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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**

{C(2018) 8012 final}

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#### 1. INTRODUCTION

Cyprus submitted its Draft Budgetary Plan for 2019 on 12 October 2018 in compliance with Regulation (EU) No 473/2013. Cyprus is subject to the preventive arm of the Stability and Growth Pact and should preserve a sound fiscal position which ensures compliance with the medium term budgetary objective (MTO).

As the debt ratio was 108% of GDP in 2015 (the year in which the excessive deficit was corrected), exceeding the 60% of GDP reference value, Cyprus is also subject to the transitional arrangements to make sufficient progress towards compliance with the debt reduction benchmark during the three years following the correction of the excessive deficit (i.e. by the end of 2018). After the transition period, as of 2019, Cyprus is subject to the debt reduction benchmark.

Section 2 of this document presents the macroeconomic outlook underlying the Draft Budgetary Plan and provides an assessment based on the Commission 2018 autumn forecast. Section 3 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 2018 autumn forecast. It also includes an assessment of the measures underpinning the Draft Budgetary Plan. Section 4 assesses the recent and planned fiscal developments in 2018-2019 against the obligations stemming from the Stability and Growth Pact. Section 5 provides an analysis of implementation of the fiscal-structural reforms in response to the latest country-specific recommendations in the context of the European Semester adopted by the Council in July 2018. Section 6 summarises the main conclusions of the present document.

#### 2. MACROECONOMIC DEVELOPMENTS UNDERLYING THE DRAFT BUDGETARY PLAN

The economy of Cyprus expanded by 4.2% in real terms in 2017 (revised up from 3.9% in the previous assessments, while real GDP growth for 2016 has been revised up by 1.4 percentage points to 4.8%).

The macroeconomic scenario underlying the Draft Budgetary Plan projects a continuously strong expansion, with real GDP growth at 4.0% in 2018 and 3.8% in 2019. 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. Compared to the 2018 Stability Programme, real GDP growth in the Draft Budgetary Plan is revised up by 0.2 percentage points for both 2018 and 2019, after the solid outturn of the first half of 2018.

The 2018-2019 projections underlying the Draft Budgetary Plan are somewhat more optimistic (+0.1 percentage point for 2018 and +0.3 percentage points for 2019) than the

Commission 2018 autumn forecast. The Draft Budgetary Plan and the Commission 2018 autumn forecast both project real growth to be driven by domestic demand, with the Draft Budgetary Plan reflecting a bit more optimistic view on investment, while the Commission's view is more upbeat on private consumption. The views diverge on performance of exports, where the Commission forecast is more optimistic for 2018 (as exports of goods were influenced by large ship de-registrations, considered to be one-offs, in the first half of 2018) but more pessimistic for 2019, due to risks for exports of tourism services (some of which have already materialised in 2018). More generally, the Commission 2018 autumn forecast reflects a more conservative assessment of net exports performance for 2019, due to substantial import content in domestic demand.

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

	2017	2018			2019		
	COM	SP	DBP	COM	SP	DBP	COM
Real GDP (% change)	4.2	3.8	4.0	3.9	3.6	3.8	3.5
Private consumption (% change)	4.1	3.5	3.9	4.2	3.0	3.0	3.8
Gross fixed capital formation (% change)	26.8	16.3	10.5	8.3	10.2	8.0	7.5
Exports of goods and services (% change)	6.0	4.4	4.4	6.2	4.2	4.2	1.7
Imports of goods and services (% change)	12.2	7.4	5.7	7.3	5.4	4.7	3.5
<i>Contributions to real GDP growth:</i>							
- Final domestic demand	8.0	6.1	5.1	4.8	4.8	4.4	4.8
- Change in inventories	0.3	0.0	0.0	0.0	0.0	0.0	0.0
- Net exports	-4.1	-2.3	-1.0	-1.0	-1.2	-0.5	-1.3
Output gap <sup>1</sup>	0.5	2.0	2.2	2.3	2.8	3.7	3.5
Employment (% change)	3.8	3.0	3.8	3.9	2.5	3.5	2.8
Unemployment rate (%)	11.1	9.5	8.5	8.2	8.0	7.0	6.3
Labour productivity (% change)	0.4	0.8	0.2	0.0	1.0	0.3	0.7
HICP inflation (%)	0.7	0.5	1.0	0.8	1.0	1.2	1.3
GDP deflator (% change)	1.5	1.0	2.0	2.1	1.0	1.2	1.3
Comp. of employees (per head, % change)	0.7	1.5	1.5	1.5	2.0	2.0	2.2
Net lending/borrowing vis-à-vis the rest of the world (% of GDP)	-8.2	-7.1	-6.5	-8.1	-7.8	-6.6	-9.3
<b>Note:</b>							
<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.							
<i>Source:</i>							
<i>Stability Programme 2018 (SP); Draft Budgetary Plan for 2019 (DBP); Commission 2018 autumn forecast (COM); Commission calculations</i>							

Regarding inflation, the Draft Budgetary Plan expects inflation to be 1% in 2018, while the Commission projects it to be slightly lower (0.8%). The inflation rate is nearly identical for 2019, with the Draft Budgetary Plan projection at 1.2% and the Commission forecast at 1.3%. With the cyclical upswing, unemployment is falling very rapidly in Cyprus. It stood at 7.4% in September 2018 (contracting by nearly by 3 pps since end-2017). The unemployment rate

is projected to fall to 8.5% in the Draft Budgetary Plan and 8.2% in the Commission forecast, while the projection for 2019 is more conservative in the Draft Budgetary Plan.

The output gap<sup>1</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), reaches 2.2% of potential output in 2018 and 3.7% in 2019, as real GDP growth outpaces potential growth. The Commission 2017 autumn forecast envisages a very similar output gap estimate of 2.3% in 2018 and slightly lower output gap of 3.5% in 2019.

Overall, the Draft Budgetary Plan presents plausible macroeconomic assumptions for both 2018 and 2019. The risks associated with the macroeconomic assumptions presented in the Draft Budgetary Plan are tilted to the downside. These risks pertain to the high private and public debt, which make Cyprus vulnerable to potential sudden reversals in investor confidence in a context of increasing external headwinds in the financial markets. The over-reliance on the construction investment financed through the citizenship-by-investment scheme may also become a source of vulnerability, dampening the growth outlook. Finally, increasing protectionism and generally higher levels of uncertainty in the global economy, in particular over developments in the UK and Russian economies (Cyprus' main trading partners), and the decreasing perception of a safety risk in Turkey, Northern Africa and the Middle East (competing tourism destinations) may weigh on Cyprus's economic outlook. Upside risks are mainly related to higher consumption or investment.

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

The macroeconomic forecast underlying the Draft Budgetary Plan was submitted to the independent Fiscal Council for endorsement. On 12 September 2018, the Council endorsed the macroeconomic forecast accompanying the Draft Budget for 2019 in a public letter<sup>2</sup>, by concluding that the forecast as projected by the Ministry of Finance was within acceptable limits. The Council's 2018 autumn report<sup>3</sup> presented a detailed comparative analysis on the plausibility of the official forecast and concluded that the fiscal targets for 2018-2019 set by the Ministry of Finance are achievable. The report also flagged risks and challenges facing the Cypriot economy, such as the lack of competitiveness and its dependence on limited production sectors, the high ratio of public and private debt and non-performing loans, the lack of more stringent criteria and potential moral hazard from the Estia scheme, as well as the overdependence on the citizenship for investment scheme and its side effects on other productive sectors of the economy.

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<sup>1</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>2</sup> <http://www.fiscalcouncil.gov.cy/fiscalcouncil/fiscalcouncil.nsf/All/7AB23F2BA37A5BF0C22583070026B5E3?OpenDocument>

<sup>3</sup> Autumn report 2018, Fiscal Council (forthcoming).

### 3. RECENT AND PLANNED FISCAL DEVELOPMENTS

#### 3.1. Deficit developments

The Draft Budgetary Plan projects a general government headline surplus of 2.9% of GDP in 2018, significantly above the 1.7% of GDP predicted in the 2018 Stability Programme and broadly in line with the Commission 2018 autumn forecast.<sup>4</sup> The improvement compared to the 2018 Stability Programme is explained by the upward revision of the macroeconomic outlook, the favourable labour market developments and the buoyant tax revenue. The revenue-to-GDP ratio is projected to increase to 39.8% in 2018, an increase by 0.7 percentage points compared to the 2018 Stability Programme. Total revenue is projected to increase in nominal terms by around 8% from a year before, notably due to the projected significant increase in tax revenue on production and imports (including the introduction of the VAT rate on building land), tax revenue on income and wealth and social contributions, which benefit from increasing domestic demand and improving labour market conditions. An important drop is projected for the non-tax revenue item (by 0.6 percentage points of GDP for other revenue), for which no detailed explanations are provided besides the lower than previous year's Central Bank dividend (by about 0.2% of GDP). In turn, the expenditure-to-GDP ratio is projected to decline to 36.9% in 2018 (by some 0.5 percentage points compared to the 2018 Stability Programme). However, total expenditure is projected to increase in nominal terms by around 5% from a year before, mainly as a result of the increase in compensation of employees, partly due to the gradual withdrawal of the wage cuts in the public sector (with an estimated impact of about 0.1% of GDP), social payments attributed to increased pension outlays, as well as other expenditure, for which detailed information was not provided.

The Commission 2018 autumn forecast shows similar developments by projecting an improvement of the general government headline to a surplus of 2.8% of GDP, given the track-record of strong revenue performance. The Commission forecasts slightly higher increases in both revenues and expenditures than the Draft Budgetary Plan. The differences are mainly due to more conservative expenditure assumptions and different estimates for specific revenue and expenditure items. More specifically, the Draft Budgetary Plan presents, on the revenue side, a lower forecast for non-tax revenue item (i.e. other revenue, by 0.3 percentage points of GDP). On the expenditure side, the differences with the Commission 2018 autumn forecast mainly concern a lower forecast for gross fixed capital formation (by 0.3 percentage points of GDP), interest expenditure (by 0.2 percentage points of GDP) and compensation of employees (by 0.1 percentage point of GDP).

Both the Draft Budgetary Plan and the Commission 2018 autumn forecast do not yet include the potential (one-off) impact on the general government balance in 2018 from the restructuring of the Cyprus Cooperative Bank Ltd (CCB), namely the sale of the good parts of

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<sup>4</sup> The latest statistical notifications to Eurostat in autumn 2018 showed data revisions on intermediate consumption and interest expenditure over the past years. For 2017, data revisions amounted to around +0.6% of GDP for intermediate consumption and to -0.5% of GDP for interest expenditure. These revisions primarily relate to the calculation of FISIM (i.e. financial intermediation services indirectly measured) on ESM loans, IMF loans and bilateral loans from Russia, following a discussion in the competent statistical working group and the advice given by Eurostat. See October 2018 EDP notification. Changes to the recording of these expenditure items do not have an impact on the general government balance, but they affect the primary balance and interest expenditure. The data revisions partly explain the differences for these expenditure items and the primary balance between the Commission 2018 spring and autumn forecast.

the CCB and the subsequent integration of the remaining public financial defeasance structure into general government accounts. However, these banking support measures related to the CCB pose fiscal risks, as they are likely to adversely affect the budget balance in 2018.<sup>5</sup>

For 2019, the Draft Budgetary Plan targets a general government headline surplus of 3.1% of GDP, which represents an upward revision of 1.4 percentage points compared to the 2018 Stability Programme. According to the Draft Budgetary Plan, this is mainly driven by the continued cyclical improvement in the economy and the already legislated increases in the social security contribution rates as of January 2019. Although decreasing as a proportion of GDP in 2019, total expenditure is expected to increase but at a slower pace than total revenue. On the revenue side, despite the significant increase in social contributions (by 0.4 percentage points of GDP), the Draft Budgetary Plan expects a significant drop in the non-tax revenue item (by 0.8 percentage points of GDP for other revenue), for which no detailed explanations are provided. The higher expenditure is mainly explained by the increase in compensation of employees (partly due to the gradual public sector pay rise), social payments and the introduction of the ESTIA scheme. The latter is a State subsidy aimed to reduce the level of non-performing loans with primary residence as collateral.

The Commission 2018 autumn forecast projects the general government headline surplus at 3.0% of GDP in 2019, 0.1 percentage point lower than in the Draft Budgetary Plan. Albeit the projected budgetary developments are similar, the Commission forecasts slightly higher increases in both revenues and expenditures than the Draft Budgetary Plan. This is mainly due to differences in estimates for non-tax revenue (i.e. other revenue) and other expenditure items, together with more conservative expenditure assumptions for compensation of employees and gross fixed capital formation.

Risks to the fiscal outlook are tilted to the downside, mainly linked to uncertainties surrounding the likely deficit-increasing impact of the banking support measures related to the CCB, the potential realisation of explicit contingent liabilities also related to the CCB<sup>6</sup>, increasing spending pressures and the sustainability of the strong tax revenue performance. As regards spending pressures, despite the 2017-2018 collective agreement with the public sector unions containing the overall public wage bill increase to below the nominal GDP growth, the absence of a permanent mechanism that regulates growth of the public sector wage bill increases the risk of fiscal slippages. There may also be a potential fiscal impact from ongoing court cases on the constitutionality of the public sector wage and benefit cuts during the crisis, although this may have been now mitigated by the government's measure to gradually withdraw these cuts. Furthermore, the fiscal impact of the National Health Insurance System remains uncertain since it might create additional budgetary pressures, in particular during the 2020-2025 transitory period for the establishment of the financial and operational autonomy of public hospitals and the preparation of the secondary legislation related to service and reimbursement provisions. Finally, it is unclear whether the current buoyant tax revenue collection, in particular from value-added tax (VAT) and corporate income tax (CIT), can be

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<sup>5</sup> The overall fiscal impact of the banking support measures is currently being investigated by the competent statistical authorities, Cystat and Eurostat. See the country note on Cyprus in Eurostat's news release of 23 October 2018: <https://ec.europa.eu/eurostat/documents/2995521/9332933/2-23102018-BP-EN.pdf/993b7e66-003e-41bf-95ec-00d2359188bf>

<sup>6</sup> The public banking support measures in relation to the CCB consist of, inter alia, counter-guarantees by the State of the guarantees provided by the CCB to Hellenic Bank, including two asset protection schemes covering a portfolio of the assets transferred to Hellenic Bank.

sustained. Tax revenue might not continue to increase at the same rate in the future, as growth of VAT's most dynamic component (i.e. collection from the construction sector) will eventually fade away and CIT is an inherently volatile source of revenue subject to relocation decisions by (large) companies. Nonetheless, it is important to note that the previous forecasts by the authorities and the Commission have proven to be more conservative than the actual fiscal outturns, mainly due to higher-than-expected economic growth. The prospects in the energy sector related to ongoing gas explorations are an upside risk.

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

(% of GDP)	2017	2018			2019			Change: 2017-2019
	COM	SP	DBP	COM	SP	DBP	COM	DBP
<b>Revenue</b>	<b>39.3</b>	<b>39.1</b>	<b>39.8</b>	<b>40.0</b>	<b>38.9</b>	<b>39.4</b>	<b>40.1</b>	<b>0.1</b>
<i>of which:</i>								
- Taxes on production and imports	15.6	15.7	16.3	16.3	15.7	16.3	16.3	0.7
- Current taxes on income, wealth, etc.	9.4	9.4	9.4	9.4	9.3	9.3	9.3	-0.1
- Capital taxes	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
- Social contributions	8.7	8.9	9.1	9.1	9.4	9.6	9.5	0.9
- Other (residual)	5.6	5.1	5.0	5.3	4.5	4.2	5.0	-1.4
<b>Expenditure</b>	<b>37.5</b>	<b>37.4</b>	<b>36.9</b>	<b>37.2</b>	<b>37.2</b>	<b>36.3</b>	<b>37.0</b>	<b>-1.2</b>
<i>of which:</i>								
- Primary expenditure	34.9	34.6	34.4	34.6	34.3	33.7	34.6	-1.2
<i>of which:</i>								
Compensation of employees	12.0	12.0	11.8	11.9	11.8	11.9	12.1	-0.2
Intermediate consumption	3.6	3.6	3.6	3.6	3.5	3.5	3.6	-0.1
Social payments	13.4	13.3	13.0	13.0	13.1	12.7	12.8	-0.7
Subsidies	0.3	0.3	0.3	0.3	0.3	0.3	0.3	0.0
Gross fixed capital formation	2.7	2.5	2.5	2.8	2.5	2.5	2.9	-0.2
Other (residual)	2.9	2.9	3.2	3.0	3.1	2.8	3.0	0.0
- Interest expenditure	2.6	2.8	2.5	2.7	2.9	2.6	2.4	0.0
<b>General government balance (GGB)</b>	<b>1.8</b>	<b>1.7</b>	<b>2.9</b>	<b>2.8</b>	<b>1.7</b>	<b>3.1</b>	<b>3.0</b>	<b>1.3</b>
<b>Primary balance</b>	<b>4.3</b>	<b>4.5</b>	<b>5.4</b>	<b>5.5</b>	<b>4.7</b>	<b>5.6</b>	<b>5.5</b>	<b>1.3</b>
One-off and other temporary measures	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
<b>GGB excl. one-offs</b>	<b>1.8</b>	<b>1.7</b>	<b>2.9</b>	<b>2.9</b>	<b>1.7</b>	<b>3.1</b>	<b>3.0</b>	<b>1.3</b>
Output gap <sup>1</sup>	0.5	2.0	2.2	2.3	2.8	3.7	3.5	3.4
Cyclically-adjusted balance <sup>1</sup>	1.5	0.6	1.8	1.7	0.3	1.2	1.2	-0.5
<b>Structural balance (SB)<sup>2</sup></b>	<b>1.5</b>	<b>0.6</b>	<b>1.8</b>	<b>1.7</b>	<b>0.3</b>	<b>1.2</b>	<b>1.2</b>	<b>-0.5</b>
Structural primary balance <sup>2</sup>	4.1	3.5	4.3	4.4	3.2	3.8	3.6	-0.5
<b>Notes:</b>								
<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 = cyclically-adjusted (primary) balance excluding one-off and other temporary measures.								
<b>Source:</b>								
Stability Programme 2018 (SP); Draft Budgetary Plan for 2019 (DBP); Commission 2018 autumn forecast (COM); Commission calculations								

Based on the information provided in the Draft Budgetary Plan, the recalculated structural balance<sup>7</sup> is expected to improve from 1.5% of GDP to 1.8% of GDP in 2018, up from the 0.6% of GDP in the 2018 Stability Programme. This is mainly due to an upward revision of the general government surplus (by 1.2 percentage points). For 2019, the recalculated structural balance deteriorates to 1.2% of GDP, although remaining above the MTO. The Commission 2018 autumn forecast estimates similar structural surpluses of 1.7% of GDP in 2018 and 1.2% in 2019. The structural effort both in 2018 and 2019 are somewhat impacted by the cyclical position, with a positive output gap of 2.2% of potential GDP in 2018 and 3.7% in 2019.

The projected improvement and deterioration in the structural balance in 2018 and 2019 (+0.3 percentage points of GDP and -0.6 percentage points, respectively) are accompanied by a smaller improvement and deterioration in the structural primary balance (+0.2 percentage points of GDP and -0.5 percentage points, respectively).

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 10-year rates in Cyprus currently standing at 2.4%. Therefore, despite an increase in public debt in 2018 due to the banking support measures related to the CCB, total interest payments (as a share of GDP) by the general government are projected to be impacted only marginally in 2018. Based on the information included in the Draft Budgetary Plan, interest expenditure in Cyprus is expected to fall from 2.6% of GDP in 2017 to 2.5% in 2018 and is projected to slightly increase next year, at 2.6% of GDP, below 3.4% recorded in 2013 at the peak of the crisis in Cyprus. The 2018-2019 interest projections in the Draft Budgetary Plan are somewhat different (-0.2 percentage points for 2018 and +0.2 percentage points for 2019) than the Commission 2018 autumn forecast. However, the Draft Budgetary Plan does not provide sufficient information to understand the underlying assumptions.

A sizeable share of total debt has floating interest rates (42% in the middle of 2018, excluding short-term debt). This is largely due to borrowing from the 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 refinancing risk is mitigated by contained financing needs in the medium term (below 7% of GDP by 2020), notwithstanding the increase in debt in relation to the CCB. This was achieved by Cyprus through prudent fiscal policy and active debt management operations.

The Draft Budgetary Plan does not provide any indication on whether its 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. According to the Fiscal Council's 2018 autumn report<sup>8</sup>, the fiscal targets (in terms of compliance with the MTO and the debt criterion) included in the Draft Budgetary Plan are considered to be achievable both in 2018 and 2019. However, it highlights concerns about future expenditure developments.

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<sup>7</sup> Cyclically adjusted balance net of one-off and temporary measures, recalculated by the Commission using the commonly agreed methodology.

<sup>8</sup> Autumn report 2018, Fiscal Council (forthcoming).



### **3.2. Debt developments**

Public debt fell significantly in 2017, dropping below 100% for the first time since 2013, to 96.1% of GDP. Cyprus has significantly accelerated its public debt reduction, owing to high nominal GDP growth, a sizeable general government primary surplus and active debt management operations. The latter entailed repaying part of the debt from the accumulated cash balances (reflected in a negative stock-flow adjustment). In particular, the government repaid part of the debt owed to the Central Bank of Cyprus (amounting to EUR 615 m, 3.1% of GDP) in November 2017.

Based on the Draft Budgetary Plan, public debt is projected to sharply increase in 2018 to 104.2 % of GDP. The increase in 2018 is mainly due to an issuance of a series of government bonds in April and July 2018, the proceeds of which with an addition of cash (in total of EUR 3.5 billion) were deposited with the CCB. This is reflected in a sizeable positive stock-flow adjustment in 2018, representing a level shift upwards for the public debt trajectory. According to the Draft Budgetary Plan, public debt-to-GDP ratio is projected to sharply decline again in 2019, mainly due to projected high primary surplus (of 5.6% of GDP) and strong nominal GDP growth.

**Table 3. Debt developments**

(% of GDP)	2017	2018			2019		
		SP	DBP	COM	SP	DBP	COM
<b>Gross debt ratio<sup>1</sup></b>	<b>96.1</b>	<b>105.6</b>	<b>104.2</b>	<b>105.0</b>	<b>100.0</b>	<b>97.2</b>	<b>98.4</b>
Change in the ratio	-9.4	9.5	8.1	8.8	-5.6	-7.0	-6.6
<i>Contributions<sup>2</sup> :</i>							
<b>1. Primary balance</b>	<b>-4.3</b>	<b>-4.5</b>	<b>-5.4</b>	<b>-5.5</b>	<b>-4.7</b>	<b>-5.6</b>	<b>-5.5</b>
<b>2. “Snow-ball” effect</b>	<b>-3.2</b>	<b>-1.5</b>	<b>-2.9</b>	<b>-2.8</b>	<b>-1.7</b>	<b>-2.4</b>	<b>-2.3</b>
<i>Of which:</i>							
Interest expenditure	2.6	2.8	2.5	2.7	2.9	2.6	2.4
Growth effect	-4.2	-3.5	-3.6	-3.5	-3.6	-3.8	-3.5
Inflation effect	-1.5	-0.9	-1.8	-1.9	-1.0	-1.2	-1.3
<b>3. Stock-flow adjustment</b>	<b>-1.8</b>	<b>15.5</b>	<b>16.4</b>	<b>17.2</b>	<b>0.8</b>	<b>1.1</b>	<b>1.3</b>
<i>Of which:</i>							
Cash/accruals difference		0.0	0.0		0.0	0.0	
Net accumulation of financial <i>of which privatisation proceeds</i>		14.3	16.9		0.8	1.1	
Valuation effect & residual		0.0	0.0		0.0	0.0	
<b>Notes:</b>							
<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.							
<i>Source:</i> Stability Programme 2018 (SP); Draft Budgetary Plan for 2019 (DBP); Commission 2018 autumn forecast (COM); Commission calculations							

In spite of somewhat higher impact of the support to the CCB than expected in the 2018 Stability Programme, public debt is now projected to be lower, mainly due to higher projected primary surplus and inflation effect. Based on the Commission 2018 autumn forecast, government debt is expected to follow similar dynamics. The increase in debt in 2018 is projected by the Commission to be somewhat larger and the decline in 2019 somewhat smaller compared to the Draft Budgetary Plan projections. The difference in debt ratio is partly explained by the fact that the authorities' projections in the Draft Budgetary Plan are not based on 2018 notified data<sup>9</sup>. The other noteworthy factor is lower projected stock-flow adjustment in both years.

Risks to public debt as projected in the Draft Budgetary Plan are tilted to the downside, mainly linked to the potential realisation of explicit contingent liabilities including related to

<sup>9</sup> Based on data reported to Eurostat in autumn 2018, see October 2018 EDP notification. The difference is of around 0.4% of GDP, reflected in lower increase in public debt ratio and lower stock-flow adjustment in Table 3 as compared to the Draft Budgetary Plan (8.5% and 16.9% of GDP, respectively). Using the data reported to Eurostat in autumn 2018 would have resulted in higher public debt in terms of GDP by 0.4% of GDP in 2018 (to be carried over into 2019), *ceteris paribus*.

the CCB as explained above (partly reflected in the Commission 2018 autumn forecast, in the projected stock-flow adjustment for 2019).

### **3.3. Measures underpinning the Draft Budgetary Plan**

The 2019 Draft Budgetary Plan reports the gradual withdrawal of wage cuts in the public sector starting from 2018 and the introduction of the Estia scheme in 2019 as discretionary measures. The measure to reinstate wage cuts to the pre-crisis level is set to be implemented in six stages, with the first stage occurring in 2018 and the full withdrawal in 2023. The fiscal impact of this deficit-increasing measure is estimated at 0.1% of GDP in 2018 and at about 0.2% of GDP for the next five years on the expenditure side. The Estia scheme involves State support for loan repayment of eligible borrowers with non-performing loans backed by primary residences for a period of 25 years. More specifically, the State will provide an annual subsidy equal to 1/3 of the repayments of those restructured loans. The annual fiscal impact of this deficit-increasing measure is estimated at 0.1% of GDP on the expenditure side.

The measures underpinning the Draft Budgetary Plan include the discretionary measures reported in the 2018 Stability Programme, such as the introduction of the VAT rate on building land in 2018 and the rise in social security contributions in 2019, both on the revenue side. The fiscal impact of the deficit-decreasing measure related to the VAT is estimated at below 0.1% of GDP in 2018 and at around 0.1% of GDP in 2019, while the impact of the deficit-decreasing measure concerning the social security contributions is estimated at 0.4% of GDP in 2019.

According to the Draft Budgetary Plan, and despite the expansionary measures taken, the recalculated structural balance is projected to remain in surplus of above 1.0% of GDP in 2018 and 2019. The estimates of the budgetary impact of the measures appear plausible and are in line with the Commission 2018 autumn forecast.

Finally, the Draft Budgetary Plan reports the government's plan to introduce new deficit-increasing measures in 2019 in relation to two taxation reforms yet to be adopted. On the one hand, a decrease in rate of the defence withholding tax on interest (from 30% to 17%) is expected to be implemented as of January 2019, with a fiscal impact estimated at -0.2% of GDP on the revenue side. On the other hand, a reform in the framework of vehicle taxation in Cyprus, entailing a revision of the calculation of road tax for newly registered cars and the abolition of vehicle excise tax, is expected to have an overall fiscal impact of -0.03% of GDP on the revenue side. However, these measures are neither factored in the Draft Budgetary Plan nor in the Commission 2018 autumn forecast as they are still to be adopted.

**Table 4. Main discretionary measures reported in the Draft Budgetary Plan****A. Discretionary measures taken by General Government - revenue side**

Components	Budgetary impact (% GDP) (as reported by the authorities)	
	2018	2019
Taxes on production and Current taxes on income, Capital taxes	0.0	0.1
Social contributions	0.0	0.4
Property Income		
Other		
<b>Total</b>	<b>0.0</b>	<b>0.5</b>
<u>Note:</u> 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. <i>Source: Draft Budgetary Plan for 2019</i>		

**B. Discretionary measures taken by general Government- expenditure side**

Components	Budgetary impact (% GDP) (as reported by the authorities)	
	2018	2019
Compensation of employees	0.1	0.2
Intermediate consumption		
Social payments		
Interest Expenditure		
Subsidies		
Gross fixed capital formation		
Capital transfers	0.0	0.1
Other		
<b>Total</b>	<b>0.1</b>	<b>0.3</b>
<u>Note:</u> 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. <i>Source: Draft Budgetary Plan for 2019</i>		

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

Cyprus is subject to the preventive arm of the Stability and Growth Pact and should preserve a sound fiscal position which ensures compliance with the MTO. Cyprus also needs to make sufficient progress towards compliance with the debt reduction benchmark during the three

years following the correction of the excessive deficit (i.e. by the end of 2018). After the transition period, as of 2019, Cyprus needs to comply with the debt reduction benchmark.

#### 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 the end of 2018) and should ensure 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. As from 2019, as its public debt exceeds the 60% of GDP reference of the Treaty, Cyprus has to comply with the debt reduction benchmark.

Based on the Draft Budgetary Plan, Cyprus is making sufficient progress towards compliance with the debt reduction benchmark in 2018. In particular, the Draft Budgetary Plan's projections point to a change in the structural balance in 2018 being higher than the required MLSA by 4.1% of GDP. This is broadly in line with the Commission 2018 autumn forecast, according to which the change in the structural balance is also expected to exceed the required MLSA in 2018 (by 4.2% of GDP). The Draft Budgetary Plan does not include sufficient information to assess compliance with the debt reduction benchmark in 2019. Based on the Commission 2018 autumn forecast, Cyprus is expected to respect the benchmark in 2019 as illustrated by a negative gap of more than 7% of GDP to the debt benchmark. Therefore, Cyprus is expected to make sufficient progress towards compliance with the debt reduction benchmark in 2018 and respect the benchmark in 2019.

**Table 5. Compliance with the debt criterion\***

	2017	2018			2019		
		SP	DBP	COM	SP	DBP	COM
Gross debt ratio	96.1	105.6	104.2	105.0	100.0	97.2	98.4
Gap to the debt benchmark <sup>1,2</sup>					-8.0	n/a	-7.4
Structural adjustment <sup>3</sup>	0.2	-1.0	0.1	0.2			
<i>To be compared to:</i>							
Required adjustment <sup>4</sup>	-1.4	-2.6	-4.0	-4.0			

**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 or DBP) budgetary projections for the previous years are achieved.

**Source:**

*Stability Programme 2018 (SP); Draft Budgetary Plan for 2019 (DBP); Commission 2018 autumn forecast (COM); Commission calculations*

#### **4.2. Compliance with the MTO**

The general government balance is expected to remain in surplus of 2.9% of GDP in 2018 and 3.1% of GDP in 2019, based on the Draft Budgetary Plan. This is broadly confirmed by the Commission 2018 autumn forecast, with slightly lower headline projections of 2.8% of GDP in 2018 and 3.0% of GDP in 2019.

According to the information provided in the Draft Budgetary Plan, Cyprus is projected to respect its MTO of a balanced budgetary position in structural terms both in 2018 and 2019, with the recalculated structural surplus projected at 1.8% of GDP in 2018 and at 1.2% of GDP in 2019.

This is confirmed based on the Commission 2018 autumn forecast, which projects similar structural surpluses of 1.7% of GDP in 2018 and 1.2% of GDP in 2019.

Cyprus is therefore projected to be compliant with the requirements of the preventive arm of the Stability and Growth Pact both in 2018 and 2019. 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.

**Table 6: Compliance with the requirements of the preventive arm**

(% of GDP)	2017	2018		2019	
<b>Initial position<sup>1</sup></b>					
Medium-term objective (MTO)	0.0	0.0		0.0	
Structural balance <sup>2</sup> (COM)	1.5	1.7		1.2	
Structural balance based on freezing (COM)	0.4	1.7		-	
<b>Position vis-a -vis the MTO<sup>3</sup></b>	At or above the MTO	At or above the MTO		At or above the MTO	
(% of GDP)	<b>2017</b>	<b>2018</b>		<b>2019</b>	
	<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>	0.0	0.0		0.0	
Required adjustment corrected <sup>5</sup>	-1.2	-0.4		-1.7	
Change in structural balance <sup>6</sup>	0.2	0.1	0.2	-0.6	-0.5
<i>One-year deviation from the required adjustment<sup>7</sup></i>	1.4	0.5	0.6	1.1	1.2
<i>Two-year average deviation from the required adjustment<sup>7</sup></i>	1.3	1.0	1.0	0.8	0.9
<b>Expenditure benchmark pillar</b>					
Applicable reference rate <sup>8</sup>	2.9	2.1		7.4	
<i>One-year deviation adjusted for one-offs<sup>9</sup></i>	-0.8	-0.9	-1.0	1.6	1.0
<i>Two-year average deviation adjusted for one-offs<sup>9</sup></i>	0.5	-0.9	-0.9	0.3	0.0
<b>Notes</b>					
<p><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 (p.p.) is allowed in order to be evaluated as having reached the MTO.</p> <p><sup>2</sup> Structural balance = cyclically-adjusted government balance excluding one-off measures.</p> <p><sup>3</sup> Based on the relevant structural balance at year t-1.</p> <p><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, page 38.).</p> <p><sup>5</sup> Required adjustment corrected for the clauses, the possible margin to the MTO and the allowed deviation in case of overachievers.</p> <p><sup>6</sup> Change in the structural balance compared to year t-1. Ex post assessment (for 20XX-1) was carried out on the basis of Commission 20XX spring forecast.</p> <p><sup>7</sup> The difference of the change in the structural balance and the corrected required adjustment.</p> <p><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.</p> <p><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.</p>					
<b>Source:</b>					
Draft Budgetary Plan for 2019 (DBP); Commission 2018 autumn forecast (COM); Commission calculations.					

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

The structural balance is expected to deteriorate in 2019, although it is projected to remain in surplus of above 1.0% of GDP. Both revenue and primary expenditure are expected to decrease relative to GDP in 2019 (to 39.4% and 33.7% of GDP, respectively). This is different from the past adjustment over 2012-2017, including the crisis years, in which the structural balance is estimated to have improved by 5.4 percentage points, as a result of broadly similar adjustment efforts from the revenue and the primary expenditure sides. The composition of Discretionary Fiscal Effort<sup>10</sup> shows a similar 2012-2017 pattern, with a slightly larger effort on the expenditure side.

Cyprus plans a marginal increase in public investment in 2018, which contrasts with the decrease in the share in total investment expenditure during the period 2011-2017. Wages and public investment are the spending categories having experienced the largest reductions since 2011, under the pressure of the fiscal consolidation needs following the crisis. By contrast, the share of social benefits other than in kind in total general government expenditure has increased over 2011-2017.

The tax structure in Cyprus is less detrimental to growth compared to other Member States, as the most distortionary taxes (i.e. taxes on labour and on income of corporations) in Cyprus are among the lowest in the EU. Taxes on labour are set to increase in the future, although labour tax revenue is not expected to catch up fully with the EU average. In particular, the tax increase concerns legislated rises in social contributions in relation to the pension system and the introduction of compulsory health insurance contributions to finance the recently adopted national health insurance service. Corporate income tax is an important source of revenue in Cyprus, partly due to its favourable tax regime which attracts companies setting up business in the country. It is important to note that Cyprus' tax base narrowed in 2017 following the abolition of the immovable property tax, which is widely considered one of the most growth-friendly sources of tax revenue.

In the context of the 2018 European Semester, Cyprus was issued country-specific recommendations 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 13 July 2018.<sup>11</sup>

As regards the public administration reform, the Draft Budgetary Plan mentions that a set of draft bills, which aim to modernise the appraisal system of civil servants, the promotion procedures and the functioning of the Public Service Commission, are expected to be discussed with relevant stakeholders within 2018 in order to reach consensus and re-submit

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<sup>10</sup> 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](http://ec.europa.eu/economy_finance/publications/european_economy/2013/pdf/ee-2013-4.pdf).

<sup>11</sup> Council Recommendation of 13 July 2018 on the 2018 National Reform Programme of Cyprus and delivering a Council opinion on the 2018 Stability Programme of Cyprus, OJ C 320, 10.9.2018, p. 58. [https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32018H0910\(12\)&from=EN](https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32018H0910(12)&from=EN)



them to the House of Representatives. These bills were rejected by the House of Representatives in 2016. 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. This is due to the collective agreement with the public sector unions for the years 2017 and 2018, which applies a similar control mechanism for the containment of the wage bill. 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.

Concerning the draft law on State-owned enterprises, its adoption is still pending at the House of Representatives since 2015. The draft law aims to improve the corporate governance of State-owned enterprises and to ensure a more effective monitoring of their functioning.

Regarding the reform of local governments, the set of relevant bills and regulations are still pending at the House of Representatives since 2015. The reform aims to improve the delivery of local public services and enhance the processes of issuing title deeds, by 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 2019 Country Report and in the context of the country-specific recommendations to be adopted by the Council in 2019.

#### **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.<sup>12</sup> 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 contains a measure that affects the tax wedge on labour, namely the increase in the social security contribution rate for employees and employers in 2019. This measure stems from the last reform of the Social Insurance Scheme in Cyprus, which foresees a gradual

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<sup>12</sup> Due to the non-availability of data for Cyprus, the tax wedge on labour in the country could not be calculated for the benchmarking exercise.

increase in the contribution rate for both employees and employers by 1 percentage point every five years, starting in January 2009.

## **6. OVERALL CONCLUSION**

According to both the information provided in the Draft Budgetary Plan and the Commission 2018 autumn forecast, Cyprus is projected to respect its medium-term objective in 2018 and 2019. In addition, according to the Draft Budgetary Plan and the Commission 2018 autumn forecast, Cyprus is expected to make sufficient progress towards compliance with the debt reduction benchmark in 2018 and respect the benchmark in 2019. Therefore, Cyprus is projected to meet the requirements under the preventive arm of the Stability and Growth Pact both in 2018 and 2019. 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.