9.2%	-0.1%
G. Accommodation	15.9	17.3	16.7	4.3%	-0.1%
I. Air transport	3.7	2.1	1.2	0.3%	-15.2%
J. Employment in tourism & related transport (G+I)	***19.6***	***19.4***	***17.9***	***4.6%***	***-1.7%***
Total employment	**330.4**	**389.1**	**388.7**	**100.0%**	**1.1%**

Sources: Cystat; author estimates in italics

Conclusion: tourism a bigger but declining employer

We can conclude that, at 17,900 in 2011, tourism and related transport was still a bigger employer than "international services", employing 13,800 people. However, international services employment grew at an estimated annual average growth rate in 2007-2011 of 3.9% per year, while employment in tourism and related transport shrank at an estimated pace of 1.7% per year. The gap is therefore narrowing rapidly. Indeed, if this trend continued, one might see "international services" employing more people than tourism within just five years.

Another important consideration from the perspective of social stability is how many young, Cypriot graduates the sectors employ. Figures from the Director of Social Insurance show that 70% of the unemployed are Cypriots. And, as mentioned earlier, youth unemployment has been soaring. Gathering employment data by nationality is beyond the scope of this work. But anecdotal evidence suggests rather strongly that "international services" employ more young, Cypriot graduates than the tourism sector. It is therefore a sector that is helping to keep local talent in the country rather than see it flee abroad.

1.4 Contribution to exports of services

As a small island Cyprus runs a large deficit on trade in goods of typically around 25% of GDP. If a country is not to rely too heavily on foreign debt or "hot money" (investment in securities such as shares), this deficit must be balanced by net inflows in other areas such as exports of services, Foreign Direct Investment (FDI) and, in the case of Cyprus, inflows of foreign assets into the local banking sector. Cyprus traditionally runs a surplus on trade in services which partly offsets the deficit on trade in goods. As already noted by the IMF in its 2011 supplement to the Staff Report and as shown in figure 1.04, professional business services and international financial services make an important contribution to this surplus.

In the balance of payments, legal, accounting and consultancy services account for two-thirds of the category called "other business services". Almost all of the remainder of this category in Cyprus is merchanting, which is defined as "the purchase of goods from abroad by merchants or commission agents and the subsequent resale of the goods abroad." Although the goods do not enter Cyprus, this activity is carried out by Cyprus-resident companies with activities outside of Cyprus. Therefore, in so far as this activity reflects the Cyprus' low corporate tax rate and other attractions as an international business centre, we include it as part of the contribution of business services to exports.

Figure 1.04

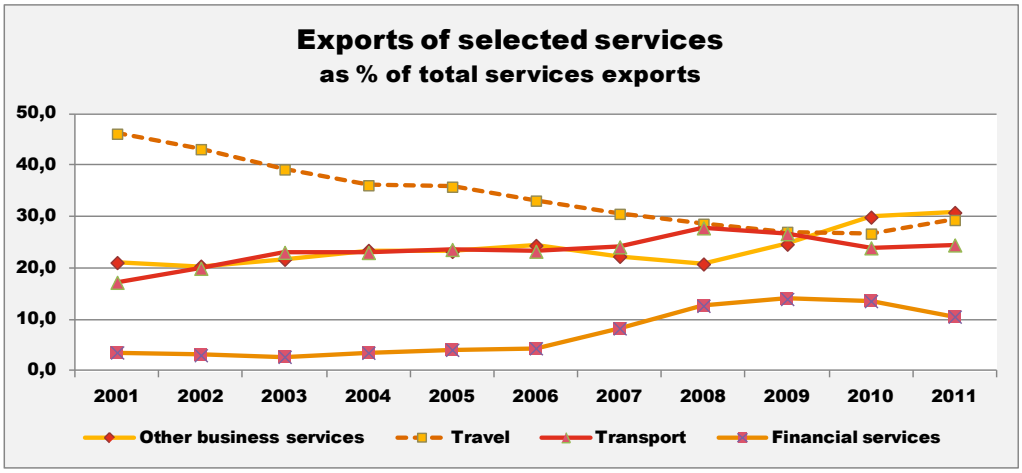
Composition of other business services exports in 2010	€ million	% of total
Exports of other business services from Cyprus	1,808	100%
Business, professional & technical services	1,223	68%
Legal, accounting, management & public relations services	1,175	65%
Legal services	339	19%
Accounting, auditing, bookkeeping & tax services	474	26%
Business & management consultancy, public relations services	362	20%
Advertising, market research & public opinion polling	24	1%
Research & development services	11	1%
Architectural, engineering & other technical	13	1%
Other (negligible)	0	0%
Merchanting & other trade-related services	576	32%
Operating leasing services	8	0%
Total services exports inc others	***6,049***	**-**

Source: Eurostat

As Figure 1.05 shows, the category of other business services has been growing as a proportion of exports. It rose from 21.0% of services exports in 2001 to 30.8% in 2011. The rise of exports of financial services has been even more dramatic since EU membership, increasing from 3.5% of exports in 2004 to 10.6% in 2011 (having actually peaked in 2009 at 14.0%). Together, other business services and exports of financial services amounted to 41.3% of all services exports. Exports of transport (mainly shipping), which also benefits from Cyprus as an international business centre, rose from 17.2% of exports in 2001 to 21.5% in 2011.

By contrast, travel, which refers to tourism revenue, fell from 46.1% of exports in 2001 to 29.3% of exports in 2011. Tourism's contribution to exports fell below that of "other business services" for the first time in 2010 and remained below other business services in 2011.

Figure 1.05



Source: Central Bank of Cyprus

A similar picture emerges when analysing exports of services (measured on a gross basis) as a percentage of GDP (measured on a value-added basis, as explained in the following section on GDP). By 2011, as shown in Figure 1.06, exports of other business services had reached 10.7% of GDP in 2011, exports of financial services 3.7% of GDP and income from transport 8.5% of GDP. By contrast, income from travel fell from 20.9% of GDP in 2001 to 10.2% of GDP in 2011. Incidentally, this is why one still occasionally hears the assertion that tourism accounts for 20% of GDP. It is based on income flows from a decade ago.

Figure 1.06

Selected services exports as % of GDP € million unless otherwise indicated	2001	2006	2011
Other business services	1,006	1,387	1,900
% of GDP	9.5%	9.6%	10.7%
Financial services	171	249	650
% of GDP	1.6%	1.7%	3.7%
Transport	823	1,323	1,510
% of GDP	7.8%	9.2%	8.5%
Travel	2,204	1,882	1,810
% of GDP	20.9%	13.0%	10.2%
Total exports of services inc others	4,781	5,688	6,171
% of GDP	45.3%	39.4%	34.7%

Source: Central Bank of Cyprus

Conclusion: "international services" exports have offset the decline in tourism

Clearly, the sector of "international services", comprising exports of both business and financial services, has been growing in importance in the past decade while that of tourism has declined. Moreover, this sector's exports have grown even when the overall contribution of services exports to GDP has declined. Total services exports dropped from 45.3% of GDP in 2001 to 34.7% of GDP in 2011. We can conclude, therefore, the "international services" sector has proven to be resilient during the current economic downturn and has not just offset the fall-off in tourism revenue, it has replaced tourism revenue as the main exporting sector.

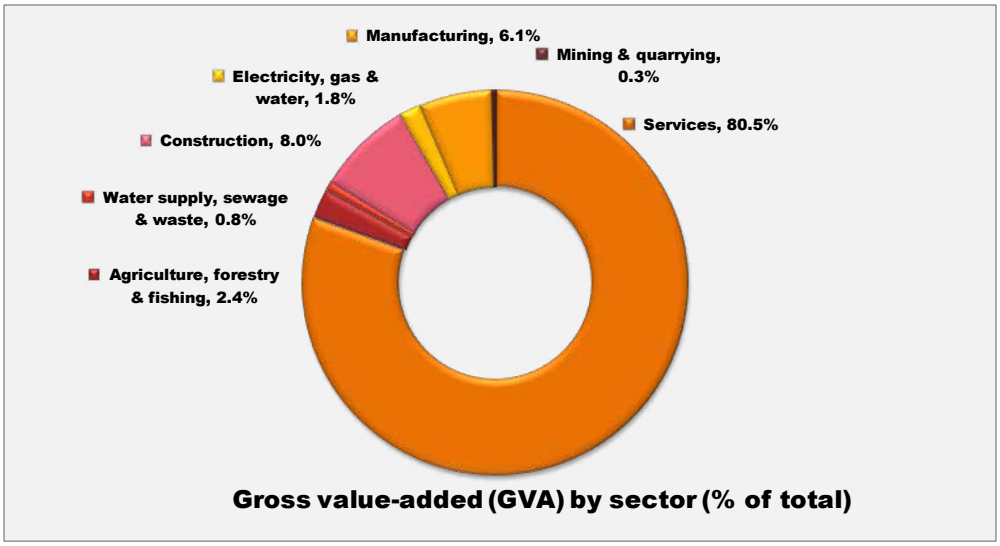
1.5 Contribution to GDP

In the previous two sections, we analysed the contribution of "international services" to jobs and exports. We shall now consider the contribution of this sector to the overall economy, that is, to Gross Domestic Product (GDP), or strictly speaking, to Gross Value-Added (GVA). We shall also consider its contribution to growth.

In the national accounts, the output of different sectors (agriculture, manufacturing, etc) is measured as "Gross Value-Added" (GVA), while expenditure by government, households etc is measured as "Gross Domestic Product" (GDP). Put in crude terms, value-added is the difference between the price of a product and the cost of producing it. For example, if a carpenter buys five pieces of wood for €50, turns them into a table and sells the table for €80, the value added is roughly €30. In the national accounts measured by sector, GVA is then added to import duties and VAT to produce GDP. Although many economic reports mix the two concepts, in the following paragraphs, we shall follow best practice and discuss the contribution of sectors to GVA as opposed to GDP.

As shown in Figure 1.07, services are by far the largest proportion of the total economy, accounting for 80.5% of GVA in 2011 (or 72.9% of GDP).

Figure 1.07



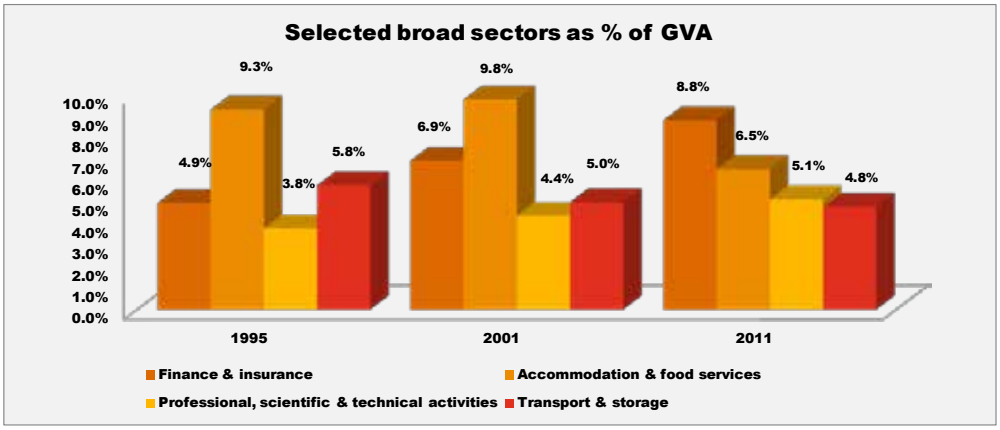
Source: Cystat

Contribution of broad sectors

We shall now turn to analysing the contribution of the sector of professional, scientific and technical activities at the broad (non-disaggregated) level. It has risen from 3.8% of GVA in 1995 (the earliest records available) to 4.4% in 2001 and 5.1% of GVA in 2011 (see Figure 1.08). Financial and insurance activities rose even higher in the same period, from 4.9% of GVA in 1995 to 6.9% in 2001 and 8.8% in 2011.

By contrast, accommodation and food service activities rose initially from 9.3% of GVA in 1995 to 9.8% in 2001 (the peak year for tourism arrivals in the past 15 years), but it had dropped to 6.5% of GVA by 2011. Via air transport, tourism is also reflected to a small extent in transport and storage. The transport and storage sector also fell, from 5.8% of GVA in 1995 to 5.0% in 2001 and 4.8% in 2011.

Figure 1.08



Source: Cystat

Contribution of specific sectors to GDP

However, as with the employment data, to get a real sense of the contribution of the specific sectors—legal and accounting services, financial services serving international clients, and tourism—we must drill into disaggregated data. Again, as with the employment data, not all of the sectors we are considering are available in disaggregated form in the national accounts. For example, tourism is not itemised separately. We must therefore make our own estimates for gross value-added in tourism, working backwards from what we know about gross tourism expenditure. Similarly, if we want a true sense of the contribution of the sectors that serve international businesses, we must also separate out international banking activities from local banking activities. A more detailed explanation of our estimates is given in the methodological appendix.

According to Cystat, legal and accounting services, as a subcategory of professional, scientific and technical services, accounted for 3.4% of GVA in 2009—the latest year available. On the basis of an increase in the broad category, we estimate that legal and accounting services rose to 3.6% of GVA in 2011. Deriving international financial services from total financial services, as explained in the appendix, we estimate that financial services serving international clients accounted for 2.9% of GVA in 2011. Together, therefore, what "international services" accounted for 6.5% of GVA in 2011 (see Figure 1.09).

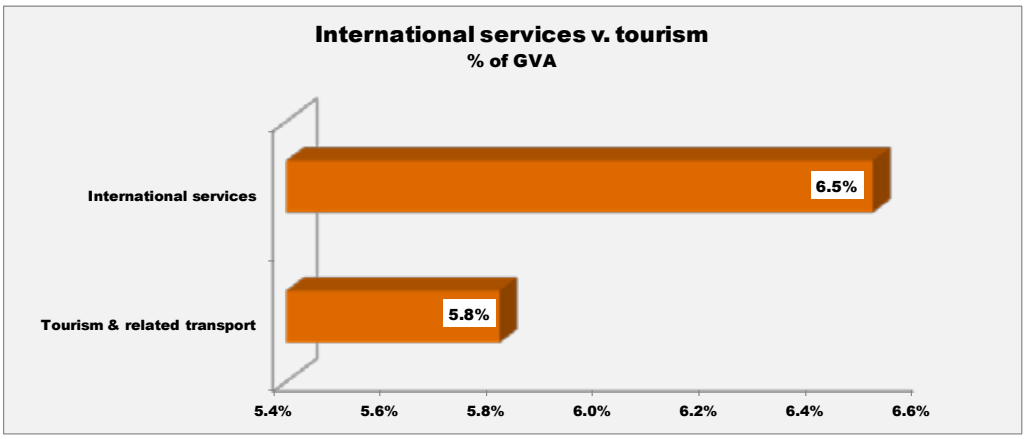
Air transport, as a subcategory of transportation and storage, accounted for 0.4% of GVA in 2009 according to Cystat. Taking as a guide a decline in the broad sector, we estimate that air transport fell to 0.3% of GVA in 2011. Deriving tourism GVA from what we know about spending by tourists, we estimate that tourism was 5.5% of GVA in 2011. Tourism and tourism-related transport sectors, therefore, accounted for 5.8% of GVA in 2011 and is therefore smaller than international services.

It is worth mentioning, however, that both "international services" and tourism are far exceeded in size by public administration and defence, which amounted to 11.8% of GVA in 2011.

Conclusion: "international services" produces higher value-added

Based on the analysis outlined above, we conclude that tourism is no longer the mainstay of the Cyprus private-sector economy, as is commonly perceived. Instead, it has been taken over by what for the purposes of this research we are calling "international services".

Figure 1.09



Source: Cystat and author estimates

In Section 1.2, we saw that tourism and related transport employed an estimated 17,900 people while "international services" 13,800. Yet tourism and related transport accounts for just 5.8% of GVA compared with 6.5% for international services. "International services" is therefore a higher value-added sector than tourism, at least in its current state, with its focus on the cheaper segment of the global tourism market. We have learned from the relative performance of countries in the eurozone that, in the context of global competition and a single currency, where currency devaluation is not possible, the ability to produce high value-added but competitive products and services is a key determinant of survival, both at the company and the country level. It may well be the tourism's relative lack of value-added is precisely the cause of its decline, both in terms of jobs and GDP.

1.6 Contribution to growth

An analysis of growth rates over the past decade shows us why the contribution of tourism to gross value-added has fallen behind that of international services. We can see from Figure 1.10 that the two broad sectors, professional, scientific and technical activities, and financial and insurance services, have grown at well above average rates in the past ten years. Whereas total GDP (and GVA) grew in real terms by 2.4% per year on average in 2002-2011, professional, scientific and technical activities grew by 3.5%. Financial and insurances services grew more than twice as fast as GDP, at an average pace of 5.1% per year. Meanwhile, the tourism-related accommodation and food service activities sector declined in the same period, falling on average by 0.9% per year.

The performance of these two sectors is even stronger in the past five years, when apart from the very small household employment sector (which reflects the employment of housemaids), professional and financial services grew faster than any other. Professional, scientific and technical activities grew on average by 4.5% per year, while financial and insurance services grew by 5.5%. Real GDP grew in the same period by just 1.7% per year and accommodation and food services by only 0.7%.

Figure 1.10

Annual average real growth rates At constant, chain-linked 2005 prices	2007-2011	2002-2011
Agriculture, forestry & fishing	-1.3%	-2.4%
Mining & quarrying	-1.9%	1.0%
Manufacturing	-1.2%	-0.8%
Electricity, gas, steam & air conditioning supply	2.5%	3.6%
Water supply; sewerage, waste management & remediation	1.2%	3.8%
Construction	-5.9%	0.4%
Wholesale & retail trade; repair of motor vehicles & motorcycles	1.5%	2.8%
Transportation & storage	1.1%	3.2%
Accommodation & food service activities	0.7%	-0.9%
Information & communication	3.5%	5.4%
Financial & insurance activities	5.5%	5.1%
Real estate activities	4.5%	4.2%
Professional, scientific & technical activities	4.5%	3.5%
Administrative & support service activities	0.0%	0.9%
Public administration & defence; compulsory social security	2.4%	3.4%
Education	3.6%	3.3%
Human health & social work activities	3.0%	2.8%
Arts, entertainment & recreation	2.6%	2.1%
Other service activities	1.8%	2.0%
Activities of households as employers	10.2%	11.3%
Total gross value added	***1.7%***	***2.4%***
Import duties & VAT	1.7%	2.4%
Gross domestic product at market prices	1.7%	2.4%

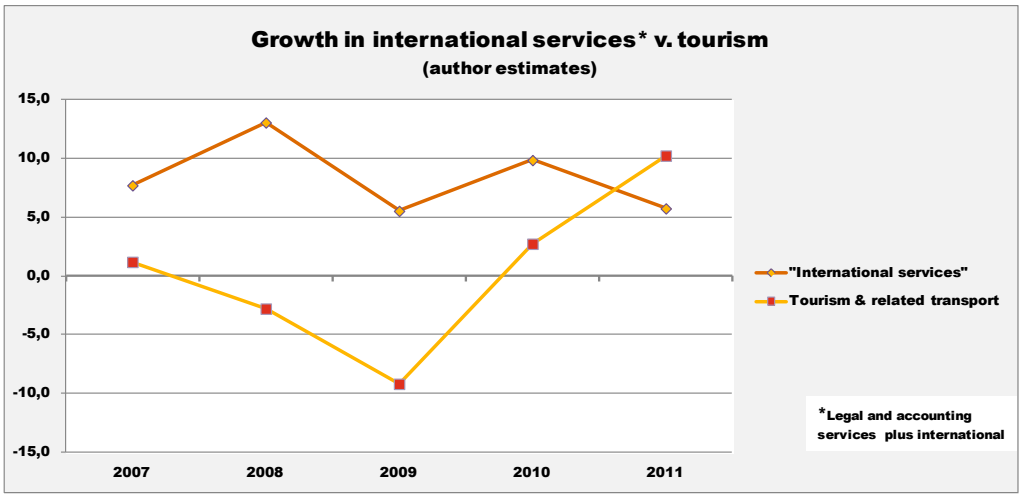
Sources: Cystat for constant prices; Sapienta Economics for growth rates

The declining contribution of tourism is in keeping with academic studies, which indicate that the contribution of tourism to economic growth diminishes with increasing specialisation and that "countries may be better off diverting their resources to other areas of economic activity" (Adamou and Clerides 2010).

Conclusion: "international services" grew 40 times faster than tourism

Inferring from the figures produced for Figure 1.04, we can also estimate the growth rates in the past five years of "international services", as well as tourism and related transport. We estimate that "international services" grew on average by 8.3% per year in 2007-11, whereas tourism and related transport grew by only 0.2% (see Figure 1.11). Thus, international services has grown more than 40 times faster than tourism in the past five years.

Figure 1.11



Source: Author estimates based on broad sector growth rates

The peak year of growth was in 2008, when we estimate that "international services" grew by 13% (see Figure 1.12). While this might seem a high growth rate at first sight, it should be noted that actual data show that professional, scientific and technical activities grew in that year by 9.3%. Moreover, 2008 was a year in which there were a large number of large real estate deals, acquisitions and disposals of assets, which generated a great deal of work for the legal and accounting profession.

Figure 1.12

Real growth rates (%)	2007	2008	2009	2010	2011	2007-2011 average
Actual						
Professional, scientific & technical activities	7.2%	9.3%	1.1%	1.4%	3.7%	4.5%
Financial & insurance activities	10.0%	6.3%	5.0%	3.4%	3.3%	5.5%
Accommodation & food service activities	3.3%	-3.4%	-6.0%	3.4%	6.7%	0.7%
Author estimates						
Legal & accounting services	6.3%	18.2%	4.0%	1.4%	3.7%	6.6%
International financial services	9.8%	5.5%	8.0%	23.2%	8.4%	10.8%
"International services"	**7.7%**	**13.0%**	**5.5%**	**9.8%**	**5.7%**	**8.3%**
Tourism	3.3%	-3.4%	-6.0%	2.8%	11.2%	1.4%
Air transport	-16.6%	3.3%	-39.4%	1.0%	-4.6%	-12.8%
Tourism & related transport	**1.2%**	**-2.8%**	**-9.2%**	**2.7%**	**10.2%**	**10.2%**

Sources: Cystat for actuals; author calculations for estimates (see methodology)

1.7 Recent growth performance

What is perhaps even more remarkable about "international services" is that they have consistently grown even during the recent downturn. When overall GDP was recording its second and third quarters of decline, growth in the professional, scientific, technical & support services actually accelerated in the fourth quarter of 2011, rising by 4.6% compared with the same period of the previous year. The sector was still growing, albeit at a slower pace, of 3.8%, in the second quarter of 2012. Growth in financial and insurance services initially accelerated from 3.1% in the fourth quarter of 2011 to 3.6% in the first quarter of 2012 but slowed sharply in the second quarter to 1.2% as the impact of the write-off of Greek government debt (the "haircut") at the end of the first quarter that dented the capital of the two largest banks. Indeed, some of this strong growth of professional services is directly related to troubles in Greece, which suggests that Cyprus benefited, at least initially, from a flight to safety despite concerns about the exposure of local banks to Greece. Reports by companies involved in the sector suggest that business from Greece was still robust even in the more difficult second quarter.

Figure 1.13

Quarterly growth by sector (seasonally adjusted) Real % change on same period of previous year	2011 Q2	2011 Q3	2011 Q4	2012 Q1	2012 Q2
Information & communication	4.1	3.7	6.2	6.1	5.1
Professional, scientific, technical & support services	2.4	2.6	4.6	3.9	3.8
Real estate activities inc imputed rent	4.4	4.2	3.9	3.3	3.0
Financial & insurance activities	2.8	3.1	3.1	3.0	1.2
Public admin, defence, educ'n, health & social services	1.4	1.5	1.1	0.8	0.6
Wh'sale, retail trade, hotels & rest's, transport & comms.	1.5	0.3	-2.2	-2.9	-3.3
Industry excl. construction	-0.4	-7.5	-5.7	-6.7	-6.0
of which: manufacturing	-2.0	-3.5	-4.2	-4.6	-3.7
Agriculture, hunting, forestry & fishing	11.0	2.0	-0.8	-4.5	-5.6
Construction	-7.5	-12.3	-14.6	-16.2	-19.6
Other services	3.8	2.3	1.8	-0.3	-1.1
Gross value added	1.4	-0.2	-0.8	-1.5	-2.1
Import duties & VAT	1.5	-0.4	-0.5	-2.2	-3.5
Gross domestic product	**1.4**	**-0.3**	**-0.8**	**-1.6**	**-2.3**

Source: Cystat

Conclusion: "international services" is the new driver of jobs and growth

At the broad sector level, actual data show that both professional and financial services were the fastest growing sectors in the past five years, after the tiny sector that relates to housemaids. By contrast, the traditional sectors such as tourism, manufacturing and construction, have actually acted as a drag on growth. However, the sector should not be viewed as a competitor to tourism but rather as complementary sector which together with tourism fosters growth. The quality of hotels in Limassol, its high occupancy rates and the 40%-50% annual growth rates of Russian tourist arrivals since 2010, are a clear testament to how the professional services sector is helping tourism to reach its long-term aim of raising the quality of the tourist product and attracting higher-spending visitors.

Nevertheless, from the analysis above one can go so far as to say that "international services" have been the key driver of both jobs growth in the past five years and are far more resilient to international trends than tourism (or construction) has ever been. Indeed, Cyprus would have found it much more difficult to weather the global financial crisis and the subsequent eurozone crisis without these two sectors. How much longer this can last without a concerted effort by the government to support its most dynamic sector is open to question.

1.8 Contribution to FDI

In the analysis above, we have concentrated primarily on the contribution of local companies serving the international business sector, rather than on the contribution of the internationally oriented clients which they serve. The latter's contribution to the economy is mainly reflected in Foreign Direct Investment (FDI) (when it includes investment by companies without a physical presence).

Assessing FDI inflows by entities without a physical presence in Cyprus (EWPPs) is a challenge for two reasons. First, data for EWPPs were not collected until 2008, therefore it is impossible to ascertain whether membership of the EU or eurozone has had a positive or negative impact on FDI from these entities. Second, although the Central Bank of Cyprus has been collecting data on EWPPs since 2008, it says that coverage of these entities is still incomplete. It is therefore taken the decision not to publish the data any more until further improvements have been made.

However, it has provided statistics on FDI including EWPPs to the IMF, which subsequently published the data. We can make some cautious inferences, therefore, by comparing data on the total stock of FDI from the Central Bank of Cyprus with that published by the IMF for 2009-10.

According to the IMF data, total inward FDI stocks including EWPPs in 2010 reached $56.7bn (€42.8bn), whereas according to Central Bank data FDI stocks excluding EWPPs amounted to only €13.1bn. Notwithstanding the Central Bank's reservations about the accuracy of the data including EWPPs, we can cautiously estimate that, over the years, the internationally oriented companies that use Cyprus as a base have invested a cumulative €29.8bn in the country, of which €18.3bn was from Russia. However, the difficulty of estimating this figure accurately is underlined by the fact that the Central Bank of Russia has different

data for outward foreign investment into Cyprus from Russia. According to its estimates, the stock of outward investment into Cyprus at the end of 2010 was $18.0bn or €13.6bn. It may be that the Russian Central Bank classifies as FDI flows that the Central Bank of Cyprus classifies as "other investment assets". Other investment assets include inflows and outflows of bank deposits. Whatever the true picture that will emerge once the Central Bank of Cyprus has completed its analysis, it is clear that the companies served by the professional services sector bring a large amount of money to Cyprus.

On the other hand, EWPPs have also been responsible for a substantial amount of direct investment outside the country, amounting to an estimated €29.1bn, which makes the net gain to Cyprus much smaller. We estimate that net FDI stocks by EWPPs were €2.6bn in 2009 and €662m in 2010 (a year in which inflows of FDI from all entities fell sharply). Thus, it cannot really be said that EWPPs bring a great deal of net FDI into the country. Perhaps the greater impact of such investment flows can be seen in the amount of business and jobs that it generates at home for the business and financial services companies serving these international clients.

In Section 6, we make recommendations on how these companies might be encouraged to invest more directly in Cyprus.

Figure 1.14

Foreign direct investment stocks	2009	2010
€ million	4.1	3.7
Including EWPPs (a)		
Inward FDI stocks	39,364	42,840
Russia	16,752	18,324
Greece	4,578	4,001
British Virgin Islands	2,137	2,533
UK	2,171	2,354
Outward FDI stocks	32,220	38,075
Net FDI stocks (inferred)	7,145	4,765
Excluding EWPPs		
Inward FDI stocks excluding EWPPs	12,779	13,084
Greece	3,699	3,198
UK	2,001	2,110
Russia	1,377	1,116
Germany	664	793
Outward FDI stocks excluding EWPPs	8,212	8,980
Net FDI stocks (inferred)	4,567	4,103
EWPPs only (inferred)		
Inward FDI stocks	26,586	29,757
Outward FDI stocks	24,008	29,095
Net FDI stocks (inferred)	2,578	662
Memorandum item		
€ per $	0.719843	0.755045

a) Converted from US dollars.

Source: Cystat

Section 2
Macro benchmarking: Cyprus as a place to do business

In this section we benchmark Cyprus at the macro level, using comparative studies from respected international institutions to compare Cyprus with its peers, at the general level, as place to do business. A more specific comparison of Cyprus as an innovator will be undertaken in Section 3. Where countries are covered by these studies, we compare Cyprus with its key competitors in terms of international financial and business services, namely Ireland, Luxembourg and Malta, as well as the "best in class" for this category, namely Singapore.

2.1 World Bank on ease of doing business

Cyprus ranks 40th for ease of doing business

The World Bank's Doing Business Report 2012 compares regulation for domestic firms in 183 economies. The rankings are based on 10 regulatory areas: starting a business, dealing with construction permits, getting electricity, registering property, getting credit, protecting investors, paying taxes, trading across borders, enforcing contracts and resolving insolvency (closing a business). It also presents data on regulations relating to employment. The rankings are based on both quantitative and survey data.

Cyprus is ranked 40th out of 183. This is better than the 2011 ranking of 49 and Cyprus is also ranked ahead of nine other EU countries—Spain (44), Luxembourg (50), Hungary (51), Bulgaria (59), Poland (62), Czech Republic (64), Romania (72), Italy (87) and Greece (100). However, with the exception of Luxembourg, the ranking is well below the other two peers covered by the World Bank. Singapore is ranked number 1 and Ireland number 10. Malta is not included in the ranking.

Figure 2.01

World Bank Doing Business Rankings 2012				
Rank out of 183	Cyprus	Ireland	Luxembourg	Singapore
Registering property	123	81	134	14
Enforcing contracts	105	62	1	12
Getting electricity	96	90	63	5
Dealing with construction permits	78	27	33	3
Getting credit	78	8	150	8
Paying taxes	37	5	17	4
Starting a business	33	13	81	4
Protecting investors	29	5	122	2
Resolving insolvency	23	10	49	2
Trading across borders	19	21	31	1
Ease of doing business (overall ranking)	**40**	**10**	**50**	**1**

Source: World Bank, Doing Business 2012

While Cyprus scores fairly well for issues such as starting a business, paying taxes and investor protection, it scores very badly for registering property, for which it is ranked 123. The backlog of 100,000 or so title deeds for property that has already been purchased is clearly damaging perceptions of doing business in Cyprus. In addition, a lengthy judicial process is probably behind the very low ranking for enforcing contracts. However, for a country that promotes itself as a international financial centre, perhaps the issue to pay attention to for the purposes of this study is the ease of obtaining credit. Here, Cyprus is ranked 78th, whereas Ireland is ranked 7th and Singapore 8th, although Luxembourg, a bigger financial centre than Cyprus, is ranked lower at 150th. This may be a by-product of the small stock market, which reduces access to alternative forms of financing and thus makes the banks the price-makers for finance.

2.2 EIU on the business environment

Cyprus ranks 33rd for business environment

A sister company of The Economist magazine, The Economist Intelligence Unit (EIU), produces Business Environment Rankings for 82 countries based on some 90 indicators covering the political and macroeconomic environment, market opportunities, policy towards private enterprise, competition and foreign investment, foreign trade and exchange controls, taxes, the labour market and infrastructure. The indicators, which are based on both quantitative and qualitative data, cover a five-year forecast period and are compared with the preceding five years.

In its most recent release of May 2012, Cyprus is ranked 33rd out of 82 for the forecast period 2012-18). The EIU says this is owing to three main weaknesses: “small market size, distance to the main EU market and lack of access to Turkey”; “a culture of cronyism” which it says affects the environment for

competition; and the division of Cyprus which "constitutes a security risk and may put off significant investors, especially in the context of Turkey's objections to hydrocarbons exploration and Cyprus co-operation with Israel in exploiting natural gas finds." The EIU's assessment is probably the only ranking in which the Cyprus problem is specifically highlighted as an obstacle to doing business. The recent deterioration in the macroeconomic outlook means that Cyprus' global ranking for the macroeconomic environment also slips from 36th place in the historical period (2007-2011) to 58th—the same as Ireland—in the forecast period (2012-2018).

On the other hand, the EIU describes Cyprus' tax regime as "one of its strongest features". While it takes note of the tax increases voted through at the end of 2011 it also says that the tax regime will be bolstered by the revised law on international trusts.

Figure 2.02

Economist Intelligence Unit Business Environment Rankings

Rank out of 82, selection from 13 indicators	Cyprus	Ireland	Luxembourg
Macroeconomic environment	58	58	6
Taxes	8	11	4
Financing	24	52	1
Overall world ranking	**33**	**16**	**1**
Regional ranking out of 18 (a)	14	8	-

(a) Excludes eastern Europe and smaller EU countries but includes Switzerland, Norway and Turkey.

Sources: EIU Country Forecast Main Reports, Cyprus, Ireland and Spain 2012

2.3 WEF on competitiveness

Cyprus has slipped to 58th for competitiveness

Another index which also reflects to a certain extent the environment for international business companies is the Global Competitiveness rankings of the World Economic Forum (WEF). The rankings are based on a large survey of small and large enterprises. Cyprus has been sliding in the rankings and in the 2012-13 report now ranks 58th (down from 47th), behind Singapore (2), Luxembourg (22), Ireland (27) and now also Malta (47), which overtook Cyprus in the latest survey. Within the subindices, Cyprus scores worse on the subcategory of "innovation and sophistication factors" than on other factors. Cyprus as a centre of innovation will be dealt with more fully in Section 3.

Figure 2.03

Global Competitiveness Rankings 2012-13

Rank out of 144	Cyprus	Ireland	Luxembourg	Malta	Singapore
Basic requirements	42	35	8	34	1
Efficiency enhancers	43	25	24	40	1
Innovation & sophistication factors	51	20	19	46	1
Overall ranking	**58**	**27**	**22**	**47**	**2**

Source: World Economic Forum, The Global Competitiveness Report 2011-2012

Despite Cyprus' reputation for a favourable tax regime and a low crime rate, respondents reported that tax rates were the most problematic area for doing business and crime and theft were the second most problematic area. It is not clear why this is the case, especially as Cyprus is ranked 18 out of 142 for tax rates—much higher than its overall ranking. No explanation is given in the report for the respondents ranking tax rates as their most problematic area. These particular rankings are based on surveys of businesses, therefore perhaps the anticipation of changes in tax rates that came at the end of 2011 might have played a factor, as well as rising crime rates from a low base for the score on crime and theft. As with the World Bank Doing Business report, access to financing was also reported as a problem.

2.4 WHF on economic freedom

Cyprus ranked 20th for economic freedom

The World Heritage Foundation (WHF) produces an annual index of economic freedom. It argues that economic freedom is important because "[i]n an economically free society, the power of economic decision-making is widely dispersed, and the allocation of resources for production and consumption is on the basis of free and open competition so that every individual or firm has a fair chance to succeed." In other words, economic freedom is good for business and is therefore another indication of how attractive Cyprus is compared with its peers.

Cyprus is ranked 20th out of 179, ahead of Malta (50) but behind Luxembourg (13) and much further behind Singapore (2) and Ireland (9). The key area that brings Cyprus' score down is government spending, which is probably influenced by the large public sector. According to Eurostat data, government spending in Cyprus was 47.3% of GDP in 2011, higher than the 43% recorded for Malta and 42% record for Luxembourg but a little lower than Ireland, at 48.7% of GDP.

Cyprus also scores fairly badly on freedom from corruption. Sometimes this is blamed on the fact that Cyprus is a small country. However, with the exception of Malta, Cyprus scores worse than the other countries in the small country peer group for corruption.

Figure 2.04

Economic Freedom Rankings 2012					
Absolute score (low score = low ranking)	Cyprus	Ireland	Luxembourg	Malta	Singapore
Government spending	37.1	30.4	46.6	43.8	91.3
Freedom from corruption	63.0	80.0	85.0	56.0	93.0
Labour freedom	69.9	78.4	40.9	60.0	92.1
Property rights	70.0	90.0	90.0	70.0	90.0
Investment freedom	70.0	70.0	80.0	60.0	70.0
Financial freedom	75.0	90.0	95.0	75.0	75.0
Business freedom	81.6	92.8	75.9	70.0	97.2
Trade freedom	82.1	87.1	87.1	87.1	90.0
Fiscal freedom	83.3	73.9	63.6	67.8	91.3
Monetary freedom	85.7	76.7	81.3	80.5	84.8
Overall ranking out of 179	**20**	**9**	**13**	**50**	**2**

Source: World Heritage Foundation, 2012 Index of Economic Freedom

2.5 Transparency International on corruption

Cyprus ranks 30th for corruption

Finally, Transparency International ranks Cyprus among 182 other countries for perceived levels of corruption in the public sector. Here, Cyprus ranks 30th, again behind three of the four others in its peer group but ahead of Malta.

Figure 2.05

Transparency International Corruption Perceptions Index

Absolute score (low score = low ranking)	Cyprus	Ireland	Luxembourg	Malta	Singapore
Overall score out of 10 (10 = no corruption)	6.3	7.5	8.5	5.6	9.2
World ranking out of 182	**30**	**19**	**11**	**39**	**5**

Source: Transparency International, Corruption Perceptions Index 2011

2.6 Conclusion: Cyprus generally behind peers as a business centre

While the abovementioned indicators are produced on the basis of different criteria and research methods, the general conclusion one can draw is that, as a general place for doing business, Cyprus is ahead of Malta but way behind Singapore, a fair way behind Ireland and in most cases behind Luxembourg. Given the importance attached by businesses and investors to international rankings, in Section 6, we shall make recommendations on how to make Cyprus a better place to do business for the international business services sector.

Section 3
Micro benchmarking: Cyprus as an innovator

Simply analysing Cyprus as a general place to do business, as we did in Section 2, is not enough to get a real sense of how the professional services sector in Cyprus compares with its main competitors, namely Ireland, Luxembourg, Malta and the "best in class", Singapore. For this, we need to take a deeper look at one of the key determinants of success for high value-added services in high-income countries, namely innovation. As mentioned above, the ability to innovate will be decisive for the future of the business services sector.

In this section, therefore, we review the performance of Cyprus as an innovator, and prospects for further innovation, by examining indicators of the Global Innovation Index, produced by the INSEAD business school and the World Intellectual Property Organisation (WIPO).

The Global Innovation Index has 84 indicators grouped under seven categories. Five categories constitute inputs to innovation (Institutions, Market Sophistication, Human Capital & Research, Business Sophistication, and Infrastructure) and two categories (Knowledge and Technology Outputs, and Creative Outputs) constitute innovation outputs.

We review the seven key categories that comprise the Innovation Index for Cyprus, focusing first on the category in which Cyprus has the highest ranking relative to its own other rankings and then on the category in which Cyprus has the lowest ranking. For Cyprus, the best ranking is for Institutions, while the worst ranking is for Creative Outputs. We shall also review the other categories for Cyprus where the score falls somewhere in between.

As part of our analysis we compare Cyprus with the best in class within the peer group of four countries that we have selected for comparison with Cyprus, namely Ireland, Luxembourg, Malta and Singapore. In this way, we can see how Cyprus as an innovator compares with its key competitors for professional business services.

3.1 Overall innovation ranking

Cyprus is far behind competitors on innovation

For 2012 Cyprus ranks 28th in the Global Innovation Index out of 141 countries. Strikingly, it is a long way behind all four countries in our selected peer group. Singapore is ranked 3rd, Ireland 9th, Luxembourg 11th and Malta 16th. Thus, as we can see from Section 2.1, Cyprus scores far worse as an innovator than it does as a general place to do business. In particular, while Cyprus tends to score better than Malta as a general place to do business, it scores worse than Malta as an innovator. This might well explain why Malta has been seen to be stealing a march on Cyprus as an international business services centre in recent years.

Figure 3.01 shows the overall ranking together with the ranks of the seven key indicators. The scores in red denote the best in class for our selected peer group and the scores in green denote the second best in class. For example, within our peer group Ireland has the second best overall ranking, which is therefore marked in green. We highlight the second best as well as the best because in benchmarking, one typically cannot shoot for breakthrough and reach the top right away. Thus, the best-in-class red score might be viewed as the long-term aim for a given timeframe that is applicable to the particular country. The second best green score can be seen as the interim goal. Therefore, for the overall ranking, Singapore ranks 3, and could be considered the longer-term goal for Cyprus. Ireland ranks 9 and would be the interim goal for a given time frame. For example, Cyprus can aim to reach a score of 7 by 2020 (an improvement of 3 overall points each year for the next 7 years).

Figure 3.01 Global Innovation Index 2012

Innovation rankings (low rank denotes high performance)	Cyprus	Ireland	Luxembourg	Malta	Singapore
Overall Ranking out of 141	28	9	11	16	3
Institutions	15	4	19	18	8
Market Sophistication	20	6	23	57	4
Knowledge & Technology Outputs	25	6	18	14	3
Human Capital & Research	30	7	12	47	2
Business Sophistication	37	2	5	4	1
Infrastructure	42	35	18	46	9
Creative Outputs	63	38	6	2	37

3.2 Best relative performance: institutions

The best category ranking for Cyprus vis-à-vis its own rank in all categories is in Institutions, where it ranks 15th out of 141. The Institutions category consists of twelve indicators that examine the political environment, the regulatory environment and the business environment. In the scores, a low score indicates a strong performance.

Figure 3.02 Institutions ranking

Institutions in Cyprus	Score	Rank
Political environment	83.6	20
Political stability	75.1	48
Government effectiveness	80.3	18
Press freedom	95.3	15
Regulatory environment	91.5	17
Regulatory quality	86.6	21
Rule of law	79.2	25
Cost of redundancy dismissal, salary weeks	8.0	1
Business environment	83.9	11
Ease of starting a business	84.8	22
Ease of resolving insolvency	85.6	21
Ease of paying taxes	81.2	27

Across these 12 Institution indicators, Cyprus has its best ranking of 1 in the cost of redundancy dismissal, which is eight weeks of paid salary. The lowest ranking in the Institutions category is 48 in political stability, which largely reflects the Cyprus problem. The Institution indicators in which Cyprus ranks relatively well are regulatory environment, press freedom and the business environment.

3.3 Lowest relative performance: creative outputs

We now turn to consider in-depth the category in which Cyprus has the lowest rank, namely Creative Outputs with a rank of 63 (out of 141). This is very far behind Malta, which is the best in the peer group at number 2, and Ireland, which is ranked 6th. It is also considerably behind Singapore (37th) and Ireland (38th).

The Creative Outputs category consists of 13 indicators under three headings. The first heading is creative intangibles, which includes measures such as domestic trademark registrations and the number of ICT business models. The second heading is creative goods and services, which includes measures such as the number of national feature films per head of population and recreation and culture consumption. The third heading is online creativity. This includes features such as registrations of generic top-level domains and monthly edits on Wikipedia.

In Figure 3.03, we review the best and lowest ranks for Cyprus within the Creative Outputs category. The best score is a tie between the Madrid Resident Trademark Indicator (Indicator 7.1.2 in the Global Innovation Index model) and Generic Top Level Domains (Indicator 7.3.1.), both of which are ranked 23 globally. These two indicators show that Cyprus does have a relatively high number of trademark registrations through the Madrid System (which simplifies the process of international trademark registration by reducing the requirement to file separate applications with different country or regional trademark offices). As regards domains, Cyprus has registered on average 35.2 generic top-level domains (i.e. websites ending with biz, info, org, net or com) per thousand people aged 15 to 69. How much this activity relates to R&D and other forms of innovation by Cypriots, as opposed to innovation of internationally oriented companies registered in Cyprus, that is, innovation by the clients of the professional services sector, is unclear, however.

Figure 3.03 Creative Outputs ranking

Creative Outputs	Score	Rank
Overall ranking	34.0	63
Best and worst		
Madrid resident trademark reg/bn PPP$ GDP	0.9	23
Generic top-level domains (TLDs)/th pop. 15–69	35.2	23
ICT & business model creation	52.3	66

The lowest rank for Cyprus within the Creative Output category is ICT & business model creation (Indicator 7.1.3). This refers to the extent to which information and communication technologies are being invented and new business models, services and products created in a particular country. Cyprus ranks 66th in this indicator, which suggests that most of the activity in creating top-level domains is not related to creating business models, services and ICT products. The combination of a high output score for trademarks and domains but a low one for ICT and business model creation reinforces our assumption above that most of the trademark registration and domain registration is being undertaken by companies that are primarily engaged in such business activity globally.

Having examined the best performance category (Institutions) and the worst (Creative Outputs), we shall now examine the remaining five indicators, which we have ordered according to their relative importance to the professional services sector. Thus, we start with Human Capital & Research, and then examine Infrastructure, Market Sophistication, Business Sophistication, and Knowledge & Technology Outputs. In the interests of space, we shall review the best and lowest indicator within each category.

3.4 Human capital and research

Human Capital and Research represents the investment of a country in its people in terms of education and academic research. Cyprus ranks 30th out of 141 economies in this category. It is behind three of the four countries in our peer group—Singapore (ranked 2nd), Ireland (7th) and Luxembourg (12th). Malta is ranked 47th.

The best performance within the Human Capital and Research category is in tertiary education with a rank of 19. This demonstrates that Cyprus not only values education highly, it also invests in it. The ranking is based on the ratio of total tertiary enrolment, regardless of age.

The lowest performance in the category of Human Capital and Research is gross expenditure of R&D as a percentage of GDP, where Cyprus ranks 59th. Cyprus also ranks low compared with EU countries for this indicator. Cyprus is clearly not investing enough in R&D, perhaps, some would say, because up to now there were no real significant research organisations that could utilise the investment.

Figure 3.04 Human Capital & Research

Human Capital & Research	Score	Rank
Overall ranking	49.3	30
Best and worst		
Tertiary Education	64.5	19
Gross expenditure on R&D, % GDP	0.5	59

3.5 Infrastructure

Infrastructure is an important indicator as it includes not only classic indicators such as trade- and transport-related infrastructure but also Information Communication Technologies (ICT), e-government and ecological sustainability. Cyprus' overall ranking for infrastructure is 42nd, behind Ireland (35), Luxembourg (18) and Singapore (9) but ahead of Malta (46).

The best relative performance for Cyprus within the Infrastructure category is the ICT use index indicator, where Cyprus ranks 28th. The ICT use index is a composite index that includes Internet users, fixed broadband Internet subscribers and mobile broadband subscriptions per 100 inhabitants. This is a relatively high performance for Cyprus and confirms the high level infrastructure the country has in terms of use, access and connectivity of ICT. Technology is a fundamental prerequisite to growth and Cyprus has ample use and access to it.

Figure 3.05 Infrastructure

Infrastructure	Score	Rank
Overall ranking	43.3	42
Best and worst		
ICT use	47.8	28
E-participation	7.9	98

While Cyprus has quite a high ranking for ICT use for the number of inhabitants, it has a low performance as regards e-participation. The ranking comes from the United Nations E-Participation Index based on a survey used for the UN Online Service Index. Questions focus on the use of the Internet to facilitate the provision of information by governments to citizens ("e-information sharing"), interaction with stakeholders ("e-consultation"), and engagement in decision-making processes ("e-decision making"). A country's E-Participation Index value reflects how useful these features are and the extent to which they have been deployed by the government compared with all other countries. The purpose of this measure is to offer insight into how different countries are using online tools to promote interaction between citizens and the government, as well as among citizens, for the benefit of all. It is clear that Cyprus is facing challenges in this area.

3.6 Market sophistication

Market Sophistication is a set of 12 indicators compiled by the Global Innovation Index to capture the ability of a country's infrastructure to foster access to credit, investment and trade, and competition. The stronger the performance in these four broad indicators and their subindicators, the higher the market sophistication in the country, whereby market forces of supply and demand and competition can flourish.

Cyprus performs relatively strongly in market sophistication with a ranking of 20 out of 141 economies. Compared to its peer group, Cyprus is third, ahead of both Luxembourg (23) and Malta (57), but well behind Ireland (6) and Singapore, the best performer in the peer group, which is ranked 4th out of 141 economies.

The best indicator within the ranking is Venture Capital Deals as reported by Thomson Reuters, where Cyprus is ranked 10th out of 141 economies. This indicator refers to

data on private equity deals, with details, among others, on the location of investment, investment company, investor firms, and funds. The series is based on venture capital deals from 1 January 2011 to 31 December 2011, with the data collected by investment location. The data are reported as deal per trillion dollars of GDP at purchasing power parity (PPP$ GDP). Clearly, this is an indicator that shows the strength and expertise of the professional services sector in Cyprus, with the expertise to facilitate Venture Capital deals amounting to over 126 trillion PPP$ GDP.

Figure 3.06 Market Sophistication

Market Sophistication	Score	Rank
Overall ranking	56.2	20
Best and worst		
Venture Capital Deals/tr PPP$ GDP	126.3	10
Market capitalisation, % GDP	19.9	75

However, these deals are clearly not taking place within Cyprus. This is underlined by the fact that the lowest performer in the category of Market Sophistication is market capitalisation (also known as "market value"). Listed domestic companies are the domestically incorporated companies listed on the country's stock exchanges at the end of the year. Listed companies do not include investment companies, mutual funds, or other collective investment vehicles. The low score for Cyprus underscores the fact that the active stock market is tiny, and is generally not used as a vehicle for raising corporate finance. This indicator therefore shows that there is plenty of opportunity for improvement.

3.7 Business sophistication

For business sophistication Cyprus ranks 37 out of 141. Notably, it is the indicator in which Cyprus falls furthest behind its peers, with Singapore ranking 1st, Ireland 2nd, Malta 4th and Luxembourg 5th.

The best relative performance for Cyprus in terms of business sophistication in this index is the amount of Joint Venture Strategic deals conducted. As in the indicator for venture capital deals, this is compiled using Thomson Reuters data on joint ventures in 2011, and reported as deals per trillion PPP$ GDP. Within this subcategory, Cyprus ranks 10th in the world, beaten only by Ireland (ranked 7th) in its peer group. This indicator attests to the expertise and strength of the professional services sector in Cyprus, which has both the know-how and the experience to structure JV alliance deals worth trillions. Yet, like market sophistication, it is likely that many of these deals concern assets or projects which take place outside Cyprus.

This is probably also why the lowest performance in the business sophistication category is the indicator referring to the percentage of gross expenditure on R&D financed by business enterprises. As discussed above, Cyprus does not invest nearly enough in R&D. Within this subcategory more specifically, Cyprus ranks 65th out of 141 economies in the percentage of R&D financed by the private sector.

Figure 3.07 Business Sophistication

Business Sophistication	Score	Rank
Overall ranking	43.3	42
Best and worst		
JV Strategic Alliance deals/tr PPP$ GDP	146.6	8
R&D financed by business, %	17.8	65

3.8 Knowledge and technology outputs

Another indication that the business services sector in Cyprus expertly facilitates client needs of global companies in the areas of innovation is in the category of knowledge and technology outputs. This is essentially a measure of what is achieved by innovation. Here Cyprus ranks 25th, a fair way behind all of its peers, with Singapore ranked 3rd, Ireland 6th, Malta 14th and Luxembourg 18th. Yet it is a great opportunity also to transfer such expertise to facilitate knowledge and innovation growth in the local economy. Discussions to this effect have been under way since the establishment of the first research university in the 1990s and culminated in suggestions to establish the Nicosia Knowledge Region, for example.

The best relative performance for Cyprus is the number of new businesses registered per 1,000 population aged 15-64 (in 2009), where Cyprus is ranked 1st in this category. This is another confirmation of the strength and capacity of the professional services sector in Cyprus.

The lowest relative performance in this section for Cyprus measures growth of GDP (measured at constant-price PPP$) per person engaged. It is therefore a measure of labour productivity defined as output per unit of labour input. GDP per person employed is gross domestic product (GDP) divided by total employment in the economy. In times of financial crisis, when companies are cutting their workforces, there may be a natural increase in productivity as fewer workers are forced to produce similar levels of output.

Thus, as long as the fall in employment is not as steep as the fall in GDP, productivity will increase in the short term. However, the greater challenge for the longer term is to invigorate workers to improve productivity on a more sustainable basis at a time when they may also be facing cuts in salaries and benefits as their employers reduce costs. However, if productivity is encouraged in the sectors of comparative advantage, such as the professional services, where demand (and therefore GDP contribution) continues to be strong, then Cyprus might improve its productivity numbers in the subsequent rankings.

Figure 3.08 Knowledge & Technology Outputs

Knowledge & Technology Outputs	Score	Rank
Overall ranking	44.7	25
Best and worst		
Growth rate of PPP$ GDP/worker, %	1.3	92
New businesses /th pop. 15–64	20.3	1

3.9 Conclusion: an opportunity to leverage current capabilities

Our analysis of Cyprus as an innovator has shown that Cyprus clearly has several strengths, as regards innovation, many of which stem from the expertise and scale of the professional services sector. However, it is also far behind its competitors in areas such as business sophistication, creative outputs and therefore the generation and capitalisation of knowledge. Where Cyprus as an innovator does excel, it seems to be as a result of the professional business services sector facilitating international clients' efforts to innovate. Now, it is critical for the professional services sector also to focus on innovation in the local economy.

Clearly, to create a model for sustainable growth the private sector needs to invest more in R&D. Venture capital deals need not only to be transacted in Cyprus but also invested in Cyprus. There are plenty of opportunities here, such as mobile and new augmented technologies, oil, gas and renewables, which would support a genuine entrepreneurship ecosystem (see Section 6). Today, the country also has several areas for research including neuroscience and genetics, energy, blue and green technologies, archaeology, etc. Cyprus can also be far more innovative than it is today by focusing more on its younger and highly educated researchers. For the professional services sector in particular, there is an opportunity to strengthen innovation in these areas.

Cyprus can first improve its innovation environment and its ranking by addressing the low hanging fruit—that is, by focusing in the next twelve to 24 months on strengthening the categories in which it does relatively well, such as Institutions and Market sophistication. In addition, in the next 12 months and beyond an implementation plan needs to be put in place to strengthen performance in the other areas and close the gaps within key categories where Cyprus is not performing as well, such as Infrastructure, Business Sophistication and Creative Outputs.

To achieve all of these improvements requires strategic planning, coordination and collaboration by the key stakeholders including the policy makers, the private sector, the voice of the industry across disciplines, as well as the universities and research centres. A detailed process improvement strategy requires in depth analysis, which is beyond the scope of this document. However, we make a number of recommendations on key steps forward in Section 6.

Section 4
SWOT analysis: strengths, weaknesses, opportunities, threats

4.1 Introduction

At the time of writing, the Cyprus economy is being battered by dismal credit ratings, increasing unemployment and minimal, if any, prospects for annual GDP growth. At the same time, a range of inefficiencies is holding the economy back. As we have seen in Section 1, the professional services sector has been the highest contributor to GDP growth in the past decade and almost the sole engine of the economy in the more recent difficult period. It has therefore become imperative to make a fresh analysis of the sector's Strengths, Weaknesses, Opportunities and Threats (SWOT). The goal of this section is to highlight the strengths and identify the weaknesses of the professional services sector, with the aim of identifying ways to leverage the opportunities and mitigate the threats.

As we have seen in Section 1, during the past decade, the professional services sector, in conjunction with the leading efforts from the tax and audit firms, anchored in over 45 double tax treaty agreements, a highly educated, specialised work force and a robust "common law" based legal system, has been able to structure a significant fee-based revenue stream which has led to a growing contribution of the sector to GDP and employment. Cyprus was placed on the OECD White List of tax jurisdictions in April 2009. This is a significant vouch of confidence in the strength and potential of the Cyprus professional services sector. Yet the sector is operating in an environment in which many of the economies of the Eurozone, including that of Cyprus, are struggling to stay afloat. After the reverberations of the 2008 global economic crisis, the ability to innovate and evolve to survive becomes imperative for every sector, as the way business has been conducted for decades is changing rapidly and radically. Such changes are also affecting the professional services sector we are reviewing here.

This analysis, while not exhaustive, it is intended to be concise enough to serve as a practical tool. It is drawn from interviews with key professionals in the sector as well as quantitative and mostly qualitative data sourced from a range of publications and surveys noted in the Appendix.

While a strong local positive business market sentiment about the sector is important, the perspective of the international market that includes key opinion leaders, clients, interested investors, corporations, analysts, international regulating bodies, rating agencies and media among others, is fundamental. One way to capture this international perspective is through global ranking reports such as the World Economic Forum Global Competitiveness Index 2012, the World Bank Doing Business Report

2012 and the PwC Annual Global CEO Survey 2012. Here, we must highlight that the methodologies of each report differ and drawing conclusions from the quantitative rankings would be the equivalent of comparing apples with oranges. To continue with the fruit analogy, we discuss how these fruit constitute the baskets of strengths and weaknesses of the professional services sector in Cyprus, while highlighting opportunities to harvest better fruit in the future at the same time as mitigating the threats.

Therefore, in this report, we compiled a SWOT analysis based on key qualitative data. We believe that this is helpful both in times of prosperity and even more in times of crisis, as it allows the sector proactively to recalibrate with the agility and timeliness that will prove critical to survival.

In this section we provide a brief overview of the SWOT analysis function and a table showing the key Strengths, Weakness, Opportunities and Threats, compiled on the basis of the abovementioned research. Then we will discuss the content of the SWOT analysis.

4.2 SWOT analysis as a tool

A SWOT analysis is simple but handy tool to capture the endogenous or internal factors of an issue in terms of strengths and weaknesses, as well as the exogenous or external factors in terms of opportunities and threats. In a SWOT analysis the strengths and opportunities are considered as positive aspects for the issue analysed, in our case the professional services sector, while the weaknesses and threats have a negative effect on the issue. The SWOT analysis is a snapshot of the present moment in time and it can provide a quick perspective of comparative advantages and disadvantages. It can also serve as a map for matching strengths to opportunities and mitigating weaknesses and threats. Sometimes, though it is challenging, some weaknesses can be converted into strengths and some threats into opportunities.

We recommend focusing first on leveraging strengths and opportunities while in parallel containing the weaknesses and mitigating the threats. Adhering to our practical approach in this document, the items in each quadrant are simply listed and not necessarily prioritised or exhaustive.

In Figure 4.01 we show the SWOT chart in four quadrants. The upper two quadrants show some of the fundamental strengths and weaknesses of the professional services sector in Cyprus, based on our review of available literature and interviews with key professionals in the sector. The lower two quadrants show the opportunities and threats facing this sector.

Figure 4.01 SWOT Analysis

Professional services sector - SWOT Analysis

4.3 Strengths

As one can see from the SWOT analysis above there are several strengths that can be leveraged as well as several weaknesses that need to be addressed internally in order to strengthen the sector and enable it to address externally driven opportunities and threats.

Common Law system

Key strengths include a legal and regulatory system based on Common Law with updates since the 2004 accession to the European Union. International counterparts easily understand a Common Law based system, its emphasis on equity cannot easily be transposed into code-based systems, especially in the judicial process, and therefore it facilitates business transactions globally.

Tax regime

The professional services sector in Cyprus is anchored around a favourable tax system that is also fully aligned with EU and international regulations and an extensive double taxation treaty network with over 45 countries worldwide. In 2003 the Cyprus tax system was overhauled in full compliance with EU directives, right before the accession of Cyprus to the EU in 2004. In April 2009 the OECD accepted Cyprus onto the White List of jurisdictions that have substantially implemented the internationally agreed standard on exchange of information. This is a clean bill of health with regard to the reliability and robustness of Cyprus tax system and a strong marketing tool for Cyprus as an international business centre.

Human capital

Another key strength is well educated, fluent in English and experienced pool of professionals that drive the Cyprus financial services sector. According to the Cyprus Bar Association, there are over 10,000 lawyers in Cyprus and they can act as both solicitors and barristers as there is no distinction between the two in Cyprus. In addition, according to The Institute of Certified Public Accountants of Cyprus (ICPAC), there are over 5,000 certified accountants and auditors, who are mostly UK educated and certified, as well as a few thousand fiduciary services professionals and ancillary services providers. The professional services sector has solid expertise in corporate and merger & acquisition services, banking and finance, and real estate, and significant expertise in tax advisory, company registration and fiduciary services.

Geography and culture

The geographic location of Cyprus makes it convenient in terms of access to various markets and time zones, including Central and Eastern Europe, South East Europe, Russia, the Caucuses, the broader Middle East and North Africa. Cyprus is located in +2GMT and about four and half hours away from London, Moscow and Dubai respectively.

And last but not least, in an era in which quality of life and work-life balance are coveted, Cyprus provides professionals with an open European culture, good Mediterranean weather with over 340 days of sunshine, easy access to beautiful beach-front establishments as well as widely available broadband access, making it easy to work outside the office.

4.4 Weaknesses

Turning now to key weaknesses, we see there are several. However, we believe they can be addressed and managed effectively with a bit of strategic planning, better collaboration and a focus on long-term sustainable growth.

Fragmentation of business development efforts

One key weakness is fragmentation in business development efforts. According to the Cyprus Business Leaders Survey published in July 2012 by Gold Magazine, when the 800 Cypriot executives surveyed were asked what were the biggest challenges facing private sector organisations, 45% responded that it was the inability to expand to new markets while 43% responded with budget reductions, postponement or cancellations of planned projects.

Fragmented and unstructured business development efforts prevent expansion into new markets. While several initiatives are organised by professional associations from the industry, individual firms, Chambers of Commerce, Federations and the Cyprus Investment Promotion Agency (CIPA), such efforts are often fragmented and lack a country-level strategic approach, goal-setting and well executed follow-up. This is in contrast to best practices applied in Malta or Luxembourg, where there is very close collaboration. Cyprus' weakness in this area could be partly a matter of lack of resources. For example, as discussed in Section 1, tourism now contributes less to the economy than the professional services sector. Yet the Cyprus Tourism Organisation received a budget of €62.5 million in government funding in 2012, while CIPA's officials report that its budget is currently only €1 to €1.5 million per year, although it is due for an increase. However, even without additional expenditure, there is a lot of room for improvement in terms of active collaboration, coordination, transparency and governance.

Lack of niche capacities

A second key weakness is a lack of niche capacities in key new areas such as energy, including not only oil and gas, but also renewables, green and blue technologies. While the oil and gas sector in Cyprus is in its nascent stages and there is a small window of about two to three years to strengthen capacity, expertise in renewable energy, given the energy needs globally, is also lacking. This is a broader phenomenon within the Cypriot economy, even though solar energy and blue technologies could have been sectors of expertise on an island country in the Mediterranean. Such niche expertise could propel smaller, younger professional services firms into the forefront of the sector. Yet today, they are often marginalised by older, more established and larger firms due to issues of scale and stronger established networks in a small market such as Cyprus.

The reason for the lack of niche capacities is that, as indicated in Section 3 on innovation, the sector has not been as innovative as it could, especially given the numbers of new graduates hired in professional services. Often, the resistance to new strategies is that they are associated with increased or new costs. However, this is not always the case, especially if social media and tech tools, which young professionals excel at, are developed or deployed to tap into local, regional and global client needs and sector trends. Overall, the professional services sector has not capitalised on the use of technology and social media to the extent that it could.

Overdependence on one market

One of the reasons for the decline of tourism in Cyprus was its overdependence on UK tourists, which until 2008 still accounted for more than 50% of arrivals. There is a risk that the professional services sector will fall into the same trap. While no official figures are available, in our research we learned that Russian clients account for a "significant proportion" of the clientele of the professional services sector in Cyprus. As long as oil prices remain at around $100 per barrel or above, the Russian economy can continue to grow. However, as noted in the Economist Intelligence Unit's Country Forecast (July 2012) there are "substantial risks" to its generally benign economic outlook, "particularly the threat that the euro zone could unravel, precipitating a renewed global recession and steep fall in commodity prices, including oil."

The report also notes the reduction in investment in exploiting oil and gas reserves after the 2009 Russian recession and says that "[r]eserve depletion will become the binding constraint on expanding production". While the Russian economy continues to grow, therefore there is a window of opportunity for the professional services sector in Cyprus to diversify into new markets.

Lack of prioritisation by policy makers

Perhaps the most significant weakness that could be both internal and externally based is the fact that policy makers seem not to prioritise the needs of this most dynamic of Cypriot sectors. According to the abovementioned Cyprus Business Leaders Survey, when asked what would be the single improvement in the way business is conducted in Cyprus they would focus on if given the chance, an overwhelming 58% responded that they would oblige the government and government departments to modernise, reduce red-tape and government bureaucracy. In addition, the November 2011 International Monetary Fund Article IV Report on Cyprus (p. 23) highlights that a key structural reform needed in Cyprus is that the regulator should identify the regulatory hurdles burdening the business environment in Cyprus and implement appropriate reforms to reduce red tape and remove obstacles to upgrading technology in the Cyprus business environment.

Lack of clear policy focus also extends to the bureaucratic and politicised delays on key initiatives such as the Nicosia Knowledge District, the concept of utilising the "triple helix" if university-city-government to promote R&D and growth. The initiative was adopted by the Federation of Employers and Industrialists, the Municipalities of Nicosia and the University of Cyprus. What ensued was a tug of war between the then Finance Minister and the Director-General of the Planning Bureau. Eventually, after replacing people, the Cabinet approved the recommendation in 2010 but nothing has happened since. Three years of institutional inertia is a key and crucial hurdle to growth.

As we have seen in Section 1 of this report, since the professional and financial services sector is large and growing, these bureaucratic hurdles largely affect the professional and financial services sector. While there has been some movement in trying to reduce red tape by the government, notably in the as part of the EU's "Better Regulation" initiative, it is in the early stages of simply quantifying the administrative burden. Moreover, it has inevitable been reactive, in response to an EU command, rather than pro-active and tailored to the requirements of the professional services sector.

A true country-level strategy requires collaboration between the private sector, the voice of the industry and the regulators. The new provisions relating to yachts, intellectual property and international trusts are examples of how collaboration can produce positive results for the sector. However, policy makers are not consistently leveraging the expertise and knowledge of this sector to the degree they could, particularly during double tax treaty negotiations, nor at the broader country-level strategy for economic growth. This appears to be the result of misallocation of resources in key ministries. During our discussions with professionals in the sector, we heard how the drafting and implementation of key policies in the finance ministry is the responsibility of a tiny group of highly competent but over-stretched officials. This approach results in fragmented business development efforts, as noted earlier, and leads to a vicious circle of inefficiency.

Not championed by country leaders

In other peer countries like Malta and Ireland, policy makers and government officials, including the president of the country, champion their professional services sectors and the voice of the industry abroad in close cooperation with the

industry. Moreover, they support requests and consultations to innovate, decrease bureaucracy, increase flexibility in the labour market and speed up processes within their countries. Such a collaborative approach would facilitate the provision of services to clients and improve the reputation of Cyprus as a professional services centre in the European Union and the broader Eastern Mediterranean region. By contrast, lack of strategic collaboration breeds lack of agility and the absence of a proactive approach, both of which are critical in today's global competitive markets. This is especially the case in the professional services sector where the deliverable and the litmus test is providing exceptional service to the client.

4.5 Threats

The threats to the sector may seem few in the chart above, but they are all grave and critical.

Lagging behind peers

As we have seen in detail in Sections 2 and 3, Cyprus tends to trail behind its peers as a general business centre even though it ranks higher in certain metrics across different ranking reports. In the World Economic Forum Global Competitiveness rankings, as we have seen, Cyprus has slid to 58th, trailing behind Luxembourg (22), Ireland (27) and Malta (47) and far behind the best in class, Singapore, ranked 2nd. Perhaps more seriously, as an innovator, Cyprus is well behind the four countries in our peer group.

International rankings are the first level of due diligence conducted by investors and clients when seeking new markets and countries to place their investments. They reflect both what is going on in the country and they provide a comparison to peer countries. However, they can also be useful tools for local actors, acting as annual targets and benchmarks for improvement both internally and within peer groups.

Loss of favourable tax regime

Perhaps the most critical threat of all is the potential loss of the favourable tax regime. In 2011 the government already made a number of alterations to the tax system that affected companies: an increase from 15% to 17% and then 20% in the withholding tax on (resident) dividends, an increase from 10% to 15% in tax on "passive" interest income, a new top rate of income tax at 35% for annual incomes over €60,000 and an increase in the value-added tax (VAT) rate from 15% to 17%. Graver threats to the tax system come in three forms: a possible increase in the corporate tax rate, the proposed introduction of an EU-wide common tax base (or even tax rate) and the proposed introduction of a financial transactions tax.

It is conceivable that an increase in the corporate tax rate, which is currently the lowest in the EU at 10 per cent, might be imposed by the "troika" (European Commission, International Monetary Fund and European Central Bank). While this is not currently on the agenda, and Ireland procured EU assistance without changing its 12.5% corporate tax rate, it managed to do so because the government was prepared to implement significant austerity measures, such as a 14% cut in public-sector salaries and large-scale voluntary redundancies in the public sector. So far these kinds of measures are being resisted in Cyprus, raising the risk that the troika will introduce the idea of an increase in the corporate tax rate if the government is unwilling to take other measures.

A second risk to the favourable tax regime comes from the Common Corporate Tax Base (CCTB), proposed by the European Commission in May 2011. This would be "a single set of rules that companies operating within the EU could use to calculate their taxable profits." The main risk to Cyprus is if this implies that tax should be levied in the place where a company conducts most of its business. This could drive away holding companies, which according to our research account for some 80% of business for the professional services sector.

A third risk is the Financial Transaction Tax (FTT), proposed by the European Commission in September 2011 and supported by the European Parliament in an opinion in May 2012. The Commission proposes that it "should be applied to a broad range of financial instruments (i.e. equities, bonds, currencies and derivatives)". Since many Cyprus holding companies use Cyprus as a base for mergers and acquisitions, this kind of tax is likely to drive them to non-EU jurisdictions, thus removing a major part of the professional services business in Cyprus.

While Cyprus was placed on the OECD Whitelist of Tax Jurisdictions in April 2009, which constitutes a strong vouch of confidence in the tax system of the country, any increase in the corporate tax rate from the current 10 per cent, or a change in which it is calculated, or any additional taxes on business would gravely jeopardise the ability of the sector, and thereby the economy of Cyprus, to recover. Especially in view of the other weaknesses we have identified, clients may flee to other, more favourable and agile jurisdictions.

Fiscal and banking crisis

Another key threat to mere survival of several firms is the economic crisis in Cyprus and the region. In Cyprus, we are undergoing both a fiscal and a banking crisis. According to the Gold Magazine Survey, 47% of the 800 surveyed strongly agree that the fiscal difficulties Cyprus is currently facing are grave and could have been avoided. According to the abovementioned International Monetary Fund Article IV Consultation Report on Cyprus (pp. 8-10), the financial conditions in Cyprus deteriorated rapidly from 2010 onwards, effectively shutting Cyprus out of the long-term sovereign debt markets. The destruction of a key power plant in July 2011 and its adverse economic effects and political fallout deepened the sense of economic uncertainty even before the escalation of the Greek crisis that affected the banks. Moreover, with the deterioration of the financial crisis in Greece and the impact on Cypriot banks' capital of their exposure to Greek sovereign debt, tighter financial conditions have come into play that have been detrimental to the confidence and the general demand for services. So far, the crisis in Greece has brought new business to the professional services sector in Cyprus as the country has been seen as a reliable place to do business. The overall bank deposit base has also remained stable, although there has been movement of deposits among banks within Cyprus. But in the worst-case scenario, if Cyprus is perceived to be unable to reach a deal with the troika or to meet its troika obligations, then companies could start pulling business and bank deposits out of Cyprus.

Emigration of young talent

According to the Labour Force Survey, the youth unemployment rate hit 26.7% in the first quarter of 2012, up from 20.7% in the first quarter of 2011. This rate is likely to rise as coveted jobs in the public sector become more scarce. Since young Cypriots can now work anywhere in the EU, and since, as mentioned above, many of the young professionals are UK-qualified, the professional services sector could see an exodus of young talent to the UK, as is happening in Ireland. Not only would this reduce the pool of available labour for the professional services sector, it would also, as argued in the opportunities section below, have a negative impact on the sector's ability to innovate, and therefore continue growing in these challenging times.

Loss of clients

Finally, in our discussion pertaining to the threats to the professional services sector in Cyprus, a key threat, which perhaps distils all the weakness and threats listed in the SWOT analysis chart, is the loss of clients, which translates to loss of business, loss of revenue, loss of tax revenue and decreasing chances of economic recovery for the country.

4.6 Opportunities

We would like to conclude the discussion in this section on a positive note by highlighting the opportunities that the professional and financial services sector can leverage.

EU-wide tax changes as an opportunity

While the professional services sector in Cyprus generally perceives the introduction of EU-wide changes to the corporate tax base as a serious threat, during our research there were also those who argued that this could be turned into an opportunity, if the sector plans well enough in advance. For example, if the EU introduces a harmonised corporate tax base, it could force the sector to think harder about how to encourage internationally oriented companies registered in Cyprus to invest and engage more closely with the local economy and also to carry out business within Cyprus. Two key opportunities in this regard are energy, including renewable, and research and development (R&D), which we discuss further below.

Energy including RES

A key new opportunity is presented by new economic sectors that will change the landscape of the Cyprus economy, such as the energy sector. This includes not only natural gas but also renewable energy sources (RES) such as solar, wind and more broadly green and blue technologies. In November 2011 Noble Energy Inc., an oil and natural gas exploration and production company, announced significant reserves of natural gas in the sea south east of Cyprus amounting to between 5 and 8 trillion cubic feet. This is enough to supply domestic consumption in Cyprus for well over 100 years. As further exploration in adjacent areas will continue, Cyprus could play a significant role in the energy needs of the European Union in the next two decades and beyond. The main and ancillary services resulting from this finding will require the provision of specialised professional and financial services. We believe that this is a great opportunity for the professional and financial services sector in Cyprus to build capacity in the next two to three years.

In addition, as alternative sources of energy are at the forefront of global focus, laws to account for and audit energy capacity and energy savings by every legal and even physical person will become imperative. This is another area on which professional services providers can focus and build capacities. There is no reason why the Cyprus professional services sector could not service such needs for corporations, foundations and even countries worldwide.

An "entrepreneurship ecosystem"

As economic growth in Cyprus is negative at this time, and much of the growth in the previous decade was based on an unsustainable property construction boom, finding new ways to generate growth organically has become even more important. As professionals in the business have already noted, the new law on tax exemptions for intellectual property investments provides the opportunity for R&D investment.

One way to encourage R&D is by building an entrepreneurship ecosystem, as discussed further in Section 6. A number of countries, including smaller economies, have successfully fostered such ecosystems and Cyprus has all of the fundamental ingredients also to foster similar organic growth.

Empower the youth

The Cyprus professional services sector employs some of the better-educated youth of the European Union, holding advanced degrees from top schools in the UK and United States.

The youth unemployment rate at the time of writing had surpassed 25%, yet there is a tendency to give younger professionals, because of perceptions that they are less experienced, lower value-added work and little responsibility when they might be better employed working on new niche markets, or developing innovation internally, within firms, to strengthen internal efficiencies and effectiveness, quality and client value-added services. Young talent could also be empowered to develop broader strategies at the country level. Over 55% of youth in Cyprus are not involved in any organisation or volunteer organisation and of these only 35% explain their non-involvement due to lack of interest. The remaining 20% say that they are not involved because they do not have time and feel left out of decision-making by the overly politicised civil society (Zenios, 2011).

The voice of the industry can leverage young talent, using social media and the Internet to create new strategies for strategic expansion into new markets. This can be done in the traditional areas of fiduciary and tax services in which the sector is already strong. Also, the young talent can foray in the new sectors mentioned earlier, in which Cyprus needs to build capacity, with the aim of competing globally in a few years for new business. Empowering this talent may be the best long-term investment the sector can make and is a clear and readily available opportunity. The new generation of talent, having grown up with Internet in their lives, has different needs and aspirations, therefore can detect the same in the new generation of clients worldwide. These talented young professionals can easily deploy smart technology to tap into prospective clients and anticipate their needs in professional and financial services globally.

Professional services firms have the opportunity to engage, nurture and empower their young talent even more. New graduates can synthesise and adapt new ideas learned from their international education and experiences. Local firms can empower them to develop and deploy innovative ideas for improving internal processes, increasing efficiency and effectiveness and adding value to customers.

In closing, we believe that a sector and even a country can have the best technology, the best infrastructure and the best gadgets, the most strengths, but the real opportunity in growth lies in empowering the people who will leverage the strengths and manage, drive and further develop each of the other opportunities to achieve sustainable growth in the next decade and beyond.

Section 5
5 Additional jobs potential if opportunities are grasped

5.1 Impact on employment

To measure the impact on employment if the sector were given the support which we outline in Section 6, we have used an econometric model, based on the historical relationship between growth and employment. The model is explained in full in the methodological appendix. The model indicates that if GDP grows in real terms by 1%, employment rises by 0.54%.

In our GDP growth forecast, we first assume that real GDP will decline in 2012 at the same pace as it did in the first half of the year, namely by around 2%. We also assume that, owing to austerity measures, real GDP will decline by another 2% in 2013. We assume that employment will decline by 3.2% in 2012—the same year-on-year decline recorded in the first half of 2012. Employment in 2013 is derived from the model and declines by 0.6%. We assume that the unemployment rate will average 11.4% in 2012—a little higher than recorded in the first half, while the unemployment rate for 2013 is derived from the model and rises to 11.7% in that year.

For the post-crisis five-year period 2014-2008 we have two scenarios. The first scenario assumes that none of the recommended measures is taken by either the government or the professional and financial services sectors. In this case, there is no new stimulus to GDP, therefore it grows at an annual average pace of 2.3%. This is just under the annual average pace of in the past ten years (2.5%), and therefore assumes that circumstances will be more difficult going forward. For the labour force growth rate we used the five-year 2007-2011 average (1.1%) for our forecast, rather than the ten-year forecast, since the labour force was skewed upwards in 2004-05 by immigration after Cyprus acceded to the EU.

In our with-reform scenario, we assume that the positive impact of measures to support the professional services sector starts to be felt in 2014 and that implementation of our recommendations could add 0.5 percentage points to the average real GDP growth rate in 2014-2018, thus lifting the average growth rate to 2.8% in that period instead of 2.3%. Achieving a higher rate of growth even under our reform scenario will be difficult. We believe that the business environment will be tougher all over Europe in the coming years than in the longer-run past and that significant investment in natural gas is still some years away and will depend on many other factors, such as willingness of Israel to export, willingness of financiers to put up the billions of euros required to liquefied natural gas (LNG) facilities, uncertainty about the impact shale gas on prices, and so on.

Using the relationship between employment and growth in our model, we then forecast the difference between the no-reform scenario and the with-reform scenario.

Under the no-reform scenario, employment rises at an annual average rate of 1.7% per year in 2014-2018, reaching 406,359 by 2018. Under the with-reform scenario, employment rises at an annual average rate of 1.9% per year, reaching 411,793 by 2018. In other words, implementing the recommendations could add, cumulatively, just over 9,700 new jobs in five years.

Figure 5.01

Reform impact on jobs	2012	2014	2016	2018
No reform				
Real GDP growth (%)	-2.0	2.3	2.3	2.3
Employment	376,262	380,195	393,059	406,359
Unemployment rate (%)	11.4	10.7	8.7	6.7
With reform				
Real GDP growth (%)	-2.0	2.7	2.7	2.7
Employment	376,262	381,207	396,205	411,793
Difference in employment (reform dividend)	0	1,012	3,146	5,435
Cumulative increase in employment	0	1,012	5,205	9,705
Unemployment rate (%)	11.4	10.5	8.2	5.9

Source: Author forecasts

Assuming these new employees earn an average salary of €3,000 per month, or €36,000 per year, this would bring in around an extra €8 million per year to the social insurance fund and another €5 million per year in income tax revenue, or just over €13 million in total additional annual budgetary revenue. To put this in context, this is more or less the same as the €14 million which the government expected to receive in late 2011 by raising public-sector contributions to the widows and orphans funds, and more than twice the estimated €5m increase in revenue generated by the rise in the top income tax threshold.

5.2 Impact on unemployment

In our no-reform scenario, unemployment rises in 2013, owing to another decline in real GDP growth, to 11.7% and then declines gradually to 6.7% by 2018. This is still well above the rates of 3% to 4% enjoyed in the early part of the last decade. In our with-reform scenario, the decline from 2014 is more rapid, with the unemployment rate reaching 5.9% by 2018. This is still higher than historically, but has traditionally been considered an "optimal" unemployment rate since it is high enough to discourage inflation. Moreover, in the with-reform scenario, unemployment should continue to fall after 2018, as the Cyprus economy would be more robust and able to withstand shocks more easily.

Incidentally this exercise also underlines quite how fast GDP must grow in order to bring unemployment back to historical levels. Using our model, the real GDP growth rate would have to average more than 3.4% per year in 2014-2018 to bring the unemployment rate below 5%.

Section 6
Adopt and adapt: a blueprint for sustainable growth

We close this study with ten key strategic-level, long-term recommendations, based on extensive research and experience of the industry. The recommendations are targeted at the three interdependent stakeholders who drive the growth and development of that sector: the regulators and policy makers, the private-sector professionals and the sector representatives, also known as voice of the industry. For each of the strategic recommendations we also make up to four recommendations for specific actions within that overall strategy within the next 12 to 24 months. All of these recommendations reflect the opinion and perspective of the authors alone.

Rather than detail a long wish list of actions, we have deliberately kept the number small, aware that budgets are likely to be tight and attention in the short run likely to be focused on mere survival. We have therefore concentrated on those areas in which we believe immediate action will have the biggest impact in enhancing the strengths and opportunities and mitigating the weaknesses and threats identified in Section 4.

Many of these recommendations may not be new. But this makes their implementation even more imperative.

6.1 Recommendations for regulators and policy makers

Regulators and policy makers are at the helm when it comes to drafting and passing the laws and regulations that provide the legal and regulatory framework for an economy to function. Our recommendations are presented in Figure 6.01. For the regulators and policy makers there are three strategic-level recommendations and in total ten specific recommendations.

Figure 6.01 Recommendations for Regulators and Policy Makers

Recommendations for Regulators and Policy Makers

- Decrease bureaucracy, enforce transparency and good governance
  - Cut company registration to 1 day by Dec 2013
  - Cut title deed backlog to 25,000 by Dec 2013
  - Create a dedicated tax team for DTAs by Dec 2013
  - Prioritise the voice of the industry calls for reform
- Consult representatives on a regular, structured basis
  - Introduce tax breaks for SMEs, venture capital, angel investors, ICIS funds, private equity
  - Introduce law to attract international foundations
  - Pass pending laws on funds and regulation of fiduciary and corporate service providers
  - Expedite pending DTA agreements
- Improve Cyprus rankings in global indices
  - Coordination and collaboration with the voice of the industry
  - Strengthen international media and social media presence

Decrease bureaucracy, enforce transparency and good governance

Our first recommendation at the strategic level is to decrease bureaucracy. A related recommendation is to increase transparency, efficiency and simplicity. Promoting these values enhances the reputation of Cyprus as a professional and financial services provider, decreases costs and increases client satisfaction, thereby increasing Cyprus' rankings as an attractive professional services provider. Higher rankings and a better reputation create more business for the professional services firms, who then create more new jobs, generate more fee revenue and in return more tax revenue for the country.

A key suggestion at the specific level is to cut procedures and processing time, especially in the Company Registrar's office. Lessons should be learned from countries like Georgia, which rose through the ranks of the World Bank Doing Business Report in just five years, from 112th in 2005 to 16th in 2010 and 12th in 2012. In Georgia it takes 3 procedures and 3 days to register a company. The number of procedures and the time taken to register a company are critical factors for businesses. We suggest that Cyprus should aim to surpass Georgia by December 2014, with 2 procedures and 1 day to register a company in person or online. Another key recommendation is to cut the title deeds backlog of more than 100,000 to 25,000 by December 2013—an issue which is still depressing an already weak property sector.

In addition, we recommend the creation of a dedicated tax team in the Ministry of Finance of three to five people with an explicit mandate to work with the ad hoc team of tax experts from the private sector to finalise pending agreements, review old ones and sign new double taxation treaties. During our research we learned that there are

more pending double taxation agreements than there are agreements signed. This is partly because of lack of resources. To send the message that this sector is a priority, the tax team individuals should not have other duties, as is often the case at present. In this area, departmental transfers could make a significant positive difference.

Consult the sector on a regular, structured basis

The second strategic-level recommendation is to prioritise suggestions by the voice of the industry for reform by consulting the sector on a regular, structured basis. The voice of the industry representatives are closest to the pulse of the local and global markets, clients' needs and competitors' new plans and can best advise on how to keep Cyprus ahead of its competitors. The regulator, while first and foremost must be firm and fair, must also be agile in adopting new regulations. Making this happen probably means a change in the way that the industry is currently consulted by the regulators and policy makers. In countries like Luxembourg, the professional services sector has been able to attract and retain significant new business in new areas such as fund registration, fund management and venture capital, mostly owing to the collaborative relationship between the private sector and the voice of the industry. A good best practice is the Association of the Luxembourg Fund Industry (ALFI, www.alf.lu), which works closely with the regulator. Luxembourg's regulator always consults ALFI prior to passing new relevant regulations.

More specifically, we recommend that the government introduce laws that facilitate organic growth, innovation and job creation by fostering entrepreneurship, venture capital and private equity. As we saw in Section 3 on innovation, the professional services sector is already highly experienced in servicing venture capital funds outside Cyprus. It is high time that they were encouraged to service venture capital within Cyprus. We recommended taking advantage of EU rules that relax state aid restrictions for certain sectors and activities to introduce measures such as tax breaks for angel and venture capital investment, for small and medium-sized enterprises and International Collective Investment Schemes (ICIS). These schemes could invest through venture capital in Cyprus-based tech and energy start-ups and research centres, such as Koios at the University of Cyprus. Venture capital and entrepreneurship have been demonstrated to be the engines of economic growth in the EU, the broader Middle East, the United States and the major emerging markets. Encouraging venture capital and entrepreneurship will therefore provide new opportunities for further specialisation and will generate more business for the professional services sector in Cyprus.

In addition, with the growth of philanthropy worldwide, Cyprus should introduce a Foundations Law to enable well endowed international charitable or philanthropic foundations to leverage the expert professional services sector in Cyprus to meet their fund and other services needs.

Our final specific recommendation for listening to the voice of the industry is to expedite pending laws relating to investment funds and on the regulation of fiduciary and corporate services providers. The law on fiduciary and corporate services has been pending for several years.

Improve Cyprus' rankings in global indices

The third, strategic-level recommendation is to focus on improving Cyprus' rankings in global indices. As noted in Section 3, global rankings are the first port of call for investors conducting due diligence. They therefore have a strong influence on investor perceptions. Global rankings can be increased by better collaboration with in the sector, as outlined above. Collaborating with the voice of the industry and the private sector and the voice of the industry to push for improvements in key benchmarks year over year for Cyprus will also not only increase rankings but also improve peer-to-peer country comparisons for Cyprus.

There is also room for regulators and policy makers to be better champions of the professional services sector by strengthening the global media and social presence of Cyprus in a consistent and fact-based way. The civil service has good talent in the various ministries that is often under-used. Policy makers might consider how to cross-pollinate such talent from the various related ministries, including the Foreign Ministry, the Ministry of Finance and Ministry of Commerce and Tourism. The aim would be to work closely with the private sector to devise and implement reforms that will improve the rankings of Cyprus that are key to promoting the country as an international business centre.

6.2 Recommendations for private-sector actors

We now turn to our key recommendations for the private-sector actors in the professional services sector, which are outlined in Figure 6.02. During the past two decades, the private sector has been quite active and perhaps even single-handedly has been able to create a positive name for the professional services sector in Cyprus. This might explain why, despite the difficult economy environment, the private sector is quite bullish on the professional services in Cyprus. According to the Cyprus Business Leaders Survey (Gold, July 2012 Edition, p. 20) of the 800 business leaders participating in the survey, 64% believe that the professional services sector will thrive in Cyprus over the next two years (2013 and 2014).

Figure 6.02 Recommendations for private-sector actors

Recommendations for private-sector actors

- Build capacity in new sectors
  - Oil & gas
  - Renewables, green and blue technologies
- Be pro-active with respect to threats
  - Prepare for possible EU-wide tax harmonisation
  - Diversify to reduce overdependence on one or two markets
- Foster innovation, technology and empower youth
  - Build an entrepreneurship ecosystem by channelling venture capital and private equity into Cyprus tech, energy, creative start-ups
  - Tap into young talent to increase efficiencies and find innovative solutions
  - Leverage social media and internet power to tap into global client needs

Since they are the core of the professional services sector we have identified three strategic-level recommendations for the private-sector actors in the professional services sector.

Build capacity in new sectors

Since the professional services sector in Cyprus is now quite mature, it may have reached a plateau. Yet the way business is done globally has been radically changing, especially since 2008. It is therefore important for the professional services sector to remain agile to withstand the competition. One way of achieving agility is to create more options. We recommend that the sector to use its worldwide network to build capacity in new opportunity sectors. Energy provides plenty of opportunities in this area. Not only are there new opportunities in natural gas exploitation, the sector can also leverage opportunities in renewables, green and blue technologies.

Be pro-active with respect to threats

Given the increasingly competitive global marketplace, the professional services sector in Cyprus needs to be more pro-active on several fronts. Here, we recommend three ways to do so in the next 12 to 24 months.

First, the sector needs to prepare for the possible introduction of EU-wide tax harmonisation of the corporate tax base or taxation of financial transactions. As alarming as this sounds, it behooves the professional services sector to manage this potential risk by diversifying and building innovative approaches to retain clients that go beyond the current tax regime. In future Cyprus may have to distinguish itself not by its tax system but purely on the basis of the quality of its service. This means, for example, moving higher up the value chain, for example by providing speedier and more exceptional services, thus aiming for the status of "best in class".

Our second specific recommendation for being pro-active is to reduce overdependence on one or two markets. Today, a large proportion of the professional services sector depends on Russia but, as noted in Section 4, this is potentially a weakness. While the prospects for the Russian economy remain strong and oil prices remain high, the sector should take the opportunity to

diversify, the better to withstand any downturn in Russia in the coming years.

Foster innovation, technology and empower youth

Diversification can be achieved with innovative ideas. Our third strategic recommendation, therefore, is to foster innovation and technology and to empower young talent to help achieve this. As we saw in Section 3, innovation is an area in which Cyprus falls behind. Other countries have found that innovation can be encouraged by creating an entrepreneurship eco-system. This involves channelling venture capital and private equity into start-ups in the technology, energy and creative sectors.

This has been achieved quite successfully in countries such as Israel and has been followed by Ireland, Denmark and Estonia among many others in the EU. Fostering an entrepreneurship ecosystem cannot be achieved only by subsidising incubators, as Cyprus has done in the past. It involves It requires a comprehensive agenda that energises the "triple helix" of industry-government-universities to create a supportive network that includes the legal, regulatory and cultural infrastructure and provide new funding mechanisms such as venture capital funds investing in Cyprus start-ups. The Global Agenda Council of the World Economic Forum, focusing on fostering entrepreneurship, highlights the creation of start-up accelerators, creating funding initiatives, idea evaluation initiatives, mentorship initiatives and government regulation reduction initiatives.

Accelerators provide not just the space for start-ups to grow, but also mentoring and guidance on business presentation, marketing and funding issues. They differ from incubators in terms of funding and concept as accelerators are largely funded by the private sector and may house several start-ups for non-directly related industries. Idea evaluation and mentorship initiatives encourage start-ups to present their ideas and receive mentoring to sharpen them and make them viable. Meanwhile, government regulation reduction initiatives include tax breaks for start-ups and funding mentors and entrepreneurial advisors from abroad.

According to the European Private Equity and Venture Capital Association (EVCA), in countries where the entrepreneurship ecosystem has been fostered and encouraged to grow, it has shown to be a key driver of economic growth. The VICO Project conducted in 2011 shows that the availability of venture capital has a significant positive effect on the likely emergence of new entrepreneurial projects with high growth and high innovation potential.

In addition, according to EVCA, European private equity firms finance about 5,000 companies per year, of which 83% are Small and Medium-sized Enterprises. As we saw in Section 3, Cyprus has one of the strongest rankings in venture capital deals globally. However, the VC funds do not remain in Cyprus. The professional services sector, having already assisted firms in this area, has a large role to play in such an ecosystem. This can range from educating, advising and investing in start-ups and entrepreneurs, setting up Cyprus venture capital funds to invest in Cyprus-based tech start ups, attracting "angel investors" and venture capital, and actively supporting the ecosystem with investment in R&D and collaboration with academia and policy makers.

Fostering innovation is closely tied to tapping into young talent. We believe that if the sector empowers young professionals with responsibilities in key areas, they can help not only increase efficiencies and cut costs but help expand into new markets with new products. We recommend that companies create new inter-disciplinary teams drawn from with their existing staff to brainstorm on new ideas and seek innovative client solutions. Young talent can also be drawn on to leverage social media and the Internet to tap into clients' developing needs at the local, regional and global level. Continuous and better understanding of clients' needs in a shifting global economy also enhances agility and competitiveness and sustainable growth.

One key area in which young professionals excel is in social media. Leveraging the power of social media is a very low cost (in terms of both time and funds) but rapid high-return approach to strengthening the perception of the market and clients about Cyprus. Social media can be used to highlight the strengths and opportunities discussed in the Section 4 SWOT analysis and explaining how the Cyprus professional services sector is mitigating the risks and threats it is facing. Such a pro-active approach reinforces the reputation of the professional services sector and its commitment to transparent, exceptional service.

6.3 Recommendations for the voice of the industry

Finally, we provide four long-term and ten short-term recommendations for the voice of the industry. Here, we refer to the professional bodies and associations representing the various firms across the legal, financial, accounting, auditing, fiduciary and other professional services. In Cyprus such organisations and professional associations do exist and some, such as the Institute of Certified Public Accountants of Cyprus (ICPAC), are more active and perhaps better organised than others. Others are very new, such as the Cyprus Fiduciary Association with plans to strengthen and improve industry standards in fiduciary services.

In this section, given the strong unionisation present in Cyprus (over 55% compared to the EU average of 23%) it is critical to highlight the need to include the unions in the voice of the industry discussions on one hand, but also to underscore the importance of dialogue and dispute resolution based on win-win and spherical perspectives rather than on monolithic and steadfast approaches, on the other.

The recommendations for the Voice of the Industry are presented in Figure 6.03. Not surprisingly, the list here is the longest as we believe that the sector needs to strengthen its voice in various ways and serve as the connector between the private sector and the regulator.

Figure 6.03 Recommendations for the Voice of the Industry

Recommendations for the Voice of the Industry

- Coordinate across industry for stronger voice
  - Create ad hoc expert teams (like tax ad hoc team)
  - Use inter-disciplinary teams
  - Foster dialogue with the unions
- Leverage technology to improve administration and PR
  - Revamp websites in both Greek and English, consider access in other languages
  - Use technology to better respond to client needs and global trends
  - Use social media to foster better and faster communication with members
- Invest in young talent
  - Consider fostering pro-bono legal services programmes
  - Ensure education programmes align with new graduate needs
  - Foster internship programmes with universities for new graduate practical training
- Focus on raising global rankings and stronger international presence
  - Continue conducting audits and reviews of members to ensure high industry standards
  - Strengthen good governance and sustainability requirements for all members

Coordinate with the industry for a stronger voice

Over the past two decades, the professional services sector has led efforts to promote Cyprus as a professional service destination and has promoted an array of legal reforms. However, without a stronger collaborative effort among firms, the broader voice of the industry and the regulator, it may be difficult in the years to come to compete aggressively, improve internally and rise in the international rankings.

Our first strategic-level recommendation, therefore, is that the various associations coordinate and collaborate to strengthen the voice of the industry and exert more pressure on the regulator to implement the various reforms recommended earlier in this section.

As a specific recommendation we suggest more ad hoc teams focusing on specialist areas, along the lines of the existing "Tax Ad Hoc Expert Team", which comprises the four tax experts from the Big Four firms in Cyprus. Ad hoc teams can be considered as best practice in Cyprus and have been quite successful in providing expert consultations to regulators on tax issues and double tax treaty negotiations. Ad hoc teams need not be focused on one discipline, however. The industry can create a stronger voice by including other professionals such as lawyers in their deliberations.

Leverage technology to improve administration and PR

Our second strategic-level recommendation for the voice of the industry is to leverage technology. This is important in a number of ways. It improves administration, such as managing membership logs and membership payments, and it also strengthens public relations efforts in areas such as events, regulatory updates and global industry trends.

One of the main pillars of the voice of the industry is to communicate with members. One of our specific recommendations, therefore, is that websites are revamped and refreshed with more user-friendly set-ups and more languages (most have all information accessible only in Greek). Accessing the latest updates and trends in the industry is nowadays at our fingertips and at virtually no cost. Revamping websites and giving them an inter-active element will enable the voice of the industry to tap into the needs of clients locally, regionally and globally, stay informed about global trends and also inform its members.

Invest in young talent

We believe that the voice of the industry also stands to gain by investing in young talent. Providing educational programmes is one method of doing so while also maintaining high standards in the industry. While some institutes and associations are quite active in educational programmes and meet-ups for their members, others are not so active. We propose that the voice of the industry considers creating pro-bono professional services programmes to offer both practical training and experience to young graduates and give more experienced professionals the opportunity to give back to the community and work side by side with the new generation. In addition, we recommend more organised internship programmes in conjunction with local universities to strengthen even more the collaboration between academia and the transition to the private sector for employment.

Focus on raising global rankings and stronger international presence

Our final strategic-level recommendation, which is more a responsibility of all stakeholders, is to work methodically and collectively across the voice of the industry, the private sector and the regulator to review global performance rankings regularly, with the aim of improving performance vis-à-vis competitors and peer groups and improving rankings year on year. Ministries should be expected to take the initiative on specific indices and the policy performance of ministries should be assessed by changes in the rankings.

Cyprus has several strengths and opportunities but it has not been as agile and pro-active in leveraging them during good economic times. Now, with the economic crisis reverberating across the island, survival can only be achieved with efficiency, agility, innovation and smarter use of technology. Applying these tenets will enable the professional services sector of Cyprus to provide exceptional services to clients abroad and plough ahead to restart the engines of economic growth at home.

Conclusions

Our study has shown that the professional services sector in Cyprus is now bigger than tourism in terms of its contribution to new jobs and economic growth. It has also proven to be resilient in the recent economic downturn. Yet the sector faces a number of challenges, which keeps Cyprus behind competitor countries for professional services, such as Ireland, Luxembourg, Malta and Singapore, in many key aspects. This is particularly true in the area of innovation—something which is crucial for the survival of a high value-added service economy.

On the home front, the sector is weakened by fragmented efforts at promotion of the sector, lack of attention by policy makers and, of course, the wider impact of the economic crisis which might also see young talent drift abroad. Externally, the sector is over-dependent on one or two markets and needs to diversify in order to maintain its competitive advantage.

However, the current economic crisis should also be seen as an opportunity to leverage the sector's strengths and mitigate its threats. Our ten strategic recommendations, backed up by a number of specific recommendations for each stakeholder are as follows:

Strategic-level (long-term) recommendations

Regulators and policy makers

- Decrease bureaucracy, enforce transparency and good governance
- Consult representatives on a regular, structured basis
- Improve Cyprus rankings in global indices

Private-sector actors

- Build capacity in new sectors
- Be pro-active with respect to known and unknown threats
- Foster innovation, technology and empower youth

Voice of the Industry

- Coordinate across industry for stronger voice
- Leverage technology to improve administration and PR
- Invest in young talent
- Focus on raising global rankings and stronger international presence

If these recommendations are followed in a systematic and comprehensive programme of reforms, our estimates suggest that the professional services sector, which has already played a strong part in offsetting the decline in tourism, could add a cumulative 9,700 new jobs in five years, and bring in extra tax and social insurance revenue of €13 million per year.

Achieving this requires focus at both government and at sector level. Our research documents the importance of this sector to the Cyprus economy and we trust that it will persuade stakeholders of the need to pay closer attention to the sector, so that this dynamic and crucial industry can continue to produce jobs and sustainable growth long into the future.

Methodological appendix

Estimating contributions to GVA

To estimate the contributions of various sectors to gross value added (GVA) where they were not provided, we started by using disaggregated national accounts data produced by Cystat. The most recent disaggregated data run to 2009 for the following:

- "Legal and accounting activities; activities of head offices; management consultancy activities" (3.4% of GVA)
- "Financial service activities, except insurance and pension funding" (7.3% of GVA)
- "Air transport" (0.4% of GVA)

Using the overall growth rates for the broad sectors, we can estimate the proportions of GVA in 2011 at 3.6% of GVA for legal and accounting, 7.8% for financial services (banking) and 0.3% for air transport.

However, banking services mainly serve the local community. To estimate the contribution of international banking activities to GVA we must isolate the international banking activities. Here we consider deposits by non-residents (€20.2bn at the end of 2011) and other euro-area residents (€5.4bn) as a proportion of the total. These come to 36.9% of the total. Applying this ratio to financial services gross value added, we conclude that international financial services amounted to €460.0 million in 2011, or 2.9% of GVA.

We then add this amount to legal and accounting services to conclude that business and international financial services accounted for 6.5% of GVA in 2011.

As for tourism, we know that tourism revenue in 2011 was €1.7 billion. To obtain an estimate for gross value-added in tourism, we use accommodation and food services as a proxy. We apply the ratio of gross value-added in accommodation and food services to gross output in accommodation and food services to tourism revenue and conclude that tourism gross value-added was €878 million in 2011, or 5.5% of GVA.

Adding this to air transport, we conclude that total tourism and air transport accounted for 5.8% of GVA, compared with 6.5% of GDP for business and international financial services, or what we term "international services".

Figure A1

Methodology for sectors as % of gross value-added (current prices)	2011	2010	2009
Business and international financial services at current prices			
Gross value-added (GVA), € million	16,079	15,618	15,145
Professional, scientific & technical activities, gross value-added, € million	820	776	727
Legal & accounting; head offices; management consultancy	586	555	519
Legal & accounting services as % of GVA	3.6	3.6	3.4
Financial & insurance activities, gross value-added, € million	1,411	1,314	1,245
Financial services excl. insurance & pensions	1,248	1,162	1,100
Financial services as % of GVA	7.8	7.4	7.3
Total deposits in the domestic banking system, € million	69,298	69,940	58,155
Deposits by non-residents	20,194	20,525	15,853
Deposits by other euro-area residents	5,355	4,035	1,291
Total international deposits	25,550	24,560	17,143
as % of total	36.9	35.1	29.5
International financial services gross value-added (estimate), € million	460	408	324
International financial services as % of GVA	2.9	2.6	2.1
International services as % of GVA	***6.5***	***6.2***	***5.6***
Tourism and transport at current prices			
Transportation and storage, gross value-added, € million	766.1	816.8	805.1
Air transport	54.7	58.3	57.5
Air transport as % of GVA	0.3	0.4	0.4
Accommodation and food services, gross value-added, € million	1,048	967	927
Accommodation and food services, gross output, € million	2,088	1,927	1,848
Gross tourism revenue, € million	1,749	1,550	1,493
Tourism gross value-added (estimate), € million	878	778	750
Tourism as % of GVA	5.5	5.0	4.9
Tourism and transport as % of GVA	***5.8***	***5.4***	***5.3***

Sources: Cystat unless otherwise indicated; author estimates in italics

Estimating the growth rates of subsectors

Cystat does not produce disaggregated data at constant prices, therefore actual data are only available for the sectors at the broad level. To estimate a constant-price series for legal and accounting services, international financial services, tourism and air transport, we have applied the same proportions at current prices to the constant-price series. Thus, for example, if legal and accounting services were 71.4% of professional, scientific & technical activities at current prices, then we estimate that they were also 71.4% of the broad sector at constant prices. Experience suggests that this can lead to statistical discrepancies if applied to the full national accounts, but in the absence of actual data it is the best approximation.

Figure A2

Methodology for growth of subsectors (constant prices)	2011	2010	2009	2008	2007
International services					
Professional, scientific & technical activities (actual), € million	683.3	659.1	650.0	643.0	588.4
Real % change	3.7%	1.4%	1.1%	9.3%	7.2%
Legal & accounting services	488.4	471.1	464.5	446.7	377.8
Real % change	3.7%	1.4%	4.0%	18.2%	6.3%
Financial & insurance activities (actual), € million	1,208	1,169	1,131	1,077	1,014
Real % change	3.3%	3.4%	5.0%	6.3%	10.0%
International financial services	393.5	362.9	294.7	272.8	258.6
Real % change	8.4%	23.2%	8.0%	5.5%	9.8%
Total international services(a)	***881.9***	***834.0***	***759.2***	***719.5***	***636.4***
Real % change	5.7%	9.8%	5.5%	13.0%	7.7%
Tourism & tourism-related transport					
Tourism derived from current prices, € million	792.2	712.4	692.7	737.1	762.9
Real % change	11.2%	2.8%	-6.0%	-3.4%	3.3%
Air transport derived from current prices	44.7	46.9	46.4	76.6	74.2
Real % change	-4.6%	1.0%	-39.4%	3.3%	-16.6%
Total tourism and tourism-related transport	837.0	759.3	739.1	813.8	837.1
Real % change	10.2%	2.7%	-9.2%	-2.8%	1.2%

(a) Legal & accounting & international financial services.

Source: Author estimates unless otherwise indicated

The econometric growth-employment model

In order to test the relationship between employment and GDP for Section 5, we analysed growth rates of real GDP and employment for the period 1996-2011. We chose annual data for two reasons. First, we are going to use this model to make a medium-term forecast for annual employment growth, using annual real GDP growth. Quarterly (quarter-on-quarter) real GDP growth rates are far more volatile than annual growth rates, especially with non-seasonally adjusted data. (Since we do not have seasonally adjusted employment data we would be forced to use non-seasonally adjusted GDP data in our tests.) We therefore believe that basing our forecast on annual data is more robust. A second consideration is that there have been revisions to historical employment data since the October 2011 census. Annual data were reissued in July 2012 but a full series of quarterly data has not yet not yet been released.

Using EViews software we estimated the following models using Ordinary Least Squares (OLS), where EMPGA is annual growth in employment, GDPGRA is the annual growth of real GDP, C is the constant, B0 is the coefficient on real GDP growth, B1 is the coefficient on employment growth lagged one period, B2 is the coefficient on employment growth lagged two periods, and e is the error term.

1. EMPGA = C + B0GDPGRA + e (with 16 observations 1996-2011) (1)

R-Squared 0.6376, AIC = -6.631, C = 0.460328 B0 = 0.541052 with Prob = 0.00.

2. EMPGA = C + B0GDPGRA + B1EMPGAt-1 + e (15 observations after adjustments) (2)

R-Squared 0.724909, AIC = -6.763, C = 0.202577 B0 = 0.484247 B1 = 0.311049 with Prob = 0.06.

3. EMPGA = C + B0GDPGRA + B1EMPGA t-1 + B2EMPGA t-2 + e (14 observations after adjustments) (3)

R-Squared 0.722359, AIC = -6.761, C = 0.204569 B0 = 0.490331 B1 = 0.244005 B2 = 0.059372 with Prob = 0.77.

Although the lagged models, Model 2 and Model 3, have higher R-squared and a lower AIC, the coefficients on the lagged employment variables are not statistically significant from zero at the 5% level. Therefore Model 1 is the best fit. It also passes all the diagnostic tests.

Diagnostic tests for EMPGA = C + B0GDPGRA + e

Breusch-Godfrey Serial Correlation LM test: The test statistic is = Obs*R-squared =2.605132, Prob 0.27. The test statistic is less than the critical value of of of 5.99 at 2 d.f. (Prob 0.27), therefore we do not reject the null hypothesis of no autocorrelation in the disturbances.

White heteroscedasticity test: Obs*R-squared = 2.129971, Prob 0.14. The test statistic is less than the critical value of of 5.99 at 2 d.f., therefore we do not reject the null hypothesis of no heteroscedasticity in the disturbances.

Ramset RESET functional form test: Calculated value of the F statistic is 0.018323, Prob 0.89. The test statistic is less than the critical value of of 3.84 at 1 d.f. (Prob 0.89), therefore we do not reject the null hypothesis of correct functional form.

Jarque-Bera normality test: the test statistic is 3.167, Prob 0.86. The test statistic is less the critical value of the critical value of of 5.99 at 2 d.f, therefore we do not reject the null hypothesis of normal distribution.

The model we shall use in our gap analysis is therefore written as:

EMPGA = 0.460328 + 0.541052*GDPGRA + e

That is, for every 1% increase in real GDP, there is a 0.54% increase in employment.

GDP growth forecasts

In our GDP growth forecast, we assume that in 2012, real GDP will decline at the same pace as it did in the first half of the year, which was around 2%. We also assume that, owing to austerity measures, real GDP will decline by another 2% in 2013. We assume that employment will decline by 3.2% in 2012—the same as the year-on-year decline recorded in the first half of 2012. Employment in 2013 is derived from the model and declines by 0.6%. We assume that the unemployment rate will average 11.4% in 2012—a little higher than recorded in the first quarter, while the unemployment rate for 2013 is derived from the model and rises to 11.7%.

For the five-year period 2014-2018 we have two scenarios. The first scenario assumes that none of the recommended measures is taken by either the government or the professional and financial services sectors. In this case, there is no new stimulus to GDP, therefore it continues to grow at the same pace as in the past ten years (2.5%), but with a slight discount to take account of our expectation that the business environment will be tougher all over Europe in the coming years and that significant investment in natural gas is still some years away and will depend on many other factors, such as willingness of Israel to export, willingness of financiers to put up the billions of euros required to liquefied natural gas (LNG) facilities, the price-impact of shale gas exploration, and so on. For that reason, we have taken as our status quo forecast an annual average real GDP growth rate of 2.3%. We have used only the past five-year average to forecast the labour force growth rate, since the population, and therefore labour force, was boosted for one-off reasons in 2004 after Cyprus joined the EU.

In our with-reform scenario, we assume that implementing our recommendations for the professional services sector could add 0.5 percentage points to the average real GDP growth rate in 2013-2017, thus lifting the growth rate to average 2.8% instead of 2.3%.

Using the relationship between employment and growth in the model above, we can now forecast the difference between the no-reform scenario and the with-reform scenario.

Under the no-reform scenario, employment rises at an annual average rate of 1.7% per year in 2014-2018, reaching 406,359 by 2018. Under the with-reform scenario, employment rises at an annual average rate of 1.9% per year, reaching 411,793 by 2018. In other words, implementing the recommendations would add around another cumulative 9,700 new jobs in five years.

Figure A3

Reform impact on jobs (constant prices)	2012	2013	2014	2015	2016	2017	2018
No reform							
Real GDP growth (%)	-2.0	-2.0	2.3	2.3	2.3	2.3	2.3
Employment	376,262	373,922	380,195	386,574	393,059	399,654	406,359
Unemployment rate (%)	11.4	11.7	10.7	9.7	8.7	7.7	6.7
With reform							
Real GDP growth (%)	-2.0	-2.0	2.7	2.7	2.7	2.7	2.7
Employment	376,262	373,922	381,207	388,634	396,205	403,924	411,793
Difference in employment (reform dividend)	0	0	1,012	2,060	3,146	4,270	5,435
Cumulative increase in employment	0	0	1,012	3,071	5,205	7,416	9,705
Unemployment rate (%)	11.4	11.7	10.5	9.4	8.2	7.1	5.9

Source: Author forecasts

Impact on unemployment

Typically there is not a 1:1 correlation between an increase in employment and a decrease in unemployment, since new employment draws in both workers from abroad as well as people who had stopped looking for work and therefore did not count as part of the labour force. We have used the estimate for EU countries of Walterskirchen (1999), which found the relationship between employment and unemployment to be 60%. That is, 60% of the increase in employment would be reflected in a decrease in unemployment.

In our no-reform scenario, unemployment rises in 2013, owing to another decline in real GDP growth, to 11.7% and then declines gradually to 6.7% by 2018. In our with-reform scenario, the decline from 2014 is more rapid, with the unemployment rate reaching 5.9% by 2018. Using our model, the real GDP growth rate would have to average more than 3.4% per year in 2014-2018 to bring the unemployment rate below 5%.

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