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COMMISSION STAFF WORKING PAPER

Analysis by the Commission services of the action taken

by Cyprus

in response to the Council Recommendation of 13 July 2010 with a view to bringing an end to the situation of excessive government deficit

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1. INTRODUCTION

According to the April 2010 EDP notification, the general government deficit in Cyprus reached 6.1% of GDP in 2009 from a surplus of 0.9% in 2008. This was a result of a severe economic downturn and discretionary measures in response to the economic downturn (in line with the EERP) but also of rather large composition effects on account of a much less tax-rich GDP growth pattern. In parallel, the general government gross debt stood at 56.2% of GDP, below the 60% of GDP reference value but on a rising trend. Against this background, on 13 July 2010, the Council decided that an excessive deficit existed and addressed recommendations to Cyprus in accordance with Article 126(7) TFEU with a view to bringing an end to the situation of an excessive government deficit by 2012.[1] In its recommendations, the Council established a deadline of 13 January 2011 for effective action to be taken.

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

To limit risks to the adjustment, a strengthening of the binding nature of Cyprus' medium-term budgetary framework and better monitoring of budget execution throughout the year were requested. In addition, the Cyprus was recommended to improve the long-term sustainability of public finances by implementing reform measures to control pension and health care expenditure in order to curb the projected increase in age-related expenditure. Finally, Cyprus was recommended to seize any opportunity beyond the fiscal effort, including from better economic conditions, to accelerate the reduction of the gross debt ratio back towards the 60% of GDP reference value.

This paper reviews the actions taken by Cyprus to meet the aforementioned Council recommendations, in light of the economic and budgetary developments. In particular, it

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

reviews the budgetary implementation in 2010 and the prospects for 2011, on the basis of the Commission services' autumn 2010 forecast, the 2011 Budget Law, voted by the Parliament on 16 December 2010, as well as additional consolidation measures adopted by Cyprus.

2. ECONOMIC DEVELOPMENTS

The global economic and financial crisis hit Cyprus through a slump in external demand. After five quarters of contracting economic activity which led to a contraction of real GDP, for the first time in 35 years, by 1.7% in 2009, compared to 4.1% for the euro-area average, the first three quarters of 2010 witnessed a stronger-than-expected rebound of economic activity. The Commission services' autumn 2010 forecast expects real GDP in 2010 as a whole to expand by 0.5%. The economic recovery that started in 2010 is set to continue into 2011 and to gain momentum in 2012. Real GDP is projected to grow by 1.5% and 2.2% respectively, while the composition of growth is set to follow a more balanced pattern.

The macroeconomic outlook for the Cypriot economy for the period 2010-11 has progressively improved since the publication of the Commission services' spring 2010 forecast underpinning the Council recommendations of 13 July 2010 (Table 1). The national authorities have revised their economic projections only slightly upwards during the course of the year: in the stability programme update of April 2010, economic activity was expected to expand by 0.5% and 1.5% in 2010 and 2011, respectively. These were also the underlying real GDP growth projections of the 2011 budget. Currently, the national authorities project economic activity to expand by ½-1% in 2010 and 1½-2% in 2011. The main factor contributing to the improved economic outlook, despite the deteriorated performance of domestic demand in 2010, is net exports. Although the adjustment of growth to a more balanced composition pattern is a positive development, on the other hand, being less tax-rich could pose a challenge on the fiscal consolidation efforts.

Table 1: Comparison of macroeconomic developments and forecasts

	2009	2010		2011	
	outturn	COM SF10	COM AF10	COM SF10	COM AF10
Real GDP (% change)	-1.7	-0.4	0.5	1.3	1.5
Contributions to real GDP growth:					
Domestic demand (excl. inventories)	-3.7	-3.2	-3.7	1.1	1.0
Changes in inventories	-4.1	1.8	1.8	0.0	0.0
Net exports	5.8	0.9	2.4	0.3	0.5
Employment (% change)	-0.7	-0.7	-0.9	-0.2	0.2
GDP deflator (% change)	0.0	2.1	2.5	2.4	3.2

Source : COM SF10 - Commission services' spring 2010 forecast; COM AF10 - Commission services' autumn 2010 forecast.

3. BUDGETARY IMPLEMENTATION IN 2010

The Commission services' autumn 2010 forecasts, on the basis of available information at the time - including the draft budget, estimated that the budget deficit appeared to have stabilised in 2010 at a level similar to the previous year, at 5.9% of GDP, as a marginal increase in revenues appeared to have been fully offset by a rise in expenditures. On the one hand, the slowdown of activity and reduced corporate profitability appear to have weighed on tax receipts. In particular, direct tax revenues declined further, dragged down by lower income-tax receipts. Indirect taxes posted only marginal growth as a rise in import duties and excise taxes, which benefited from the increase of the excise duty on petrol as of 1 July due to the derogation expiration, was largely offset by a fall in VAT receipts. Social contributions posted positive growth, benefiting from the full- year impact of the rise of contribution rates adopted in the first half of the 2009. On the other hand, current expenditure continued to rise, despite the fall in interest payments, on the back of increases in the public wage bill, social outlays and subsidies. Given that revenues benefited from a one-off factor of almost ¾ pp. of GDP, associated with the profit on an interest swap agreement and a transfer of higher-than-usual Central Bank profits, the budgetary outcome could have been worse on the basis of underlying fiscal trends.

Moreover, recently published cash data of the consolidated accounts of the central government and administered funds for the period January – November 2010 appear to support and even better outturn for 2010, at about 5.5% of GDP. In particular, cash data demonstrates a reduction of the deficit to 2.44% of GDP for central government and administered funds compared with 2.97% over the same period of 2009, an improvement by 0.5 percentage points.

4. PROJECTED BUDGETARY DEVELOPMENTS IN 2011 AND 2012

On the basis of the 2011 draft budget available at the time, the Commission services' autumn 2010 forecast[2] projected a deficit of 5.7% of GDP for 2011.

For 2011, the Budget Law[3] targets a deficit of 5.4% of GDP, on the basis of an estimated deficit for 2010 of just below 6% of GDP. This budgetary target is lower than that set in last April's update of the stability programme, of 4.5% of GDP. On the revenue side, the budget does not incorporate any additional measures, apart from the phasing-out of the tax-relief, which was part of the stimulus measures and the harmonisation of excise duties on petroleum products, in effect since last July. Nevertheless, these effects are partly offset by a reduction in other current revenues. On the expenditure side, the budget aims at savings through a reduction of operational expenditure, as well as restraint in public investment and employment. However, these elements are fully offset by a rise in the public wage bill, interest payments and in social outlays. Compared to the draft budget, the Commission services' forecast incorporates a more prudent assessment of revenue prospects, given a less tax-rich growth composition, and on the expenditure side, given past trends on key items such as the wage bill and social transfers.

After the autumn forecast, Cyprus adopted a fiscal consolidation package in tandem with the adoption of the Budget, which consists of measures on both the revenue and expenditures sides. As explained in the letter sent by Minister of Finance Stavrakis to Commissioner Rehn on 7 January 2011, the authorities estimate the consolidation arising from this package at 1 percentage point (pp.) of GDP, out of which 0.6 pp. of GDP are on the revenue side and of permanent nature. In particular, these include the introduction of 5% VAT on foodstuffs and pharmaceutical products as of January 2011 (0.3% of GDP), in line with the EU *acquis* and the increase of excise duties on cigarettes and tobacco products by 30% (0.3% of GDP). On the expenditure side, the authorities plan to make savings through cuts in operating

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2 The Commission services autumn 2010 forecasts were published on 29 November 2010. The data cut-off date was 15 November 2010.

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

expenditure (0.25% of GDP) and through reduction of the size of civil service by 1000 persons annually (0.15% of GDP).

In addition, the coalition parties have agreed on an additional set of measures, which will be submitted to the Parliament for approval in February 2011. This is estimated by the authorities to yield an additional 0.6 p.p. of GDP of consolidation in 2011, from both revenue supporting and expenditure containing measures. In particular, it includes the harmonisation of water consumption tariffs in line with the EU *acquis* (0.05% of GDP), levies on the deposits of banks for two years, subject to a minimum profitability (0.35% of GDP) and wage moderation in the public sector (0.2% of GDP).

Table 2: Composition of the budgetary adjustment

(% of GDP)	2009		2010			2011			2012
	SP Apr 2010	outturn	SP Apr 2010	Budget 2011	COM AF2010	SP Apr 2010	Budget 2011	COM AF2010	COM AF2010[3]
Revenue	**40.3**	**39.8**	**41.6**	**40.2**	**40.2**	**42.8**	**40.8**	**40.4**	**40.5**
of which:									
- Taxes on production and imports	15.0	15.1	15.5	15.1	15.1	16.1	15.5	15.7	15.8
- Current taxes on income, wealth, etc.	11.2	11.2	11.6	10.7	10.7	12.1	11.0	10.8	10.8
- Social contributions	9.3	8.6	9.6	8.9	8.9	9.7	9.2	8.9	8.8
- Other (residual)	4.8	4.9	4.9	5.5	5.5	4.9	5.0	5.0	5.0
Expenditure	**46.4**	**45.8**	**47.6**	**46.2**	**46.2**	**47.2**	**46.1**	**46.2**	**46.2**
of which:									
- Primary expenditure	43.9	43.2	45.3	43.9	43.9	44.8	43.7	43.8	43.7
of which:									
Compensation of employees	15.6	15.6	15.8	15.9	15.9	15.9	16.0	16.1	16.1
Intermediate consumption	5.6	5.6	5.6	5.3	5.3	5.6	5.0	5.0	5.0
Social payments	13.8	13.3	14.4	14.2	14.2	14.9	15.0	15.1	15.1
Subsidies	0.1	0.2	0.4	0.3	0.3	0.4	0.4	0.4	0.4
Gross fixed capital formation	4.1	4.1	4.1	3.9	3.9	4.1	3.8	3.7	3.7
Other (residual)	4.7	4.4	5.0	4.2	4.2	4.1	3.6	3.5	3.5
- Interest expenditure	2.5	2.5	2.3	2.3	2.3	2.4	2.4	2.4	2.4
General government balance (GGB)	**-6.1**	**-6.0**	**-6.0**	**-5.9**	**-5.9**	**-4.5**	**-5.4**	**-5.7**	**-5.7**
Primary balance	**-3.6**	**-3.4**	**-3.7**	**-3.6**	**-3.6**	**-2.1**	**-3.0**	**-3.3**	**-3.3**
One-off and other temporary measures	0.0	0.7	0.1	0.7	0.7	0.1	0.0	0.0	0.0
GGB excl. one-offs	**-6.1**	**-6.6**	**-6.1**	**-6.6**	**-6.6**	**-4.6**	**-5.4**	**-5.7**	**-5.7**
Output gap[1]	-1.3	-1.2	-2.4	n.a.	-2.2	-2.5	n.a.	-1.8	-0.7
Cyclically-adjusted balance[1]	-5.6	-5.5	-5.1	n.a.	-5.1	-3.5	n.a.	-5.0	-5.4
Structural balance[2]	**-5.6**	**-5.7**	**-5.2**	n.a.	**-5.7**	**-3.6**	n.a.	**-5.0**	**-5.4**
Change in structural balance	*-5.4*	*-5.4*	*0.4*	*n.a.*	*0.0*	*1.5*	*n.a.*	*0.7*	*-0.4*
Structural primary balance[2]	-3.1	-3.2	-2.9	n.a.	-3.4	-1.2	n.a.	-2.6	-3.0
Change in structural primary balance	*-5.7*	*-5.7*	*0.2*	*n.a.*	*-0.2*	*1.6*	*n.a.*	*0.8*	*-0.4*
Memorandum Items	%								
Real GDP growth	-1.7	-1.7	0.5	0.5	0.5	1.5	1.5	1.5	2.2
GDP deflator	0.0		1.7	3.0	2.5	2.0	2.5	3.2	2.5
Nominal GDP	-1.7	-1.7	2.2	3.5	3.0	3.5	4.0	4.7	4.8

Notes:

1 Output gap (in % of potential GDP) and cyclically-adjusted balance according to the programme as recalculated by Commission services on the basis of the information in the programme.
2 Structural (primary) balance = cyclically-adjusted (primary) balance excluding one-off and other temporary measures.

3 On a no policy change basis.

Source:

Stability programme (SP) update, April 2010; Commission services' autumn 2010 forecasts (COM); Commission services' calculations

However, despite the adopted measures, the public wage bill is still on a rising trend. This may suggest that the numerical reduction of public sector's employees is not enough to restrain expenditure on this field. Also, no measures have been adopted to target social transfers, which have been on high growth rates in recent years. Together, the public wage bill and social outlays account for about ⅔ of total expenditure. The adopted consolidation strategy does not address comprehensively these expenditure categories.

The Commission services' autumn 2010 forecast does not incorporate the recently adopted package of consolidation measures, as this was not available as at the data cut-off date. This forecast implies an improvement in the structural balance (the cyclically-adjusted balance net of one-off and other temporary measures) by ¾ pp. of GDP in 2011, after a neutral impact in 2010. The adoption of the aforementioned fiscal consolidation package, taken at face value, would improve both the headline and the structural balance by a 1 percentage point of GDP. The adoption of the additional set of pending measures, accounting for 0.6 pp. of GDP is expected to have a similar impact. Overall, the improvement of the headline and the structural balance in 2011 would be around 2¼ pp. of GDP. Benefiting from the base-effect of the lower-than-expected deficit outturn in 2010 (by 0.4 percentage points of GDP), the headline balance would thus be expected to amount to 3¾% of GDP in 2011.

However, the Commission services see risks to the achievement of the 2011 deficit target. These are mainly stemming from the standard practise of adopting supplementary budgets during the course of the year. Hitherto, this implied an increase in current expenditure, beyond the intended reallocation of funds. Moreover, slippages in social transfers due to pressure to adopt measures to alleviate the impact of indirect tax rises, especially given that Cyprus enters an electoral cycle, pose a considerable risk. Furthermore, the impact of the wage indexation (COLA) on the public wage bill, in case of a higher-than-expected increase in inflation also due to aforementioned VAT rise, constitutes a non-negligible risk. Moreover, there are risks for the budgetary impact of announced yet not adopted consolidation measures due to pressures from affected parties.

For 2012, the authorities plan to reduce the deficit further, below the 3% of GDP reference value, through the continuation of the adopted consolidation measures. Based on the customary no-policy-change assumption and without incorporating the announced package of consolidation measures, the Commission services' autumn 2010 forecast projected the deficit to stabilise as a percentage of GDP to the same levels as in 2011, at 5.7%. Nevertheless, in view of the base effect in 2011, from a lower-than-expected deficit in 2010 (0.4% of GDP), and of the continuation in 2012 of the adopted consolidation measures, the 2012 budgetary deficit would also be expected to decline by 1 pp. of GDP and by an additional 0.6 p.p., subject to Parliament's approval of the additional consolidation measures.

5. DEBT DEVELOPMENTS

In the autumn 2010 forecast, the Commission services estimate Cyprus' gross government debt-to-GDP ratio to increase to 65.2% by 2011. The main driver of this deterioration is the primary deficit, which is only partly offset by the positive impact from the acceleration of growth.

In the 2011 budget, the Cypriot authorities project the government debt to deteriorate mildly and reach about 62% of GDP in 2010, from 58% in 2009. The positive impact of the projected growth in nominal GDP is more than offset by interest payments. Moreover, the existence of a primary deficit weighs on the debt. For 2011, the authorities project a further increase in the debt ratio to 63.8%, due to the continuation of a primary deficit.

The adoption of the fiscal consolidation package is expected to stabilise the debt-to-GDP-ratio in 2011 at levels similar to 2010, through the containment of the primary deficit. The continuation of consolidation measures in 2012, coupled with the acceleration of growth, should contribute in reversing debt to a declining trend.

Table 3: Debt Developments

(% of GDP)	2009		2010			2011		
	Outturn	**SP Apr 2010**	**SP Apr 2010**	**Budget 2011**	**COM AF10**	**SP Apr 2010**	**Budget 2011**	**COM AF10**
Gross debt ratio[1]	**58.0**	**56.2**	**61.0**	**61.9**	**62.2**	**63.2**	**63.8**	**65.2**
Change in the ratio	9.7	7.8	4.8	3.9	4.2	2.2	1.9	3.0
Contributions[2]*:*								
1. Primary balance	**3.4**	**3.6**	**3.7**	**3.6**	**3.6**	**2.1**	**3.0**	**3.3**
2. "Snow-ball" effect	**3.5**	**3.3**	**1.1**	**0.3**	**0.5**	**0.4**	**0.0**	**-0.4**
Of which:								
Interest expenditure	2.5	2.5	2.3	2.3	2.3	2.4	2.4	2.4
Nominal GDP growth effect	1.0	0.8	-1.2	-2.0	-1.7	-2.1	-2.4	-2.8
3. Stock-flow adjustment	**2.8**	**0.9**	**0.0**	**0.0**	**0.0**	**-0.2**	**-1.1**	**0.1**
Of which:								
Cash/accruals diff.	0.2	0.2	0.0	n.a.	n.a.	0.0	n.a.	n.a.
Acc. financial assets	2.6	0.7	0.0	n.a.	n.a.	-0.1	n.a.	n.a.
Privatisation	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Val. effect & residual	0.0	0.0	0.0	n.a.	n.a.	0.0	n.a.	n.a.

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 effects.

Source:

Stability programme (SP); Commission services' spring 2010 forecasts (COM); Commission services' calculations

6. FISCAL GOVERNANCE, QUALITY OF THE PUBLIC FINANCES AND LONG-TERM SUSTAINABILITY

The authorities have not outlined any specific measures to accelerate the implementation and to strengthen the binding nature of Cyprus' three-year medium-term budgetary framework (MTBF). The full implementation of the new budgeting framework is expected to cease the practise of adopting supplementary budgets during the course of the year, which has hitherto implied an increase in current expenditure, beyond the intended reallocation of funds. A medium-term budgetary framework, as noted by the authorities, is expected to lead to a more effective and efficient budgeting process, contributing to contain expenditure by ministry according to the ceilings set. At the same time, the new budgeting process would set a sound basis for reallocating expenditure in favour of growth enhancing activities consistent with the priorities set by the National Reform Programme. Furthermore, no independent institution is involved in the formulation of the macroeconomic assumptions underlying the budgetary projections.

As regards reform measures to control pension and health care expenditure, the authorities are in the process of setting up negotiations with the public sector's social partners with a view to reform the public sector's pensions. For this purpose, an independent actuarial firm has been appointed to assess the impact of the government pensions' scheme on public finances. The preliminary findings of this study, which will form the basis of dialogue with the social partners, are expected within the next two months. In this framework the authorities also envision to also discuss reforms of other sector-related issues, such as the public sector's wage structure and the wage indexation.

Table 4: Comparison of key macroeconomic and budgetary projections

		2008	**2009**	**2010**	**2011**
Real GDP (% change)	COM	3.6	-1.7	0.5	1.5
	CY	3.6	-1.7	0.6	1.5
	SP	*3.6*	*-1.7*	*0.5*	*1.5*
Output gap (% of potential GDP)	COM[2]	3.1	-1.2	-2.2	-1.8
	CY	n.a.	n.a.	n.a.	n.a.
	SP[1]	*2.9*	*-1.3*	*-2.4*	*-2.5*
General government balance (% of GDP)	COM	0.9	-6.0	-5.9	-5.7
	CY	0.9	-6.0	-5.9	-5.4
	SP	*0.9*	*-6.1*	*-6.0*	*-4.5*
Primary balance (% of GDP)	COM	3.7	-3.4	-3.6	-3.3
	CY	3.7	-3.4	-3.6	-3.0
	SP	*3.7*	*-3.6*	*-3.7*	*-2.1*
Cyclically-adjusted balance (% of GDP)	COM	-0.3	-5.5	-5.1	-5.0
	CY	n.a.	n.a.	n.a.	n.a.
	SP[1]	*-0.2*	*-5.6*	*-5.1*	*-3.5*
Structural balance[3] (% of GDP)	COM	-0.3	-5.7	-5.7	-5.0
	CY	n.a.	n.a.	n.a.	n.a.
	SP	*-0.2*	*-5.6*	*-5.2*	*-3.6*
Government gross debt (% of GDP)	COM	48.3	58.0	62.2	65.2
	CY	48.3	58.0	61.9	63.8
	SP	*48.4*	*56.2*	*61.0*	*63.2*

Notes:

1 Output gaps and cyclically-adjusted balances according to the programmes as recalculated by Commission services on the basis of the information in the programmes.

2 Based on estimated potential growth of 2.5%, 1.5%, 1.1% and 1.1% respectively in the period 2009-2012

3 Cyclically-adjusted balance excluding one-off and other temporary measures. One-off and other temporary measures are 0.3% of GDP in 2009 and 0.7% in 2010; all deficit-reducing.

Source:

April 2010 update of Stability programme (SP); Commission services' autumn 2010 forecasts (COM); Commission services' calculations