EUROPEAN
COMMISSION

Brussels, 6.9.2013
SWD(2013) 327 final

COMMISSION STAFF WORKING DOCUMENT

Analysis by the Commission services of the action taken by Cyprus in response to the Council Recommendation of 16 May 2013 with a view to bringing an end to the situation of excessive government deficit

Accompanying the document

COMMUNICATION FROM THE COMMISSION TO THE COUNCIL

Assessment of action taken by Cyprus

in response to the Council Recommendation of 16 May 2013 with a view to bringing an end to the situation of excessive government deficit

{COM(2013) 626 final}

1. INTRODUCTION

On 13 July 2010, the Council decided in accordance with Article 126(6) of the Treaty of the Functioning of the European Union (TFEU) that an excessive deficit existed in Cyprus and issued a recommendation to Cyprus in accordance with Article 126(7) of the TFEU with a view to bringing an end to the situation of an excessive government deficit by 2012[1].

Cyprus' general government deficit remained at high levels in recent years, despite a sizeable consolidation effort. In 2011 and 2012, the headline balance reached 6.3% of GDP, compared to 5.3% of GDP in 2010, the year of the initial EDP Council recommendation. In 2012, less tax-rich growth, reduced revenue elasticities and a one-off expenditure kept the deficit at high levels.

On 25 April 2013, the Council addressed a decision to Cyprus on specific measures to restore financial stability and sustainable growth ('the programme').

In parallel the European Stability Mechanism (ESM) granted a financial assistance facility to Cyprus. In this context, a Memorandum of Understanding on Specific Economic Policy Conditionality (MoU) was signed on 26 April 2013 by the Cypriot authorities and the Commission, acting on behalf of the ESM.

On 16 May 2013, the Council concluded that effective action over the years 2011-2012 had been taken, and that an extension of the deadline by four years for the correction of the excessive deficit procedure was justified. The average annual improvement of the structural budget balance over 2011-2012, after correction for the effects of revised potential output growth and less tax-rich growth was estimated to be 2.4% of GDP. This was above the minimum average annual fiscal effort of at least 1½% of GDP required by the Council recommendation, indicating that Cyprus could be considered to have taken effective action in line with the Council recommendations.

This was supported by a careful analysis[2] that shows that Cyprus adopted sizeable consolidation measures over 2011-12, with an estimated direct deficit-reducing impact of around 1½% of GDP in 2011 and around 4¼% of GDP in 2012, based on a bottom-up assessment.

Subsequently, the Council recommended that "Cyprus should put an end to the present excessive budget deficit situation by 2016. In order to bring the headline government deficit below the 3% of GDP reference value by 2016, Cyprus should achieve the headline general government deficit targets of 6.5% of GDP in 2013, 8.4% of GDP in 2014, 6.3% of GDP in 2015, and 2.9% of GDP in 2016. To this end, Cyprus should rigorously implement the 2013 Budget Law and the agreed additional consolidation measures, which should amount to at least EUR 351mn in 2013. Cyprus should fully implement the fiscal measures for 2014 that were adopted in December 2012, amounting to at least 270mn EUR in 2014. Cyprus should monitor the budgetary effect of consolidation measures taken on a monthly basis and stand ready to preserve fiscal targets by taking additional measures in the event of underperformance of revenues or higher social spending, taking into account macroeconomic

1 OJ L 186, 20.7.2010, p. 30.
EDP-related documents for Cyprus can be found at the following website:
http://ec.europa.eu/economy_finance/sgp/deficit/countries/cyprus_en.htm

2 Commission Staff Working Document accompanying the Recommendation for a Council Recommendation with a view to bringing an end to the situation of an excessive government deficit in Cyprus - SWD(2013) 176 final, 7.5.2013.

circumstances. Cyprus should maintain fiscal consolidation over the medium term, converging towards its medium-term budgetary objective of a balanced budget in structural terms, by containing expenditure growth, improving the structure of taxation and undertaking fiscal-structural measures".

In its recommendations, the Council established a deadline of 3 months for the Cypriot authorities to take effective action, in accordance with Article 3(4) of Council Regulation (EC) No 1467/97.

This document provides an assessment of whether Cyprus has undertaken effective action towards the correction of its excessive general government deficit in the 3 months following the 16 May 2013 Council Recommendation. In particular, it examines the budgetary developments since the May 2013 Council Recommendation.

2. RECENT MACROECONOMIC DEVELOPMENTS

In 2012, economic activity in Cyprus significantly weakened, with real GDP decreasing by 2.4%. The deterioration was driven by the unwinding of Cyprus' unsustainable economic imbalances, which led to a widespread loss of confidence among economic agents. Domestic demand contracted markedly against the background of falling domestic consumption and private investment. The largest fall in economic activity took place in construction and in the broad industrial sector, while growing financial stability concerns led to weakening activity in financial services. The unemployment rate rose sharply, reaching nearly 12%.

In the first quarter of 2013, real GDP declined by 4.7% y-o-y, accelerating from -3.5% y-o-y in the fourth quarter of 2012. Private and, particularly, public consumption continued its downward movement, and the underlying growth momentum of gross fixed capital formation remained weak. The weak domestic demand resulted in a significant decline in imports of goods and services. With export of goods and services displaying a small increase compared to the first quarter of 2012, net exports provided a significant positive contribution to GDP growth.

Activity in the second quarter of this year was down 5.2% y-o-y[3]. Large uncertainty in the composition of growth persists, particularly, due to the restructuring of the banking sector and the imposition of administrative measures on financial transactions to safeguard financial stability. However, short term indicators suggest a continuation of the underlying weak trend in both the household sector as well as the corporate sector. The spill-overs from financial sector instability to the real economy are likely to have imposed a significant drag on economic activity in the second quarter of 2013, mainly via concerns over financial sector stability in the short and medium terms. Amid declining lending, deposits were gradually finding their way out of the banking sector, rendering efficient financial intermediation even more difficult. Foreign investors were adopting a wait-and-see attitude, as future prospects remained uncertain. International transactions were hampered by restrictions on capital flows.

Real GDP is expected to decline drastically by 8.7% in 2013 as a whole, unchanged compared to the Commission 2013 Spring Forecast (see Table 1). The envisaged contraction is driven by the immediate restructuring of the banking sector and its impact on net credit growth, the

[3] On 14 August, a Q2 GDP flash estimate was released by ESTAT. Since it was published after the finalisation of the macroeconomic forecast by the programme partners and due to its flash nature, this preliminary figure has not been taken into account. The programme projection will be reviewed and updated, if needed in the context of the second review mission.

longer-lasting deleveraging of corporate and household balance sheets, the fiscal consolidation pursued, and the high degree of economic uncertainty which will strain domestic demand and investment. In addition, the temporary imposition of capital controls and withdrawal restrictions combined with the related uncertainty are expected to hamper international capital flows and to reduce business volumes in both domestic and internationally-oriented companies. The bail-in of uninsured depositors is expected to cause a loss of wealth, which will also affect private consumption and investment.

Compared to the Commission 2013 Spring Forecast (which is identical to the programme scenario of April 2013), the macroeconomic projection remains broadly unchanged. Overall activity is unchanged, however, private consumption has been revised slightly down as the unemployment rate is projected to increase faster than previously envisaged; this is reflected also in the downward revision of imports.

Table 1: Macroeconomic developments and outlook

	2012	**2013**		**2014**		**2015**		**2016**	
	Outturn	**PF April**	**PF July**	**PF April**	**PF July**	**PF April**	**PF July**	**PF April**	**PF July**
Real GDP (% change)	-2.4	-8.7	-8.7	-3.9	-3.9	1.1	1.1	1.9	1.9
Contributions to real GDP growth (pp.):									
Final domestic demand	-6.1	-13.7	-13.8	-5.5	-5.5	0.9	0.9	2.0	2.0
Changes in inventories	-0.8	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Net exports	4.4	5.0	5.0	1.6	1.6	0.2	0.2	0.0	-0.1
Employment (% change)	-4.1	-6.6	-7.8	-3.1	-3.7	1.1	1.1	1.3	1.3
GDP deflator (% change)	2.0	0.6	0.6	1.1	1.1	1.5	1.5	1.8	1.8
Output gap (% of potential GDP)	0.0	-6.2	-5.8	-7.6	-6.6	-4.3	-3.0	-0.9	0.8
Potential output growth (% change)	-1.3	-2.6	-3.0	-2.5	-3.1	-2.3	-2.7	-1.6	-2.0

Source: Commission staff estimates; Programme Forecast (PF) April: Commission 2013 Spring Forecast; PF July: Commission most recent forecast underlying the revised MoU from July 2013.

Macroeconomic risks remains important and tilted to the downside. Downside risks relate to the tighter domestic credit conditions and a further deterioration of confidence in the banking system, a further worsening of labour market conditions and a non-negligible risk of household and corporate defaults propagating further through the economy. Also, the deep restructuring of the Cypriot economy, and its banking sector in particular, could cause stronger negative spill-overs on related professional business services and financial services' exports. More generally, the transition to a more varied growth model will be challenging for the economy in the coming years and will imply a re-allocation of economic resources across sectors, which may take time and whose absorption will require flexible factor and product markets. Upside risks for the Cypriot economy relate mainly to possible improvements in the external outlook and, in the outer years, investments in the energy sector and a more competitive tourist sector could contribute increasingly to economic growth.

3. ASSESSMENT OF EFFECTIVE ACTION

Following the expiry of the deadline established for taking effective action in a recommendation under Article 126(7), the Commission shall assess whether the Member State concerned has acted in compliance with the recommendation. This assessment should consider whether the Member State concerned has publicly announced or taken measures that seem sufficient to ensure adequate progress towards the correction of the excessive deficit within the time limits set by the Council. A Member State should be considered to have taken effective action if it has acted in compliance with the recommendation, regarding both the implementation of the measures required therein and budgetary execution. The assessment should in particular take into account whether the Member State concerned has achieved the annual budgetary targets initially recommended by the Council and the underlying improvement in the structural balance. Where relevant, a careful analysis should take into account whether expenditure targets have been met and the planned discretionary measures on the revenue side have been implemented.

3.1. Budgetary implementation in 2013

Despite the adverse macroeconomic environment and the faster-than-expected decline in employment, the general government headline budget deficit for the first half of 2013 amounted to 1.2% of GDP. This is significantly better than the authorities' half-year target for 2013 (by 2.3% of GDP), which has been established as an intermediary target in accordance with programme conditionality[4]. It is also a significantly better outcome than in the respective period in 2012 (by 2.2% of GDP). Similarly, the primary balance exceeded the end-Q2 value targeted by the authorities by 1.6% of GDP.

Total revenue for the first 2 quarters of the year was in accordance with what has been targeted by the authorities, albeit around 1% of GDP lower than the same period in 2012. The outcome in the first half of 2013 benefited from extraordinary high non-tax revenues. These one-off revenues mainly comprised, inter alia, higher dividends due to exceptional profits by the Central Bank of Cyprus. Due to these one-off effects, one has to be cautious about overall revenue trends, since there are risks to the future performance of key revenue items. Overall, the end-year projection of total revenues remains in line with the projection underpinning the Commission 2013 Spring Forecast.

Revenues from both taxes on income and wealth and social contributions, in the first half of the year, performed somewhat better than expected. The developments were driven by the increased collection of taxes on interest and (deemed) dividends, which mitigated the negative impact of falling wages, employment and profits on income tax collection. In light of the large fall in banking sector deposits, the decrease in deposit rates as well as negative employment trends eventually showing up in the collection of social security contributions, this positive performance is, however, not expected to persist.

Revenues from taxes on production and imports at the end of the second quarter showed signs of weakness. This was in particular due to a significant drop in Land and Survey fees

[4] CYSTAT publishes accrual data (ESA95) for the General Government on a quarterly basis. For monitoring purposes, the Ministry of Finance establishes quarterly targets in ESA95 terms which are in accordance with the annual EDP targets.

collections, associated with the continued contraction in the real estate market, as well as a significant decline in excise duties collected. The latter can be explained by cyclical conditions, a stronger-than-expected behavioural change in the demand for tobacco products and a steep decline of new motor vehicle purchases. Conversely, in spite of the shrinking tax base, VAT collection turned out better than expected, most likely driven by the hikes in the VAT rate of 2 pp. and 1 pp. in March 2012 and January 2013, respectively.

Total expenditure has been kept under strict control and has been restrained for key spending categories. Consequently, total primary expenditure was in the first half of the year significantly lower (by 1.7% GDP) than projected by the authorities. Primary expenditure was also significantly lower than in the respective period in 2012 (by 3.3% of GDP). Programme conditionality for total primary expenditure (in cash terms) was over-achieved.

Expenditure targets have been met. Current expenditure was lower than projected, mainly due to expenditure restraint in the categories of current transfers, goods and services and wages and salaries. On the contrary, social transfers other than in kind equalled the authorities' projection for the first half of the year, but grew at a faster pace than expected in the second quarter of 2013. This trend bears witness to the increasingly difficult labour market conditions. Capital expenditure receded over the first six months of the year, driven largely by the treatment of signing fees for gas exploitation as disposal of non-produced assets and an administrative delay of land annexation compensations during the first half of 2013. Interest payments for 2013 are on track, based on the outcome of the first half of the year.

Overall, Cyprus has executed the 2013 Budget effectively in the first half of the year. The measures taken by the authorities with regard to direct taxes are expected to counteract the negative impact to this tax category of wage cuts in both the private and the broader public sector. The projection of indirect tax revenue is broadly unchanged, balanced between relatively resilient VAT collection and other indirect taxes that appear more sensitive to adverse macroeconomic circumstances over the coming quarters. On the expenditure side, the cautious execution of expenditure measures is expected to continue compensating for higher social payments driven by the increasingly difficult labour market conditions.

Table 2: Composition of the budgetary adjustment

	2012	2013		2014	
	Outturn	**PF April***	**PF July***	**PF April**	**PF July**
	% of GDP				
Revenue	40.0	39.6 (40.6)*	39.6 (40.6)*	39.1	39.3
of which:					
- Taxes on production and imports	14.8	14.1	14.1	13.8	14.2
- Current taxes on income, wealth, etc.	11.1	10.9	11.2	10.8	10.7
- Social contributions	9.1	8.5	8.4	8.0	8.7
- Other (residual)	4.9	6.1 (7.1) *	5.9 (6.9)*	6.4	5.6
Expenditure	46.3	46.1 (47.1)*	47.9 (48.9)*	47.5	47.6
of which:					
- Primary expenditure	43.1	42.1 (43.1)*	43.8 (44.8)*	43.4	43.6
of which:					
- Compensation of employees	15.8	15.8	15.9	15.4	15.9
- Intermediate consumption	3.2	5.3	5.2	5.7	5.2
- Social payments	15.0	15.8	15.7	16.4	16.7
- Subsidies	0.5	0.6	0.6	0.6	0.6
- Capital expenditure	4.0	2.4 (3.4) *	2.4 (3.4)*	3.3	3.2
- Other (residual)	4.6	2.2	4.0**	1.9	2.0
- Interest expenditure	3.2	4.1	4.1	4.1	4.0
General government balance (GGB)	-6.3	-6.5	-8.3	-8.4	-8.3
GGB excl. compensation of pension funds	-6.3	-6.5	-6.5	-8.4	-8.3
Primary balance (PB)	-3.1	-2.4	-4.2	-4.3	-4.3
PB excl. compensation of pension funds	-3.1	-2.4	-2.4	-4.3	-4.3
One-off and other temporary measures	0.4	1.5	-0.2**	0.0	0.0
Cyclically-adjusted balance	-6.3	-3.8	-5.8	-5.1	-5.4
Structural balance	-6.7	-5.4	-5.6	-5.1	-5.4
Change in structural balance	-0.1	1.3	1.2	0.3	0.1
Real GDP growth	-2.4	-8.7	-8.7	-3.9	-3.9
GDP deflator	2.0	0.6	0.6	1.1	1.1
Nominal GDP	17.9	16.4	16.4	16.0	16.0

Source: Commission staff estimates; PF April: Commission 2013 Spring Forecast; PF July: Commission most recent forecast underlying the revised MoU from July 2013.
*: In April PF it was assumed that the signing fees for gas exploitation of EUR 174.8mn (1.1% of GDP) are recorded as sales revenue under Other (residual) but in July PF it has been reclassified as negative expenditure in ESA 95 terms (disposal of non-produced assets); for ease of comparison the table reports April PF numbers at face value (figures in brackets) and numbers corrected for this reclassification.
**: This includes the compensation of pension funds amounting to 1.8% of GDP.

Against the background of these developments in the first two quarters of 2013, an updated projection of the fiscal accounts confirms that the underlying budgetary trends in the first half of 2013 remain in line with the adjustment path established in the EDP recommendation.

However, taking into account the compensation for provident and retirement funds in Cyprus Popular Bank (CPB) to ensure equal treatment with such funds in Bank of Cyprus (BoC) following the conversion of deposits into equity, the 2013 deficit is likely to be substantially higher than the government deficit of 6.5% of GDP recommended by the Council (see Table 2)[5].

The first review mission under the programme established that the rate of compensation will be no larger than 52.5% of the total deposit balance held in CPB, based on a rate of conversion of 47.5% of deposits into equity in BoC. This implies that the total budgetary costs of compensation would amount to around 1.8% of GDP, of which about half can be released by the time of the second review of the adjustment programme. Based on the currently available information, it is expected that the budgetary commitment can be fully accounted for in 2013. In this case, the corresponding 2013 primary balance deficit would amount to around 4¼% of GDP and the headline deficit would amount to around 8½% of GDP, thus exceeding the 2013 target set in the 16 May Council Recommendation. The Cypriot authorities have committed to adopt the modalities of this scheme before the release of the second tranche of assistance, after review by and consultation of the programme partners. Due to its extraordinary one-off nature, the compensation for provident and retirement funds would not impact on the budgetary outcomes in the outer years, and the headline deficit for 2014 is projected to meet the EDP target of 8.4% of GDP. Further, the EDP deadline for correction of the excessive deficit in 2016 appears achievable based on currently available information.

The 16 May Council Recommendation focused on the headline balance targets and the bottom-up effort, given the exceptional situation of highly uncertain macroeconomic environment in Cyprus at that time, with structural balance estimates being more uncertain and subject to variation over time than under more stable macroeconomic conditions. Since Cyprus can be expected not to meet the 2013 target for the headline balance recommended by the Council, due to the budgetary impact of the compensation of pension funds, a careful analysis should be conducted in order to assess whether expenditure targets have been met and the planned discretionary measures have been implemented.

An in-depth bottom-up assessment of the implemented fiscal measures is of particular relevance in the case of Cyprus, since the Council Recommendation of 16 May 2013 explicitly specifies also the recommended amount of discretionary consolidation measures. An assessment of the consolidation measures that have a fiscal impact in the years 2013 and 2014 is therefore required to assess if Cyprus has taken effective action.

[5] In the Memorandum of Understanding on Specific Economic Policy Conditionality for Cyprus' adjustment programme (as approved on 24 April 2013 by the ESM Board of Governors) was explicitly mentioned that "the 2013 deficit target may be revised to incorporate compensation for provident and retirement funds in Cyprus Popular Bank to ensure equal treatment with such funds in Bank of Cyprus following the conversion of deposits into equity". It was moreover agreed that "given the social welfare nature of provident and retirement funds, the Cypriot authorities will use the necessary amount out of programme financing for such compensation". For this purpose, indicative financing of close to 2.5% of GDP was earmarked for the third quarter of 2013 in the assessment of Cyprus' financing needs (note to the ESM pursuant to Article 13.1 of the ESM Treaty). At the time of adopting the Council recommendation, the budgetary impact of this compensation could, however, not be established with precision, since it would depend on the conversion rate to be determined for deposits in BoC. The primary and headline balance deficit targets for 2013 were therefore set without explicitly taking into account the budgetary impact of this compensation.

Cyprus has implemented fiscal consolidation measures in three different rounds. A first set of measures was implemented in December 2012, including immediate cuts in public sector wages and pensions. A second set of measures was adopted via the 2013 Budget Law in December 2012. After the MoU negotiations were finalised in April 2013, a third round of measures was adopted. These measures were prior actions and were implemented before the granting of the first disbursement of financial assistance.

Including the effect of two additional measures that were not prior actions and that are expected to be implemented by end-2013, consolidation measures with an estimated direct deficit-reducing impact amounting to around 4.5% of GDP in 2013 and 2.2% in 2014 (see Table 3) will have been implemented. In both years, the figures include a negative impact of -0.1% of GDP related to an extraordinary dividend from a semi-government organisation, which is expected to be successively reduced in 2013 and 2014. Table 4 gives an overview of the main measures with budgetary impact in 2013 and 2014.

For 2013 the majority of consolidation measures are on the expenditure side. The 2.6% of GDP of expenditure measures notably refer to sizeable reductions in social transfers, public sector wage and pension cuts and reduced transfers to state-owned enterprises and other semi-governmental organisations. On the revenue side, the effort in 2013 amounts to close to 2% of GDP and comprised of increases in both indirect taxes (VAT and excise duties on energy, alcohol and tobacco) and direct taxes (e.g., tax on interest income, corporate income tax and property tax).

Table 3: Fiscal consolidation measures, 2012-2014

% of GDP	**2012**	**2013**	**2014**	**2013-2014**
Total measures	0.3	4.5	2.2	6.7
Revenue measures	0.2	2.0	1.6	3.6
Expenditure measures	0.1	2.6	0.6	3.2
Source: Commission staff estimates.				

For 2013, the Council recommended that the agreed consolidation measures should amount to at least EUR 351mn (2.1% of GDP). These measures comprise first and foremost an increase in the statutory corporate income tax rate to 12.5% (expected to yield EUR 88mn), an increase in the tax rate applied to interest income to 30% (EUR 97mn), and an increase in the bank levy to 0.15% (EUR 8mn). As part of the prior actions, the immovable property tax was increased substantially (expected to yield EUR 53mn), further wage and pension cuts were implemented (EUR 8mn), social transfers to pensioners and for housing purposes were reduced (EUR 47mn) and measures to control healthcare expenditure were introduced (EUR 16mn). Furthermore, the government streamlined social transfers by more than the EUR 113mn required (additional EUR 78mn). While these additional savings from social transfers were already included in the 2013 Budget Law, they were not taken into account for the fiscal projection underpinning the Council Recommendation of 16 May 2013. Hence, the agreed measures implemented amount to more than EUR 351mn for 2013.

For 2014, the estimated direct deficit-reducing impact of the consolidation measures amounts to 2.2% of GDP. On the expenditure side, the biggest impact comes from a further cut of public sector wages and measures to contain the growth in social transfers and health care expenditures. However, most of the effort comes from the revenue side (1.6% of GDP) with further increases in indirect taxes (VAT and excise duties on energy) and increases in contributions on wages and pensions. The increases in 2013 in property tax, the tax on interest income and VAT reach their full-year effects only in 2014, contributing to the revenue-bias of the fiscal effort in that year.

Under the updated fiscal and macroeconomic projections, Cyprus would achieve a budgetary impact for 2014 of more than the EUR 270mn recommended by the Council by fully implementing the agreed fiscal measures. Public sector wages and pensions will be cut by another 3% (expected to yield EUR 53mn) and social transfers will be further streamlined (EUR 29mn). The scaled temporary contribution of up to 3.5% on wages and pensions will be extended until the end of 2016 with the introduction of a new band at the lower end (EUR 58mn), and the contribution to the General Social Insurance Scheme will increase by 0.5 pps for both employers and employees (EUR 43mn). Further hikes of the standard and reduced-rate VAT and the full year effect of the 2013 VAT increase are estimated to contribute a sizeable amount (EUR 67mn), and so does another increase in the excise duties on petrol and gasoil by 5ct/litre (EUR 30mn). Finally, savings are expected from the increase in the bank levy to 0.15% reaching its full-year effect (EUR 9mn) and from the introduction of a fee on monthly transportation cards for students and pensioners (EUR 10mn).

In spite of their implementation, some measures on the revenue side are expected to underperform. For example, a shortfall will likely occur for the withholding tax for interest income, where for constitutional reasons, the increase was enacted only as of 29 April 2013 instead of 1 January 2013. Also the yield of the increase in the bank levy (paid by credit institutions) has been revised downwards, due to a change in legislation, which effectively reduced the tax base for 2013 in order to avoid financial institutions paying levy on a deposit base substantially higher than the current amount of deposits. With regard to the motor vehicle tax reform, generating additional revenues turned out more difficult than anticipated due to Cyprus' steeply deteriorating motor vehicle market, but it was agreed to cover the shortfall by compensatory measures.

Table 4: Main discretionary budgetary measures with budgetary impact in 2013 and 2014

2013 (% of GDP)	**Expenditure**	**Revenue**
December 2012	• Public sector wage and pension cuts (-0.9%)	
2013 Budget law	• Reduction in outlays for social transfers (-1.0%) • Reduction in transfers to SOEs and in budgetary appropriations to semi-governmental organisations (-0.3%) • Reduction of allowances to public sector employees (-0.1%) • Freezing pensions under the General Social Insurance Scheme (-0.1%)	• Increases in excise duties on energy, tobacco and alcohol products (0.3%) • Increase in the standard VAT rate (0.2%)
April 2013 prior actions	• Reduction in outlays for social transfers (-0.3%) • Measures to control health care expenditure (-0.1%)	• Increase in the tax rate on interest income (0.6%) • Increase in the corporate income tax rate (0.5%) • Increase in property tax (0.3%)
2014 (% of GDP)		
2013 Budget law	• Public sector wage and pension cuts (-0.4%) • Reduction in outlays for social transfers (-0.2%)	• Increases in the standard and reduced VAT rates (0.4%) • Increase in excise duties on energy products (0.2%) • Extension of the temporary contribution on wages and pensions (0.4%) • Increase in the contribution to the General Social Insurance Scheme (0.4%)
April 2013 prior actions	• Measures to control health care expenditure (-0.1%)	• Increase in the tax rate on interest income (0.1%) • Increase in the corporate income tax rate (-0.2%) • Increase in property tax (0.1%)

Note: A positive sign implies that revenue / expenditure increases.
Only measures yielding more than 0.1% of GDP are listed, which explains discrepancies with Table 3. The loss in tax income due to public sector wage and pension cuts and increases in contributions is not accounted for in the numbers. In total, the loss amounts to 0.3% of GDP for 2013 and another 0.3% for 2014.
Source: Commission staff estimates.

Summing up, expenditure targets have been met, the discretionary measures on the revenue side have been implemented and the agreed consolidation measures are currently assessed to amount to more than the required EUR 351mn in 2013 and EUR 270mn in 2014. Thus, the in-depth bottom-up assessment of measures that have a fiscal impact in 2013 and 2014 suggests that Cyprus has taken effective action with regard to the 16 May Council Recommendation.

The exceptional situation of highly uncertain macroeconomic environment in Cyprus makes it difficult to accurately estimate the fiscal effort in structural terms. Moreover, as noted in the analysis of the Commission services[6], swings in potential growth estimates are quite strong in the case of Cyprus, and the variation over successive forecasts in the contributions to potential growth from total labour, capital accumulation, and productivity (TFP) has been large. These shifts in estimated potential output and the highly uncertain macroeconomic conditions imply a corresponding impact on the estimated structural effort, even when no changes occur to the budgetary execution or the implementation of individual consolidation measures.

Nevertheless, the recommended headline balance targets under the April Programme Forecast implied an estimated structural fiscal effort of 1.3% of GDP in 2013 and of 0.3% in 2014. Under the updated July Programme Forecast a worse labour market projection impacts negatively on potential output which was revised downwards by 0.4 pp. in 2013 and 0.6 pp. in 2014[7]. This, in turn, reduces the estimated output gap in both years. As a result, given the unchanged projection of real GDP growth, the cyclical component is estimated as less negative than in the April Programme Forecast. Thus, the structural improvement for 2013 and 2014 ("Uncorrected fiscal effort") is slightly lower than implied in the 16 May Council Recommendation (see Table 5). Correcting for the revision of potential output growth ("**α**"), the fiscal effort improves to 1.3% and 0.4% for 2013 and 2014[8].

Table 5: Change in the structural balance corrected for revisions in potential output gap and revenue windfalls/shortfalls

Uncorrected fiscal effort		Fiscal effort corrected for **α**		Fiscal effort corrected for **α** and **β**		Average implicit fiscal effort recommended (2013-2014)	Deadline for correction
2013	2014	2013	2014	2013	2014	0.8	2016
1.2	0.1	1.3	0.4	0.9	0.7		

Source: Commission services

In contrast, tax revenue elasticities appear slightly lower in 2013 and slightly higher in 2014, compared to the April Programme Forecast, which leads to a reduction of the corrected fiscal effort in 2013 of 0.4% and an increase in 2014 of 0.3%. The assessment of the yield of certain revenue measures has been revised down for 2013. This includes those revenue measures, where the implementation was delayed (see above) and where the full-year effect therefore materialises only in 2014. Hence, while the agreed amount of total discretionary measures

[6] Commission Staff Working Document accompanying the Recommendation for a Council Recommendation with a view to bringing an end to the situation of an excessive government deficit in Cyprus - SWD(2013) 176 final, 7.5.2013.

[7] The revision of the labour market forecast is driven both by a larger fall in employment and a significant upward revision of unemployment.

[8] For an explanation of the methodology of calculating the corrected structural fiscal effort, please consult http://ec.europa.eu/economy_finance/publications/occasional_paper/2013/op151_en.htm

have been implemented by the Cypriot authorities, the downwards adjustment of the effect of discretionary revenue measures is predominantly driven by a shift in timing of revenue collection as several revenues foreseen for 2013 in the April Programme Forecast were shifted to 2014 in the July Programme Forecast.

Correcting for both of these effects (**"α"** and "**β"**), the fiscal effort amounts to 0.9% and 0.7% in 2013 and 2014. On average, the corrected fiscal effort for 2013-2014 is therefore in line with the implicitly recommended effort.

3.2. Budgetary prospects for 2014-16

An ambitious but achievable fiscal adjustment path over the medium-term is essential to make Cyprus' public debt sustainable. For this reason, a key objective of the fiscal strategy and the agreed consolidation measures is to achieve a strengthening of the primary balance over the programme period and a further strengthening in the years that follow. The authorities are bound to stand ready to preserve the programme objectives by taking additional measures in the event of fiscal underperformance, taking into account adverse macroeconomic effects.

On the revenue side, fiscal performance in the programme years is expected to reflect broadly the macroeconomic developments. Specifically, revenues from taxes on production and imports are expected to be in line with trends in nominal private consumption, with a sizeable drop in 2014 followed by a steady rebound in 2015 and 2016. Similarly, the collection of direct taxes is expected to initially follow a decreasing trend. Social contributions are expected to be on a downwards trend in 2014 and 2015 and start increasing again in 2016, reflecting the developments in employment and wages.

On the expenditure side, total expenditure is expected to be kept tight, despite the increased unemployment. Specifically, the compensation of employees is projected to decline throughout the programme period, both due to the reduction of employees and the reduction of wages and allowances. Moreover, the reform of the welfare system is expected to contain the growth in social transfers. Public investment is expected to be reduced even further in 2014, but then to increase again in 2015 and 2016, along with the amelioration of the overall macroeconomic conditions. Lastly, only minor fluctuations in interest payments are expected throughout the programme period.

All in all, the annual targets established in the Council recommendation are projected to be met, leading to a correction of the excessive deficit by 2016.

3.3. Budgetary framework and fiscal structural measures

The adoption and implementation of fiscal-structural measures are critical to achieve a permanent consolidation over the longer-term, leading to a primary balance surplus of 3% of GDP in 2017 and 4% of GDP in 2018, which should be maintained at such level thereafter.

Moreover, the implementation of the fiscal-structural measures specified in Decision 2013/236/EU will support the achievement of long-term sustainability of public finances. The fiscal-structural measures are far-ranging and comprise, inter alia, establishing a medium-term budgetary framework, undertaking reforms of the pension, health care and welfare system as well as the revenue administration, and ensuring improvements to the public finance management and the functioning of the public sector.

Significant pension reform measures were implemented as of 1 January 2013. An actuarial study is underway to help decisions on further reforms to ensure the long-run viability of the national pension system.

For healthcare reform, an updated actuarial study of the National Health System (NHS) has now been completed, leading to the implementation of a financially sustainable NHS by end-2015. In the meantime, co-payments for using public healthcare services have been introduced, expected to raise revenues and to control demand, while eligibility for free public healthcare has been constrained, particularly through the introduction of a compulsory health care income-based contribution for public sector employees and pensioners. Also, efficiency increasing structural measures have been initiated; these include the re-organisation of hospitals, the introduction of protocols and clinical guidelines and the introduction of an IT-infrastructure.

A reform plan was announced by the government that will form the basis for a comprehensive reform of the welfare system, to be prepared in stages and enter into force on 1 July 2014. The reform aims to provide better protection of vulnerable groups, to ensure efficient use of public funds within the welfare system, while at the same time ensure balance between welfare benefits and incentives to take up work. The authorities' reform plan makes clear that the reformed welfare system must be consistent with the programme's fiscal targets. In a situation where the total spending envelope for social protection may have to be reduced in the coming years, the authorities have decided that priority should be given to protecting the most vulnerable people and that sufficient budgetary means for fundamental social policies should be ensured. The core of the reform is therefore the introduction of a guaranteed minimum income (GMI) scheme together with the elimination of duplicate benefits.

In public finance management, the Fiscal Strategy Statement adopted for the first time in May 2013 was a step forward in better fiscal planning. Meanwhile, the authorities decided to adopt an umbrella law covering budgetary processes in the broad sense, which would rescind the MTBF law and would also encompass the provisions grounding the Fiscal Council. To improve the effectiveness and efficiency of the revenue administration**,** the Cypriot authorities agreed to implement a comprehensive reform. Under the reform, a new integrated tax department covering direct and indirect taxes will be established and a compliance management strategy will be implemented. Lastly, work on public administration reform has been initiated with the reduction of impediments to staff mobility and the change of working hours. An independent external review has been commissioned, to identify further areas of public administration reform.

3.4. Public debt

Public debt rose by almost 10 pp. in 2011 and in 2012, reaching almost 71.1% of GDP in 2011 and 85.8% of GDP in 2012, mostly driven by higher stock-flow adjustments related to the government's participation in the recapitalisation of one commercial bank in June 2012. In addition, higher-than-expected deficit outcomes in the past, partly arising from higher borrowing costs due to Cyprus' difficulty in accessing international markets, as well as the slowdown in the nominal GDP (through the denominator effect) also increased the debt-to-GDP ratio.

The general government's gross debt stock remained broadly stable over the four first months of 2013, reflecting favourable fiscal developments. The Cypriot authorities announced on 27 June an exchange of some EUR 1bn of domestic-law bonds held by residents (higher than foreseen in April) with new bonds maintaining the same coupon rates. This exchange was completed on 1 July 2013. Further, the first disbursement of programme money by the ESM and the IMF took place in May and June 2013, amounting to EUR 2.1bn and EUR 1bn, respectively as was foreseen in April. In the absence of significant long-term debt maturities, debt redemption in the first half of 2013 was linked almost exclusively to short-term obligations. The first disbursement provided the Cypriot authorities with sufficient funds to cover needs for debt service and deficit financing until the next cash disbursement foreseen by the end of the fourth quarter 2013. During the second quarter, funds were used to reimburse in particular the foreign-law bond worth EUR 1.4bn which matured on 7 June and to cover fiscal needs of about EUR 300m. Hence, the government's cash buffer has also increased and will be sufficient to cover estimated third quarter fiscal financing needs of between EUR 600 and 700m.

The fiscal consolidation implies that the improvement in the primary balance over 2013-16 will eventually contribute to reducing the debt ratio, in spite of the rather strong debt-increasing effects from interest expenditure and the projected recession (see Table 6). Provided that the budget execution remains on track, the debt-to-GDP ratio can be expected to reach 115% at the end of 2013 and to around 127% of GDP in 2015. Thereafter, on the back of solid primary surpluses and the projected return to positive GDP growth rates, the debt-to-GDP ratio is set to start falling to around 123% of GDP in 2016. This is in line with the April Programme Forecast and the debt sustainability assessment presented.

Table 6: Public debt trajectory 2013-2016 under the updated Programme Forecast

	2012	2013	2014	2015	2016
Gross debt ratio (% of GDP)	**85.8**	**115.0**	**123.2**	**126.9**	**122.5**
Changes in the ratio (pp.)	*14.7*	*29.2*	*8.2*	*3.6*	*-4.4*
of which					
(1) Primary balance (pp.)	**3.1**	**4.2**	**4.3**	**2.1**	**-1.2**
(2) Snowball effect (pp.)	**3.6**	**11.7**	**7.6**	**1.0**	**-0.5**
Interest expenditure (pp.)	*3.2*	*4.1*	*4.3*	*4.1*	*4.2*
Growth effect (pp.)	*1.8*	*8.2*	*4.6*	*-1.3*	*-2.4*
Inflation effect (pp.)	*-1.4*	*-0.6*	*-1.3*	*-1.8*	*-2.2*
(3) Stock flow adjustment (pp.)	**8.1**	**13.3**	**-3.6**	**0.6**	**-2.7**

Source: Commission staff estimates.

4. FISCAL ADJUSTMENT PATH

The Council Recommendation of 16th May 2013 was based on the Commission 2013 Spring Forecast. The updated fiscal and macroeconomic projections in the context of the July review of Cyprus' programme are largely unchanged compared to the Commission 2013 Spring Forecast.

Given that the deviation from the headline target set in the 16 May Council Recommendation is explained by the extraordinary one-off compensation of provident and pension funds in CPB, no additional measures appear needed at this stage.

At present, Cyprus continues to rigorously implement the 2013 Budget Law and the agreed additional consolidation measures, which at this point in time are assessed to amount to slightly more than the required EUR 351mn in 2013 and at least 270mn EUR in 2014. The situation will have to be monitored closely and further corrective action would have to be taken early on if deviations from budgetary plans were to materialise. The total amount of fiscal policy measures required to underpin the 2014 budgetary targets will be assessed in the context of the 2014 Budget Law consultation. For 2015-2016, Cyprus should achieve a deficit in the 2015 general government primary balance of no more than EUR 344mn (2.1% of GDP) and a surplus in the 2016 general government primary balance of at least EUR 204mn (1.2% of GDP), which under the updated programme forecast will require further measures to be specified in the outer years.

Table 7: Baseline scenario (Commission 2013 Spring Forecast)

% of GDP (unless indicated otherwise)	**2012**	**2013f**	**2014f**	**2015f**	**2016f**
Revenues	40.0	40.6	39.1	39.4	40.8
Current revenues	39.9	40.6	39	39.4	40.7
Discretionary measures with impact on current revenue (EUR bn)	0.362	0.631	0.167	-0.021	-0.027
Expenditure	46.3	47.1	47.5	45.7	43.7
Nominal GDP (EUR bn)	17.9	16.4	16.0	16.4	17.0
Nominal GDP growth	-0.5	-8.2	-2.9	2.6	3.7
Real GDP growth	-2.4	-8.7	-3.9	1.1	1.9
Potential GDP growth	-1.3	-2.6	-2.5	-2.3	-1.6
Structural balance	-6.7	-5.4	-5.1	-4.4	-2.5
Primary balance	-3.1	-2.4	-4.3	-2.1	1.2
General government balance	-6.3	-6.5	-8.4	-6.3	-2.9
p.m CAB methodology revenue elasticity	1.0	1.0	1.0	1.0	1.0
p.m Apparent revenue elasticity	9.5	1.9	1.4	1.3	2.0
p.m Output gap (% of potential output)	0.0	-6.2	-7.6	-4.3	-0.9

Source: Commission staff estimates; f: forecasted data

Table 8: Updated Programme Forecast, July 2013

<table>
<tr><th></th><th></th><th>2012</th><th>2013</th><th>2014</th><th>2015</th><th>2016</th></tr>
<tr><td rowspan="2">Potential Growth (annual % change)</td><td>PF April</td><td>-1.3</td><td>-2.6</td><td>-2.5</td><td>-2.3</td><td>-1.6</td></tr>
<tr><td>PF July</td><td>-1.4</td><td>-3.0</td><td>-3.1</td><td>-2.7</td><td>-2.0</td></tr>
<tr><td rowspan="2">Actual Growth (annual % change)</td><td>PF April</td><td rowspan="2">-2.4</td><td rowspan="2">-8.7</td><td rowspan="2">-3.9</td><td rowspan="2">1.1</td><td rowspan="2">1.9</td></tr>
<tr><td>PF July</td></tr>
<tr><td rowspan="2">Output gap (% of potential GDP)</td><td>PF April</td><td>0.0</td><td>-6.2</td><td>-7.6</td><td>-4.3</td><td>-0.9</td></tr>
<tr><td>PF July</td><td>0.1</td><td>-5.8</td><td>-6.6</td><td>-3.0</td><td>0.8</td></tr>
<tr><td colspan="7">Source: Commission staff estimates; PF April: Commission 2013 Spring Forecast; PF July: Commission's most recent forecast underlying the revised MoU from July 2013.</td></tr>
</table>

5. CONCLUSION

Based on currently available information, it appears that Cyprus remains on track towards correcting the excessive deficit by 2016 as recommended by the Council on 16 May 2013.

The current forecast suggests that, due to the compensation of provident and pension funds in Cyprus Popular Bank, the headline deficit target for 2013 will not be achieved. However, the underlying budgetary trends and the execution of the 2013 budget remain in line with the adjustment path established in the EDP recommendation. Given the extraordinary nature of the pension funds compensation, the EDP deadline for correction of the excessive deficit in 2016 appears achievable based on currently available information.

Further, an in-depth bottom-up analysis shows that Cyprus has adopted sizeable consolidation measures with a direct deficit-reducing impact in 2013 of around 4.5% of GDP and around 2.2% of GDP in 2014. In line with the Council Recommendation, Cyprus continues to rigorously implement the 2013 Budget Law, has met expenditure targets and implemented the agreed discretionary consolidation measures, which are assessed to amount to more than the required EUR 351mn in 2013 and EUR 270mn in 2014.