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COMMISSION STAFF WORKING DOCUMENT

Analysis by the Commission services of the budgetary situation in Cyprus in response to the Council Recommendation of 13 July 2010 with a view to bringing an end to the situation of excessive deficit

Accompanying the document

COMMUNICATION FROM THE COMMISSION TO THE COUNCIL

Assessment of budgetary implementation in the context of the ongoing Excessive Deficit Procedures after the Commission services' 2011 Autumn Forecast

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1. INTRODUCTION

The global economic crisis and counter-cyclical policy action to attenuate its impact on the Cypriot economy (in line with European Economy Recovery Plan, EERP), along with a shift in aggregate demand towards less tax-rich components, led to a swing of Cyprus' general government balance from a surplus of 0.9% of GDP in 2008 to a deficit of 6.1% of GDP in 2009. In parallel, the general government gross debt, which stood at 58.0% in 2009, embarked on a steep upward path with the prospect of exceeding the 60% of GDP reference value in subsequent years. Against this background, the Council decided on 13 July 2010 that an excessive deficit existed and addressed recommendations to Cyprus in accordance with Article 126(7) of the Treaty with a view to bringing an end to the situation of an excessive government deficit by 2012.[1] In its recommendations, the Council established in line with Article 3(4) of Regulation (EC) 1467/97 a deadline of 13 January 2011 for effective action to be taken.

Specifically, the Council recommended Cyprus to bring the general government deficit below 3% of GDP by 2012 in a credible and sustainable manner by taking action in a medium-term framework. To this end, Cyprus was recommended to: (a) take necessary measures to reduce the 2010 deficit to at most 6% of GDP and define an expenditure-driven consolidation strategy, in order to bring the deficit below the reference value by 2012; (b) ensure an average annual fiscal effort of at least 1½% of GDP in 2011-12, also in order to contribute to bringing the government gross debt ratio back on a declining path that approaches the reference value at a satisfactory pace by restoring an adequate level of the primary surplus; and (c) specify and rigorously implement the measures that are necessary to achieve the correction of the excessive deficit by 2012, cyclical conditions permitting, and accelerate the reduction of the deficit if economic or budgetary conditions turn out better than expected at the time.

To limit risks to the adjustment, the Council requested Cyprus to adopt a binding medium-term budgetary framework and to better monitor budget execution throughout the year. In addition, Cyprus was recommended to improve the long-term sustainability of public finances via control of pension and health care spending and to seize any opportunity beyond the fiscal

[1] All EDP-related documents for Cyprus can be found at the following website: http://ec.europa.eu/economy_finance/sgp/deficit/countries/cyprus_en.htm

effort, including from better economic conditions, to control the negative evolution of the gross debt ratio.

This paper reviews the progress made by Cyprus towards a timely and sustainable correction of the excessive deficit. In particular, it examines the budgetary developments since the Commission communication to the Council on action taken as of 27 January 2011. The assessment takes into account all decisions publically announced after the cut-off date for the 2011 Autumn Forecast, including the Budget Law for 2012 adopted by Parliament on 16 December 2011.

2. ECONOMIC DEVELOPMENTS AND OUTLOOK

Economic activity recovered in 2010 with real GDP growth of 1.1%. While the recovery was relatively modest, the outturn was considerably better than expected at the time of the Council recommendations of 13 July 2010 (when real GDP was expected to contract in 2010 by 0.4% according to the Commission services’ 2010 Spring Forecast, the latest available at the time). Despite an exceptionally good tourist season in 2011, the recovery suffered a setback from the grave accident in July 2011 that destroyed the country’s largest electricity power plant accounting for half of the island's generating capacity. A worsening external economic environment and weakening financial and fiscal conditions compounded the damaging effect. As a consequence, the Commission services' 2011 Autumn Forecast revised GDP growth for 2011 down to 0.3%, a full percentage point below the forecast available at the time of the Council recommendations (1.3%).

Table 1: Comparison of macroeconomic developments and forecasts

	2010	2011		2012		2013	
	Outturn	**COM AF2011**	**National projections**	**COM AF2011**	**National projections**	**COM AF2011**	**National projections**
Real GDP (% change)	1.1	0.3	0.5	0.0	0.2	1.8	2.0
Contributions to real GDP growth							
Final domestic demand	-1.2	-0.8	0.5	0.1	1.1	1.3	1.7
Changes in inventories	3.5	0.0	-0.1	0.0	0.0	0.0	0.0
Net exports	-1.2	1.1	1.7	-0.1	0.6	0.5	1.7
Employment (% change)	-0.3	-1.0	0.0	-0.2	-0.5	0.4	0.0
GDP deflator (% change)	1.7	3.1	3.5	2.7	3.0	2.2	2.0

Sources: Commission services' 2011 Autumn Forecast (COM AF 2011), National projections of the Ministry of Finance – November 2011

Stagnation is projected to continue in 2012. The squeeze in disposable income, tighter lending conditions followed by commercial banks, and undermined consumer confidence will weigh on domestic demand, traditionally the main driver of growth, while the external environment will provide little relief. National growth assumptions for 2012 underlying the budgetary plans deviate only marginally from the Commission services' 2011 Autumn Forecast, although they are somewhat more optimistic on export prospects.

For 2013, the Commission services project GDP growth of 1.8%, on account of a recovery of domestic demand and, to a lesser extent, a higher contribution from net exports.

3. BUDGETARY SITUATION AND PROJECTIONS FOR THE PERIOD 2011-2013

3.1. Estimated outturn for 2011

For 2011, the Budget Law[2] targeted a deficit of 5.4% of GDP, on the basis of an estimated deficit for 2010 of just below 6% of GDP. On the revenue side, the budget did not incorporate any consolidation measures, apart from the phasing-out of tax relief that was part of earlier stimulus measures, and the lagged effect of higher excise duties on petroleum products since July 2010. Nevertheless, these were partly offset by a reduction in other current revenues. On the expenditure side, the budget provided for a reduction of operational expenditure, as well as restraint in public investment and employment. However, these elements were fully offset by a rise in the public wage bill, interest payments and in social outlays.

With a view to the July 2010 Council recommendation, the Parliament adopted, in tandem with the 2011 Budget Law, a fiscal consolidation package designed to cut the fiscal deficit to 4.5% of GDP in 2011. In addition, the coalition parties at that time had agreed on an additional set of measures, both revenue supporting and expenditure containing, to be submitted to the Parliament for approval in February 2011, with an estimated deficit reduction of 0.6% of GDP in 2011.

The Commission services' 2010 Autumn Forecast[3], on the basis of the 2011 draft budget available at the time, had projected a deficit of 5.7% of GDP for 2011. That forecast did not incorporate the additional consolidation measures agreed by the coalition parties but not adopted by the government and the Parliament by the data cut-off date. The forecast implied an improvement in the structural balance (the cyclically-adjusted balance net of one-off and other temporary measures) by ¾% of GDP in 2011. The adoption of the aforementioned fiscal consolidation packages, taken at face value, would have improved both the headline and the structural balance by 1.6% of GDP. As a result, the Commission concluded in January 2011 that Cyprus had ensured a fiscal effort of at least 1½% of GDP in 2011 and had taken effective action with a view to putting an end to the situation of excessive deficit by 2012.

However, the Commission noted that the bulk of the fiscal consolidation measures adopted by Cyprus had been on the revenue side despite the Council recommendation for an expenditure-driven consolidation strategy. The Commission also pointed out that there were risks to the achievement of the deficit targets, mainly stemming from the standard practice of adopting supplementary budgets during the course of the year. Slippages in social transfer spending to alleviate the impact of indirect tax rises and the impact of wage indexation (COLA) on the public wage bill, in case of a higher-than-expected increase in inflation, were also considered to pose considerable risks. Moreover, the Commission saw implementation risks for announced, but not yet adopted consolidation measures, due to political pressure from affected parties.

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2 The 2011 Budget Law was adopted by the Parliament on 16 December 2010.

3 The Commission services' 2010 Autumn Forecast was published on 29 November 2010. The data cut-off date was 15 November 2010.

The 2011 update of the Stability Programme (SP) presented a planned deficit of 4.0% of GDP for 2011, on the basis of a lower-than-expected deficit outturn of 5.3% of GDP in 2010. The latter was owed to successful expenditure containment, partly offset by a shortfall in government revenues. It also benefited from a one-off receipt from an interest-swap agreement and a higher-than-usual transfer of Central Bank profit.

In contrast to the target of the 2011 update of the SP, the Commission services' 2011 Autumn Forecast estimates the budget deficit to have widened to 6.7% of GDP in 2011 from 5.3% in the previous year. The deviation from the national target of 4.0% of GDP is explained mainly by lower-than-expected revenues (2¼% of GDP) and also slightly higher expenditures (½% of GDP). The revenue shortfall was due to: (i) a slowdown of activity and non-negligible growth composition effects; (ii) reduced corporate profitability; and (iii) the disruption of economic activity following the Vassilikos power plant destruction. At the same time, expenditure slippages appear to be related to (i) rising social outlays due to higher unemployment and redundancy payments, as well as to the electoral cycle and (ii) higher debt financing cost.

In order to bring public finances on a consolidation path, the government adopted a series of fiscal "packages". The first one, adopted on 26 August 2011, is estimated to cut the deficit by about ½% of GDP p.a. in 2011-12. This package included two important structural measures: the enactment of contributions from public sector employees to their public pensions, and the inclusion of newcomers in public sector in the social security fund, with the abolition of occupational pensions. The other fiscal packages, adopted later in 2011, impact on the year 2012 and thereafter.

At the moment of the Commission services' 2011 Autumn Forecast, the structural deficit, as measured by the cyclically-adjusted balance net of one-offs, would rise to almost 6% of GDP in 2011, up from 5¾% of GDP in 2010. This clearly falls short of the average annual fiscal effort recommended by the Council of at least 1½% of GDP (Table 2). However, taking into account the additional measures adopted since the publication of the Commission services' 2011 Autumn Forecast, the average annual fiscal effort in 2011-2012 is estimated at 1¾% of GDP, which is higher than the 1½ of GDP average annual fiscal effort recommended in the Council Recommendation.

Table 2: Comparison of fiscal efforts, change in the structural balance (% of GDP) based on the Commission services' 2011 Autumn Forecast

Average annual change of structural balance 2011		Average annual change of structural balance 2011-2012		Additional average annual effort needed to correct the excessive deficit	Average annual fiscal effort recommended by the Council	Deadline for correction
Uncorrected	Corrected	Uncorrected	Corrected			
-0.2	-0.2	0.7	0.8	1.9	at least 1½% in 2011-2012	2012

Notes:
- The additional average annual effort (i.e. on top of measures already included in the 2011 Autumn Forecast) is calculated for the period from 2011 until the deadline for correction (2012).
- The uncorrected average annual change in the structural balance is the estimated change in the structural balance from the Commission services' 2011 Autumn Forecast. The corrected average annual change in the structural balance is the uncorrected average annual change in the structural balance plus a correction factor capturing the effect of revisions to potential output growth between the projections at the time of the EDP recommendations and the Commission services' 2011 Autumn Forecast (see European Commission (2004) Public Finances in EMU – 2004, European Economy, Brussels; and European Commission (2006) Public Finances in EMU – 2006, European Economy, Brussels).
Source: Commission services.

3.2. Deficit projections for 2012-13

For 2012, the Budget Law[4] targets a deficit of 2.8% of GDP, and for 2013 of 2.1% of GDP, on the basis of an estimated deficit of 6.5% of GDP, in 2011. The 2012 Budget Law includes four successive consolidation packages. The first consolidation package, adopted on 26 August 2011, is explained above. The second package aims at an additional estimated consolidation impact of about 3% of GDP in 2012, of which 2.1 of GDP are measures on the expenditure side and mostly permanent in nature. The second package contains a better targeting of social transfers and a hike of the VAT rate from 15% to 17%, together accounting for consolidation of almost 2% of GDP. In December 2011, the government presented a third consolidation package with additional measures for a two-year period. The bulk of this third package is a freeze of emoluments, including pensions, in the broader public sector for two years, implying a downward level shift on the public wage bill. Moreover, it includes a temporary contribution on gross earnings of private sector employees and pensioners based on a scaled contribution rate (of up to 3.5%), and an increase in the tax rate on deemed dividend distribution from 17% to 20%. Overall, this third package is estimated to yield additional consolidation of about ¼% of GDP in 2012 and ¾% of GDP in 2013. Following the Parliamentary adoption of the three packages, the national authorities have revised downwards their deficit target to 2.5% of GDP in 2012 and 1.5% in 2013. The target of a balanced budget in 2014 is reaffirmed.

[4] The 2012 Budget Law was adopted by the Parliament on 16 December 2011.

Table 3: Comparison of budgetary developments and projections

	2010	2011				2012				2013	
	Outturn	National projections		COM AF 2011		National projections		COM AF 2011		COM AF 2011	
	%GDP	%GDP	%ch	%GDP	%ch	%GDP	%ch	%GDP	% ch	%GDP	% ch
Total current revenue	41.0	40.7	3.3	40.0	1.9	41.5	5.3	40.1	2.7	40.1	4.1
of which											
Taxes on production and imports	15.5	15.4	3.8	15.2	2.7	16.0	6.8	14.9	0.3	14.9	4.1
Current taxes on income and wealth	11.1	10.8	1.5	10.7	0.1	11.4	8.3	11.2	8.2	11.2	4.1
Social contributions	9.0	9.6	11.2	9.4	9.7	9.7	4.9	9.6	4.8	9.6	4.1
Capital revenue	0.1	0.1	47.1	0.1	76.3	0.1	0.0	0.1	2.4	0.1	4.0
1. TOTAL GOVERNMENT REVENUES	**41.0**	**40.8**	**3.3**	**40.1**	**2.0**	**41.6**	**5.3**	**40.2**	**2.7**	**40.2**	**4.1**
Total current expenditure	41.1	42.0	63	41.7	5.8	39.6	-2.8	40.6	-0.1	40.4	3.5
Total capital expenditure	5.3	5.2	3.5	5.1	1.0	4.8	-6.2	4.5	-10.0	4.5	4.1
2. TOTAL GOVERNMENT EXPENDITURE	**46.4**	**47.2**	**6.0**	**46.8**	**5.2**	**44.4**	**-3.1**	**45.1**	**-1.2**	**44.8**	**3.6**
Net lending (+) or net borrowing (-)	**-5.3**	**-6.5**		**-6.7**		**-2.8**		**-4.9**		**-4.7**	
- primary balance	-3.1	-4.0		-4.3		0.0		-2.2		-1.9	
General government debt	**61.5**	**66.0**		**64.9**		**67.0**		**68.4**		**70.9**	

Sources: Commission services' 2011 Autumn Forecast (COM AF 2011); National projections of the Ministry of Finance – November 2011

Finally, on the day of budget adoption, the Parliament voted additional last-minute amendments, amounting to a cut of about 8% in selected government expenditure categories with an expected consolidation effect of about ½% of GDP in 2012. This reduced further the national target of the budget deficit to around 2% of GDP, thus well below the required correction by 2012, as set in the Council recommendation.

Table 4: Main budgetary measures for 2012

Revenue	Expenditure
• Increase of the standard VAT rate from 15% to 17%, from 1 March 2012 (0.7% of GDP). • Introduction of a levy to all companies (0.1% of GDP). • Increase of the tax rate on deemed dividend distribution from 15% to 20% (0.1% of GDP). • Increase of withholding tax on interest accrued on deposits of local banks from 10% to 15% (0.2% of GDP). • Introduction of a temporary contribution on gross earnings of **private** sector employees and pensioners for a period of two years from 0% to 3.5% (0.1% of GDP). • Revision of scales used for applying the tax coefficients on immovable property, until the re-evaluation of land prices from 1980’s prices to current prices. (0.1% of GDP).	• Targeting of all social schemes based mainly on income and economic criteria (-1.1% of GDP) • Last-minute budget amendments, amounting to a cut of about 8% in selected government expenditure categories and the withholding of certain budget items worth about €100 million (-0.5% of GDP). • Increased contribution of 3% on gross earnings of broader public sector employees for public pensions (-0.2% of GDP). • Introduction of a temporary contribution on gross earnings of broader **public** sector employees and pensioners for a period of two years from 0% to 3.5% (-0.1% of GDP). • Increase of the rate of contribution in the Widows and Orphans Fund by 1.25 p.p. to 2% on gross earnings (-0.1% of GDP). • Reduction of the number of personnel in the broader public sector by 5,000 over the next five years (one recruitment for every four retirees) (-0.1% of GDP)

	• Reduction of overtime pay by an additional 20% in 2012 (-0.1% of GDP).
Other supporting measures are: • Legislation to support the banking sector. • Medium-Term Budgetary Framework for years 2012 -2014, setting expenditure ceilings per government department. • Incentives for SMEs to boost growth and development	
<u>Note</u>: *Budgetary impact as reported in the budget and additional information provided by the national authorities. A positive sign implies that revenue / expenditure increases.*	

The Commission services' 2011 Autumn Forecast projected a deficit of 4.9% of GDP for 2012, on the basis of an estimated budget deficit outturn of 6.7% of GDP for 2011, based on a comparable real GDP growth forecast to the one of the Cypriot authorities (0.3% vs. 0.5%). However, the 2011 Autumn Forecast included only measures adopted by the cut-off date. In particular, while it incorporated the first consolidation package, it did not take into account from the second package the targeting of social transfers and a hike of the VAT rate from 15% to 17%. The third consolidation package was not envisaged at the time. Furthermore, the 2011 Autumn Forecast incorporated a more prudent assessment of revenue prospects, assuming a less tax-rich growth composition, and possible overruns on the expenditure side, especially of current primary expenditure in view of past trends on key items such as the wage bill and social transfers. As a result, the structural balance was expected to improve by about 1½% of GDP in 2012.

Based on the customary no-policy-change assumption, the 2013 deficit was projected at 4.7% of GDP. The slight improvement is due to savings on the public wage bill from cuts to public sector employment.

After adoption by Parliament of the legal acts relating to the targeting of social transfers and the hike of the VAT rate from 15% to 17% (i.e. from the 'second' consolidation package), the Commission's assessment of the budgetary outlook changes as follows. Taken at face value, these two measures would have led to a revision of the government deficit from 4.9% of GDP to 3% of GDP in 2012 and from 4.7% of GDP to 2.7% of GDP in 2013. However, given the very present risks of negative repercussions to growth from (i) the size of consolidation and the deterioration of the external environment and (ii) notably a squeeze of both public and private consumption, the impact of these two measures is estimated to be less than what is anticipated by the national authorities. As a result, the Commission services budgetary projections, taking into consideration the Budget Law with only the two consolidation packages, could have been revised downwards to 3.4% of GDP in 2012 and to 3.2% of GDP in 2013, at best.

Taking into account, at face value, the consolidation measures included in the third package, the Commission services’ projection for 2012 and 2013 would have been revised downwards to 3.1% of GDP and 2.2% respectively. Again though, there are downside risks to the estimated impact of these measures, relating notably to the trend in public sector employment and the fight of tax evasion which put the full effectiveness of these measures into question. .

The adopted last-minute budget amendments (fourth consolidation package) confirm Cyprus' efforts to comply with the Council's recommendation to correct the excessive deficit by 2012. This extra fiscal effort amounts to about ½% of GDP in 2012. Taking this into account, the

Commission services' deficit projections would now be revised down to 2.7% of GDP for 2012 and 1.8% of GDP for 2013 (Table 4). Thus, there now appears to be a safety margin (0.3%) to hedge against the aforementioned implementation risks. In conclusion, the Commission considers that Cyprus has taken effective action to correct the excessive budget deficit in a timely and sustainable manner.

Table 4: Comparison of budgetary projections, including impact of measures taken post Commission services' 2011 Autumn Forecast, general government balance (% of GDP)

	2010	2011	2012	2013
COM AF 2011	-5.3	-6.7	-4.9	-4.7
National authorities		-6.5	>-2.5	>-1.0
COM Jan 2012		-6.7	-2.7	-1.8

Notes: *COM AF 2011 – Commission services' 2011 Autumn Forecast; projections by the national authorities dated as of 19/12/2011; COM Jan 2012 – Commission services' assessment taking into account the measures adopted by the Parliament in the 2012 Budget and consolidation packages of 26/08/2011 and 14/12/2011.*

Sources: *National authorities and Commission services*

3.3 Debt Developments

According to the national projections as depicted in the budget for 2012, gross general government debt is projected to peak at 67% of GDP in 2012 from an estimated 66.0% in 2011, due to fiscal deterioration and subdued nominal GDP developments. Thereafter, it is set to move to a declining trend due to an increasing primary surplus.

With weak growth and an increasing deficit, the Commission services' 2011 Autumn Forecast projected the debt-to-GDP ratio to remain on a rising trend and from 61.5% of GDP in 2010 to reach almost 71% by 2013. Debt projections include the impact of the guarantees to the EFSF, bilateral loans to Greece and the participation in the capital of the ESM as planned by the cut-off date of the forecast.

Beyond 2013, and under the assumption of no further policy changes on top of the Commission services' 2011 Autumn Forecast, the debt ratio would be on an increasing path and reach 90% of GDP by 2020. By contrast, an additional annual structural fiscal consolidation of 0.5 pp. of GDP from 2014 onwards until the Medium-Term Budgetary Objective (MTO) – in the case of Cyprus a balanced budget in structural terms - is reached would limit the rise in the debt ratio, reaching 77% of GDP in 2020. The consolidation effort currently pursued by the Cypriot authorities aims at achieving a balance budget by 2014.