COMMISSION OF THE EUROPEAN COMMUNITIES

Brussels, 21.6.2006
SEC(2006) 787 final

Recommendation for a

COUNCIL DECISION

abrogating Decision 2005/184/EC on the existence of an excessive deficit in Cyprus

(presented by the Commission)

EXPLANATORY MEMORANDUM

1. INTRODUCTION

Article 104 of the Treaty establishes that Member States should avoid excessive deficits and lays down a procedure for their identification and correction. This excessive deficit procedure (EDP) is further specified in Council Regulation (EC) No 1467/97 on "speeding up and clarifying the implementation of the excessive deficit procedure"[1], which is part of the Stability and Growth Pact.

According to the Protocol on the excessive deficit procedure annexed to the Treaty, the Commission provides the data for the implementation of the EDP. As part of the application of this Protocol, Member States have to notify data on government deficits and debt and other associated variables twice a year, namely before 1 April and before 1 October, in accordance with Article 4 of Council Regulation (EC) No 3605/93[2].

On 7 April 2004, the Commission published its forecasts of spring 2004[3]. According to these forecasts, which took into consideration data reported by the Cypriot government in March 2004, the general government deficit in Cyprus increased from above 4½% of GDP in 2002 to about 6¼% of GDP in 2003, thus exceeding the 3% of GDP Treaty reference value. The Commission report also concluded that the debt-to-GDP ratio, which had reached 72¼% of GDP in 2003, would further deviate from the 60% reference value of the Treaty to above 74½% of GDP in 2004. Based on this evidence, the Commission initiated the excessive deficit procedure for Cyprus on 12 May 2004, with the adoption of the report foreseen in Article 104(3) of the Treaty[4]. On 24 May 2004, the Cypriot authorities submitted the Convergence Programme covering the period 2004-2007, which confirmed a deficit figure of about 6¼% of GDP for 2003 and projected a debt-to-GDP ratio of 75¼% of GDP for 2004. Having taken into account all the relevant factors in this report and the opinion of the Economic and Financial Committee in accordance with Article 104(4), the Commission adopted an Opinion (in accordance with Article 104(5)) on 24 June 2004 stating that an excessive deficit existed in Cyprus. On 5 July 2004, the Council adopted a Decision[5] to that effect, in accordance with Article 104(6).

At the same time, the Council adopted an Opinion on the Convergence Programme of Cyprus of 24 May in accordance with Council Regulation (EC) No 1466/97[6] of 7 July 1997, and a Recommendation addressed to Cyprus in conformity with Article 104(7) of the Treaty with a view to bringing the situation of an excessive government deficit to an end.

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1 OJ L 209, 2.8.1997, p. 6. Regulation as amended by Regulation (EC) No 1056/2005 (OJ L 174, 7.7.2005, p. 5).

2 OJ L 332, 31.12.1993, p. 7. Regulation as last amended by Regulation (EC) No 2103/2005 (OJ L 337, 22.12.2005, p. 1).

3 The Commission Spring 2004 forecast is available at the following website: http://europa.eu.int/comm/economy_finance/publications/european_economy/2004/ee204en.pdf.

4 The full text of this report is available at the following website: http://europa.eu.int/comm/economy_finance/about/activities/sgp/country/edp/edprep2004_cy.pdf

5 Council Decision 2005/184/EC published on 9.3.2005 in the Official Journal: OJ L062, p.19

6 OJ L 209, 2.8.1997, p.1.Regulationas amended by Regulation (EC) No 1055/2005 (OJ L 174, 7.7.2005, p.1)

2. RECOMMENDATIONS UNDER THE EDP

The Council recommended the Cypriot government *"to put an end to the present deficit situation as rapidly as possible"*. Specifically, it was recommended *"to implement with vigour the measures envisaged in the May 2004 convergence programme; in particular, to take effective action by 5 November 2004 in order to achieve their objective of bringing the deficit below 3% of GDP in 2005 in a credible and sustainable manner, as specified in the Council Opinion of 5 July 2004 on the convergence programme submitted in May 2004"*. The Council also recommended *"the Cypriot authorities to ensure that the rise in the debt ratio is brought to a halt in 2004 and reversed thereafter as specified in the Council Opinion on the convergence programme"*.

In making recommendations for the correction of the excessive deficit, the Council invited the Cypriot authorities *"to ensure that budgetary consolidation towards the medium term budgetary position of close to balance or in surplus is sustained after the excessive deficit has been corrected"*.

On 22 December 2004 the Commission concluded[7] that the Cyprus government had taken effective action regarding the measures envisaged to achieve the 2005 deficit target, by the deadline of 5 November, in response to the Council recommendation, of which the Council took note on 18 January 2005.

According to Article 104(12), a Council decision on the existence of an excessive deficit is to be abrogated, on the basis of a Commission recommendation, when the excessive deficit in the Member State concerned has, in the view of the Council, been corrected.

3. DEFICIT DEVELOPMENTS UNTIL 2005

The April 2006 EDP notification (which was submitted on 22 March 2006 and published by Eurostat on 24 April 2006) estimated the general government deficit in 2005 at 2.4% of GDP (table 1). This outcome compares with the target of 2.9% of GDP in the Convergence Programme of May 2004, confirmed by the 2005 Budget Law approved by the Parliament in December 2004, and with the 2.5% target of the latest Convergence Programme update which was submitted on 14 December 2005. According to the 2005 budget, the adjustment was to be achieved through both revenue increases and expenditure restraint. Revenue measures were a mix of structural (VAT tax rates were revised upward in line with the acquis in May 2004 having a full year impact in 2005) and one-off measures (a tax amnesty that has allowed for the collection of additional revenues amounting to ¾ of a percentage point in 2004 and almost 1% in 2005). Nominal expenditure growth was restricted through a ceiling on the nominal growth rate of current and capital expenditures, the containment of current transfers and subsidies in line with inflation and an increase in the retirement age of public sector employees. The better-than-expected outcome occurred on the back of a high tax content of growth, which was almost fully based on domestic consumption, and was accompanied by sustained employment growth. Revenues from the tax amnesty also turned out higher than expected. In addition, the 2004 deficit outcome (slightly above 4% of GDP) was below the figure projected by the end of 2004 (about 4¾% of GDP) when the 2005 budget was approved. The deficit outcome could have been even better had part of such base-year effects

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7 http://europa.eu.int/comm/economy_finance/about/activities/sgp/edp/comm_comm_22_dec_en.pdf

and additional revenues not been offset by expenditure overruns. Although the cap on wages was broadly respected and capital expenditures actually fell in nominal terms, social transfers increased to 13%.

Table 1: Budgetary developments 2003-2005 (as % of GDP)

Outturn		2003	2004	2005
General government balance		-6.3	-4.1	-2.4
- Total revenue		39.1	39.7	42.3
Of which:	*current taxes*	26.2	25.6	26.9
	social contributions	7.1	7.8	8.4
- Total expenditure		45.3	43.8	44.7
Of which:	*collective consumption*	10.9	9.9	10.0
	transfers in kind	9.0	8.2	8.3
	transfers other than in kind	11.4	12.2	12.9
	interest expenditure	3.4	3.2	3.4
	gross fixed capital formation	3.4	4.1	3.2
Primary balance		-2.8	-0.9	1.0
Pm	Tax burden	33.2	33.4	35.3
Pm	Cyclically-adjusted balance (1) [1]	-6.1	-3.9	-2.1
Pm	One-offs (2)	1.8	1.0	0.9
Pm	Structural balance (1-2)[1]	-7.9	-4.9	-3.0
Pm	Structural primary balance [1]	-4.4	-1.7	0.4
Pm	Real GDP [1] (annual percentage change)	1.9	3.9	3.8

Interest expenditure and balances include swaps in line with the definitions used in the excessive deficit procedure. Total revenues and total expenditures are in line with the harmonised definitions as in ESA95.
[1] Commission services' spring 2006 economic forecast.
Source: Commission services.

Overall, the deficit improved in 2005 by almost 4% points of GDP compared with 2003 and by 1¾% points of GDP compared with 2004. Temporary revenues accounted by around 1% of GDP in both 2004 and 2005. The primary balance was brought into the positive for the first time since 2002. Specifically, the primary surplus of 1% of GDP in 2005 compares with the primary deficits of 3% and 1% in 2003 and 2004, respectively. Measured by the estimated change in the structural balance (the cyclically-adjusted balance net of one-offs and other temporary measures), the improvement in the government balance implied a fiscal effort of almost 5 percentage points of GDP between 2003 and 2005, when the structural deficit attained almost 8% and 3% of GDP respectively.

4. BUDGETARY PROSPECTS FOR 2006 AND BEYOND

According to the Commission services' spring 2006 forecast, the general government deficit for 2006 is projected to be just above 2% of GDP (table 2), or about ¼ of a percentage point of GDP higher than the official target. The difference is mainly explained by a more optimistic growth scenario in the official projections provided by Cyprus. According to the 2005 convergence programme update, GDP would grow at 4.2% this year, while the Commission services' spring 2006 forecast project GDP to grow at 3.8%. The primary surplus is projected to remain at 1% of GDP since the reduction in the general government deficit compared with the 2005 outcome (just above ¼% of GDP) would just mirror the projected reduction in interest payments.

Table 2: Projections for general government finances (as % of GDP)

	2005	2006		2007	
		CP	Comm.	CP	Comm. (1)
General government balance	-2.4	-1.9	-2.1	-1.8	-2.0
- Total revenue	42.3	41.9	41.8	41.9	41.8
Of which: current taxes	26.9	26.9	26.9	27.0	26.8
social contributions	8.4	8.1	8.1	8.1	8.1
- Total expenditure	44.7	43.8	43.9	43.7	43.8
Of which: - collective consumption	10.0	9.5	9.8	9.0	9.8
- transfers other than in kind	12.9	11.4	11.4	11.5	11.4
- interest expenditure	3.4	3.1	3.1	3.0	3.0
- gross fixed capital formation	3.2	3.4	3.4	3.4	3.4
Primary balance	1.0	1.2	1.0	1.2	1.0
Pm Cyclically-adjusted balance (1)	-2.1	-1.8	-1.9	-1.8	-2.0
Pm One-offs (2)	0.9	0.3	0.3	0.3	0.3
Pm *Structural balance(1-2)*	-3.0	-2.1	-2.2	-2.1	-2.3
Pm Structural primary balance	0.4	1.0	0.9	0.9	0.7
Pm *Real GDP (annual percentage* change)	3.8	4.2	3.8	4.2	3.8

Sources: April 2006 EDP notification for 2005, the December 2005 update of the convergence programme (CP), and the Commission services' spring 2006 forecast (Comm.). Cyclically adjusted and structural balances for the CP calculated by Commission services on the basis of inputs given in the programme (difference with Comm. reflects different macro-economic scenarios). Total revenues and total expenditures of the CP have been increased by 1.9% points of GDP, in line with the harmonised definitions as in ESA95. *(1) Under the customary no-policy-change scenario.*

Once one-offs and other temporary measures are netted out from the cyclically-adjusted balance, the structural improvement would amount to about ¾ of a percentage point of GDP, and situate the structural deficit at around 2¼% in 2006. The projected level of the structural deficit achieves the minimum annual improvement of at least ½% of GDP set by the Stability and Growth Pact, and points to a credible and sustainable correction of the excessive deficit, which is confirmed by the budgetary projections for 2007 in the Commission services' spring 2006 forecasts. Under the customary no-policy-change scenario, and taking account of one-off revenues of slightly above ¼ of a percentage point of GDP, the structural balance is projected to remain broadly unchanged at around 2¼% of GDP. The lack of improvement in the structural balance in 2007 reflects the anticipated deterioration of Cyprus' net position vis-à-vis the EU budget, as temporary compensating grants associated with accession to the EU are terminated in 2006.

According to the Council Opinion[8] on the updated convergence programme of Cyprus for 2005-2009, the measures planned by the Cypriot authorities over the programme period would further consolidate public finances until 2009, when the deficit would approach ½% of GDP. After reaching ¾% of GDP in 2005, the primary surplus is projected to rise gradually to 1¾% of GDP in 2009. The structural deficit would decrease from around 3% of GDP in 2005 to about ½% of GDP by 2009[9], representing an improvement of more than ½% of GDP per year on average. Based on the estimated outturn for 2005 and taking account of the balance of risks to the budgetary targets, the budgetary stance in the programme seems sufficient to ensure that the medium-term objective (MTO) identified by the Cypriot authorities is almost reached by 2009, as envisaged in the programme. In the years following the correction of the excessive deficit, the pace of adjustment towards the programme's MTO implied by the programme would show progress towards close-to-balance, which in turn would be at an appropriate level[10] as it would lie within the range indicated for euro area and ERM II Member States in the Stability and Growth Pact and its Code of Conduct[11]. Furthermore, it is also the Council's opinion that the budgetary strategy outlined in the programme would provide a sufficient safety margin against breaching the 3% of GDP threshold with normal macroeconomic fluctuations from 2008 onward.

5. GOVERNMENT DEBT

In 2005, the gross government debt-to-GDP ratio decreased to 70¼%, from 71¾ in 2004, on the back of the recorded primary surplus and high growth, the debt-reducing effects of which were partially offset by the accumulation of financial assets in the form of deposits in sinking funds with the Central Bank (table 3).

According to the 2006 Budget Law, the debt-to-GDP ratio is expected to further decline to 67% in 2006. The Commission services' spring 2006 forecasts also foresee a reduction, though a smaller one, in the debt-to-GDP ratio, from 70¼% of GDP in 2005 to 69% in 2006. The difference between the Commission forecast and the Budget Law can be explained by

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8 Council Opinion: http://register.consilium.eu.int/pdf/en/06/st07/st07380.en06.pdf. Technical assessment: http://europa.eu.int/comm/economy_finance/about/activities/sgp/country/commwd/cy/com_cy20052006.pdf

9 Council Opinion: http://register.consilium.eu.int/pdf/en/06/st07/st07380.en06.pdf. Technical assessment: http://europa.eu.int/comm/economy_finance/about/activities/sgp/country/commwd/cy/com_cy20052006.pdf

10 The medium-term budgetary objective may diverge from close-to-balance or in surplus for individual Member States. For euro area and ERM2 Member States, there would thus be in range between – 1 % of GDP and balance or surplus, in cyclically adjusted terms, net of one-off and temporary measures.

11 Council Regulations (EC) No 1466/97 - OJ L 209, 2.8.1997, p.1. Regulation as amended by Regulation (EC) No 1055/2005 (OJ L 174, 7.7.2005, p.1) - and (EC) No 1467/97 - OJ L 209, 2.8.1997, p.6. Regulation as amended by Regulation (EC) No 1056/2005 (OJ L 174, 7.7.2005, p.5) - and the Resolution of the European Council on the Stability and Growth Pact of 7 July 1997. The Code of conduct can be found at http://europa.eu.int/comm/economy_finance/about/activities/sgp/codeofconduct_en.pdf

different projections of the primary balance and nominal GDP growth (different projections of the snow-ball effect), and the fact that the Commission forecasts do not include the debt-reducing effects of the decumulation of sinking funds (if they did, this would bring the projection down to about 68% of GDP). On the basis of known policies, the Commission services project the debt-to-GDP ratio to further decline to 67¾% of GDP in 2007. Mainly on the back of the envisaged decumulation of sinking funds, the 2005 update of the convergence programme projects further reductions of the debt-to-GDP ratio starting from 64% in 2007 to 57% in 2008 and 53½% in 2009. The above-mentioned Council Opinion on the convergence programme concludes that, given the balance of risks in the programme, the debt ratio seems to be sufficiently diminishing towards the 60% of GDP reference value.

Table 3: Debt dynamics

	2003	2004	2005	2006		2007	
				CP	Comm.	CP	Comm. (1)
Government gross debt ratio(2)	69.7	71.7	70.3	67.0	69.1	64.0	67.8
Change in debt ratio	4.5	1.9	-1.3	-3.5	-1.2	-3.0	-1.3
Contributions to change in gross debt ratio:							
- Primary balance	2.8	0.9	-1.0	-1.2	-1.0	-1.2	-1.0
- "Snow-ball" effect	-0.8	-1.0	-1.1	-1.6	-1.0	-1.2	-1.0
- Interest expenditure	3.4	3.2	3.4	3.1	3.1	3.0	3.0
- Stock-flow adjustment	2.5	2.0	0.8	-0.8	0.8	-0.6	0.7
Of which:							
- Difference between cash and accruals	0.6	0.3	0.3	0.0		0.0	
- Net accumulation of financial assets	1.8	1.6	0.3	-0.6		-0.4	
of which: Privatisation proceeds	0.0	0.0	0.0	0.0		0.0	
- Valuation effects & residual adj.	0.1	0.1	0.1	0.0		0.0	

Sources: April 2006 EDP notification for 2005, the December 2005 update of the convergence programme (CP), and the Commission services' spring 2006 forecast (Comm.).

(1) Under the customary no-policy-change scenario

(2) The change in the gross debt ratio can be decomposed as follows:

$$\frac{D_t}{Y_t} - \frac{D_{t-1}}{Y_{t-1}} = \frac{PD_t}{Y_t} + \left(\frac{D_{t-1}}{Y_{t-1}} * \frac{i_t - y_t}{1 + y_t} \right) + \frac{SF_t}{Y_t}$$

where t is a time subscript; D, PD, Y and SF are the stock of government debt, the primary deficit, nominal GDP and the stock-flow adjustment respectively, and i and y represent the average cost of debt and nominal GDP growth. The term in parentheses represents the "snow-ball" effect.

6. CONCLUSIONS

The general government deficit decreased from 4.1% of GDP in 2004 to 2.4% in 2005, below the 3% of GDP reference value. The measures underlying the deficit reduction are mainly of a permanent nature. The structural balance, i.e. the cyclically-adjusted balance net of one-off and other temporary measures, is estimated to have improved by almost 2% points of GDP. According to the Commission services' spring 2006 forecast, the headline deficit is expected to narrow to 2¼% of GDP in 2006 and, on a no-policy-change basis, to 2% in 2007. This suggests that the deficit has been brought below the 3% of GDP ceiling in a credible and sustainable manner.

General government gross debt declined from 71¾% of GDP in 2004 to 70¼ % in 2005 and can be considered to be sufficiently diminishing towards the 60% of GDP reference value. According to the Commission services' spring 2006 forecast, albeit still remaining above the 60% of GDP reference value, the debt ratio is expected to fall further to around 69% and 68% of GDP in 2006 and 2007 respectively (on a no-policy-change basis).

From this overall assessment, it can be concluded that the excessive deficit situation in Cyprus has been corrected. Accordingly, the Commission recommends that the Council abrogate its decision on the existence of an excessive deficit in Cyprus.

Recommendation for a

COUNCIL DECISION

abrogating Decision 2005/184/EC on the existence of an excessive deficit in Cyprus

THE COUNCIL OF THE EUROPEAN UNION,

Having regard to the Treaty establishing the European Community, and in particular Article 104(12) thereof,

Having regard to the recommendation from the Commission,

Whereas:

(1) By Council Decision 2005/184/EC[12], following a recommendation from the Commission in accordance with Article 104(6) of the Treaty, it was decided that an excessive deficit existed in Cyprus.

(2) In accordance with Article 104(7) of the Treaty and Article 3(4) of Regulation (EC) No 1467/97, the Council made a Recommendation on 5 July 2004 addressed to Cyprus with a view to bringing the excessive deficit situation to an end by 2005 at the latest. The recommendation was made public. Specifically, it was recommended to implement with vigour the measures envisaged in the May 2004 convergence programme; in particular, to take effective action by 5 November 2004 in order to bring deficit below 3% of GDP in 2005 in a credible and sustainable manner. The Council also recommended ensuring that the rise in the debt ratio is brought to a halt in 2004 and reversed thereafter. The Council invited the Cypriot authorities to ensure that budgetary consolidation towards the MTO is sustained after the excessive deficit has been corrected.

(3) In accordance with Article 104(12) of the Treaty, a Council Decision on the existence of an excessive deficit is to be abrogated when the excessive deficit in the Member State concerned has, in the view of the Council, been corrected.

(4) According to the Protocol on the excessive deficit procedure annexed to the Treaty, the Commission provides the data for the implementation of the procedure. As part of the application of this Protocol, Member States have to notify data on government deficits and debt and other associated variables twice a year, namely before 1 April and before 1 October, in accordance with Article 4 of Council Regulation (EC) No 3605/93 of 22 November 1993 on the application of the Protocol on the excessive deficit procedure annexed to the Treaty establishing the European Community[13].

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[12] OJ L 62, 9.3.2005, p. 19.

[13] OJ L 332, 31.12.1993, p. 7. Regulation as last amended by Regulation (EC) No 2103/2005 (OJ L 337, 22.12.2005, p. 1).

(5) Based on data provided by the Commission (Eurostat) according to Article 8g of Regulation (EC) No 3605/93 following the notification by Cyprus before 1 April 2006 and on the Commission services' spring 2006 forecast, the following conclusions are warranted:

– The general government deficit was reduced from 4.1% of GDP in 2004 to 2.4% of GDP in 2005, which is below the 3%-of-GDP deficit reference value. This compares with a target of 2.9% of GDP set in the May 2004 update of the convergence programme and with the 2.5% target of the latest Convergence Programme update of December 2005. The reduction below the reference value in 2005 is in line with the Recommendation under Article 104(7). Fiscal adjustment was pursued in 2005 through both revenue increases and expenditure restraint. Although some one-off measures helped reduce the deficit, the budgetary consolidation in Cyprus was achieved mainly through structural measures. The structural deficit (the cyclically adjusted deficit net of one-off and other temporary measures) fell to 3% of GDP, compared to almost 5% and 8% of GDP in 2004 and 2003 respectively.

– For 2006, the Commission services' spring 2006 forecast projects the deficit to be reduced further, to 2¼% of GDP, largely through measures of a structural nature. This is slightly above the official deficit target of 1.9% of GDP set in the December 2005 update of the convergence programme. For 2007, the spring forecast projects, on a no-policy-change basis, a further decline in the deficit to 2% of GDP. This suggests that the deficit has been brought below the 3% of GDP ceiling in a credible and sustainable manner, as required by the Recommendation under Article 104(7);

– Government debt declined from 71¾% of GDP in 2004 to 70¼% in 2005. According to the Commission services' spring 2006 forecast, the debt ratio is projected to fall further to around 69% and 68% of GDP in 2006 and 2007 respectively. The pace of debt reduction towards the 60 % of GDP reference value is in line with the Recommendation under Article 104(7);

(6) According to the Council Opinion of 14 March 2006 on the updated convergence programme of Cyprus, 2005-2009, the measures planned by the Cypriot authorities over the programme period would bring the structural deficit to about ½% of GDP by 2009, which is considered the medium-term objective chosen by the Cypriot authorities. Based on the estimated outturn for 2005 and taking account of the balance of risks to the budgetary targets, the budgetary stance in the programme seems sufficient to ensure that the programme's MTO is almost reached by 2009, as envisaged in the programme. In the years following the correction of the excessive deficit, the pace of adjustment towards the programme's MTO implied by the programme is broadly in line with the Stability and Growth Pact.

(7) Decision 2005/184/EC should therefore be abrogated

HAS ADOPTED THIS DECISION:

Article 1

From an overall assessment it follows that the excessive deficit situation in Cyprus has been corrected.

Article 2

Decision 2005/184/EC is hereby abrogated.

Article 3

This Decision is addressed to the Republic of Cyprus.

Done at Brussels, 11 July 2006.

For the Council
The President