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Analysis by the Commission services of the budgetary situation in Cyprus following the adoption of the Council Recommendation to Cyprus of 13 July 2010 with a view to bringing an end to the situation of an excessive government deficit

Accompanying the document

Recommendation for a

COUNCIL RECOMMENDATION

with a view to bringing an end to the situation of an excessive government deficit in Cyprus

{COM(2013) 284 final}

1. INTRODUCTION

On 13 July 2010, the Council decided in accordance with Article 126(6) of the Treaty of the Functioning of the European Union (TFEU) that an excessive deficit existed in Cyprus and issued a recommendation to Cyprus in accordance with Article 126(7) of the 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 in line with Article 3(4) of Regulation (EC) 1467/97 a deadline of 13 January 2011 for effective action to be taken.

Specifically, the Council recommended that Cyprus brings the general government deficit below 3% of GDP by 2012 in a credible and sustainable manner by taking action in a medium-term framework. To this end, Cyprus was recommended to: "(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) ensure an average annual fiscal effort of at least 1½% of GDP in 2011-12, also in order to 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 expected at the time"[2].

On 27 January 2011, the Commission (following an assessment of action taken by Cyprus, in line with Art. 9(3) of Regulation (EC) No 1467/97) concluded that, on the basis of information available at the time, Cyprus had taken action representing adequate progress towards the correction of the excessive deficit within the time limits set by the Council[3]. On 11 January 2012, the Commission confirmed that Cyprus had taken effective action in compliance with the Council Recommendation of 13 July 2010 to bring its government deficit below the 3% of GDP reference value and considered that no additional step in the excessive deficit procedure was therefore necessary.

This document provides an assessment of whether Cyprus has undertaken effective action towards the correction of its excessive general government deficit and considers the case for an extension of the time necessary for a sustainable correction of the excessive deficit. In particular, the document examines the budgetary developments since the Commission Communications to the Council on action taken as of 27 January 2011 and of 11 January 2012.

On 25 June 2012, Cyprus formally presented to euro-area Member States a request for external financial assistance from the EFSF/ESM to contain the risks to the Cypriot economy, notably those arising from the banking sector. On 27 June 2012, the Eurogroup invited the

[1] OJ 115, 9.5.2008, p. 99–102. 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.

[2] Council Recommendation to Cyprus with a view of bringing an end to the situation of an excessive deficit procedure, 11296/10, Council of the European Union.

[3] Communication from the Commission to the Council - Current state of the excessive deficit procedure in the Member States and assessment taken by Cyprus, Finland, Bulgaria and Denmark in response to the Council Recommendation of 13 July 2010 with a view to bringing an end to the situation of excessive government deficit - COM(2011) 22 final.

European Commission (EC), in liaison with the European Central Bank (ECB), the Cypriot authorities and the International Monetary Fund (IMF) to agree on an economic adjustment programme, including the financing needs, and to take appropriate action to safeguard financial stability, in light of the very challenging external environment and spill-over effects from sovereign market turbulence. On 23 November 2012, a provisional staff level agreement was reached with Cyprus on the policy adjustments and conditionality underpinning an economic adjustment programme, which were laid down in a draft Memorandum of Understanding on Specific Economic Policy Conditionality (MoU). On 16 March and 25 March 2013, the Eurogroup reached a political agreement with Cyprus on the key elements of a programme, which included the restructuring and substantial downsizing of the banking sector and the reinforcement of efforts on fiscal consolidation, structural reforms and privatisation. On 2 April 2013, staff level agreement on the updated MoU was reached between Cyprus and the EC/ECB/IMF. On 25 April 2013, the Council adopted a decision under Article 136 TFEU containing the main elements of the macroeconomic adjustment programme to be implemented by Cyprus. On 26 April 2013, a Memorandum of Understanding consistent with the said decision was signed by the Cypriot authorities and the Commission, acting on behalf of the ESM.

2. RECENT MACRO-ECONOMIC AND BUDGETARY DEVELOPMENTS

More than a decade of sustained and strong economic expansion in Cyprus came to an end in 2009. Economic activity in Cyprus fell by 1¾%, with weak domestic demand and an adverse external environment weighing strongly on growth. Economic activity recovered in 2010 with real GDP growth of 1.1%.

The Cypriot economy grew by a modest 0.5% in 2011, 0.8 p.p. lower than projected in the Commission services' 2010 Spring Forecast underlying the Council recommendation of 13 July 2010. After a relatively strong first half year, when GDP increased by 1.5% (yoy), economic activity was seriously affected by an accident in July 2011, which destroyed the Vasilico power station. Significant reductions in investment and private consumption were observed following the explosion.

Table 1: Macroeconomic developments and outlook

	2011		2012	2013	2014	2015	2016
	Outturn	SF10	Programme Forecast (*forecasted data)*				
Real GDP (% change)	0.5	1.3	-2.4	-8.7	-3.9	1.1	1.9
Contributions to real GDP growth (pps):							
Final domestic demand	-2.2	1.1	-6.1	-13.7	-5.5	0.9	2.0
Changes in inventories	0.5	0	-0.8	0	0	0	0
Net exports	2.2	0.3	4.4	5.0	1.6	0.2	0
Employment (% change)	0.5	-0.2	-4.1	-6.5	-3.1	1.1	1.3
GDP deflator (% change)	2.7	1.1	2.0	0.6	1.1	1.5	1.8
Output gap (% of potential GDP)	1.2	-1.6	0.0	-6.2	-7.6	-4.3	-0.9
Potential output growth	0.3	0.7	-1.3	-2.6	-2.5	-2.3	-1.6

(% change)								

Source: Commission services, SF10: Spring Forecast 2010; Programme Forecast: Commission services' most recent forecast underpinning the economic adjustment programme agreed in April 2013

At the same time, over the course of 2011 developments in the financial sector and growing uncertainty regarding the public finances position, including the impact of financial sector related contingent liabilities started having a negative impact on consumer and corporate sector confidence and economic activity. These adverse developments relate to the unwinding of very serious private and public sector imbalances in the Cypriot economy as well as the negative spill-over from financial and economic turmoil in neighbouring economies. The onset of the deleveraging process was marked by tightening financial conditions and much-needed fiscal consolidation measures, which compounded the negative effect on economic activity. This, together with a high degree of economic uncertainty and the deterioration in labour market conditions, took its toll on the growth of domestic demand in 2011, which registered -2.2% compared to the 1.1% projected in the Commission's 2010 Spring Forecast. Private consumption grew slightly (0.5%) and investment activity suffered a sharp decline (-13.0%), both of which were significantly below the Commission's 2010 Spring Forecast (1.9% for private consumption growth and -3.8% for GFCF). The continued weakness of the international environment prevented external demand from fully offsetting the subdued domestic demand even if a positive contribution to growth was observed as a result of two good consecutive tourist seasons and a reduction in imports in line with the fall of domestic demand.

The Commission services' forecast which underpins the agreed economic adjustment programme and thus incorporates the agreed MoU measures, and being also the most recent Commission services' forecast, (hereafter the Programme Forecast) projects a worsening of economic activity in 2012, with real GDP declining by 2.4%. Private consumption is forecasted to recede by 3.0%, while investment activity is expected to suffer a further sharp drop (-23.0%). Although 2012 was beyond the forecast horizon at the time of the Commission services' 2010 Spring Forecast underlying the Council recommendation, higher growth than in 2011 was expected for 2012 at that time, under the hypothesis of a gradual closure of the negative output gap. This was apparent in the Commission's services 2010 Autumn Forecast which projected GDP growth for 2012 at 2.2%, with positive private consumption growth of 2.2% and only a small fall (-1.5%) in gross fixed capital formation. The main reasons for the significantly worse 2012 outcome than earlier expected are found in a series of events that affected the Cypriot economy adversely from the second half of 2011 onwards. These relate notably to the unwinding of Cyprus' unsustainable economic imbalances, which led to a widespread loss of confidence among economic agents and a loss of access to long-term market financing for both the sovereign and major financial institutions, to the Cypriot economy's exposure to Greece, the explosion of the major electricity plant, and the implementation of much-needed fiscal consolidation measures.

The Programme Forecast projects that the economy would suffer an important output loss in 2013 and continue to contract in 2014 due to a significant drop in private consumption and investments, as well as weak export volumes. Developments are driven by the immediate restructuring of the banking sector, temporary capital controls, the worsening labour market outlook with rising unemployment and negative real wage growth, the impact of fiscal consolidation and anaemic consumer and business confidence.

Public debt developments

Public debt rose by almost 10 p.p. to 71.1% of GDP in 2011. Debt developments were mostly driven by higher stock-flow adjustments due to a bilateral loan granted from Russia in 2011 and the government's participation in the recapitalisation of one commercial bank in June 2012. In addition, higher-than-expected deficit outcomes, partly arising from higher borrowing costs due to Cyprus' difficulty in accessing international markets, as well as the slowdown in the nominal GDP (through the denominator effect) also increased the debt level. It is projected to reach 85.8% of GDP in 2012 based on the Programme Forecast.

Table 2: Public debt developments 2009-2012

	2009	2010	2011	2012
Gross debt ratio (% of GDP)	**58.5**	**61.3**	**71.1**	**85.8**
Changes in the ratio (pps)	*9.6*	*2.8*	*9.7*	*14.7*
of which				
(1) Primary balance (pps)	**3.6**	**3.0**	**3.9**	**3.1**
(2) Snowball effect (pps)	**3.4**	**0.4**	**0.4**	**3.6**
Interest expenditure (pps)	*2.6*	*2.3*	*2.4*	*3.2*
Growth effect (pps)	*0.9*	*-0.8*	*-0.3*	*1.8*
Inflation effect (pps)	*0.0*	*-1.1*	*-1.7*	*-1.4*
(3) Stock flow adjustment (pps)	**2.6**	**-0.6**	**5.4**	**8.1**

Source: Commission services

3. EFFECTIVE ACTION

3.1. Background information

In 2010, the year of the Council recommendation, the general government deficit was reduced to 5.3% of GDP from 6.1% in 2009 due to discretionary revenue measures (in particular a deemed dividend distribution fee of 15% on undistributed corporate profits, a rise in the excise duties imposed on petroleum products and increased contribution rates as part of a pension reform) and one-off revenues (the transfer of higher-than-usual central bank profits). The increase in revenues was partially offset by higher expenditures, in particular rising expenditure on social benefits due to an increase in the unemployment rate and the enactment of discretionary social policy measures.

With a view to ensuring a fiscal effort in line with the Council's recommendation, the Cypriot authorities put forward in autumn 2010 - in preparation of the 2011 Budget Law - a fiscal consolidation package aimed at containing the fiscal deficit at 4.5% of GDP in 2011. On the expenditure side, measures included cuts in the government's operating expenditure (i.e., reduction in intermediate consumption) and restraint in public investment and employment. On the revenue side, measures included a phase-out of the tax relief on excise duties and VAT, which was part of an earlier stimulus package of 2010. The 2011 budget also incorporated higher excise duties on petroleum products, foodstuff and pharmaceuticals.

In the second half of 2011, the government adopted three further sets of fiscal measures. The first set of measures adopted in August 2011 included additional contributions from public sector employees to the Government Employees Pension Scheme, the inclusion of new public sector employees in the general pension scheme under the social security fund instead of the more generous public sector pension scheme, and the increase of the withholding tax on interest accrued on deposits of credit institutions operating in Cyprus, excluding subsidiaries and branches operating outside of Cyprus, and branches in Cyprus of credit institutions and

Member States of the European Union and of branches of credit institutions from third countries. In context of preparing the 2012 Budget Law, an additional set of measures contained, inter alia, better targeting of social transfers, a hike in the VAT rate from 15% to 17%, a temporary reduction in the public sector wage bill by freezing emoluments, and an increase of the tax rate on deemed dividend distribution from 17% to 20% for a period of two years. On the day of adoption of the 2012 Budget Law, the Parliament voted last-minute amendments comprising a cut of about 8% in selected government expenditure categories.

In November 2012, in context of the provisional staff-level agreement on an economic and financial adjustment programme, Cyprus took steps to implement additional measures for the remainder of 2012. In particular, a scaled reduction in emoluments of public and broader public sector employees and pensioners was implemented for the remaining salary payments in 2012 (salary payments of December and the 13th salary), while general government received a one-off additional dividend income collected from a semi-public organisation.

3.2. Earlier assessments of effective action

On the basis of the 2011 draft budget available at that time, the Commission services' 2010 Autumn Forecast[4] projected a deficit of 5.7% of GDP for 2011. This forecast did not incorporate the additional consolidation measures agreed by the Government and presented in context of the 2011 Budget Law since the measures had not been yet adopted by the Parliament. The adoption of the consolidation package was taken into account subsequently. As a result, the Commission concluded on 27 January 2011 that Cyprus would ensure a fiscal effort of at least 1½% of GDP in 2011 and had taken effective action with a view to bringing an end to the situation of excessive deficit by 2012.

The 2011 update of the Stability Programme (SP) presented a headline deficit target of 4.0% of GDP for 2011 on the basis of a lower-than-expected deficit outturn of 5.3% of GDP in 2010. In contrast to the target of the SP, the Commission services' 2011 Autumn Forecast estimated the budget deficit at 6.7% of GDP. The deviation from the national forecast was mainly due to expected lower revenues (2¼% of GDP) and slightly higher expenditures (½% of GDP). Based on its assessment of the adopted consolidation measures, and taking into account cyclical conditions, the Commission concluded on 11 January 2012 that Cyprus had taken effective action to correct the excessive budget deficit in a timely and sustainable manner.

3.3. Current assessment of effective action

The assessment of effective action should be seen as the result of the comparison of the recommended fiscal effort in the Council recommendation, the apparent fiscal effort, measured by the change in structural balance, and the adjusted structural effort. The adjustment takes into account: (i) the impact of revisions in potential output growth compared to that underlying the growth scenario in the Council recommendation (alpha), and (ii) the impact on revenue of revisions of the tax content of economic activity (composition of economic growth) relative to what was assumed at the time of the recommendation (beta). This top-down approach is complemented by a careful analysis, including a bottom-up assessment of consolidation measures undertaken by Cyprus.

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[4] The Commission services' 2010 Autumn Forecast was published on 29 November 2010. The data cut-off date was 15 November 2010.

According to the Programme Forecast, which incorporates the policy measures agreed in the MoU, the structural deficit was 5.7% of GDP in 2010, 6.6% of GDP in 2011 and is projected at 6.7% of GDP in 2012.

At the time of the Council Recommendation, a steady economic recovery was expected to materialise over the adjustment period. After a projected fall in GDP in 2010, real GDP growth in 2011 was projected at 1.3% and was seen to strengthen thereafter (see section 2). In terms of actual outturn, real GDP growth however weakened year-by-year over 2010-2012 and fell significantly short of projected in both 2011 and 2012 (Table 4). This was mainly due to less resilient domestic demand than expected, in particular weaker private consumption growth and a larger contraction of investment activity. For 2011, the shortfall in growth was marked by the loss in output after the destruction of the Vasilico power plant. The Commission services' 2011 Spring Forecast projected growth of 1.5% for 2011 compared to the Commission services' 2011 Autumn Forecast of 0.3%, which took into account the disruption of economic activity. For 2012, the more pronounced and protracted recession than expected in the Commissions' services successive forecasts was caused in particular by an abrupt drop in domestic demand and investment activity, and a deterioration in the labour market, which had a negative impact on disposable income and private consumption.

The fall in investment and worse labour market developments, depicted in successive Commission services' forecasts from the time of the Council Recommendation in July 2010, also find evidence in the considerable downward revisions in the estimate of Cyprus' potential growth (Table 3). At the time of the Council Recommendation, 2011 potential output growth was estimated at around 0.7% compared to the current estimate of 0.3% in the Programme Forecast. Actual growth for 2011 turned out well below what was originally projected in the forecast underpinning the EDP recommendation. Together with revisions to potential growth in preceding years this has resulted in the estimated output gap to now be considered positive, while it was estimated to be largely negative at the time of the Council Recommendation. However, despite the significant revisions in the level of output gap, the year-on-year change in the output gap in 2011 has only been slightly revised.

For 2012, the Commission services' Autumn 2010 forecast estimated potential output growth to be in the order of 1% compared to the current estimate of -1.3% in the Programme Forecast. The significant revisions of the estimates of the potential growth underlie also the large changes in the estimates of the output gap in 2012, which from being largely negative have progressively being projected as more positive. This is the case also for recent forecasts, where the projection of actual growth has been stable, while the estimate of potential growth has changed. The year-on-year change in the output gap has also been significantly revised in the direction of depicting worsening cyclical conditions.

Table 3: Comparison of potential growth estimates for 2011 and 2012

		SF 2010	AF 2010	SF 2011	AF 2011	SF 2012	AF 2012	WF 2013	SF 2013
Potential Growth (annual % change)	2011	0.7	1.1	1.3	0.9	0.3	0.8	0.8	0.3
	2012	1.5	1.1	1.4	1.1	0.4	-0.7	-0.7	-1.3
Actual Growth (annual % change)	2011	1.3	1.5	1.5	0.3	0.5	0.5	0.5	0.5
	2012	n.a.	2.2	2.4	0.0	-0.8	-2.3	-2.3	-2.4
Output gap (% of potential output)	2011	-1.6	-1.8	-1.5	-1.0	-0.6	-0.4	0.4	1.2
	2012	n.a.	-0.7	-0.5	-2.1	-1.9	-2.0	-1.3	0.0

Swings in potential growth estimates are quite strong in the case of Cyprus, related to the revisions to actual growth and real economy variables. This is seen by variation over successive forecasts in the contributions to potential growth stemming from total labour, capital accumulation, and productivity (TFP). Revisions to the contributions concern both their share in potential growth and in some cases the sign of the contribution to potential growth (i.e. positive or negative) for 2011-2012. Correcting the apparent change in the structural balance for the impact of revisions in potential output growth ('alpha') compared to that underlying the growth scenario in the Council recommendation of July 2010, the average annual change in the structural balance over the period 2011-2012 would be around 0.5% of GDP.

Table 4: Comparison of budgetary adjustment

	2010		2011		2012	
	outturn	COM 2010 SF	outturn	COM 2010 SF	Programme Forecast	COM 2010 AF
	% of GDP	% of GDP	% of GDP	% of GDP	% of GDP	% of GDP
Revenue	40.9	41.2	39.7	41.3	40.0	40.5
of which:						
- Taxes on production and imports	15.4	15.0	14.5	15.2	14.8	15.8
- Current taxes on income, wealth, etc.	11.1	11.2	11.7	11.2	11.1	10.8
- Social contributions	8.9	9.6	8.7	9.6	9.1	8.8
- Other (residual)	5.5	5.4	4.8	5.3	5.0	5.0
Expenditure	46.2	48.3	46.0	49.0	46.3	46.2
of which:						
- Primary expenditure	43.9	45.6	43.6	46.1	43.1	43.7
of which:						
- Compensation of employees	15.8	15.9	16.0	16.0	15.8	16.1
- Intermediate consumption	5.6	5.8	5.3	5.8	5.1	5.0
- Social payments	14.4	15.2	14.6	15.7	15.1	15
- Subsidies	0.4	0.4	0.5	0.4	0.5	0.4
- Gross fixed capital formation	3.8	4.1	3.5	4.1	2.7	3.7
- Other (residual)	3.9	4.2	3.7	4.1	3.9	3.6
- Interest expenditure	2.2	2.7	2.4	2.9	3.2	2.4
General government balance	-5.3	-7.1	-6.3	-7.7	-6.3	-5.7

(GGB)						
Primary balance	-3.0	-4.4	-3.9	-4.8	-3.1	-3.3
One-off and other temporary measures	0.0	0.0	-0.2	0.0	0.4	0
Cyclically-adjusted balance	-5.7	-6.3	-6.8	-7.1	-6.3	-5.4
Structural balance	-5.7	-6.3	-6.6	-7.1	-6.7	-5.4
Change in structural balance	0.8	0.0	-0.9	-0.8	-0.1	-0.4
Corrected change in structural balance due to revision of potential output growth ('alpha')			0.1		0.5	
Real GDP growth	1.3	-0.4	0.5	1.3	-2.4	2.2
GDP deflator	1.9	2.1	2.7	2.4	2.0	2.5
Nominal GDP	3.3	1.5	3.3	3.6	-0.5	4.8

Source: COM 2010 SF: Commission Services' 2010 Spring Forecast; Programme Forecast; COM 2010 AF: Commission Services' 2010 Autumn Forecast, which was the first forecast to include projections for 2012.

Table 5: Change in the structural balance corrected for revisions in potential output gap and revenue windfalls/shortfalls

Uncorrected fiscal effort (ΔS)		Fiscal effort corrected for **α** and **β** (ΔS*)		*Required fiscal effort in the latest 2010 Council recommendation (**R**)*	Deadline for correction
2011	2012	2011	2012	2011 – 2012	2012
-0.9	-0.1	2.2	2.4	1½	

Source: Commission services

The less tax-rich growth composition in 2011 and 2012, marked by lower-than-projected final domestic demand and lower imports, and the stronger deterioration in the labour market also led to major revenue shortfalls, notably in indirect taxes. For 2011, the difference between the projected revenue ratio underpinning the Council Recommendation and the actual outcome is around 1.5 p.p. of GDP. This was in particular due to: (i) the loss in output after the destruction of the Vasilico power plant; (ii) growth composition effects leading to lower revenue collection, e.g. due to lower activity in the construction sector and lower collection of revenues from income taxation and social contributions due to the reduction of compensation of employees in the public sector; (iv) reduced corporate profitability as a consequence of the economic slowdown. For 2012, the total revenue ratio turned out closer to projected, but indirect tax collection was particularly weak, showing a shortfall of 1 p.p. compared to what was projected in autumn 2011. In addition to the factors that impacted on 2011, this was in particular due to: (i) tightening bank lending conditions and weakening confidence weighing on private consumption, (ii) subdued foreign demand for housing, (iii) restructuring of corporate balance sheets which kept investment on a strong downwards correction path and (iv) less tax rich growth, e.g. exports of tourism gaining relative weight while final domestic demand posted a negative drag to GDP of around 6% of GDP. Moreover, a further worsening of the labour market caused a certain shortfall in social contributions compared to the projected. As a result, despite the adoption and implementation of discretionary revenue measures, overall revenue collection turned out weaker than expected.

The deterioration of the expectations about economic developments, and therefore revenue collection, is also reflected in the downward trend in successive Commission services' forecasts since spring 2011.

After revising upward the forecast of the 2011 nominal GDP between the 2010 spring and autumn forecasts, nominal GDP was substantially revised downwards in three successive forecasts and then revised upward again in the autumn of 2012. In parallel, the forecast of total revenues was also adjusted downwards, even in the last forecast of autumn of 2012. Finally, total revenues collected in 2011 were only slightly higher than in 2010 in spite the 3.3% growth in GDP. Abstracting from one-offs, this was driven by developments in taxes on production and imports and in social contributions rather than current taxes on income and wealth, which were higher in 2011 compared to 2010 and also higher than projected in 2010. Looking deeper into the reasons for this underperformance in taxes on production and imports results in a mixed picture. A comparison of 2010 with 2011 shows that the weak performance cannot be explained by developments in the tax bases. However, compared to the forecast underpinning the Council Recommendation, the tax base for indirect taxes, which constitute more than 80% of taxes in production and imports, indeed turned out much lower. In addition, excise duties on motor vehicles also performed considerably worse than in 2010. The downward revision of expected social contributions is partially explained by a downward revision of compensation of employees.

For 2012, nominal GDP has been revised downward by close to 7% from EUR billion 19.2 (and nominal GDP growth of 4.8%) in autumn 2010 to 17.9 (and nominal GDP growth of -0.5%) in the spring forecast of 2013, with a parallel deterioration of the forecasted tax bases as well. Compared to 2011, the overall performance of revenues was slightly better than expected. Despite the 0.5% decrease of nominal GDP from the previous year, revenues increased by 0.2%. However, eliminating the effect of one-offs and discretionary measures, revenues would have gone down by around 3%. Contrary to 2011, the source of underperformance does not lie in indirect taxes. Despite a decrease in total consumption, collection of taxes on production and imports went up compared to 2011. This is partially explained by discretionary measures, also considering that some of the 2011 measures came into full effect only in 2012, but is also linked to the weak performance in 2011. For taxes on income and wealth, the picture is different. They deteriorated more than what standard elasticities would suggest. Looking into a breakdown of revenues gives a mixed picture. While personal income tax performed roughly as expected, corporate income tax underperformed substantially compared to developments in its tax base (gross operating surplus). Increased capital write-offs could have contributed to this underperformance. The parallel deterioration of collection from the special defence contribution by roughly 10%, despite a tax rate increase on dividend and interest income, is likely due to substantially lower pay-outs of dividends. Other revenues in the category taxes on income and wealth that deteriorated substantially are capital gains taxes, which are likely linked to the deteriorating real estate market, and penalties, which are probably due to the tax amnesty that was decided at the end of 2011. Social contributions in 2012 seem to have performed well since collection of social contributions went up by 4.3% despite a stronger than expected contraction of the revenue base. The additional collection is partially explained by the introduction of a 3% contribution on public sector salaries, but the increase may have been large also due to the weak performance of social contributions in 2011.

Accounting for the impact of revisions to the composition of economic growth and shortfalls of revenue, the adjusted average annual improvement of the structural budget balance over 2011-2012 would be around 2.4% of GDP. This is above the minimum average annual fiscal effort of at least 1½% of GDP over 2011-2012 required by the Council recommendation. Cyprus can therefore be considered to have taken effective action.

This analysis is confirmed by the bottom-up assessment of Cyprus having adopted sizeable consolidation measures over 2011-12. As described in section 3.1, the Cypriot authorities have undertaken in all five sets of fiscal consolidation measures impacting on 2011-2012, which have, however, been ineffective in containing the continued deterioration in public finances caused by shortfalls in indirect taxation and social contributions.

A first set of measures accompanied the 2011 Budget Law (Table 6) which amounted to an estimated impact of 1% of GDP on the 2011 fiscal outcome (0.4% GDP deriving from expenditure measures and 0.6% of GDP from revenue measures). The measures were implemented as of October 2011. The adoption of the package of consolidation measures in August 2011 is estimated to have had a deficit-reducing impact of 0.3% of GDP in 2011 and an additional impact in 2012 of 0.8% of GDP (equally distributed between expenditure and revenue).

The additional set of measures prepared for implementation via the 2012 Budget Law is estimated to have had a fiscal impact of 2.9% of GDP in 2012 (2.1% expenditure side and 0.8% revenue side). The last-minute amendments to the Budget Law 2012 produced an additional fiscal impact of 0.3% of GDP in 2012. All measures were implemented as of January 2012 with the exception of the increase of the standard VAT rate from 15% to 17% on 1 March 2012.

Finally, in November 2012, in the context of the provisional staff-level agreement reached, Cyprus took steps to implement additional measures with a fiscal impact of 0.3% of GDP for the remaining part of 2012.

In sum, the Cypriot authorities have adopted consolidation measures with an estimated direct deficit-reducing impact in 2011 of around 1½% of GDP. For 2012, the Cypriot authorities have adopted consolidation measures with an estimated direct deficit-reducing impact of around 4¼% of GDP.

Table 6: Main discretionary budgetary measures in 2011 and 2012

	2011 (% GDP)	**2012 (% GDP)**
2010 (2011 Budget Law) measures (expenditure)	• Reduction of operational expenditures and current transfers (-0.4%) • Containment in the rate of growth of capital expenditure (-0.2%) • Temporary mitigating measures in view of the application of a reduced VAT on foodstuffs and pharmaceutical products (0.1%)	• Termination of the mitigating measures in view of the application of a reduced VAT on foodstuffs and pharmaceutical products (-0.1%)
2010 (2011 Budget Law) measures (revenue)	• Increased excise duties on petroleum products in line with the *acquis* (0.4%) • Application of a reduced VAT on foodstuffs and pharmaceutical products (0.3%) • Termination of the application of reduced VAT on hotels and restaurants (0.2%) • Termination of the reduced excise duty on heating oil during the winter season (0.1%)	
2011 measures (expenditure)	• Reduction in the government's social security contribution on gross earnings of broader public sector employees (-0.1%) • Public sector wage cut in the form of a temporary contribution on gross earnings of broader public	• Reduction in the government's social security contribution on gross earnings of broader public sector employees (-0.2%) • Public sector wage cut in the form of a temporary contribution on gross earnings of broader public sector

	sector employees and pensioners (-0.1%) • Transfer to CY Airways due to extra costs related to embargo of airspace use (0.1%)	employees and pensioners (-0.1%) • The reverse effect of the transfer to CY Airways due to extra costs related to embargo of airspace use (-0.1%)
2011 measures (revenue)	• Bank levy at a rate of 0.095% of bank's deposits excluding intra-bank deposits (0.4%) • Application of increased excise duties on tobacco products (0.1%) • Introduction of a levy on registered companies (0.1%) • Return of penalty imposed by the national competition authority on petroleum companies (-0.2%) • The reverse effect of 2010 extraordinary dividends from the Central Bank of Cyprus (-0.5%)	• Introduction of a levy on registered companies (0.1%) • Effect of the 2011 reduced revenue due to the return of penalty imposed by the national competition authority on petroleum companies (0.2%)
2012 (2012 Budget Law) measures (expenditure)		• Targeting of all social schemes based mainly on income and economic criteria. (-0.8%) • Freezing of emoluments including pensions in the public sector for a period of two years (this includes COLA effect) (-0.7%) • Reduction of the number of personnel in the broader public sector by 5,000 over the next five years (one recruitment for every four retirees) (-0.1%)
2012 (2012 Budget Law) measures (revenue)		• Increase of the standard VAT rate from 15% to 17%. The inflationary impact of this measure on the calculation of the COLA index will be excluded (0.6%) • Increase of the tax rate on deemed dividend distribution from 15% to 17% (0.3%) • Application of the reduced VAT rate on purchases or construction of primary residences (0.3%) • Revenue from rights issue of one of the banks (0.2%) • Temporary contribution on gross earnings of private sector employees and pensioners: 0-€2500 0%; €2501 - €3500 2.5% (0.1%)
Note: A positive sign implies that revenue / expenditure increases.		

Only measures yielding more than 0.1% of GDP are listed.

Source: Commission services

Table 7: Consolidation measures for 2012 in the MoU

2012 measures (expenditure)	• Scaled reduction in emoluments of public and broader public sector pensioners and employees including employees of private organizations as follows: €0-1000: 0%, €1001-1500: 6.5%, €1501-2000: 8.5%, €2001-3000: 9.5%, €3001-4000: 11.5%, €4001: 12.5% (-0.2%)
2012 measures (revenue)	• Dividend from a semi-government organization (0.2%)
Note: A positive sign implies that revenue / expenditure increases.	

Source: Commission services

4. Proposed new adjustment path

Despite the significant fiscal consolidation undertaken in 2011-2012, Cyprus did not correct its excessive deficit by the deadline established in the Council Recommendation of 13 July 2010 due to the deterioration in the budgetary position resulting from the weaker overall position of the economy.

4.1 Macroeconomic outlook

Looking ahead, the Cypriot economy is expected to face strong headwinds in the coming years, with a projected return to growth only in 2015 (Table 8). Under the Programme Scenario, the weakness of economic activity is expected to persist over the first years of the programme period. It is projected that domestic demand will continue to contract up to and including 2014, due to a drag on economic activity from both falling household consumption and investment. The immediate restructuring of the banking sector, which will impact on net credit growth, the rapid deterioration in labour market conditions and the high degree of economic uncertainty are together expected to weigh heavily on domestic demand. Furthermore, there is a continued need to deleverage corporate and private sector balance sheets. In addition, the temporary restrictions required to safeguard financial stability are expected to hamper international capital flows and to reduce business volumes in both domestic and internationally oriented companies. The bail-in of uninsured depositors causes a loss of wealth and will have short-term confidence effects, which will reduce private consumption and business investment. This, compounded by the impact of fiscal consolidation already undertaken and new measures agreed, is expected to result in a considerable fall in domestic demand. Little reprieve can be expected from exports amid uncertain external conditions and a shrinking financial service sector.

Growth is projected to rebound mildly in 2015 and stronger in 2016. The fiscal consolidation is expected to restore the confidence of consumers and investors, while the result of deleveraging of both household and corporate balance sheets over time would create the conditions for more balanced growth. At the same time, the restoration of a sound and well-capitalised banking system is expected to gradually loosen the tight credit conditions in the economy. In 2015, first positive effects of the economic adjustment programme are expected to be supported also by an improved external environment and a gradual normalisation of labour market conditions. In 2016, the economy is expected to build on the positive momentum set up in 2015 with private consumption again driving economic activity, as economic sentiment improves. Also, in the outer years 2015-2016, investment projects related to the exploitation of natural gas should contribute increasingly to economic growth. The recent reform of Cyprus' wage-indexation system (COLA) will contribute to align public wages with developments in economic activity, improve competitiveness, and support the economic recovery. This is expected to have a positive impact on the external balance, with the current account deficit contracting over the programme period and external debt, in particular related to external liabilities of financial institutions, projected to decline.

Macroeconomic risks remain important and tilted to the downside. On the domestic front, downside risks are associated with domestic credit conditions and further deterioration of confidence in the banking system. Moreover, there is a non-negligible risk of a cycle of household and corporate defaults propagating through the economy, leading to further banking sector losses, worsening of labour market conditions, stronger than expected fall in house price and a prolonged loss of business and consumer confidence. Also, the deep restructuring of the Cypriot banking sector could have strong spill-overs on related professional business services and financial services exports. More generally, the transition to a more diversified growth model will be challenging for the economy in the coming years and will imply a re-allocation of economic resources across sectors, which may take time and will require flexible factor and product markets. Upside risks for the Cypriot economy are limited, relating mainly to higher investment activity in the energy sector and possible improvements in the external outlook, should the euro area economic activity strengthen beyond expected.

Table 8: Forecast of key macroeconomic and budgetary variables under the Programme Scenario

% of GDP (unless indicated otherwise)	2012p	2013f	2014f	2015f	2016f
Revenues	40.0	40.6	39.1	39.4	40.8
Current revenues	39.9	40.6	39.0	39.4	40.7
Discretionary measures with impact on current revenue (EUR million)	362	631	167	-21	-27
Expenditure	46.3	47.1	47.5	45.7	43.7
Nominal GDP (EUR million)	17,887	16,425	15,951	16,361	16,967
Nominal GDP growth	-0.5	-8.2	-2.9	2.6	3.7
Real GDP growth	-2.4	-8.7	-3.9	1.1	1.9
Potential GDP growth	-1.3	-2.6	-2.5	-2.3	-1.6
Structural balance	-6.7	-5.4	-5.1	-4.4	-2.5
Primary balance	-3.1	-2.4	-4.3	-2.1	1.2
General government balance	-6.3	-6.5	-8.4	-6.3	-2.9
p.m CAB methodology revenue elasticity	1.0	1.0	1.0	1.0	1.0
p.m Apparent revenue elasticity	9.5	1.9	1.4	1.3	2.0
p.m Output gap (% of potential output)	0.0	-6.2	-7.6	-4.3	-0.9

Source: Commission services
p:provisional data; f:forecasted data

4.2 Government deficit and public debt trajectory

An ambitious but achievable fiscal adjustment path over the medium-term is essential to make Cyprus' public debt sustainable. For this reason, a key objective of the fiscal strategy and the agreed consolidation measures in the MoU is to achieve a strengthening of the primary balance over the programme period, with primary balance targets of -2.4% of GDP in 2013, -4.3% of GDP in 2014, -2.1% of GDP in 2015 and 1.2% of GDP in 2016. The attainment of these targets is consistent with headline deficit targets of 6.5% of GDP for 2013, 8.4% of GDP for 2014, 6.3% of GDP for 2015, and 2.9% of GDP in 2016

The adoption and implementation of fiscal-structural measures are critical to achieve a permanent consolidation and maintain a primary surplus at high level over the longer-term, leading to a primary balance surplus of 3% of GDP in 2017 and 4% of GDP in 2018, which should be maintained at such level thereafter. The range of fiscal-structural and structural reforms agreed in the MoU include establishing a medium-term budgetary framework, undertaking pension, health care and welfare system reform measures, enhancing revenue collection and tax administration, and ensuring improvement to the public finance management and the functioning of the public sector.

The majority of the fiscal adjustment measures for 2012-14 agreed in November 2012 are already enacted. Some measures agreed in November 2012, amounting to around 0.6% of GDP, are not yet implemented, notably the revision of the property tax and of the social housing schemes. These measures will be legislated and implemented before disbursement of the first tranche of financial assistance. Moreover, as part of the 16 and 25 March 2013 Eurogroup political agreements, additional fiscal consolidation measures for 2013 of around 1.5% of GDP will be legislated and implemented before disbursement of the first tranche of financial assistance, namely (i) increase in the statutory corporate income tax to 12.5%, (ii) increase in the interest income withholding tax to 30% and (iii) increase in the bank levy to 0.15%. Finally, some further measures, in particular additional public sector wage cuts and a contribution by public sector employees to their health care scheme, will also be implemented as prior actions. The total additional fiscal measures in 2013 therefore amount at minimum to 2.5% of GDP.

The fiscal consolidation implies that the improvement in the primary balance over 2013-16 will contribute to reducing the debt ratio substantially within the programme period, in spite of the rather strong debt-increasing effects from interest expenditure and the projected recession (Table 9). Public debt developments are projected to be largely influenced by the financial assistance granted to finance the general government deficit, the redemption of maturing medium- and long-term debt and the recapitalisation of some financial institutions, notably the cooperative credit sector. Debt is projected to jump from 85.8% of GDP in 2012 to around 128% of GDP in 2015. Thereafter, on the back of solid primary surpluses and the projected return to positive GDP growth rates, the debt-to-GDP ratio will start falling to around 124% of GDP in 2016.

Medium-term downside risks to the projected debt developments are, however, material and linked to: (i) a possible stronger contraction of the economy and further worsening of the labour market outlook, which would affect expenditure and revenue collection and have a negative denominator effect, (ii) non-attainment of the agreed primary surplus targets established in the programme, (iii) insufficient structural fiscal measures to underpin sustained high primary surpluses, iv) a less tax-rich composition of growth and possible stronger sensitivity of revenues to the structural adjustment of the Cypriot economy, (v) lower-than-expected privatisation proceeds; (vi) a worsening of the economic situation in trade-partner economies, (vii) lack of success in regaining market access at a reasonable borrowing cost following the programme period.

Table 9: Public debt trajectory 2013-2016 under the Programme Forecast

	2013	2014	2015	2016
Gross debt ratio (% of GDP)	**109.5**	**124.0**	**127.9**	**123.9**
Changes in the ratio (pps)	*23.6*	*14.5*	*3.8*	*-4.0*
of which				

(1) Primary balance (pps)	**2.4**	**4.3**	**2.1**	**-1.2**
(2) Snowball effect (pps)	**11.7**	**7.4**	**1.0**	**-0.4**
Interest expenditure (pps)	*4.1*	*4.2*	*4.2*	*4.2*
Growth effect (pps)	*8.1*	*4.5*	*-1.3*	*-2.4*
Inflation effect (pps)	*-0.5*	*-1.2*	*-1.8*	*-2.2*
(3) Stock flow adjustment (pps)	**9.6**	**2.9**	**0.6**	**-2.4**

Source: Commission services

4.3 Extension of the EDP deadline

In view of the distance at end-2012 to the 3% of GDP reference value, and taking into account the current adverse macro-economic circumstances and the perspective of a longer-lasting deleveraging of the economy, it would appear that four additional years will be necessary for a sustainable correction of the excessive deficit.

Fully-specified consolidation measures of around 4¾% of GDP in 2013 are agreed in the MoU. This consolidation effort includes, as described above, additional fiscal measures in 2013 therefore of around 2.5% of GDP, due to (i) the additional consolidation measures decided by the Eurogroup as part of the political agreement on 16 and 25 of March 2013, (ii) the remaining 0.6% of GDP of measures to which Cyprus agreed in November 2012 and which are not yet legislated (i.e. on property taxation and expenditure cuts in housing schemes) and (iii) the public sector wage cuts and contribution by public sector employees to their health care scheme, amounting to about 0.4% of GDP. The Commission services' Winter 2013 forecast did not take into account these measures and nevertheless estimated an improvement in the structural balance from 2012 to 2013 of 1.8% of GDP. Against the background of a worse-than-expected deficit outcome in 2012 and substantial revisions to the macroeconomic outlook and potential output estimates, the improvement in the structural balance from 2012 to 2013 is now estimated at around 1.3% of GDP. On the basis of the Programme Forecast of deteriorating macroeconomic conditions, the headline deficit in 2013 is projected to increase marginally to 6.5% of GDP.

In 2014, fully-specified further consolidation measures amount to around 1¾% of GDP and are projected to improve the structural balance by 0.3% of GDP. It should be noted that these policy measures for 2014 have remained unchanged compared to those that were laid down in the November 2012 draft MoU. The Commission services' Winter 2013 forecast took into account these measures and indicated an improvement in the structural balance from 2013 to 2014 of around 1.4% of GDP. Based on the Programme Forecast, the structural balance is now set to improve only by 0.3% of GDP. This lower projected improvement of structural balance in 2014 – in spite of an unchanged set of consolidation measures – can be explained by (i) the deterioration of the tax base of the permanent measures introduced in 2013, which implies that some of these measures are projected to have a decreasing impact in 2014. An example of this is the increase in the withholding tax on interest income from 15% to 30%, which is projected to yield EUR 138mn in 2013 but only EUR 83mn in 2014, due to the reduction of the deposit base and of the interest rate paid. Albeit a permanent measure, it shows up as a deterioration of the structural balance due to a year-on-year reduction of the measure's budgetary impact by around EUR 55mn (0.3% of GDP). The same is the case for the increase in the bank levy; (ii) the downward revision of the impact of some of the consolidation measures already taken in light of the worse macroeconomic conditions throughout the programme period; (iii) a projected reduction of revenue collection in 2014 of some tax measures (e.g. collection of income taxation and VAT), since their revenue depends on economic activity of 2013 when the economy is projected to contract by 8.7% and, (iv) the fact that the standard elasticity used to determine the split between the cyclical component and the structural balance may not capture well the erratic economic developments. This may imply that the negative impact from the cyclical conditions is underestimated, which for a given headline deficit would arithmetically reduce the calculated structural effort. The bottom-up forecast of individual measures, item-by-item, may under the highly uncertain macroeconomic conditions give a more appropriate view of the fiscal effort, not least in a situation of significant shifts in actual and estimated potential output. The amount of fiscal consolidation measures is on average above 3% of GDP for the years 2013-2014. Albeit significant, the corresponding improvement in the structural balance is only around ¾% of GDP on average and remains insufficient to reduce the headline deficit.

It should also be noted that in light of the substantial additional consolidation measures for 2013 agreed in the Eurogroup meetings of 16 and 25 March and the adverse and highly uncertain macroeconomic conditions, inter alia due to the imposition of temporary capital controls, loss of confidence and financial sector instability, programme partners found that an ex-ante obligation to implement further fiscal consolidation measures for 2014 (additional to the measures adopted in December 2012 with effect from 1 January 2014) would not represent an appropriate fiscal policy stance. However, an obligation of the Cypriot authorities to stand ready to preserve the programme objectives by taking additonal measures in the event of underperformance of revenues or higher social spending, taking into account adverse macroeconomic effects, is laid down in the economic and financial adjustment programme.

High-quality permanent measures will be needed in 2015-2016 and beyond to achieve the annual budgetary targets as set out in the MoU. For 2015-16, an additional around 2½% of GDP of measures would be required to achieve the MoU targets of a primary deficit of 2.1% of GDP in 2015 and a primary surplus of 1.2% of GDP in 2016. In line with the overarching principle of an expenditure based adjustment, the measures should include, in particular, reducing growth in expenditure on the public sector wage bill, social benefits and discretionary spending, while minimising the impact of consolidation on vulnerable groups and preserving the good implementation of Structural and other EU Funds. Based on the macroeconomic projection and estimated interest payments, the headline deficit is expected to be below the reference value in 2016.

5. CONCLUSIONS

On current information, the average annual improvement of the structural budget balance over 2011-2012, after correction for the effects of revised potential output growth and less tax-rich growth is estimated to be 2.4% of GDP. This is above the minimum average annual fiscal effort of at least 1½% of GDP required by the Council Recommendation, which is an important indication for the assessment of whether Cyprus could be considered to have taken effective action in line with the Council recommendations. This is supported by a careful analysis that shows that Cyprus adopted sizeable consolidation measures over 2011-12, with an estimated direct deficit-reducing impact of around 1½% of GDP in 2011 and around 4¼% of GDP in 2012, based on a bottom-up assessment.

For the period 2013-2016, Cyprus has committed to a detailed consolidation path as outlined in the agreed MoU, which is fully underpinned by specified measures for 2013-2014, most of which were already legislated in the 2013 Budget Law or legislated as prior actions before the disbursement of the first tranche of financial assistance. The 2013 Budget Law was accompanied by a three-year Medium Term Budgetary Framework that embedded the agreed deficit targets for 2013-2016. According to the MoU, the total amount of fiscal consolidation measures amounts to about 4¾% of GDP in 2013 and around 1¾% of GDP in 2014. Overall, the measures included in the agreed MoU are expected, on the basis of the realistic macro-economic scenario underpinning the MoU to lead to a sustainable correction of the excessive deficit situation by 2016.

The substantial deterioration in the budgetary position resulting from the worse-than-expected economic downturn and the weaker overall position of the economy than envisaged at the time of the Council Recommendation implies that a new deadline for correction of the excessive deficit by Cyprus is needed. In view of the projected distance at end-2012 to the 3% of GDP reference value for the deficit, after taking into account the current adverse macro-economic circumstances and the perspective of a longer-lasting deleveraging of the economy, it would appear that four additional years will be necessary for a sustainable correction of the excessive deficit.

Granting four additional years for the correction of the excessive deficit would be commensurate with intermediate headline deficit targets of 6.5% of GDP for 2013, 8.4% of GDP for 2014, 6.3% of GDP for 2015, and 2.9% of GDP in 2016. The underlying improvement in the structural budget balance implied by these targets is 1.3% in 2013, 0.3% in 2014, 0.7% in 2015, and 1.8% in 2016. This would correspond to an average annual fiscal effort of 1% of GDP over 2013-2016 in order to bring the headline government deficit below the 3% of GDP reference value by 2016.

Table 10: Comparison of key macroeconomic and budgetary projections

		2010	2011	2012	2013	2014	2015	2016
Real GDP	COM PF	1.3	0.5	-2.4	-8.7	-3.9	1.1	1.9
(% change)	COM SF 10	-0.4	1.3	n.a.	n.a.	n.a.	n.a.	n.a.
Output gap[1]	COM PF	0.9	1.2	0.0	-6.2	-7.6	-4.3	-0.9
(% of potential GDP)	COM SF 10	-1.7	-0.7	n.a.	n.a.	n.a.	n.a.	n.a.
General government balance	COM PF	-5.3	-6.4	-6.3	-6.5	-8.4	-6.3	-2.9
(% of GDP)	COM SF 10	-7.1	-7.7	n.a.	n.a.	n.a.	n.a.	n.a.
Primary balance	COM PF	-3.0	-3.9	-3.1	-2.4	-4.3	-2.1	1.2
(% of GDP)	COM SF 10	-4.4	-4.8	n.a.	n.a.	n.a.	n.a.	n.a.
Cyclically-adjusted balance[1]	COM PF	-5.7	-6.8	-6.3	-3.8	-5.1	-4.4	-2.5
(% of GDP)	COM SF 10	-6.3	-7.1	n.a.	n.a.	n.a.	n.a.	n.a.
Structural balance[2]	COM PF	-5.7	-6.6	-6.7	-5.4	-5.1	-4.4	-2.5
(% of GDP)	COM SF 10	-6.3	-7.1	n.a.	n.a.	n.a.	n.a.	n.a.
Government gross debt	COM PF	61.3	71.1	85.8	109.5	124.0	127.9	123.9
(% of GDP)	COM SF 10	62.3	67.6	n.a.	n.a.	n.a.	n.a.	n.a.

Note:

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

[2] Cyclically-adjusted balance excluding one-off and other temporary meaures

Source: COM 2010 SF - Commission services' 2010 Spring Forecast; COM PF - Programme Forecast