EUROPEAN
COMMISSION

Brussels, 22.11.2017
SWD(2017) 512 final

COMMISSION STAFF WORKING DOCUMENT

Analysis of the draft budgetary plan of Cyprus

Accompanying the document

COMMISSION OPINION

on the draft budgetary plan of Cyprus

{C(2017) 8012 final}

COMMISSION STAFF WORKING DOCUMENT

Analysis of the draft budgetary plan of Cyprus

Accompanying the document

COMMISSION OPINION

on the draft budgetary plan of Cyprus

1. INTRODUCTION

Cyprus submitted its Draft Budgetary Plan (DBP) for 2017 on 16 October 2017 in compliance with Regulation (EU) No 473/2013 of the Two-Pack. Cyprus is subject to the preventive arm of the Pact and should preserve a sound fiscal position, which ensures compliance with the medium term budgetary objective (MTO) of a structural balance of 0% of GDP.

As the debt ratio was 107.5% of GDP in 2015, during the three years following the correction of the excessive deficit Cyprus is also subject to the transitional arrangements as regards compliance with the debt reduction benchmark. Following the end of the transition period, Cyprus is subject to the debt reduction benchmark.

Section 2 of this document presents the macroeconomic outlook underlying the DBP and provides an assessment based on the Commission 2017 autumn forecast. The following section presents the recent and planned fiscal developments, according to the DBP, including an analysis of risks to their achievement based on the Commission 2017 autumn forecast. In particular, it also includes an assessment of the measures underpinning the DBP. Section 4 assesses the recent and planned fiscal developments in 2017-2018 (also taking into account the risks to their achievement) against the obligations stemming from the Stability and Growth Pact. A box on the application of constrained judgement is contained in this section, as Cyprus is flagged by the plausibility tool. Section 5 provides an analysis on the composition of public finances and on fiscal-structural issues, including reducing the tax wedge. Section 6 summarises the main conclusions of the present document.

2. MACROECONOMIC DEVELOPMENTS UNDERLYING THE DRAFT BUDGETARY PLAN

The economy of Cyprus expanded by 3.0% in real terms in 2016 (revised up from 2.8% in the previous assessments).

The macroeconomic scenario underlying the DBP projects a strong recovery, with real GDP growth at 3.6% in 2017 and 3.0% in 2018. Growth is forecast to be driven mainly by private consumption and net exports in 2017 and by private consumption, investment and net exports in 2018. Real GDP growth in the DBP is revised to be much stronger than in the Stability Programme for 2017, after the solid outturn of the first half of the year, and slightly higher for 2018.

The 2017-2018 projections underlying the DBP are only marginally more optimistic (+0.1 percentage points) than the Commission 2017 autumn forecast. However, the composition of growth is different, with weaker domestic demand expected in the DBP than in the Commission 2017 autumn forecast, while the contribution of net exports is assumed higher in the DBP. The difference stems mainly from the DBP projecting quite subdued investment growth (unrevised from the spring Stability Programme projection, despite strong performance in the first half of the year), which contributes to much lower import growth. The Commission 2017 autumn forecast also includes a more conservative assessment of export growth for both years, on the back of a downward trend in exports of goods and capacity constraints in exports of services.

Table 1. Comparison of macroeconomic developments and forecasts

	2016	2017			2018		
	COM	SP	DBP	COM	SP	DBP	COM
Real GDP (% change)	3.0	2.9	3.6	3.5	2.9	3.0	2.9
Private consumption (% change)	3.3	2.3	3.0	3.3	2.3	2.5	2.9
Gross fixed capital formation (% change)	35.0	0.2	0.2	7.8	6.5	6.5	7.3
Exports of goods and services (% change)	3.9	3.0	3.2	2.8	3.5	3.6	2.2
Imports of goods and services (% change)	6.6	1.0	1.2	3.7	3.2	3.3	3.2
Contributions to real GDP growth:							
- Final domestic demand	6.8	1.7	2.4	4.1	2.7	2.9	3.6
- Change in inventories	-2.1	0.0	0.0	0.0	0.0	0.0	0.0
- Net exports	-1.7	1.2	1.2	-0.6	0.2	0.2	-0.7
Output gap[1]	-1.1	1.3	1.2	1.3	3.0	2.8	2.7
Employment (% change)	3.1	2.2	3.0	2.9	2.0	2.4	1.9
Unemployment rate (%)	13.0	11.5	11.0	11.0	10.0	9.5	10.0
Labour productivity (% change)	-0.1	0.7	0.6	0.6	0.9	0.6	0.9
HICP inflation (%)	-1.2	1.1	1.0	1.0	1.0	1.0	1.1
GDP deflator (% change)	-0.9	1.3	1.4	1.2	1.0	1.0	1.1
Comp. of employees (per head, % change)	-0.8	1.3	1.0	1.7	1.7	1.5	1.5
Net lending/borrowing vis-à-vis the rest of the world (% of GDP)	-4.8	-4.5	-4.4	-5.1	-4.3	-4.3	-6.2

Note:

[1]In percent of potential GDP, with potential GDP growth recalculated by Commission services on the basis of the programme scenario using the commonly agreed methodology.

Source:

Stability Programme 2017 (SP); Draft Budgetary Plan for 2018 (DBP); Commission 2017 autumn forecast (COM); Commission calculations

The DBP and the Commission 2017 autumn forecast expect the same inflation rate for 2017, with HICP at 1%, while the Commission projects slightly higher inflation in 2018. The unemployment rate is projected to fall to 11% in both the Commission forecast and the DBP, while the projection for 2018 is more optimistic in the DBP.

The output gap, as recalculated by the Commission based on the information in the DBP and according to the commonly agreed methodology (recalculated output gap), reaches 1.2% of potential output in 2017 and 2.8% in 2018, as real GDP growth outpaces potential growth. The Commission 2017 autumn forecast envisages an output gap estimate of 1.3% in 2017 and somewhat lower output gap of 2.7% in 2018.

Overall, the DBP presents plausible macroeconomic assumptions until 2018, with marginally more favourable macroeconomic outlook than the Commission 2017 autumn forecast for both years and an outlook more tilted towards export-driven growth. The risks associated with the macroeconomic assumptions presented in the DBP are broadly balanced. Downside risks pertain to the still very high share of non-performing loans, the macroeconomic prospects of the UK, one of the key trading partners of Cyprus, and adverse developments in the external environment. Upside risks are mainly related to higher investment, particularly in tourism and energy sectors.

Box 1: The macro economic forecast underpinning the budget in Cyprus

The macroeconomic forecast underlying the DBP is prepared by the Ministry of Finance. The task of assessing and endorsing this macroeconomic forecast was assigned to the independent Fiscal Council by the Fiscal Responsibility and Budgetary Framework Law of 2014.

The Fiscal Council endorsed the macroeconomic scenario underpinning the DBP for 2018 in a letter to the Minister of Finance on 15 September 2017. The Fiscal Council's 2017 autumn report, which contains a detailed comparative analysis on the plausibility of the official forecast as well as an assessment of the DBP fiscal stance, is expected to be published in November.

3. RECENT AND PLANNED FISCAL DEVELOPMENTS

3.1. Deficit developments

The DBP projects a general government headline surplus of 1% of GDP in 2017, significantly above the 0.2% of GDP predicted in the 2017 Stability Programme and broadly in line with the Commission 2017 autumn forecast. The improvement compared to the 2017 Stability Programme is explained by the upward revision of the macroeconomic scenario, the better-than-projected labour market developments, the strong performance of tax revenues, as well as additional revenue from a fee accompanying the production sharing contracts for the exploration and exploitation of hydrocarbons reserves for the 2017-2019 period. In fact, the higher projected total revenues, by 1.4 percentage points compared to the 2017 Stability Programme, are the result of larger-than-expected indirect, corporate and personal income tax receipts, as well as social contributions. The higher revenues will more than offset the impact of the abolition of the temporary contribution on emoluments of private sector employees and the total abolition of the immovable property tax in 2017, which is estimated at 0.5% of GDP. Total expenditure is also projected to increase by 0.6 percentage points, compared to the 2017 Stability Programme. This is mainly due to higher expenditure on social payments attributed to an increase in pensions, intermediate consumption of electricity and medical supplies, as well as other expenditures that are not detailed in the DBP.

The Commission 2017 autumn forecast shows similar developments, but it projects somewhat lower increases in revenues (by 0.4 percentage points) and expenditures (by 0.5 percentage points), compared to the DBP. This is due to a less dynamic macroeconomic scenario, as well as different estimates for specific revenue and expenditure items. On the revenue side, lower nominal GDP growth implies that revenues are also expected to be growing less fast. The lower nominal GDP in the Commission 2017 autumn forecast explains 0.3 percentage points of the difference in the expenditure-to-GDP ratio. In addition, the Commission forecast a contained rate of growth of the wage bill in line with the collective agreement in place, which limits the overall wage bill growth in the broad public sector below nominal GDP growth, lower social payments due to a fall in unemployment benefits, as well as lower interest expenditure and other expenditures. These developments are partly offset by a higher projection of gross fixed capital formation compared to the DBP.

For 2018, the DBP targets a general government headline surplus of 1.3% of GDP, which represents an upward revision of 0.9 percentage points compared to the Stability Programme target of 0.4% of GDP. According to the DBP, this is mainly driven by the expected good performance in revenues underpinned by a further improvement in the labour market and positive developments in economic activity. Public expenditures are also expected to increase, but at a slower pace than revenues. The increase in expenditure appears to be mainly due to higher expenditure for intermediate consumption and social payments. The Commission 2017 autumn forecast projects the general government headline surplus at 1.4% of GDP in 2018, 0.1 percentage points higher than planned by the DBP. Albeit the projected budgetary developments are similar, the Commission forecasts slightly lower increases in both revenues and expenditures than the DBP.

Table 2. Composition of the budgetary adjustment

(% of GDP)	2016	2017			2018			Change: 2016-2018
	COM	SP	DBP	COM	SP	DBP	COM	DBP
Revenue	**38.8**	**38.6**	***40.0***	**39.6**	**38.4**	***39.9***	**39.6**	**1.1**
of which:								
- Taxes on production and imports	15.1	15.1	*16.0*	15.5	15.0	*15.9*	15.5	0.8
- Current taxes on income, wealth, etc.	9.7	9.0	*9.6*	9.7	9.0	*9.5*	9.7	-0.2
- Capital taxes	0.0	0.0	*0.0*	0.0	0.0	*0.0*	0.0	0.0
- Social contributions	8.5	8.7	*9.0*	8.8	8.8	*9.0*	8.7	0.5
- Other (residual)	5.5	5.8	*5.4*	5.6	5.6	*5.5*	5.6	0.0
Expenditure	**38.3**	**38.4**	**39.0**	**38.5**	**38.0**	**38.6**	**38.2**	**0.2**
of which:								
- Primary expenditure	35.8	35.9	36.4	36.1	35.5	36.1	35.9	0.3
of which:								
Compensation of employees	12.4	12.5	12.5	12.4	12.3	12.3	12.3	-0.1
Intermediate consumption	3.6	3.5	3.7	3.7	3.5	3.7	3.6	0.1
Social payments	14.1	13.9	14.1	13.9	13.6	13.8	13.6	-0.4
Subsidies	0.5	0.5	0.5	0.5	0.5	0.5	0.5	-0.1
Gross fixed capital formation	2.3	2.8	2.7	2.8	2.8	2.8	3.0	0.5
Other (residual)	2.8	2.7	2.9	2.7	2.8	3.0	3.0	0.3
- Interest expenditure	2.6	2.5	2.5	2.4	2.5	2.5	2.2	0.0
General government balance (GGB)	**0.5**	**0.2**	**1.0**	**1.1**	**0.4**	**1.3**	**1.4**	**0.8**
Primary balance	**3.0**	**2.6**	**3.5**	**3.5**	**2.9**	**3.8**	**3.6**	**0.8**
One-off and other temporary measures	-0.1	0.0	0.0	0.0	0.0	0.0	0.0	0.1
GGB excl. one-offs	**0.5**	**0.2**	**1.0**	**1.1**	**0.4**	**1.3**	**1.4**	**0.8**
Output gap[1]	-1.1	1.3	1.2	1.3	3.0	2.8	2.7	4.0
Cyclically-adjusted balance[1]	1.0	-0.5	0.4	0.4	-1.1	-0.2	0.0	-1.3
Structural balance (SB)[2]	**1.1**	**-0.5**	**0.4**	**0.4**	**-1.1**	**-0.2**	**0.0**	**-1.3**
Structural primary balance[2]	3.6	2.0	2.9	2.8	1.4	2.3	2.2	-1.4

Notes*:*

[1]Output gap (in % of potential GDP) and cyclically-adjusted balance according to the DBP/programme as recalculated by Commission on the basis of the DBP/programme scenario using the commonly agreed methodology.

[2]Structural (primary) balance = cyclically-adjusted (primary) balance excluding one-off and other temporary measures.

Source:

Stability Programme 2017 (SP); Draft Budgetary Plan for 2018 (DBP); Commission 2017 autumn forecast (COM); Commission calculations

Risks associated with the DBP and the Commission budgetary projections mainly relate to the increasing pressures for fiscal relaxation. At a time of sizable budgetary surpluses, pressures for fiscal relaxation may pose a risk to the fiscal performance, which could materialise through new policy initiatives affecting negatively the budgetary outcomes.

Cyprus' cost of servicing public debt is currently low owing to a large share of official borrowing and the historically low interest rate environment in the markets. Moreover, the market premium for Cyprus' government bonds has been decreasing alongside continuing improvement in Cyprus' sovereign credit rating, with 8-year rates currently standing at 1.48%[1]. As a consequence, total interest payments by the general government have continued to decrease as a share of GDP. Based on the information included in the DBP, interest expenditure in Cyprus is expected to fall from 2.6% of GDP in 2016 to 2.5% in 2017 and is projected to remain at that level next year, well below the 2.9% recorded in 2012 at the peak of the euro area sovereign debt crisis. This is broadly confirmed by the Commission forecast.

A sizeable share of total debt has floating interest rates (46% in 2016). This is largely due to borrowing from European Stability Mechanism (ESM) and the IMF. Given that most of the variable debt relates to the ESM loans, which are funded on a pool of fixed rate instruments that would only generate an increase in borrowing cost gradually over time, it is deemed to be of relatively low risk. The repayment of official loans has already started in 2017, marking the start in the gradual decline of floating rate debt stock as in parallel more fixed rate instruments are being issued. Refinancing risk is mitigated by low financing needs in the medium-term, achieved through prudent fiscal policy and active debt management operations.

The DBP does not provide any indication on whether the DBP budgetary targets comply with the national fiscal rules enshrined in the Fiscal Responsibility and Budgetary Framework law (FRBFL).The FRBFL contains rules on structural balance, corrective adjustment and debt. Given that the structural balance projected in the DBP is expected to remain above the MTO, risks to non-compliance with the national fiscal rules are limited.

On the basis of the information provided in the DBP, the recalculated structural balance[2] is estimated at 0.4% of GDP in 2017, down from 1.1% of GDP in 2016, but significantly better than the estimated level in the 2017 Stability Programme (-0.5% of GDP). This is mainly due to an upward revision of the general government surplus (by 0.8 percentage points). For 2018, the recalculated structural balance deteriorates to -0.2% of GDP. The Commission 2017 autumn forecast estimates a structural surplus of 0.4% of GDP in 2017 and 0% in 2018. The structural effort in 2018 is somewhat impacted by the cyclical position, with a positive output gap of 2.7% of potential GDP.[3]

Against the background of falling interest expenditure, the projected deterioration in the structural balance in 2017-2018 (by 0.7 percentage points and 0.4 percentage points, respectively) is accompanied by a deterioration in the structural primary balance (by 0.8 percentage points and 0.6 percentage points, respectively).

3.2. Debt developments

The general government gross debt declined from its peak of 107.5% of GDP in 2015 to 107.1% in 2016, according to revised national accounts figures.[4] The DBP projects a further decrease in the debt-to-GDP ratio to 99% in 2017 and below 93% in 2018, owing to general government budget surpluses, nominal GDP growth and active debt management operations.

[1] In the absence of 10-year to maturity bonds for Cyprus, the longest 8-year to maturity bond yield is indicated, as of 6 November 2017. Source: Bloomberg

[2] Cyclically adjusted balance net of one-off and temporary measures, recalculated by the Commission using the commonly agreed methodology.

[3] The output gap, which measures the cyclical position of an economy, is defined as the difference between actual and potential output. The latter is estimated by the Commission using a production function method, endorsed by the ECOFIN Council on 12 July 2002, which allows identifying the different components of potential output.

[4] For 2013, 2014, 2015 and 2016, public debt and nominal GDP have been revised and have led to a revision of the debt ratios in 2013, 2014 and 2016. The ratio was revised from 107.8% of GDP to 107.1% in 2016.

This declining trend is more pronounced in the DBP than in the 2017 Stability Programme, representing an additional expected decrease in the debt-to-GDP ratio by 5 percentage points and 1.8 percentage points in 2017 and 2018, respectively. This is mainly due to additional debt management operations in the form of early repayments of domestic debt of EUR 0.6 bn and EUR 0.3 bn in 2017 and 2018, respectively (reflected in differences of projected stock-flow adjustments[5]). Those early repayments were envisaged by the authorities only recently. The revision of the primary balance and nominal growth projections on the back of better-than-expected economic and fiscal outturn in the first eight months of 2017 also played a role in the revision of the debt forecast.

The debt-to-GDP projection in the DBP is also more optimistic than the Commission 2017 autumn forecast, mainly due to the difference in expected stock-flow adjustments. The Commission forecast does not take into account the early repayments of debt under a no-policy change assumption. It expects instead an accumulation in cash reserves with a negative effect on gross debt. However, in the beginning of November 2017, the Government has already carried out the early debt repayment of EUR 0.6 bn (3.2% of GDP). Given the track record of active debt management by Cyprus, the envisaged operation for 2018 is also likely to be executed.

Table 3. Debt developments

(% of GDP)	2016	2017			2018		
		SP	DBP	COM	SP	DBP	COM
Gross debt ratio[1]	**107.1**	**104.0**	**99.0**	**103.0**	**99.7**	**92.4**	**98.3**
Change in the ratio	-0.4	-3.1	-8.1	-4.1	-4.3	-6.6	-4.8
Contributions [2] :							
1. Primary balance	**-3.0**	**-2.6**	**-3.5**	**-3.5**	**-2.9**	**-3.8**	**-3.6**
2. "Snow-ball" effect	**0.3**	**-1.9**	**-2.6**	**-2.5**	**-1.5**	**-1.3**	**-1.7**
Of which:							
Interest expenditure	2.6	2.4	2.5	2.4	2.5	2.5	2.2
Growth effect	-3.2	-3.0	-3.6	-3.6	-2.9	-2.9	-2.8
Inflation effect	0.9	-1.3	-1.4	-1.2	-1.1	-0.9	-1.0
3. Stock-flow adjustment	**2.4**	**1.4**	**-2.0**	**1.9**	**0.1**	**-1.5**	**0.6**
Of which:							
Cash/accruals difference		0.0	0.00		0.0	0.00	
Net accumulation of financial		0.7	-2.60		0.1	-1.50	
of which privatisation proceeds		0.0	0.00		0.0	0.00	
Valuation effect & residual		0.0	0.00		0.0	0.00	

Notes:

[1] End of period.

[2] The snow-ball effect captures the impact of interest expenditure on accumulated debt, as well as the impact of real GDP growth and inflation on the debt ratio (through the denominator). The stock-flow adjustment includes differences in cash and accrual accounting, accumulation of financial assets and valuation and other residual

Source:

Stability Programme 2017 (SP); Draft Budgetary Plan for 2018 (DBP); Commission 2017 autumn forecast (COM); Commission calculations

3.3. Measures underpinning the draft budgetary plan

The 2017 DBP reports the full abolition of the immovable property tax in 2017 and the abolition of the temporary contribution of employees in 2017 as discretionary measures. The

[5] The present note refers to the recalculated stock-flow adjustments by the Commission as a residual, after taking into account the primary balance and snow-ball effect projections in the programme.

fiscal impact of these deficit increasing measures is estimated at 0.5% of GDP on the revenue side, and at 0.2% of GDP on the expenditure side. According to the DBP, and despite these expansionary measures, Cyprus would be above its MTO in 2017, mainly as a result of revenue windfalls. The estimates of the budgetary impact of these measures appear plausible and are in line with the Commission 2017 autumn forecast.

The DBP also describes the introduction of the standard VAT rate on building land transactions, in accordance with the European VAT Directive, as a measure awaiting the approval of the House of Representatives. However, given that the measure is still to be adopted, its expected budgetary impact of about 0.2% of GDP is not factored in the DBP.

Table 4. Main discretionary measures reported in the DBP

A. Discretionary measures taken by General Government - revenue side

Components	Budgetary impact (% GDP) (as reported by the	
	2017	**2018**
Taxes on production and Current taxes on income, Capital taxes Social contributions Property Income Other	-0.5	0.0
Total	-0.5	0

Note:
The budgetary impact in the table is the aggregated impact of measures as reported in the DBP, i.e. by the national authorities. A positive sign implies that revenue increases as a consequence of this measure.
Source: Draft Budgetary Plan for 2018

B. Discretionary measures taken by general Government- expenditure side

Components	Budgetary impact (% GDP) (as reported by the	
	2017	**2018**
Compensation of employees Intermediate consumption Social payments Interest Expenditure Subsidies Gross fixed capital formation Capital transfers Other	0.2	0.0
Total	0.2	0

Note:
The budgetary impact in the table is the aggregated impact of measures as reported in the DBP, i.e. by the national authorities. A positive sign implies that expenditure increases as a consequence of this measure.
Source: Draft Budgetary Plan for 2018

4. Compliance with the provisions of the Stability and Growth Pact

Cyprus is subject to the preventive arm of the Pact and should preserve a sound fiscal position which ensures compliance with its MTO. Box 2 reports the latest country specific recommendations in the area of public finances. Cyprus is also subject to the transitional arrangements to make sufficient progress towards compliance with the debt reduction benchmark.

Box 2. Council Recommendation addressed to Cyprus

On 11 July 2017, the Council addressed recommendations to Cyprus in the context of the European Semester.[6] In particular, in the area of public finances the Council recommended Cyprus to remain at its medium-term budgetary objective in 2018 and to use windfall gains to accelerate the reduction of the general government debt ratio.

The Council recalled that in 2018, based on the Commission 2017 spring forecast, Cyprus should ensure that the nominal growth rate of net primary government expenditure does not

[6] Council Recommendation of 11 July 2017 on the 2017 National Reform Programme of Cyprus and delivering a Council opinion on the 2017 Stability Programme of Cyprus, OJ C 261, 9.8.2017.

exceed 0.3 %, corresponding to a structural adjustment of 0.2 % of GDP. However, in view of the Commission 2017 autumn forecast, Cyprus would be above its MTO in 2017 and in line with the arrangements in place for updating the fiscal requirements contained in the country-specific recommendations[7], the nominal growth rate of net primary government expenditure should not exceed 1.9%, corresponding to an allowed deterioration in the structural balance by 0.4% of GDP.

4.1. Compliance with the debt criterion

After it corrected its excessive deficit in 2015, Cyprus is in the transition period for the following three years (until 2018) to make sufficient progress towards compliance with the debt reduction benchmark. This implies that, during this period, it is required to make sufficient progress (as defined by the minimum linear structural adjustment (MLSA)) towards compliance with the debt reduction benchmark at the end of the transition period.

Cyprus is in a transition period and based on an overall assessment of the DBP, Cyprus is expected to make sufficient progress towards compliance with the debt reduction benchmark in both 2017 and 2018. A similar assessment stems from the Commission 2017 autumn forecast. In particular, Cyprus is projected to be compliant with the required MLSA in 2017 (-0.7% of GDP vis-à-vis the required -1.8% of GDP) and 2018 (-0.4% of GDP vis-à-vis the required -3.6% of GDP). The expected decline in Cyprus' debt-to-GDP ratio mostly owes to the more favourable path of the general government balance, of real GDP growth and a pick-up in inflation.

Table 5. Compliance with the debt criterion

	2016	2017			2018		
		SP	DBP	COM	SP	DBP	COM
Gross debt ratio	107.1	104.0	99.0	103.0	99.7	92.4	98.3
Gap to the debt benchmark [1,2]							
Structural adjustment [3]	-0.5	-1.5	-0.7	-0.7	-0.7	-0.6	-0.4
To be compared to:							
Required adjustment [4]		-2.5		-1.8	-4.1		-3.6

Notes:

[1] Not relevant for Member Sates that were subject to an EDP procedure in November 2011 and for a period of three years following the correction of the excessive deficit.

[2] Shows the difference between the debt-to-GDP ratio and the debt benchmark. If positive, projected gross debt-to-GDP ratio does not comply with the debt reduction benchmark.

[3] Applicable only during the transition period of three years from the correction of the excessive deficit for EDP that were ongoing in November 2011.

[4] Defines the remaining minimum annual structural adjustment over the transition period which ensures that – if followed – Member State will comply with the debt reduction benchmark at the end of the transition period, assuming that COM (SP) budgetary projections for the previous years are achieved.

Source:

Stability Programme 2017 (SP); Draft Budgetary Plan for 2018 (DBP); Commission 2017 autumn forecast (COM); Commission calculations

[7] These arrangements, known as the 'unfreezing' principle, are referred to in the Opinion of the Economic and Financial Committee of the Council on "Improving the predictability and transparency of the SGP: A stronger focus on the expenditure benchmark in the preventive arm", of 29 November 2016, and have been specified further in subsequent discussions with the Member States.

4.2. Compliance with the MTO

In 2017, according to the information provided in the DBP, the expenditure benchmark points to a risk of significant deviation, while the structural balance points to compliance. The growth rate of net primary government expenditure is expected to exceed the applicable (real) benchmark rate (of 2.4%) leading to a deviation of 1.4% of GDP. However, the reading of the fiscal effort based on the expenditure benchmark is negatively impacted by the use of a medium-term potential GDP growth rate that reflects the negative growth rates in previous years due to the economic crisis and, therefore, it is deemed to underestimate Cyprus' underlying fiscal effort. The recalculated structural balance is estimated to exceed its MTO by 0.3% of GDP, albeit deteriorating by 0.7 percentage points from the previous year. However, the structural balance is positively impacted by sizeable revenue windfalls (0.9% of GDP) and negatively by the rise in nationally financed public investments (0.1% of GDP), thus pointing to a risk of some deviation from the requirements. The revenue windfalls mainly relate to high revenue buoyancy, underpinned by the favourable macroeconomic situation and the positive developments in the labour market. Taking into account the above-mentioned factors, the expenditure benchmark points to a risk of significant deviation and the structural balance to a risk of some deviation. Thus, the overall assessment points to a risk of significant deviation in 2017 based on the expenditure benchmark and therefore expenditure developments should be monitored very closely.

Based on the Commission 2017 autumn forecast, the expenditure benchmark points to a risk of significant deviation (deviation of 1.1% of GDP). However, the benchmark rate reflects the negative potential growth rates due to the economic crisis in previous years and, therefore, it is deemed to underestimate the relevant medium-term potential growth rate at the current juncture. Furthermore, the expenditure benchmark is negatively impacted by the difference in deflators, with actual inflation turning out to be higher than the one assumed initially. Given that the inflation rise is impacting only some expenditure items, such as intermediate consumption, the expenditure benchmark reading is expected to be only partly affected by this development. Taking into account the above-mentioned factors, the expenditure benchmark points to a risk of some deviation. Cyprus is expected to remain above its MTO in 2017, with the structural balance at 0.4% of GDP. However, the structural balance is positively impacted by significant revenue windfalls (0.7% of GDP) and negatively by the rise in nationally financed public investments (0.1% of GDP), thus pointing to a risk of some deviation. All in all, the overall assessment confirms that some deviation from the adjustment path towards the MTO is to be expected for Cyprus in 2017.

The overall assessment is better in the Commission 2017 autumn forecast, compared to the assessment based on the 2018 DBP. In particular, the improved expenditure benchmark position in the Commission 2017 autumn forecast is explained by different expenditure projections, i.e. different estimates for specific expenditure items (see section 3.1) as well as distinct growth projections.

In 2018, according to the information provided in the DBP, the nominal growth of net primary government expenditure is expected to exceed the expenditure benchmark[8] reference rate of 1.9% (deviation of 0.5% of GDP), pointing to a risk of significant deviation. The recalculated

[8] As part of the agreement on the EFC Opinion on "Improving the predictability and transparency the SGP: a stronger focus on the expenditure benchmark in the preventive arm", which was adopted by the EFC on 29 November 2016, the expenditure benchmark, that is the maximum allowable growth rate of expenditure net of discretionary revenue measures, is expressed in nominal terms as from 2018.

structural balance is expected to deviate by 0.2% of GDP from the required adjustment, moving away from the MTO and pointing to a risk of some deviation. This calls for an overall assessment. On the one hand, the reading of the fiscal effort based on the expenditure benchmark pillar is negatively impacted by the use of a medium-term potential GDP growth rate that reflects the negative growth rates in previous years due to the economic crisis and, therefore, it is considered to underestimate Cyprus' underlying fiscal effort. On the other hand, the structural balance pillar is negatively impacted by revenue shortfalls (0.2% of GDP) and interest rates expenditure (0.1% of GDP), and positively by the fall of nationally-financed public investment (0.2% of GDP). After taking into account the above-mentioned factors, both the expenditure benchmark and the structural balance are expected to point to a risk of some deviation in 2018.

Based on the Commission 2017 autumn forecast, the expenditure benchmark points to a risk of significant deviation (deviation of 0.6% of GDP) in 2018. The structural balance is expected to deteriorate and be slightly below the MTO of a balanced position, pointing to a risk of some deviation (deviation of 0.1% of GDP). This calls for an overall assessment. The expenditure benchmark is negatively impacted by the negative potential growth rates, which underestimate the relevant medium-term potential growth rate at the current juncture. The structural pillar is negatively impacted by revenue shortfalls (0.3% of GDP) and positively by a fall of nationally-financed public investments (0.2% of GDP) and interest rate expenditure (0.1% of GDP). All in all, the overall assessment confirms that Cyprus is expected to be at risk of some deviation in 2018.

For the years 2017 and 2018 together, based on the information provided in the DBP, the expenditure benchmark points to a risk of significant deviation (deviation of 1.0% of GDP), while the recalculated structural balance is expected to reach a balanced position in line with the MTO. Similarly, based on the Commission 2017 autumn forecast, the expenditure benchmark points to a risk of significant deviation (deviation of 0.9% of GDP), while the structural balance is projected at 0.1% of GDP. Therefore, an overall assessment has to be carried out. Based on the information provided in the DBP, and taking into account the differences in potential growth rates, revenue windfalls and shortfalls, as well as dynamics of investment and interest expenditures impacting on 2017 and 2018, both the expenditure benchmark and the structural balance pillars point to a risk of significant deviation over the years 2017 and 2018 together following an overall assessment. Based on the Commission 2017 autumn forecast, and notably taking into account the above-mentioned differences in potential growth rates, deflators, revenue windfalls and shortfalls, as well as dynamics of investment and interest expenditures impacting on both 2017 and 2018, the overall assessment points to a risk of some deviation from the adjustment path towards the MTO for Cyprus over the years 2017 and 2018 together.

Overall, the structural balance suggests that Cyprus is above its MTO in 2017 and almost at its MTO in 2018. However, in 2017, the structural balance is improved by significant revenue windfalls, in the absence of which the MTO would not be achieved. Therefore, expenditure developments should be monitored very carefully in the short and medium term, especially due to the risks associated with increases in expenditure financed by temporary revenue windfalls. Experience suggests that a build-up of additional expenditure financed by such windfalls is very difficult and costly to revert.

Box 3. Implementation of the "constrained judgement" approach and its impact on fiscal surveillance

The April 2016 Amsterdam Informal ECOFIN Council requested that improvements be made to the commonly agreed methodology for the estimation of potential growth and the output gap. In response, it was agreed, alongside a revision of the methodology for the estimation of the non-accelerating wage rate of unemployment, to introduce a "constrained judgement" approach for cases where the commonly agreed methodology appears to produce "counterintuitive" output gap results for individual Member States. This has already been implemented in the assessment of the 2017 Draft Budgetary Plans and the 2017 Stability and Convergence Programmes.

The objective of the "constrained judgement" approach is to have a transparent and economically grounded tool to statistically test the plausibility of the output gap estimates for individual Member States estimated on the basis of the common method. To this end, the Commission developed an objective screening tool - based on a set of cyclically relevant indicators as well as thresholds/ranges - to signal cases when the outcomes of the commonly agreed methodology could be interpreted as being subject to a large degree of uncertainty and therefore deserving of further investigation on the part of the Commission. If this plausibility tool flags the estimate of a Member State's output gap using the common methodology, the Commission carries out an "in depth" analysis which could lead to the application of a "constrained" degree of judgement in conducting Member States' budgetary assessments.

For Cyprus, the plausibility tool provided indications that the output gap estimated for 2017 at 1.3% on the basis of the commonly agreed methodology may be counterintuitive as it compares with lower values of 0.3% estimated on the basis of this tool. The IMF estimate for the output gap in Cyprus is of -2.0%. The estimation of the output gap in Cyprus is surrounded by a larger-than-usual degree of uncertainty, due to recent financial crisis and ensuing deep recession, combined with a strong cyclical recovery. Lower labour market participation, a higher structural unemployment rate and subdued investment are the factors that have led to low potential growth estimates. These specific features of Cyprus' economy are not taken into account by the plausibility tool and therefore its application to Cyprus seems not appropriate.

In light of the uncertainty surrounding the estimation of the level of the output gap for Cyprus, there does not seem to be sufficient ground to deviate from the output gap estimated on the basis of the commonly agreed methodology.

Table 6: Compliance with the requirements of the preventive arm

(% of GDP)	2016	2017		2018	
Initial position[1]					
Medium-term objective (MTO)	0.0	0.0		0.0	
Structural balance[2] (COM)	1.1	0.4		0.0	
Structural balance based on freezing (COM)	1.0	0.4		-	
Position vis-a -vis the MTO[3]	At or above the MTO	At or above the MTO		At or above the MTO	
(% of GDP)	**2016**	**2017**		**2018**	
	COM	**DBP**	**COM**	**DBP**	**COM**
Structural balance pillar					
Required adjustment[4]	Compliance	0.0		0.0	
Required adjustment corrected[5]		-1.0		-0.4	
Change in structural balance[6]		-0.7	-0.7	-0.6	-0.4
One-year deviation from the required adjustment [7]		0.3	0.4	-0.2	-0.1
Two-year average deviation from the required adjustment [7]		0.7	0.8	0.0	0.1
Expenditure benchmark pillar					
Applicable reference rate[8]		2.4		1.9	
One-year deviation adjusted for one-offs [9]		-1.4	-1.1	-0.5	-0.6
Two-year average deviation adjusted for one-offs [9]		0.2	0.4	-1.0	-0.9
PER MEMORIAM: One-year deviation [10]		-1.4	-1.1	-0.5	-0.6
PER MEMORIAM: Two-year average deviation [10]		0.7	0.8	-0.9	-0.8
Conclusion					
Conclusion over one year	Compliance	Overall assessment	Overall assessment	Overall assessment	Overall assessment
Conclusion over two years	Compliance	Compliance	Compliance	Overall assessment	Overall assessment

Notes

[1] The most favourable level of the structural balance, measured as a percentage of GDP reached at the end of year t-1, between spring forecast (t-1) and the latest forecast, determines whether there is a need to adjust towards the MTO or not in year t. A margin of 0.25 percentage points (p.p.) is allowed in order to be evaluated as having reached the MTO.

[2] Structural balance = cyclically-adjusted government balance excluding one-off measures.

[3] Based on the relevant structural balance at year t-1.

[4] Based on the position vis-à-vis the MTO, the cyclical position and the debt level (See European Commission: Vade mecum on the Stability and Growth Pact, page 38.).

[5] Required adjustment corrected for the clauses, the possible margin to the MTO and the allowed deviation in case of overachievers.

[6] Change in the structural balance compared to year t-1. Ex post assessment (for 2016) was carried out on the basis of Commission 2017 spring forecast.

[7] The difference of the change in the structural balance and the corrected required adjustment.

[8] Reference medium-term rate of potential GDP growth. The (standard) reference rate applies from year t+1, if the country has reached its MTO in year t. A corrected rate applies as long as the country is adjusting towards its MTO, including in year t.

[9] Deviation of the growth rate of public expenditure net of discretionary revenue measures, revenue increases mandated by law and one-offs from the applicable reference rate in terms of the effect on the structural balance. The expenditure aggregate used for the expenditure benchmark is obtained following the commonly agreed methodology. A negative sign implies that expenditure growth exceeds the applicable reference rate.

[10] Deviation of the growth rate of public expenditure net of discretionary revenue measures and revenue increases mandated by law from the applicable reference rate in terms of the effect on the structural balance. The expenditure aggregate used for the expenditure benchmark is obtained following the commonly agreed methodology. A negative sign implies that expenditure growth exceeds the applicable reference rate.

Source :

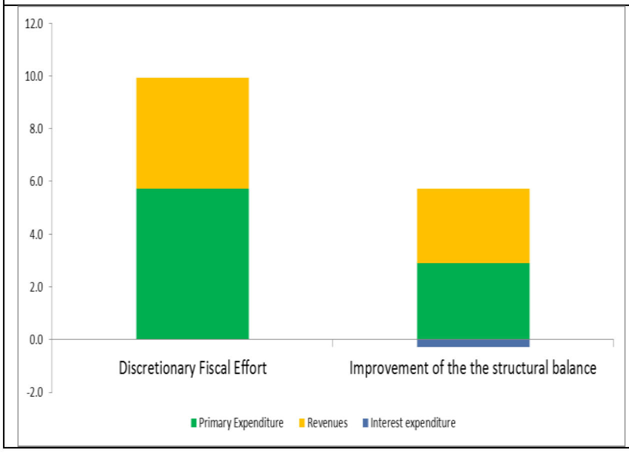
Draft Budgetary Plan for 2018 (DBP); Commission 2017 autumn forecast (COM); Commission calculations.

5. COMPOSITION OF PUBLIC FINANCES AND IMPLEMENTATION OF FISCAL STRUCTURAL REFORMS

The nominal adjustment projected by the DBP in 2018 is driven by a stronger decline in expenditure, with expenditure expected to decline by 0.4 percentage points and revenue by 0.1 percentage points (to 38.6% and 39.9% of GDP in 2018, respectively). Over a longer horizon 2011-2018, the projected improvement of the structural balance is driven in a relatively balanced way by the increase in revenue and the decline in expenditure, mainly due to the policy decisions taken concerning fiscal consolidation during the crisis.

Based on the DBP projections, in 2018 public investment is expected to increase marginally to 2.8% of GDP from 2.7% in 2017, still 0.9 percentage points below the share of public investment in 2011. Expenditure on public wages is expected to remain below the level recorded in 2011 (by 2.3 percentage points) as a result of the public administration measures implemented by the government. However, social spending had an increasing trend compared to 2011 due to the cyclical conditions in the first years of the period of consideration and the introduction of the guaranteed minimum income (GMI), which allows for more efficient and targeted social benefits, in the later years.

Graph 1: Composition of the fiscal effort (2011-2017), Cyprus (% GDP)



Graph 2: Change in the share in total expenditure of selected expenditure items (2011-2017), Cyprus (% change)

Source:

Draft Budgetary Plans 2018, European Commission 2017 autumn forecast. The Discretionary Fiscal Effort (DFE) combines a top-down approach on the expenditure side with a bottom-up or narrative approach on the revenue side. In a nutshell, the DFE consists of the increase in primary expenditure net of cyclical components relative to economic potential on the one hand, and of discretionary revenue measures on the other hand. See European Commission (2013): Measuring the fiscal effort, Report on Public Finances in EMU, part 3 http://ec.europa.eu/economy_finance/publications/european_economy/2013/pdf/ee-2013-4.pdf.

Taxes on labour and on income of corporations in Cyprus are among the lowest in the EU. Given that these taxes are the most distortionary ones, the tax structure in Cyprus is less detrimental to growth. At the same time, a significant share of corporate tax revenue stems from Cyprus' ability to attract companies setting up business, partly due to its favourable tax regime. However, Cyprus decided in 2016 to eliminate the tax on immovable property, with full effect from 2017 onwards. This represents a setback, as it narrowed the tax base and reduced the fiscal space for financing additional growth enhancing reforms or consolidating the social welfare and safety net.

In the context of the 2017 European Semester, Cyprus was issued the country-specific recommendation to adopt key legislative reforms aiming to improve efficiency in the public sector by end of 2017, notably on the functioning of public administration, governance of State-owned entities and local governments. This country-specific recommendation relates to the structural part of the fiscal recommendations contained in the Council Recommendation of 11 July 2017.[9]

Concerning the public administration reform, the DBP mentions that in July 2017 the House of Representatives adopted a law governing the indefinite suspension of public and broader public sector hiring of new personnel, with a simultaneous introduction of a mechanism governing a procedure for exemptions. The House of Representatives also adopted a bill regarding the mobility between the public service and State-owned organisations, and among State-owned organisations in May 2017. The remaining five bills relating to the horizontal reforms have been redrafted and are expected to be submitted to the House of Representatives by the end of the year. Finally, the DBP refers to the collective agreement with the broader public sector introducing a wage-setting mechanism which contains the growth rate of public sector compensation to nominal economic growth, although this is in place until 2018 and not of a permanent nature.

Concerning the draft law on State-owned enterprises, which aims to improve their corporate governance and ensure a more effective monitoring of their functioning, its adoption has been significantly delayed at the House of Representatives since April 2015. The delay in adopting this law undermines the public sector's efficiency, by holding up the improvement of State-owned enterprises' governance and preventing the mitigation of related fiscal risks.

Concerning the reform of local governments, which aims to improve the delivery of quality local public services and enhance the processes of issuing title deeds, the set of relevant bills and regulations have only been submitted to the House of Representatives, but not adopted yet, and their implementation deadlines remain vague. The reform particularly aims at making the issuing of building permits and certificates more efficient. It also improves public financial management by addressing the current gaps in local government financial reporting with the establishing of a common accounting and reporting framework.

A comprehensive assessment of progress made in the implementation of the country-specific recommendations will be made in the 2018 Country Reports and in the context of the country-specific recommendations to be adopted by the Council in 2018.

Box 4 – Addressing the tax burden on labour in the euro area

The tax burden on labour in the euro area is relatively high, which weighs on economic activity and employment. Against this background, the Eurogroup has expressed a commitment to reduce the tax burden on labour. On 12 September 2015, the Eurogroup agreed to benchmark euro area Member States' tax burden on labour against the GDP-weighted EU average, relying in the first instance on indicators measuring the tax wedge on labour for a single worker at average wage and a single worker at low wage. It also agreed to relate these numbers to the OECD average for purposes of broader comparability.

The tax wedge on labour measures the difference between the total labour costs to employ a worker and the worker's net earnings. It is made up of personal income taxes and employer and employee social security contributions. The higher the tax wedge, the higher the disincentives to take up work or

[9] Council Recommendation of 11 July 2017 on the 2017 National Reform Programme of Cyprus and delivering a Council opinion on the 2017 Stability Programme of Cyprus, OJ C 261, 9.8.2017.

hire new staff. Benchmarking is only the first step in the process towards firm, country-specific policy conclusions. The tax burden on labour interacts with a wide variety of other policy elements such as the benefit system and the wage-setting system. A good employment performance indicates that the need to reduce labour taxation may be less urgent while fiscal constraints can dictate that labour tax cuts should be fully offset by other revenue-enhancing or expenditure-reducing measures. In-depth, country-specific analysis is necessary before drawing policy conclusions.

Cyprus' Draft Budgetary Plan does not include any measures that affect the tax wedge on labour.

6. OVERALL CONCLUSION

Based on the Commission 2017 autumn forecast, the structural position in 2017 and 2018 is projected to be compliant with the minimum linear structural adjustment to ensure sufficient progress towards compliance with the debt criterion.

The structural balance is expected to exceed the MTO in 2017 and to be almost at the MTO in 2018. Following an overall assessment based on the DBP, the planned structural adjustment points to a risk of significant deviation in 2017 based on the expenditure benchmark. Therefore, expenditure developments should be carefully monitored. The overall assessment based on the DBP points to a risk of some deviation in 2018 and of significant deviation over 2017 and 2018 taken together. Following an overall assessment based on the Commission 2017 autumn forecast, there is a risk of some deviation from the adjustment path towards the MTO in 2017, in 2018, as well as over 2017 and 2018 taken together.