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COMMISSION OPINION

of 22.11.2017

on the Draft Budgetary Plan of Cyprus

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GENERAL CONSIDERATIONS

1. Regulation (EU) No 473/2013 sets out provisions for enhanced monitoring of budgetary policies in the euro area for ensuring that national budgets are consistent with the economic policy guidance issued in the context of the Stability and Growth Pact (SGP) and the European Semester for economic policy coordination.

2. Article 6 of Regulation (EU) No 473/2013 requires Member States to submit annually to the Commission and to the Eurogroup a Draft Budgetary Plan presenting by 15 October the main aspects of the budgetary situation of the general government and its subsectors for the forthcoming year.

CONSIDERATIONS CONCERNING CYPRUS

3. On the basis of the Draft Budgetary Plan for 2018 submitted on 16 October 2017 by Cyprus, the Commission has adopted the following opinion in accordance with Article 7 of Regulation (EU) No 473/2013.

4. Cyprus is subject to the preventive arm of the Pact and should preserve a sound fiscal position which ensures compliance with its medium term budgetary objective (MTO) of a structural balance of 0% of GDP. As the debt ratio was 107.5% of GDP in 2015, during the three years following the correction of the excessive deficit Cyprus is also subject to the transitional arangements as regards compliance with the debt reduction benchmark.

5. Overall, the macroeconomic outlook of the Draft Budgetary Plan is based on plausible macroeconomic projections. The macroeconomic scenario underlying the Draft Budgetary Plan projects real GDP growth at 3.6% in 2017 and 3.0% in 2018. Real GDP growth in the Draft Budgetary Plan is projected to be much stronger than in the Stability Programme for 2017 (revised up by 0.6 percentage points), and slightly higher for 2018 (0.1 percentage points). The Draft Budgetary Plan projection is broadly in line with the Commission 2017 autumn forecast, which expects a marginally lower real GDP growth rate of 3.5% in 2017 and 2.9% in 2018, with a more conservative outlook on net exports for both years.

6. Cyprus complies with the requirement of Regulation EU No 473/2013 that the draft budget has to be based on independently endorsed or produced macroeconomic forecasts. The macroeconomic forecast underlying the Draft Budgetary Plan was prepared by the Ministry of Finance and endorsed by the Fiscal Council.

7. The Draft Budgetary Plan projects a general government headline surplus of 1.0% of GDP in 2017 and 1.3% of GDP in 2018, which represents an upward revision of 0.8 percentage points and 0.9 percentage points, respectively, compared to the 2017 Stability Programme. The improvement compared to the 2017 Stability Programme is explained by the expected good performance in revenues underpinned by an improvement in the labour market and positive developments in economic activity. Higher projected revenues are the result of larger indirect and direct tax receipts,

social security contributions, as well as additional revenue from a fee accompanying the production sharing contracts for the exploration and exploitation of hydrocarbons reserves for the 2017-2019 period. Public expenditures are also expected to increase but at a slower pace than revenues, mainly due to intermediate consumption, social payments and other expenditures. The structural balance[1] based on the information provided in the Draft Budgetary Plan is estimated at 0.4% of GDP and -0.2% of GDP in 2017 and 2018, respectively, significantly better than the estimated level in the 2017 Stability Programme (-0.5% of GDP in 2017 and -1.1% of GDP in 2018). This is mainly due to the upward revision of the general government surplus and significant revenue windfalls in 2017.

The Draft Budgetary Plan projects a decrease in the debt-to-GDP ratio to 99% in 2017 and below 93% in 2018 owing to general government budget surpluses, the denominator effect of nominal GDP growth and active debt management operations. This declining trend is more favourable than in the Stability Programme, as the Draft Budgetary Plan takes into account additional debt management operations in the form of early repayments of domestic debt in 2017 and 2018, together with the revision of the primary balance and nominal growth projections.

8. The Draft Budgetary Plan reports the full abolition of the immovable property tax in 2017 and the abolition of the temporary contribution of employees in 2017 as discretionary measures. The fiscal impact of these deficit increasing measures is estimated at 0.5% of GDP on the revenue side, and at 0.2% of GDP on the expenditure side. The estimates of the budgetary impact of these measures appear plausible and are in line with the Commission 2017 autumn forecast.

9. The budgetary projections in the Draft Budgetary Plan are broadly in line with the projections in the Commission 2017 autumn forecast, which estimates the general government headline surplus at 1.1% of GDP in 2017 and 1.4% of GDP in 2018. The Commission projects similar budgetary developments, albeit it expects somewhat lower increases in revenues and expenditures compared to the Draft Budgetary Plan. This is due to a less dynamic macroeconomic scenario, as well as different estimates for specific revenue and expenditure items. Risks associated with the Draft Budgetary Plan and the Commission budgetary projections mainly relate to the increasing pressures for fiscal relaxation, which could materialise through new policy initiatives affecting negatively the budgetary outcomes.

10. According to the Draft Budgetary Plan, Cyprus is expected to make sufficient progress towards compliance with the debt reduction benchmark in 2017 and 2018. This is consistent with the assessment based on the Commission 2017 autumn forecast. The expected decline in Cyprus' debt-to-GDP ratio mostly owes to the debt-decreasing impact of the favourable path of the general government balance in 2017 and 2018, as well as real GDP growth and a pick-up in inflation.

11. In 2017, the (recalculated) structural balance is estimated to exceed the MTO by 0.4% of GDP. However, the structural balance is improved by significant revenue windfalls, in the absence of which the MTO would not be achieved. The revenue windfalls mainly relate to high revenue buoyancy, underpinned by the favourable macroeconomic situation and the positive developments in the labour market. According to the information provided in the Draft Budgetary Plan, the expenditure benchmark points to a risk of significant deviation from the applicable (real)

[1] Cyclically adjusted balance net of one-off and temporary measures, recalculated by the Commission using the commonly agreed methodology.

reference rate (gap of 1.4% of GDP). Following an overall assessment and taking into account the low estimates of potential GDP growth, the expenditure benchmark still points to a risk of significant deviation. The structural balance is positively impacted by sizeable revenue windfalls and negatively by the rise in nationally financed public investments, pointing to a risk of some deviation from the requirements. Thus, according to the Draft Budgetary Plan, the overall assessment points to a risk of significant deviation in 2017 based on the expenditure benchmark. Based on the Commission 2017 autumn forecast, Cyprus is also expected to remain above its MTO in 2017. However, following an overall assessment and after taking into account the above-mentioned factors impacting on the expenditure benchmark and the structural balance, as well as differences in deflators, Cyprus is expected to be at risk of some deviation on both the expenditure benchmark and the structural balance pillars. Expenditure developments should be monitored very carefully in the short and medium term, especially due to the risks associated with increases in expenditure financed by temporary revenue windfalls. Experience suggests that a build-up of additional expenditure financed by such windfalls is very difficult and costly to revert.

In 2018, according to the information provided in the Draft Budgetary Plan, the expenditure benchmark[2] points to a risk of significant deviation from the required (nominal) reference rate (gap of 0.5% of GDP). The (recalculated) structural balance points to a risk of some deviation from the MTO (gap of 0.2% of GDP). However, following an overall assessment and taking into account the differences in potential growth rates, revenue shortfalls, as well as dynamics of investment and interest expenditures impacting on 2018, both the expenditure benchmark and the structural balance pillars point to a risk of some deviation. This conclusion is confirmed based on the Commission 2017 autumn forecast.

12. Taxes on labour and on income of corporations in Cyprus are among the lowest in the EU. Given that these taxes are the most distortionary, the tax structure in Cyprus is less detrimental to growth. However, Cyprus decided in 2016 to eliminate the tax on immovable property, with full effect from 2017 onwards. This represents a drawback, as it narrowed the tax base and reduced the fiscal space for financing additional growth enhancing reforms or consolidating the social welfare system and safety net.

The Draft Budgetary Plan contains measures taken in response to the country-specific recommendations with regard to the structural part of the fiscal recommendations contained in the Council Recommendation of 11 July 2017.[3] These measures relate to the adoption of a law governing the indefinite suspension of public and broader public sector hiring of new personnel, as well as a bill regarding the mobility between the public service and State-owned organisations, and among State-owned organisations. The collective agreement with the broader public sector introducing a wage-setting mechanism which contains the growth rate of public sector compensation to nominal economic growth is in place until 2018. In addition, five bills regarding the public administration reform are to be submitted to the House of Representatives for their adoption. The adoption of the law on State-owned

[2] As part of the agreement on the EFC Opinion on "Improving the predictability and transparency the SGP: a stronger focus on the expenditure benchmark in the preventive arm", which was adopted by the EFC on 29 November 2016, the expenditure benchmark, that is the maximum allowable growth rate of expenditure net of discretionary revenue measures, is expressed in nominal terms as from 2018.

[3] OJ C 261, 9.8.2017.

enterprises has been significantly delayed at the House of Representatives since April 2015. The draft bill on local governments was also submitted to relevant parliamentary committees but the implementation deadlines remain vague. These measures, once implemented, would help contain growth in public expenditure.

13. Overall, the Commission is of the opinion that the Draft Budgetary Plan of Cyprus, which is currently under the preventive arm and subject to the transitional period to make sufficient progress towards compliance with the debt reduction benchmark, is broadly compliant with the provisions of the Stability and Growth Pact. Based on the Commission 2017 autumn forecast, there is a risk of some deviation from the MTO in 2017 and in 2018. Cyprus is projected to be compliant with the debt criterion in 2017 and 2018. The Commission invites the authorities to stand ready to take the necessary measures within the national budgetary process to ensure that the 2018 budget will be compliant with the SGP, and to carefully monitor expenditure developments in the short and medium term, due to the risks associated with increases in expenditure being financed by temporary revenue windfalls.

The Commission is also of the opinion that Cyprus has made some progress with regard to the structural part of the fiscal recommendations contained in the Council Recommendation of 11 July 2017 in the context of the 2017 European Semester and invites the authorities to make further progress. A comprehensive assessment of progress made with the implementation of the country-specific recommendations will be made in the 2018 Country Reports and in the context of the country specific recommendations to be proposed by the Commission in May 2018.

Done at Brussels, 22.11.2017

For the Commission
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Member of the Commission