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**COMMISSION STAFF WORKING DOCUMENT**

**Analysis of the Draft Budgetary Plan of Cyprus**

*Accompanying the document*

**COMMISSION OPINION**

**on the Draft Budgetary Plan of Cyprus**

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# 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 for 2020 on 15 October 2019 in compliance with Regulation (EU) No 473/2013. 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. Following the end of the transition period in 2018, during which Cyprus was subject to the transitional arrangement to make sufficient progress towards compliance with the debt reduction benchmark, Cyprus needs to comply with the debt reduction benchmark as the debt ratio is projected to be 93.8% of GDP, exceeding the 60% of GDP reference value of the Treaty.

Section 2 of this document presents the macroeconomic outlook underlying the Draft Budgetary Plan and provides an assessment based on the Commission 2019 autumn forecast. The following section presents the recent and planned fiscal developments, according to the Draft Budgetary Plan, including an analysis of risks to their achievement based on the Commission 2019 autumn forecast. Section 4 assesses the recent and planned fiscal developments in 2019-2020 (also taking into account the risks to their achievement) against the obligations stemming from the Stability and Growth Pact. Section 5 provides an analysis of implementation of fiscal-structural reforms in response to the latest country-specific recommendations in the context of the European Semester adopted by the Council in July 2019, including those to reduce 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 4.1% in real terms in 2018, revised up from 3.9% in the 2019 Stability Programme due to the benchmarking exercise.<sup>1</sup> Real GDP growth for 2017 has also been revised up by 0.2 percentage points to 4.4%, while for 2016 by 1.9 percentage points to 6.7%. It is important to note that in contrast to the Commission 2019 autumn forecast, the macroeconomic scenario underlying the Draft Budgetary Plan has not taken into account the historically revised data, thus making the two scenarios not fully comparable.

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<sup>1</sup> The national accounts data used in the Commission 2019 autumn forecast are based on a benchmark revision, as published in October 2019, after the 2020 Draft Budgetary Plan cut-off date chosen by the authorities of 16 September 2019. Therefore, the nominal GDP for 2018 in the Commission forecast amounts to EUR 21,138 billion compared to EUR 20,731 billion in the Draft Budgetary Plan. GDP figures in 2018 are thus approximately 2 % higher than the Draft Budgetary Plan.

The macroeconomic scenario underlying the Draft Budgetary Plan projects a continuously strong expansion, albeit somewhat decelerating, with real GDP growth at 3.2% in 2019 and 2.9% in 2020. Growth is forecast to be driven mainly by private consumption and investment in both years, while net exports are expected to weigh down on growth in 2019 and to slightly recover in 2020. Public consumption has also a positive contribution in both years, due to expenses related to the introduction of the National Health Insurance System. Compared to the 2019 Stability Programme, real GDP growth in the Draft Budgetary Plan is revised down by 0.4 percentage points for 2019 and 0.3 percentage points for 2020, after the slowdown exhibited in the first half of 2019.

The 2019-2020 projections underlying the Draft Budgetary Plan are slightly higher (+0.3 percentage points for 2019 and 2020) than the Commission 2019 autumn forecast. The Draft Budgetary Plan and the Commission 2019 autumn forecast both project real growth to be driven by domestic demand, with the Draft Budgetary Plan reflecting slightly higher projections on investment and exports. The views diverge on performance of exports, where the Commission forecast is lower for both years, due to downside risks for exports of tourism services (some of which have already materialised in 2019). The Commission 2019 autumn forecast reflects a more conservative assessment of net exports performance, also due to a substantial import content in domestic demand.

**Table 1. Comparison of macroeconomic developments and forecasts**

	2018	2019			2020		
	COM	SP	DBP	COM	SP	DBP	COM
Real GDP (% change)	4,1	3,6	3,2	2,9	3,2	2,9	2,6
Private consumption (% change)	3,3	3,3	4,0	3,8	2,8	2,8	2,7
Gross fixed capital formation (% change)	-6,6	9,4	19,8	14,7	7,8	10,7	8,3
Exports of goods and services (% change)	4,6	2,7	-1,5	-2,5	2,4	0,8	-1,3
Imports of goods and services (% change)	2,4	4,0	6,1	2,6	3,4	4,6	2,5
<i>Contributions to real GDP growth:</i>							
- Final domestic demand	1,3	4,6	8,2	6,6	4,0	5,6	5,4
- Change in inventories	1,2	0,0	0,0	0,0	0,0	0,0	0,0
- Net exports	1,6	-1,0	-5,0	-3,7	-0,8	-2,7	-2,8
Output gap <sup>1</sup>	3,4	3,0	4,2	3,9	3,1	4,6	4,0
Employment (% change)	4,1	3,5	3,0	2,5	3,0	2,7	2,2
Unemployment rate (%)	8,4	7,0	7,0	7,2	6,0	6,0	6,3
Labour productivity (% change)	0,0	0,1	0,2	0,4	0,2	0,2	0,5
HICP inflation (%)	0,8	0,5	0,5	0,6	1,2	1,2	0,7
GDP deflator (% change)	1,4	1,0	0,4	1,5	1,2	1,2	1,5
Comp. of employees (per head, % change)	0,5	0,5	3,5	3,4	1,3	3,3	3,1
Net lending/borrowing vis-à-vis the rest of	-3,8	-7,8	-10,8	-7,1	-8,2	-12,4	-9,9

Note:

<sup>1</sup>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 2019 (SP); Draft Budgetary Plan for 2020 (DBP); Commission 2019 autumn forecast (COM); Commission calculations

The inflation rate is nearly identical for 2019, with the Draft Budgetary Plan projection at 0.5% and the Commission forecast at 0.6%. The Draft Budgetary Plan expects inflation to increase to 1.2% in 2020, while the Commission projects it to be largely unchanged (0.7%) due to the expected decrease of energy prices. Regarding unemployment rate, the projections of the Commission are slightly higher than the Draft Budgetary Plan reflecting the corresponding differences in the projections of the economic growth. In the Draft Budgetary Plan, unemployment is projected to fall to 7% and in the Commission forecast to 7.2% for 2019, whereas for 2020, it is expected to drop to 6% and 6.3% respectively.

The output gap<sup>2</sup>, as recalculated by the Commission based on the information in the Draft Budgetary Plan and according to the commonly agreed methodology (recalculated output gap), is expected to reach 4.2% of potential output in 2019 and 4.6% in 2020, as real GDP growth is forecast to outpace potential growth. The Commission 2019 autumn forecast envisages a broadly similar output gap estimate of 3.9% in 2019 and a slightly lower output gap of 4% in 2019.

Overall, the Draft Budgetary Plan presents plausible macroeconomic assumptions for both 2019 and 2020, with the Draft Budgetary Plan projections being slightly higher than the Commission's forecast. The risks associated with the macroeconomic assumptions presented in the Draft Budgetary Plan are tilted to the downside stemming mainly from the domestic environment and in particular the developments in the financial sector. The still high percentage of non-performing loans, compared to the EU average, is the remaining legacy challenge facing the banking sector. The Draft Budgetary Plan highlights also budgetary risks that can destabilize the economy. These are related to contingent liabilities that may arise from judicial cases pending before the courts<sup>3</sup> regarding the wages' and pensions' cuts during the crisis. The most important external risk is also tilted on the downside and concerns the uncertainty about the timing and manner of exit of the United Kingdom from the EU and associated repercussions on the United Kingdom's economy. Other external risks are concentrated on the relatively volatile global economic environment, due to the continuing tension in trade relations and geopolitical developments in the surrounding Eastern Mediterranean region, including migration issues and the slowdown of the growth of the EU and Eurozone economies. The Commission also considers the over-reliance on the construction investment financed through the citizenship-by-investment scheme to be also a source of vulnerability that exposes the economy to adverse external developments. Furthermore, the persisting air travel problems and increasing competition from neighbouring tourist destinations may have a negative impact on the growth trajectory. Upside risks are mainly related to higher investment.

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<sup>2</sup> 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.

<sup>3</sup> Supreme court's imminent rulings on the appeals submitted by the Republic on the administration court's ruling that the reduction of salaries and pensions of public service officials, employers and pensioners of the public sector law of 2012 (168 (I) / 2012) was unconstitutional.

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

The macroeconomic forecast underpinning the Draft Budgetary Plan was endorsed by the independent Fiscal Council, as recalled in the Draft Budgetary Plan document. The draft 2020 budget document, including the official forecast, was submitted to the Fiscal Council on 23 September 2019. On 30 September 2019, the Council published a press statement<sup>4</sup> announcing the endorsement by concluding that the projections for macroeconomic variables as prepared by the Ministry of Finance was “*within acceptable limits*”.

The Council's 2019 autumn report<sup>5</sup> presented a detailed comparative analysis covering risks to the official macroeconomic scenario as well as other fiscal challenges. As regards economic risks, the Council specifically pointed to the deterioration in the external environment, the aftershocks of the Thomas Cook bankruptcy to the tourism sector, the remaining vulnerabilities stemming from the high ratio of public and private debt, as well as the stock of non-performing loans in the banking sector. The report also listed some fiscal risks, such as the overdependence on the ‘citizenship for investment’ scheme. It also emphasised risks beyond the upcoming court decision on wage cuts in the public sector, e.g. those relate to the launch of the new National Health System.

## **3. RECENT AND PLANNED FISCAL DEVELOPMENTS**

### **3.1. Deficit developments**

The Draft Budgetary Plan projects a general government headline surplus of 3.8% of GDP in 2019, a significant upward revision compared to the 3.0% of GDP target in the 2019 Stability Programme. The target revenue-to-GDP ratio is revised upward to 42.3% (by 1.6 percentage points of GDP). The expenditure-to-GDP ratio target is revised up to 38.4% in 2019 (by 0.7%)<sup>6</sup>. The improvement of the headline surplus by 0.8 percentage points compared to the 2019 Stability Programme is explained by stronger-than-expected revenue collection from taxes on production and exports (by 0.5% of GDP) and current taxes on income and wealth (by 0.5 % of GDP) due to the favourable labour market developments and the higher profitability of companies. In addition, the newly introduced National Health Insurance System is expected to record a surplus of 0.5 % of GDP as spending did not increase in the same proportion as social contributions<sup>7</sup>. This surplus was not foreseen in the more conservative assumption made in the 2019 Stability Programme. On the spending side, the

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<http://www.fiscalcouncil.gov.cy/fiscalcouncil/fiscalcouncil.nsf/All/D489DBA3BDECF6C5C225849A003E32F1?OpenDocument>

5 Autumn report 2019, Fiscal Council (2019).

6 The marked upward revision for revenues and expenditure is largely caused by changes in the statistical treatment of government’s contribution to NHS as third party. In the 2020 Stability Programme, government’s contributions as a third party were recorded in a consolidated way as current transfers within the general government. The new classification in the Draft Budgetary Plan is no longer consolidated and leads according to the authorities to an increase in social contributions and social benefit spending by 0.6 % of GDP in 2019 and 2.4 % of GDP in 2020. This change has no effect on the headline budget balance.

7 In the 2020 Stability Programme, the Health Insurance Organisation was assumed to have a fiscally neutral effect in 2019, despite the fact that increased contributions were to be collected earlier (in March) than the first welfare benefit payments in June 2019. This 3-month time lag resulted in the current surplus.

target for compensation of employees increased by 0.4% of GDP, whereas an upward revision of other spending by 0,4% of GDP was partially compensated by a decline in projected public investment (by 0.2% GDP).

The headline surplus projection for 2019 in the Draft Budgetary Plan is marginally above that of the Commission 2019 autumn forecast, which projects a surplus of 3.7% of GDP (0.1% lower than in the Draft Budgetary Plan). The Commission 2019 autumn forecast projects slightly lower revenues (0.7 % of GDP) and expenditure (0.5% of GDP) than the Draft Budgetary Plan, mainly reflecting differences in the values of the denominators<sup>8</sup>.

**Table 2. Composition of the budgetary adjustment**

(% of GDP)	2018		2019			2020			Change: 2018-2020
	COM	DBP	SP	DBP	COM	SP	DBP	COM	DBP
<b>Revenue</b>	<b>39,2</b>	<b>39,2</b>	<b>40,7</b>	<b>42,3</b>	<b>41,6</b>	<b>40,9</b>	<b>44,6</b>	<b>44,0</b>	<b>5,4</b>
<i>of which:</i>									
- Taxes on production and imports	15,7	15,7	15,2	15,7	15,4	15,0	15,5	15,3	-0,2
- Current taxes on income, wealth,	9,1	9,1	9,2	9,7	9,5	9,2	9,7	9,5	0,6
- Capital taxes	0,0	0,0	0,0	0,0	0,0	0,0	0,0	0,0	0,0
- Social contributions	8,7	8,7	10,9	11,5	11,2	12,1	14,6	14,2	5,9
- Other (residual)	5,6	5,6	5,4	5,4	5,6	4,6	4,8	5,1	-0,8
<b>Expenditure</b>	<b>43,6</b>	<b>43,6</b>	<b>37,7</b>	<b>38,4</b>	<b>37,9</b>	<b>38,3</b>	<b>42,0</b>	<b>41,4</b>	<b>-1,6</b>
<i>of which:</i>									
- Primary expenditure	41,2	41,2	35,4	36,1	35,6	36,1	39,6	39,4	-1,6
<i>of which:</i>									
Compensation of employees	11,7	11,7	12,1	12,5	12,4	12,4	12,9	12,9	1,2
Intermediate consumption	3,8	3,8	4,0	4,1	4,0	3,7	3,9	3,9	0,1
Social payments	12,8	12,8	14,4	14,4	14,1	15,4	17,8	17,5	5,0
Subsidies	0,3	0,3	0,3	0,3	0,3	0,3	0,3	0,3	0,0
Gross fixed capital formation	5,7	5,7	2,1	1,9	2,1	2,0	1,9	2,1	-3,8
Other (residual)	6,8	6,8	2,5	2,9	2,8	2,3	2,8	2,8	-4,0
- Interest expenditure	2,4	2,4	2,3	2,3	2,3	2,2	2,4	2,0	0,0
<b>General government balance (GGB)</b>	<b>-4,4</b>	<b>-4,4</b>	<b>3,0</b>	<b>3,8</b>	<b>3,7</b>	<b>2,6</b>	<b>2,7</b>	<b>2,6</b>	<b>7,1</b>
<b>Primary balance</b>	<b>-2,0</b>	<b>-2,0</b>	<b>5,3</b>	<b>6,2</b>	<b>6,0</b>	<b>4,8</b>	<b>5,1</b>	<b>4,6</b>	<b>7,1</b>
One-off and other temporary measures	-8,0	-8,0	0,0	0,0	0,0	0,0	0,0	0,0	8,0
<b>GGB excl. one-offs</b>	<b>3,6</b>	<b>3,6</b>	<b>3,0</b>	<b>3,8</b>	<b>3,7</b>	<b>2,6</b>	<b>2,7</b>	<b>2,6</b>	<b>-0,9</b>
Output gap <sup>1</sup>	3,4	3,3	3,0	4,2	3,9	3,1	4,6	4,0	1,3
Cyclically-adjusted balance <sup>1</sup>	-6,1	-6,0	1,5	1,7	1,7	1,0	0,4	0,6	6,5
<b>Structural balance (SB)<sup>2</sup></b>	<b>1,9</b>	<b>2,0</b>	<b>1,5</b>	<b>1,7</b>	<b>1,7</b>	<b>1,0</b>	<b>0,4</b>	<b>0,6</b>	<b>-1,5</b>
<b>Structural primary balance<sup>2</sup></b>	<b>4,3</b>	<b>4,4</b>	<b>3,8</b>	<b>4,0</b>	<b>4,0</b>	<b>3,2</b>	<b>2,8</b>	<b>2,6</b>	<b>-1,6</b>

Notes:

<sup>1</sup> 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.

<sup>2</sup> Structural (primary) balance corresponds to cyclically-adjusted (primary) balance excluding one-off and other temporary measures.

Source:

Stability Programme 2019 (SP); Draft Budgetary Plan for 2020 (DBP); Commission 2019 autumn forecast (COM); Commission calculations

<sup>8</sup> The Commission 2019 autumn forecast does not use the same series of nominal GDP as denominator compared to the data reported in the Draft Budgetary Plan. The Commission's forecast uses a higher nominal GDP realised in 2018, in line with the revision of national accounts published on October 2019, unlike the Draft Budgetary Plan. For further details, see footnote 1.

In 2020, the Draft Budgetary Plan projects a general government headline surplus of 2.7% of GDP, an upward revision of 0.1 percentage points compared to the 2020 Stability Programme. The Draft Budgetary Plan maintains the assumption made in the 2020 Stability Programme of a fiscal neutral impact of KEDIPES and of the National Health Insurance System in 2020 despite the surpluses recorded in 2019. Total expenditure is expected to increase from 38.4% of GDP in 2019 to 42% in 2020, at a slightly faster pace than the growth in total revenue (by 0.3 % of GDP). On the revenue side, the Draft Budgetary Plan expects an increase from 42.3% to 44.6 % of GDP. The higher expenditure is mainly explained by the increase in compensation of employees (partly due to the gradual public sector pay rise), higher social payments related to the roll out of the second stage of the introduction of National Health Insurance System, and the ESTIA scheme. The latter is a state subsidy aimed to reduce the level of non-performing loans with primary residence as collateral. On the revenue side, social contributions are expected to increase markedly again as social contributions rates will rise, whereas the growth of tax collection is expected to remain strong.

The Commission 2019 autumn forecast projects the general government headline surplus at 2.6% of GDP in 2020, broadly in line with the Draft Budgetary Plan projection. Although the projected budgetary developments are similar, the Commission 2019 autumn forecast projects slightly higher increases in both revenues and expenditures than the Draft Budgetary Plan. On the expenditure side, the Commission 2019 autumn forecast uses more conservative assumptions on the growth of compensation of employees and gross fixed capital formation, whereas it expects lower interest expenditure. On the revenue side, the Commission autumn forecast 2019 expects slightly higher growth of revenues from tax on production and imports and current tax on income and wealth compared to 2019, based on the track record of significantly higher-than-expected revenue collection in recent years.

Risks to the budgetary targets are tilted to the downside. Public finances remain exposed to implicit contingent liabilities related to the declining but high share of non-performing loans in the banking sector, as well as to explicit contingent liabilities related to state-owned enterprises and guarantees (asset protection scheme) created in the context of the sale of the Cyprus Cooperative Bank. The government commitment to bridge potential financial losses during the 2020-2025 transitory period for the establishment of the financial and operational autonomy of public hospitals could lead to additional spending while the overall financial sustainability of the National Health Insurance System remains uncertain. In the absence of a permanent mechanism that regulates growth of the public sector wage bill, risks of fiscal slippages persist. Moreover, the government may need to incur a large additional fiscal cost in case of an unfavourable judgment on ongoing court cases on the constitutionality of the public sector wage and benefit cuts during the crisis. On the revenue side, it is unclear to what extent the current buoyant tax revenue collection can be sustained, in particular given the weakening of the outlook for GDP and private consumption growth. In addition value-added tax is highly concentrated on a few key sectors, construction in particular, whereas corporate income tax is typically a volatile revenue source, exposed to large firms' relocation decisions. It should be noted, however, that the previous forecasts by the authorities and the Commission have proven to be more conservative than the actual fiscal outturns, partly due to higher-than-expected economic growth and the use of conservative revenue elasticities. On the positive side, the state-owned asset management company KEDIPES could generate surpluses in the upcoming years, thus providing additional fiscal resources to the state.

The Draft Budgetary Plan projects the (recalculated) structural balance<sup>9</sup> to deteriorate slightly from 1,9% in 2018 to 1.7% of GDP in 2019, an upward revision by 0.2 % of GDP compared to the 2019 Stability Programme. This improvement reflects the stronger-than-expected fiscal performance during the first nine months of the year in 2019, which led to an upward revision of the general government surplus (by 0.8 percentage points) compared to the 2019 Stability Programme. At the same time, this was partly offset by lower GDP projections that leads to a higher output gap. For 2020, the (recalculated) structural balance is expected to deteriorate to 0.4% of GDP, down from 1 % of GDP in the 2019 Stability Programme, but above the medium-term budgetary objective. The Commission 2019 autumn forecast projects broadly similar structural surpluses of 1.7% of GDP in 2019 and 0.6 % in 2020. The structural effort both in 2019 and 2020 is thus somewhat impacted by the cyclical position, with positive output gaps of 3.9% of potential GDP in 2019 and 4% in 2019.

Euro area sovereign bond yields remain at historically low levels, with 10-year rates in Cyprus currently standing at 0,48%<sup>10</sup> compared to 2.4% in November 2019. At the same time, continuous improvement in Cyprus' credit rating also contributed to lower market risk premia<sup>11</sup> whereas Cyprus' cost of servicing public debt has also been contained in recent years owing to a large share of official borrowing. Based on the information provided in the Draft Budgetary Plan, interest expenditure is expected to decline from 2.4% of GDP in 2018 to 2.3 % in 2019, well below the 3.4% recorded in 2013 at the peak of the crisis in Cyprus. For 2020, the Draft Budgetary Plan projects an increase of interest payments to 2.4% of GDP. The Commission 2019 autumn forecast projects similar interest expenditure developments in 2019 but foresees a decline in interest payments for 2020. However, the Draft Budgetary Plan does not provide sufficient information to clarify differences in underlying assumptions in 2020.

### **3.2. Debt developments**

According to notified data, public debt markedly increased to 100.6% in 2018, from 93.6% in 2017. This development was caused exclusively by the one-off government support measures for the sale and orderly winding down of the Cyprus Cooperative Bank. These measures implied EUR 3.2 billion bond issues (15.1% of GDP in 2018). Nevertheless, the debt-to-GDP ratio in 2018 increased by only 7% of GDP due to the strong underlying fiscal performance, a very favourable snowball effect supported by strong growth, and active debt management operations – all together compensating partially for the costs related to the support measures to the Cyprus Cooperative Bank.

According to the Draft Budgetary Plan,<sup>12</sup> the authorities project a decrease in the debt-to-GDP ratio in 2019 to 97.4% of GDP. The decline is projected to come on the back of large expected primary surpluses (6.2% of GDP) in 2019 and solid nominal GDP growth. For 2020, public debt is projected to decline further to 91.1% of GDP, mainly driven by a high primary surplus (5.1% of GDP) and strong nominal GDP growth. Comparing the Draft Budgetary Plan with the 2020 Stability Programme, the public debt is projected to decrease slower in

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<sup>9</sup> Cyclically adjusted balance net of one-off and temporary measures, recalculated by the Commission using the commonly agreed methodology.

<sup>10</sup> Average 10-year bond yield in September 2019. Source: Eurostat.

<sup>11</sup> The sovereign long-term credit rating of Cyprus remains at 'investment grade' by Standard & Poor, Fitch and DBRS, and at below investment grade by Moody's.

<sup>12</sup> As explained in footnote 1, it should be noted that compared to the Draft Budgetary Plan, the Commission 2019 autumn forecast uses more recent and upwardly revised data for nominal GDP, which contributed to a lower projection of the debt-to-GDP ratio.



2019 – to 97.4% of GDP versus 95.7% of GDP. This revision reflects an upward reassessment of the expected stock flow adjustment and a less favourable snowball effect driven by lower GDP growth expectations and lower expected inflation. For 2020 the Draft Budgetary Plan projection is less upbeat than the Stability Programme forecast. The decrease in the debt-to-GDP ratio is slower in the Draft Budgetary Plan reflecting a slightly higher stock flow adjustment and less favourable snowball effect, driven in turn by higher projected interest expenditures and slightly lower projected growth.

**Table 3. Debt developments**

(% of GDP)	2018	2019			2020		
		SP	DBP	COM	SP	DBP	COM
<b>Gross debt ratio<sup>1</sup></b>	<b>100,6</b>	<b>95,7</b>	<b>97,4</b>	<b>93,8</b>	<b>89,1</b>	<b>91,1</b>	<b>87,8</b>
Change in the ratio	6,7	-4,9	-3,2	-6,7	-6,6	-6,3	-6,0
Contributions <sup>2</sup> :							
<b>1. Primary balance</b>	<b>2,0</b>	<b>-5,3</b>	<b>-6,2</b>	<b>-6,0</b>	<b>-4,8</b>	<b>-5,1</b>	<b>-4,6</b>
<b>2. “Snow-ball” effect</b>	<b>-2,4</b>	<b>-2,1</b>	<b>-1,2</b>	<b>-1,9</b>	<b>-1,8</b>	<b>-1,4</b>	<b>-1,7</b>
<i>Of which:</i>							
Interest expenditure	2,4	2,3	2,3	2,3	2,2	2,4	2,0
Real growth effect	-3,6	-3,5	-3,1	-2,8	-2,9	-2,7	-2,4
Inflation effect	-1,2	-0,9	-0,4	-1,4	-1,1	-1,1	-1,3
<b>3. Stock-flow adjustment</b>	<b>7,2</b>	<b>2,5</b>	<b>4,2</b>	<b>1,2</b>	<b>0,0</b>	<b>0,2</b>	<b>0,4</b>
<i>Of which:</i>							
Cash/accruals difference		0,1	0,7		0,0	0,0	
Net accumulation of financial		0,6	1,7		0,0	0,2	
of which privatisation proceeds		0,0	0,0		0,0	0,0	
Valuation effect & residual		0,0	0,0		0,0	0,0	

Notes:

<sup>1</sup> End of period.

<sup>2</sup> 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 effects.

Source:

Stability Programme 2019 (SP); Draft Budgetary Plan for 2020 (DBP); Commission 2019 autumn forecast (COM); Commission calculations

According to the Commission 2019 autumn forecast, the public debt-to-GDP ratio is projected to decline from 100.6% of GDP in 2018 to 93.8% of GDP in 2019. The projected decline is driven by sizeable headline surpluses, a favourable interest rate-growth differential (snowball effect) supported by robust real GDP growth and active debt management. Following the issuance of three international benchmark bonds (5-year, 15-year and 30-year bonds) in early 2019, the government repaid the outstanding Russian loan (of around €1.56 billion) ahead of schedule in September 2019.

Compared to the Draft Budgetary Plan, the Commission 2019 autumn forecast expects stronger debt reduction in 2019 and a somewhat lower debt reduction in 2020. The Commission’s projections are broadly in line with the Draft Budgetary Plan, as the public debt follows a similar downward path. There are differences in the debt-to-GDP ratios for

2019 and 2020, but these are mainly driven by the fact that the authorities' forecast is not based on the 2018 notified data<sup>13</sup>. For 2019, the other relevant factors are a more favourable snowball effect and a smaller stock flow adjustment compared to the Draft Budgetary Plan. In 2020, the difference in the public debt ratios is explained by a smaller stock flow adjustment and a slightly higher projected primary balance in the Draft Budgetary Plan compared to the Commission 2019 autumn forecast. Risks to public debt as projected in the Draft Budgetary Plan are on the downside, mainly linked to the potential realisation of contingent liabilities (see section 3.1).

#### **4. COMPLIANCE WITH THE PROVISIONS OF THE STABILITY AND GROWTH PACT**

Cyprus is subject to the preventive arm of the Pact. Cyprus also needs to comply with the debt reduction benchmark.

##### **4.1. Compliance with the debt criterion**

After it corrected its excessive deficit in 2015, Cyprus was in the transition period for the following three years (until the end of 2018) to make sufficient progress towards compliance with the debt reduction benchmark. This implies that, during this period, it was required to make sufficient progress (as defined by the minimum linear structural adjustment) towards compliance with the debt reduction benchmark at the end of the transition period. As of 2019, since its debt ratio is above 60 % of GDP, Cyprus needs to comply with the debt reduction benchmark.

According to the projections provided in the Draft Budgetary Plan, Cyprus is expected to respect the debt reduction benchmark in 2019, with a negative gap to the debt benchmark of 6.8. This is broadly in line with the Commission 2019 autumn forecast, which points to a negative gap to the benchmark of 8.8.

Based on the Draft Budgetary Plan, Cyprus is also expected to respect the debt reduction benchmark in 2020, as the gap to the benchmark is projected to remain negative, at 7.1. The Commission's projections point to a similar assessment as the negative gap to the debt benchmark is forecast to be 7.4 in 2020.

Thus, based on an overall assessment of the Draft Budgetary Plan, the debt reduction benchmark is expected to be met in 2019, and to be respected in 2020.

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<sup>13</sup> As explained in footnote 1, the most recent revision notified by Eurostat re-estimated nominal GDP upward by approximately 2 percent compared to the data used in the Draft Budgetary Plan. Once recalculated with similar GDP figures, the Draft Budgetary Plan projections are significantly closer to those in the Commission 2019 autumn forecast.

**Table 4. Compliance with the debt criterion\***

	2018	2019			2020		
		SP	DBP	COM	SP	DBP	COM
<b>Gross debt ratio</b>	<b>100,6</b>	<b>95,7</b>	<b>97,4</b>	<b>93,8</b>	<b>89,1</b>	<b>91,1</b>	<b>87,8</b>
Gap to the debt benchmark <sup>1,2</sup>		-9,1	-6,8	-8,8	-8,7	-7,1	-7,4
Structural adjustment <sup>3</sup>	1,0						
<i>To be compared to:</i>							
<b>Required adjustment <sup>4</sup></b>	<b>-3,2</b>						

Notes:

<sup>1</sup> Not relevant for Member States that were subject to an EDP procedure in November 2011 and for a period of three years following the correction of the excessive deficit.

<sup>2</sup> 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.

<sup>3</sup> Applicable only during the transition period of three years from the correction of the excessive deficit for EDP that were ongoing in November 2011.

<sup>4</sup> 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 2019 (SP); Draft Budgetary Plan for 2020 (DBP); Commission 2019 autumn forecast (COM); Commission calculations*

**4.2. Compliance with the medium-term budgetary objective**

Cyprus is subject to the preventive arm of the Stability and Growth Pact and should ensure compliance with its medium-term budgetary objective of a balanced structural budget. According to the information provided in the Draft Budgetary Plan, Cyprus is expected to achieve a (recalculated) structural surplus of 1.7 % of GDP in 2019, above its medium-term budgetary objective of a balanced structural budget. For 2020, based on the information in the Draft Budgetary Plan, the (recalculated) structural balance is expected to decline to a surplus of 0.4% of GDP, still above the medium-term budgetary objective.

These conclusions are confirmed by the Commission 2019 autumn forecast, which projects structural surpluses of 1.7 % of GDP in 2019 and 0.6% of GDP in 2020.

Cyprus is therefore expected to be compliant with the preventive arm of the Stability and Growth Pact in 2019 and 2020. In order to safeguard fiscal sustainability in line with the Stability and Growth Pact, public expenditure developments should nevertheless be monitored carefully, especially in light of possible future risks to the robustness of revenues.

**Table 5: Compliance with the requirements of the preventive arm**

(% of GDP)	2018	2019	2020
<b>Initial position<sup>1</sup></b>			
Medium-term budgetary objective (MTO)	0,0	0,0	0,0
Structural balance <sup>2</sup> (COM)	1,9	1,7	0,6
Structural balance based on freezing (COM)	1,7	1,7	-
Position vis-a-vis the MTO <sup>3</sup>	At or above	At or above the MTO	At or above the MTO
	<b>2018</b>	<b>2019</b>	<b>2020</b>
(% of GDP)	<b>COM</b>	<b>DBP</b>	<b>COM</b>
		<b>DBP</b>	<b>COM</b>
<b>Structural balance pillar</b>			
Required adjustment <sup>4</sup>	<b>Compliant</b>		
Required adjustment corrected <sup>5</sup>			
Change in structural balance <sup>6</sup>			
One-year deviation from the required adjustment <sup>7</sup>			
Two-year average deviation from the required			
<b>Expenditure benchmark pillar</b>			
Applicable reference rate <sup>8</sup>	<b>Compliant</b>		
One-year deviation adjusted for one-offs <sup>9</sup>			
Two-year average deviation adjusted for one-offs <sup>9</sup>			
<i>Notes</i>			
<sup>1</sup> 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 is allowed in order to be evaluated as having reached the MTO.			
<sup>2</sup> Structural balance corresponds to cyclically-adjusted government balance excluding one-off measures.			
<sup>3</sup> Based on the relevant structural balance at year t-1.			
<sup>4</sup> 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 ed. 2018, page 38.).			
<sup>5</sup> Required adjustment corrected for the clauses, the possible margin to the MTO and the allowed deviation in case of overachievers.			
<sup>6</sup> Change in the structural balance compared to year t-1. Ex post assessment (for 2018) was carried out on the basis of Commission 2019 spring forecast.			
<sup>7</sup> The difference of the change in the structural balance and the corrected required adjustment.			
<sup>8</sup> 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.			
<sup>9</sup> 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.			
<i>Source :</i>			
<i>Draft Budgetary Plan for 2020 (DBP); Commission 2019 autumn forecast (COM); Commission calculations.</i>			

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

The composition of the planned public finances in 2020 consists of a 2.4 percentage points of GDP increase in revenue, and a 3.6 percentage points of GDP increase in expenditure<sup>14</sup>. According to the Draft Budgetary Plan, the headline budgetary in 2020 is projected at 2.7 % of GDP, compared to 3.8% of GDP in 2019. According to the Draft Budgetary plan, and in line with the Commission 2019 autumn forecast, the fiscal stance is expected to be expansionary, based on the structural balance estimates. The recalculated structural balance is expected to deteriorate from 1.7% of GDP in 2019 to 0.4% in 2020. Revenue and expenditure

<sup>14</sup> Changes to the statistical treatment of government transfers to the Health Insurance Organisation as a third party are responsible alone for an increase in revenue and expenditure by 2.4% of GDP in 2020.

are expected to increase markedly as a share of GDP in 2020 (to 44% and 41.4% of GDP respectively).

Cyprus' tax system is relatively growth-friendly compared to other Member States. Taxes that are considered as most distortionary (ie. corporate and labour taxes) are among the lowest in the EU (see Box 4). The tax burden on labour is however set to increase substantially in 2019 and 2020 due to the pre-legislated increases in social security contribution rate in 2019 and the introduction of compulsory health contributions to finance the National Health Insurance System in 2019 and 2020. Nevertheless, tax revenue from labour are expected to remain below the EU average. At the same time, corporate tax collection is an important – yet volatile - source of revenue, partially reflecting its favourable tax regime to companies.

The Draft Budgetary Plan stresses that Cyprus submitted a Draft Integrated National Energy and Climate Plan for the period 2021- 2030 to the European Commission in 2019, with consultations now under way. Furthermore, a proposal for a “Green Tax Reform” by 2021 is under discussion, which envisages a fiscally-neutral environmental taxation reform focusing on the introduction of a carbon tax and touching, inter alia, upon waste and water management.

In the context of the 2019 European Semester, country-specific recommendations were issued for Cyprus to adopt key legislative reforms to improve efficiency in the public sector, in particular as regards the functioning of the public administration and the 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 9 July 2019.<sup>15</sup>

As regards the public administration reform, the Draft Budgetary Plan mentions that a set of revised draft bills, which aim to modernise the appraisal and promotion systems of civil servants and the recruitment procedures were re-submitted to the House of Representatives in October 2019. These draft laws, which are pending adoption by the House of Representatives, aim mainly at modernising the performance appraisal system and the promotion evaluation of civil servants. The revised draft bills address issues raised by the House of Representatives in 2016, when the initial bills were rejected. However, the authorities do not expect to re-submit a bill establishing a permanent mechanism containing increases in the public sector payroll based on the developments in fiscal conditions and nominal GDP growth. The collective agreement with the public sector unions for 2019, which applies a control mechanism for the containment of the wage bill in the public and broader public sector, will thus remain the main lever to contain the growth of public wage expenditure. Both the bill regarding mobility between the public service and State-owned organisations and among State-owned organisations, as well as the law governing the indefinite suspension of public and broader public sector hiring of new personnel, including a mechanism governing a procedure for exemptions, were adopted in 2017.

The draft bill on State-owned enterprises, which aimed to improve their corporate governance and ensure a more effective monitoring of their functioning, was withdrawn as it was deemed that it had no potential of being adopted by the House of Representatives. In an effort to

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<sup>15</sup> Council recommendation of 9 July 2019 on the 2019 National Reform Programme of Cyprus and delivering a Council opinion on the 2019 Stability Programme of Cyprus, OJ C 301, 5.9.2019, p. 80 <https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX%3A32019H0905%2813%29>

implement some aspects of the draft bill, as mentioned in the Draft Budgetary Plan, the Council of Ministers adopted several measures in April 2019. These include the compulsory preparation of a three-year period mid-term financial framework and the preparation of strategic plans linked to their budget and the adoption of the Code of Public Governance by State Organisations and State-owned enterprises.

Regarding the reform of local governments, the preparations of three revised draft bills (the municipalities and communities bills and the bill on creation of five provincial clusters) have progressed. The bill on provincial clusters was submitted to the House of Representatives, whereas the other two draft bills are expected to be submitted to the House of Representatives by the end of the year. The reform aims to significantly improve the delivery of local public services and make savings through economies of scale. It will also make the processes for issuing building permits and title deeds more efficient. Furthermore, it is expected to improve public financial management by addressing the current gaps in local government financial reporting with the establishing of a common accounting and reporting framework.

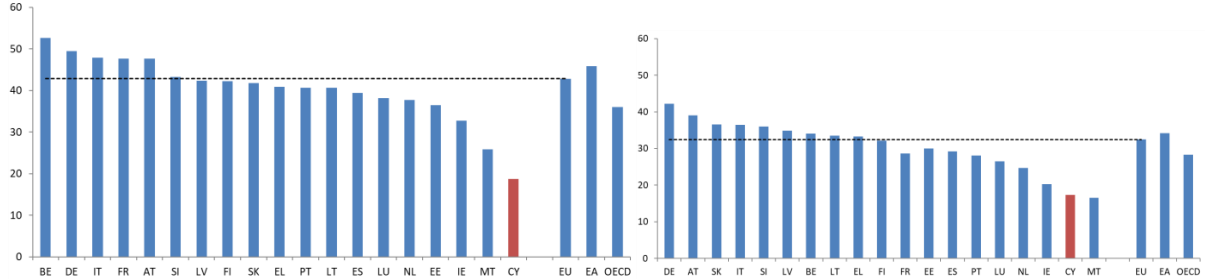
A comprehensive assessment of progress made in the implementation of the country-specific recommendations will be made in the 2020 Country Report and in the context of the country-specific recommendations to be adopted by the Council in 2020.

**Box 2 – 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 that 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 those 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 hire new staff. The graphs below show the tax wedge in Cyprus for a single worker earning respectively the average wage and a low wage (50% of the average) compared to the EU average.

**The tax burden on labour in Cyprus at the average wage and at low wage (2018)**



Notes: EU and EA averages are GDP-weighted. The OECD average is not weighted.

Source: European Commission Tax and Benefit Indicator database based on OECD data.

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 new measures affecting the tax wedge on labour but two significant policy measures will kick-in and affect the tax wedge in 2019 and 2020. On the one hand, social contributions increase by 1 percentage point in 2019 for employers and employees as part of the a reform of the Social Insurance Scheme related to the pension system. This reform foresees a gradual increase in contribution rates every five years, starting in January 2009. On the other hand, the gradual introduction of compulsory health insurance contributions for employers and employees in March 2019 and March 2020 to finance the National Health Insurance System reform will also increase the tax wedge, pushing Cyprus closer, but still below the EU average.

## **6. OVERALL CONCLUSION**

According to both the information provided in the Draft Budgetary Plan and the Commission 2019 autumn forecast, Cyprus is projected to maintain a structural surplus above its medium-term budgetary objective in 2019 and 2020. Cyprus is also expected to respect the debt reduction benchmark in 2019 in 2020. Therefore, Cyprus is projected to meet the requirements under the preventive arm of the Stability and Growth Pact both in 2019 and 2020. At the same time, expenditure developments should be monitored carefully, especially in light of possible future risks to the robustness of revenues, to safeguard fiscal sustainability in line with the Stability and Growth Pact.