EUROPEAN
COMMISSION

Brussels, 16.11.2016
SWD(2016) 502 final

COMMISSION STAFF WORKING DOCUMENT

Analysis of the draft budgetary plans of Cyprus

Accompanying the document

COMMISSION OPINION

on the draft budgetary plan of Cyprus

{C(2016) 8002 final}

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1. INTRODUCTION

Cyprus submitted its Draft Budgetary Plan (DBP) for 2017 on 17 October 2016 in compliance with Regulation (EU) 473/2013 of the Two-Pack. Cyprus is subject to the preventive arm of the Pact and should preserve a sound fiscal position, which ensures compliance with the medium term budgetary objective (MTO).

As the debt ratio was 107.5% of GDP in 2015, exceeding the 60% of GDP reference value, during the three years following the correction of the excessive deficit Cyprus is also subject to the transitional arrangements as regards compliance with the debt reduction benchmark. In this period it should ensure sufficient progress towards compliance.

Section 2 of this document presents the macroeconomic outlook underlying the DBP and provides an assessment based on the Commission 2016 autumn forecast. Section 3 presents the recent and planned fiscal developments, according to the DBP, including an analysis of risks to their achievement based on the Commission 2016 autumn forecast. In particular, it also includes an assessment of the measures underpinning the DBP. Section 4 assesses the recent and planned fiscal developments in 2016-2017 (also taking into account the risks to their achievement) against the obligations stemming from the Stability and Growth Pact. Section 5 provides an analysis of implementation of fiscal-structural reforms in response to the latest country-specific recommendations adopted by the Council in the spring of 2016, including those to reduce the tax wedge. Section 6 summarises the main conclusions of the present document.

2. MACROECONOMIC DEVELOPMENTS UNDERLYING THE DRAFT BUDGETARY PLAN

The macroeconomic scenario underlying the DBP projects growth at 2.7% and 2.8%, in 2016 and 2017, respectively. As in 2015, growth in 2016 and 2017 is expected to be driven by private consumption and exports, the latter with the support of a booming tourism sector. The DBP envisages that private consumption will continue to strengthen on the back of improving labour market conditions. Compared to the Stability Programme (SP), real GDP growth in

2016 and 2017 has been revised upwards (from 2.2% to 2.7% in 2016 and from 2.5% to 2.8% in 2017), mainly because of higher contributions from domestic demand. The Commission 2016 autumn forecast projects broadly similar real GDP growth rate of 2.8% in 2016 but expects a somewhat lower real GDP growth of 2.5% in 2017 mainly due to an expected less strong growth in the tourism sector. The main risk to the macroeconomic outlook underpinning the DBP relates to how strongly the reduction of the high stock of non-performing loans will affect the real economy. Compared to the DBP, the Commission 2016 autumn forecast projects a similar decline in the GDP deflator of –1.1% in 2016, and a somewhat lower increase in the deflator of 0.3% in 2017, due to higher energy price assumptions and the ensuing higher import prices.

The macroeconomic scenario underlying the DBP estimates a positive output gap of 2.4 % of potential output in 2017. This is much higher than the Commission's estimate of 1.6% and relates mainly to higher GDP growth envisaged for 2017 in the macroeconomic scenario underpinning the DBP. It is also due to differences in the estimates of potential growth. Potential growth has suffered in Cyprus due to the recent financial crisis and ensuing deep recession. Lower labour market participation, a higher structural unemployment rate and subdued investment are the factors that have brought potential growth to around 0% and explain the rapid closing of the output gap. Investment growth in the DBP is lower than envisaged in the Commission 2016 autumn forecast, leading to lower potential output and hence a higher output gap. Due to the low potential growth and strong growth forecast for 2017, the Commission 2016 autumn forecast envisaged an improvement in the output gap estimate of 2.4 pps of GDP for 2017. Following a detailed assessment, the level of output gap, using the commonly agreed methodology and various plausibility tests, suggests that the output gap estimations for Cyprus are economically intuitive.

Overall, the DBP is based on a broadly plausible macroeconomic scenario, although nominal GDP growth in 2017 is higher. The DBP assumes a higher utilisation of production capacities over the forecast horizon.

Table 1. Comparison of macroeconomic developments and forecasts

	2015	2016			2017		
	COM	SP	DBP	COM	SP	DBP	COM
Real GDP (% change)	1.7	2.2	2.7	2.8	2.5	2.8	2.5
Private consumption (% change)	1.9	1.9	2.5	2.4	1.9	2.5	1.8
Gross fixed capital formation (% change)	12.0	5.0	7.0	9.1	4.7	4.0	8.3
Exports of goods and services (% change)	0.0	2.7	3.0	5.5	3.2	3.2	4.6
Imports of goods and services (% change)	2.1	2.4	2.4	5.7	2.6	2.6	4.7
Contributions to real GDP growth:							
- Final domestic demand	2.6	2.1	2.3	2.9	2.2	2.5	2.5
- Change in inventories	0.3	0.0	0.0	0.0	0.0	0.0	0.0
- Net exports	-1.3	0.2	0.4	-0.1	0.3	0.3	0.0
Output gap[1]	-3.7	-1.8	-0.6	-0.8	0.3	2.4	1.6
Employment (% change)	0.8	1.2	2.2	1.8	1.5	2.0	1.6
Unemployment rate (%)	15.0	13.5	12.5	12.5	12.5	11.0	11.1
Labour productivity (% change)	0.9	1.0	0.5	1.0	1.0	0.8	0.9
HICP inflation (%)	-1.5	-0.7	-0.9	-1.1	0.5	0.5	0.7
GDP deflator (% change)	-1.3	-0.5	-1.2	-1.1	0.5	0.5	0.3
Comp. of employees (per head, % change)	-0.5	0.0	0.5	1.2	0.5	1.0	1.5
Net lending/borrowing vis-à-vis the rest of the world (% of GDP)	-2.7	-3.4	-3.4	-2.5	-3.2	-3.2	-2.9

Note:

[1] In percent of potential GDP, with potential GDP growth recalculated by Commission services on the basis of the programme scenario using the commonly agreed methodology.

Source:
Stability Programme 2016 (SP); Draft Budgetary Plan for 2017 (DBP); Commission 2016 autumn forecast (COM); Commission calculations

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

The macroeconomic forecast underlying the DBP and SP are prepared by the Ministry of Finance. The task of assessing and endorsing the macroeconomic forecast underpinning the DBP was assigned to Fiscal Council in the Fiscal Responsibility and Budget System Law (FRBSL - February 2014).

The assessment of the macroeconomic scenario in the DBP for 2017 was published in the Fiscal Council's 2016 autumn report on 19 October 2016, where it concluded that the macroeconomic scenario was plausible. The specific assessment of the fiscal stance for the DBP is expected in November.

The Fiscal Council is an independent statutory body, which may assess and publicly comment on whether the government is meeting its own stated budgetary targets and objectives (in particular through assessments of annual budgets and the SP).

Its three board members are appointed by the Council of Ministers, based on competence and experience, for a four to six year term that can be renewed. The Fiscal Council's staff consists of two employees, but should in principle not be less than three nor more than six. Due to the hiring freeze in the public sector, the Fiscal Council is currently staffed by secondments from the public sector.

3. RECENT AND PLANNED FISCAL DEVELOPMENTS

3.1 Deficit developments

The DBP projects a general government budget deficit of 0.3% of GDP for 2016, compared to a deficit of 0.4% of GDP planned in the latest SP. The almost unchanged headline budget target for 2016 between the DBP and the SP is due to a similar increase of 0.3 pps of GDP of both revenue and expenditure. On the revenue side, this is mainly due to higher-than-expected revenue from taxes on production and imports (up by 0.4 pps of GDP) offset partially by a contraction of the current taxes on income and wealth (by 0.1 pps of GDP) as a result of the phasing out of the immovable property tax. Social security contributions were revised upward too (by 0.2 pps of GDP) due to improved labour market conditions, while the other (residual) taxes were revised downward due to lower than expected dividends from the Central Bank of Cyprus (CBC). On the expenditure side, this is notably due to higher-than-expected compensation of employees in the public sector (0.2 pps of GDP) because of increased costs related to the switch to professional soldiers as well as social payments (0.2 pps of GDP).

For 2017, the DBP plans a general government budget deficit of 0.6% of GDP, 0.1 pps higher compared to the SP target of 0.5% of GDP. Total revenues were revised upward by 0.2 pps of GDP in the DBP compared to the SP due to the increase of the taxes on production and imports and the higher than expected decrease of the current taxes on income and wealth. The taxes on production and imports were revised upward (by 0.4 pps of GDP) in the DBP compared to the SP due to the base effect from the better than expected outcome in 2016. In contrast, the current taxes on income and wealth were revised downward (by 0.2 pps of GDP) explained by the reduction of the immovable property tax in November 2016. Total expenditures were revised upward by 0.3 pps of GDP due to higher compensation of employees and subsidies. Interest rate expenditure was revised upward (by 0.1 pps in the DBP) compared to the SP for 2017.

The general government balance is projected at a deficit of 0.3% of GDP for 2016 in the Commission 2016 autumn forecast, the same as in the DBP, leading to a structural balance position of 0.2 % of GDP. For 2016, the total revenues are lower in the Commission 2016 autumn forecast by 0.4 pps of GDP compared to the DBP due to lower taxes on production and imports (0.4 pps of GDP) and social security contributions (0.3 pps of GDP) offset partially by higher current taxes on income and wealth (0.2 pps of GDP). Total expenditures are lower as well in the Commission 2016 autumn forecast by 0.5 pps of GDP compared to the DBP mainly due to lower compensation of employees (0.3 pps of GDP) and subsidies (0.2 pps of GDP).

For 2017, the Commission forecasts a general government deficit at 0.4% of GDP, -0.2 pps of GDP lower than the0.6% of GDP planned in the DBP. This difference can be explained by the following two elements working into opposite direction. One the one hand, the Commission 2016 autumn forecast does not expect the lower taxes on production and imports and social security contributions to be fully offset by higher current taxes on income and wealth and therefore, the total revenues are projected to be lower by 0.4 pps of GDP than in the DBP. On the other hand, the Commission 2016 autumn forecast expects total expenditure to be lower by 0.6 pps of GDP compared to the DBP, mainly due to lower compensation of employees (0.2 pps of GDP) and subsidies (0.2 pps of GDP).

The (recalculated) deterioration of the structural balance is 1.9 pps of GDP between 2016 and 2017 in the DBP compared to 1.2 pps of GDP in the SP. This 0.7 pps is mainly due to an upward revision of the output gap in the DBP compared to SP (which explains 0.5 pps) as well as to additional fiscal measures (i.e. the abolition of the immovable property taxes, which explains the remaining 0.2 pps).

The deterioration of the structural balance is estimated at 1.5 pps of GDP in the Commission 2016 autumn forecast. This is mainly due to the improved cyclical position (by 2.4 pps of GDP) and to a lesser extent due to the abolition of the immovable property tax.

Euro area sovereign bond yields remain at historically low levels, with 10-year rates in Cyprus currently standing at 3.3%[1]. As a consequence, total interest payments by the general government have continued to decrease as a share of GDP. Based on the information included in the DBP, interest expenditure in Cyprus is expected to fall from 2.8% of GDP in 2015 to 2.6% in 2016 and it is projected to decrease further next year, to 2.5% of GDP, below the 2.9% recorded back in 2012 at the peak of the euro area sovereign debt crisis.

Against the background of falling interest expenditure, the projected deterioration in the structural balance in 2016-17 (1.6 pps and 1.9 pps, respectively) is accompanied by a more pronounced deterioration in the structural primary balance (1.9 pps and 2.0 pps for 2016 and 2017, respectively).

[1] 10-year bond yields as of 26 October 2016. Source: Bloomberg.

Table 2. Composition of the budgetary adjustment Cyprus

(% of GDP)	2015	2016			2017			Change: 2015-2017
	COM	**SP**	**DBP**	**COM**	**SP**	**DBP**	**COM**	**DBP**
Revenue	**39.0**	**38.4**	***38.7***	**38.3**	**37.9**	***38.1***	**37.7**	**-0.9**
of which:								
- Taxes on production and imports	14.7	14.6	*15.0*	14.6	14.4	*14.8*	14.4	0.1
- Current taxes on income, wealth, etc.	9.7	9.7	*9.6*	9.8	9.5	*9.3*	9.5	-0.4
- Capital taxes	0.0	0.0	*0.0*	0.0	0.0	*0.0*	0.0	0.0
- Social contributions	8.4	8.5	*8.7*	8.4	8.6	*8.6*	8.4	0.2
- Other (residual)	6.1	5.6	*5.4*	5.3	5.4	*5.4*	5.4	-0.7
Expenditure	**40.1**	**38.7**	**39.0**	**38.5**	**38.4**	**38.7**	**38.1**	**-1.4**
of which:								
- Primary expenditure	37.3	36.1	36.4	36.0	36.0	36.2	35.7	-1.1
of which:								
Compensation of employees	12.6	12.6	12.8	12.5	12.7	12.8	12.6	0.2
Intermediate consumption	3.9	3.6	3.6	3.5	3.6	3.5	3.4	-0.4
Social payments	14.0	14.2	14.4	14.3	14.1	14.1	14.2	0.1
Subsidies	0.4	0.4	0.6	0.4	0.4	0.6	0.4	0.2
Gross fixed capital formation	1.9	1.9	1.9	1.9	2.0	1.9	1.9	0.0
Other (residual)	4.5	3.4	3.1	3.4	3.2	3.3	3.2	-1.2
- Interest expenditure	2.8	2.6	2.6	2.6	2.4	2.5	2.5	-0.3
General government balance (GGB)	**-1.1**	**-0.4**	**-0.3**	**-0.3**	**-0.5**	**-0.6**	**-0.4**	**0.5**
Primary balance	**1.7**	**2.2**	**2.3**	**2.3**	**1.9**	**2.0**	**2.0**	**0.3**
One-off and other temporary measures	-0.8	0.0	0.0	-0.1	0.0	0.0	0.0	0.8
GGB excl. one-offs	**-0.3**	**-0.4**	**-0.3**	**-0.2**	**-0.5**	**-0.6**	**-0.4**	**-0.3**
Output gap[1]	-3.7	-1.8	-0.6	-0.8	0.3	2.4	1.6	6.1
Cyclically-adjusted balance[1]	0.8	0.5	0.0	0.1	-0.7	-1.9	-1.3	-2.7
Structural balance (SB)[2]	**1.7**	**0.5**	**0.0**	**0.2**	**-0.7**	**-1.9**	**-1.3**	**-3.5**
Structural primary balance[2]	4.5	3.1	2.6	2.8	1.7	0.6	1.2	-3.8

Notes:

[1]Output gap (in % of potential GDP) and cyclically-adjusted balance according to the DBP/programme as recalculated by Commission on the basis of the DBP/programme scenario using the commonly agreed methodology.

[2]Structural (primary) balance = cyclically-adjusted (primary) balance excluding one-off and other temporary measures.

Source:

Stability Programme 2016 (SP); Draft Budgetary Plan for 2017 (DBP); Commission 2016 autumn forecast (COM); Commission calculations

3.2 Debt developments

The debt-to-GDP ratio increased marginally by 0.4pps of GDP to 107.5% in 2015, according to revised national accounts figures released after the cut-off date of the DBP.[2] The DBP,

[2] Nominal GDP for 2015 has been revised up after the cutoff date of the DBP and has led to a revision of the debt ratio from 108.9% of GDP to 107.5% in 2015.

which relies on outdated national accounts figures, projects a decrease in the debt-to-GDP ratio from 108.9% in 2015 to 105.3% in 2017 owing to the budget balance and the denominator effect of nominal GDP growth. These projections are higher compared to the SP by 2.7 pps and 3.6 pps in 2016 and 2017, respectively. The debt ratio planned by the DBP is also in line with the Commission 2016 autumn forecast, though the revised 2015 nominal GDP leads to a slightly lower debt-to-GDP ratio in the Commission 2016 autumn forecast.

Table 3. Debt developments

(% of GDP)	2015	2016			2017		
		SP	DBP	COM	SP	DBP	COM
Gross debt ratio[1]	**107.5**	**105.6**	**108.3**	**107.1**	**101.7**	**105.3**	**103.7**
Change in the ratio	0.4	-1.9	0.8	-0.4	-3.9	-3.0	-3.4
Contributions[2] *:*							
1. Primary balance	**-1.7**	**-2.2**	**-2.3**	**-2.3**	**-1.9**	**-2.0**	**-2.0**
2. "Snow-ball" effect	**2.4**	**0.8**	**1.0**	**0.8**	**-0.7**	**-0.8**	**-0.5**
Of which:							
Interest expenditure	2.8	2.6	2.6	2.6	2.4	2.6	2.5
Growth effect	-1.8	-2.3	-2.9	-2.9	-2.6	-2.9	-2.6
Inflation effect	1.3	0.5	1.2	1.1	-0.5	-0.5	-0.3
3. Stock-flow adjustment	**-0.3**	**-0.5**	**2.1**	**1.1**	**-1.3**	**-0.1**	**-0.8**
Of which:							
Cash/accruals difference			0.00			0.00	
Net accumulation of financial			0.60			-0.20	
of which privatisation proceeds			0.00			0.00	
Valuation effect & residual			0.30			0.00	

Notes:

[1] End of period.

[2] The snow-ball effect captures the impact of interest expenditure on accumulated debt, as well as the impact of real GDP growth and inflation on the debt ratio (through the denominator). The stock-flow adjustment includes differences in cash and accrual accounting, accumulation of financial assets and valuation and other residual

Source:

Stability Programme 2016 (SP); Draft Budgetary Plan for 2017 (DBP); Commission 2016 autumn forecast (COM); Commission calculations

3.3 Measures underpinning the draft budgetary plan

The DBP includes on the revenue side the reduction of the immovable property tax burden by up to 75% for the year 2016 and its total abolition in 2017 as voted by the House of Representatives in July 2016. The fiscal impact of this measure is estimated at 0.3% of GDP in 2016 and 0.5% of GDP cumulative in 2017. The estimates of the budgetary impact of the measure appear plausible and are in line with the Commission 2016 autumn forecast.

Although not reported explicitly as discretionary measures in the DBP, the abolition of the temporary contribution on emoluments of public and private sector employees and the recruitment of additional personnel in security forces are mentioned as factors behind the increase in the expenditure. The Commission deems both measures as discretionary. According to the DBP, together they have an estimated impact of 0.6% of GDP in 2017, which appears plausible and in line with the Commission 2016 autumn forecast.

Table 4. Main discretionary measures reported in the DBP

A. Discretionary measures taken by General Government - revenue side

Components	Budgetary impact (% GDP) (as reported by the authorities)	
	2016	**2017**
Taxes on production and	0	0
Current taxes on income,	-0.3	-0.5
Capital taxes	0	0
Social contributions	0	0
Property Income	0	0
Other	0	0
Total	-0.3	-0.5

Note:

The budgetary impact in the table is the aggregated impact of measures as reported in the DBP, i.e. by the national authorities. A positive sign implies that revenue increases as a consequence of this measure.

Source: Draft Budgetary Plan for 2017

B. Discretionary measures taken by general Government- expenditure side

Components	Budgetary impact (% GDP) (as reported by the authorities)	
	2016	**2017**
Compensation of employees	0	0
Intermediate consumption	0	0
Social payments	0	0
Interest Expenditure	0	0
Subsidies	0	0
Gross fixed capital formation	0	0
Capital transfers	0	0
Other	0	0
Total	0	0

Note:

The budgetary impact in the table is the aggregated impact of measures as reported in the DBP, i.e. by the national authorities. A positive sign implies that expenditure increases as a consequence of this measure.

Source: Draft Budgetary Plan for 2017

4. Compliance with the provisions of the Stability and Growth Pact

Cyprus is subject to the preventive arm of the Pact and should ensure sufficient progress towards its MTO of a structural balance of 0% of GDP. Box 2 reports the latest country specific recommendations in the area of public finances.

Box 2: Council recommendations addressed to Cyprus

On 18 May 2016, the Council also addressed recommendations to Cyprus in the context of the European Semester. In particular, in the area of public finances the Council recommended, following the correction of the excessive deficit, to respect the medium-term budgetary objective in 2016 and in 2017. By the end of 2016, adopt a binding mechanism containing the growth rate of the compensation of public employees. By the end of 2016, adopt the horizontal reform of the public administration and the law on the governance of state-owned entities, and implement the reform of local governments. By the end of 2016, adopt the secondary legislation to complete the new budgetary framework.

4.1 Compliance with the debt criterion

After it has corrected its excessive deficit in 2015, Cyprus is also subject to the transitional debt rule for the following three years (2016-2018). Based on an overall assessment of the DBP, Cyprus is making sufficient progress towards compliance with the debt criterion in 2016 and in 2017. According to the Commission 2016 autumn forecast, Cyprus is projected to be compliant with the transitional debt rule in 2016 and 2017.

Table 5. Compliance with the debt criterion*

	2015	2016			2017		
		SP	DBP	COM	SP	DBP	COM
Gross debt ratio	107.5	105.6	108.3	107.1	101.7	105.3	103.7
Gap to the debt benchmark [1,2]		n.r	n.r.	n.r.	n.r.	n.r.	n.r.
Structural adjustment [3]	-1.4	-1.4	-1.6	-1.5	-1.2	-1.9	-1.4
To be compared to:							
Required adjustment [4]		-1.9	n.r.	-1.5	-2.1	n.r.	-1.5

Notes:

[1] Not relevant for Member Sates that were subject to an EDP procedure in November 2011 and for a period of three years following the correction of the excessive deficit.

[2] Shows the difference between the debt-to-GDP ratio and the debt benchmark. If positive, projected gross debt-to-GDP ratio does not comply with the debt reduction benchmark.

[3] Applicable only during the transition period of three years from the correction of the excessive deficit for EDP that were ongoing in November 2011.

[4] Defines the remaining minimum annual structural adjustment over the transition period which ensures that – if followed – Member State will comply with the debt reduction benchmark at the end of the transition period, assuming that COM (SP) budgetary projections for the previous years are achieved.

Source:

Stability Programme 2016 (SP); Draft Budgetary Plan for 2017 (DBP); Commission 2016 autumn forecast (COM); Commission calculations

4.2 Compliance with the MTO

According to the information provided in the DBP, with a (recalculated) structural balance, Cyprus is expected to remain at its medium-term objective in 2016, which is confirmed by the Commission 2016 autumn forecast.

For 2017, the structural balance is expected to deteriorate according to the DBP to a deficit of -1.9% of GDP, pointing to a risk of significant deviation from the maximum allowed required adjustment under the preventive arm of -0.4% in structural terms (gap of -1.5% of GDP). The deterioration of the structural balance in 2017 is primarily driven by the following: abolition of the immovable property tax (0.2% of GDP), expiration of the temporary contribution on public and private employees (0.3% of GDP), cost of the switch to a professional soldiers' regime as well as wage increases stemming from promotions and seniority in the public sector (0.3% of GDP), as well as the expected reduction in central bank dividends, the implementation of new location rules regarding VAT for e-commerce services and provisions for guarantees, which together account for another 0.4% of GDP[3]. The remaining deterioration in the structural balance is explained by the improved economic cyclical position. According to the information provided in the DBP, the growth rate of government expenditure, net of discretionary revenue measures, in 2017 is planned to exceed the

[3] All these measures have been included in the Cyprus' Stability Programme in May 2016 and continue to be valid.

applicable expenditure benchmark rate (0.7%), leading to a significant deviation of -0.7% of GDP.

Over two years 2016 and 2017 together, the structural balance points to a significant deviation, while the expenditure benchmark points to compliance. This calls for an overall assessment. In 2016, the expenditure benchmark is favourably influenced by a one-off measure related to the recapitalisation of the banking sector. When the expenditure benchmark is corrected for this factor, it still points to compliance. On the other hand, the structural balance is negatively affected by revenue shortfalls, including related to the reduction in the dividends received from the Central Bank of Cyprus. Correcting the structural balance for these revenue shortfalls, it would also point to compliance. Cyprus is thus projected to comply over 2016 and 2017 together, considering its initial position well above the MTO.

Nonetheless, in view of the projected significant deviation from the MTO in 2017, the conclusion of the overall assessment points to a risk of a significant deviation. This conclusion for 2017 is confirmed based on the Commission 2016 autumn forecast.

Table 6: Compliance with the requirements of the preventive arm

(% of GDP)	2016		2017	
Initial position[1]				
Medium-term objective (MTO)	0.0		0.0	
Structural balance[2] (COM)	0.2		-1.3	
Structural balance based on freezing (COM)	0.4		-	
Position vis-a -vis the MTO[3]	At or above the MTO		At or above the MTO	
(% of GDP)	**2016**		**2017**	
	DBP	**COM**	**DBP**	**COM**
Structural balance pillar				
Required adjustment[4]	0.0		0.0	
Required adjustment corrected[5]	-1.7		-0.4	
Change in structural balance[6]	-1.6	-1.5	-1.9	-1.4
One-year deviation from the required adjustment [7]	0.1	0.2	-1.5	-1.0
Two-year average deviation from the required adjustment [7]	n.a. (in EDP in 2015)		-0.7	-0.4
Expenditure benchmark pillar				
Applicable reference rate[8]	4.5		0.7	
One-year deviation [9]	3.2	2.1	-0.7	-0.9
Two-year average deviation [9]	n.a. (in EDP in 2015)		1.3	0.6
Conclusion				
Conclusion over one year	Compliance	Compliance	Significant deviation	Significant deviation
Conclusion over two years	Compliance	Compliance	Overall assessment	Overall assessment

Notes

[1] The most favourable level of the structural balance, measured as a percentage of GDP reached at the end of year t-1, between spring forecast (t-1) and the latest forecast, determines whether there is a need to adjust towards the MTO or not in year t. A margin of 0.25 percentage points (p.p.) is allowed in order to be evaluated as having reached the MTO.

[2] Structural balance = cyclically-adjusted government balance excluding one-off measures.

[3] Based on the relevant structural balance at year t-1.

[4] Based on the position vis-à-vis the MTO, the cyclical position and the debt level (See European Commission: Vade mecum on the Stability and Growth Pact, page 27.).

[5] Required adjustment corrected for the clauses, the possible margin to the MTO and the allowed deviation in case of overachievers.

[6] Change in the structural balance compared to year t-1. Ex post assessment (for 2014) was carried out on the basis of Commission 2015 spring forecast.

[7] The difference of the change in the structural balance and the corrected required adjustment.

[8] Reference medium-term rate of potential GDP growth. The (standard) reference rate applies from year t+1, if the country has reached its MTO in year t. A corrected rate applies as long as the country is adjusting towards its MTO, including in year t.

[9] Deviation of the growth rate of public expenditure net of discretionary revenue measures and revenue increases mandated by law from the applicable reference rate in terms of the effect on the structural balance. The expenditure aggregate used for the expenditure benchmark is obtained following the commonly agreed methodology. A negative sign implies that expenditure growth exceeds the applicable reference rate.

Source :

Draft Budgetary Plan for 2017 (DBP); Commission 2016 autumn forecast (COM); Commission calculations.

5. IMPLEMENTATION OF REFORMS IN THE AREA OF FISCAL GOVERNANCE

The DBP includes measures taken in response to the country-specific recommendations issued in the broader area of public finances. The main recommendations were related to the adoption of a binding mechanism containing the growth rate of the compensation of public employees and the secondary legislation to complete the new budgetary framework. Furthermore, there were requirements to adopt the horizontal reform of the public administration including local governments and the law on the governance of state-owned entities.

In particular, the Council of Ministers adopted a binding mechanism to contain the growth rate of the compensation of employees within acceptable fiscal limits by capping the growth rate to the nominal GDP after taking into account the evolution of employment, pension outlays and other non-wage related changes.

Furthermore, the secondary legislation to complete the new budgetary framework was approved by the House of Representatives laying down, inter-alia, procedures for budget preparation, requirements for within-year budgetary adjustments, and the responsibilities of commitment control officers.

Six bills and regulations related to public administration reforms are under consideration in the relevant parliamentary committees aiming to modernise the appraisal system through written exams and interviews, to improve the promotion system by opening promotion posts to all qualified candidates and to incentivise staff mobility and redeployment. The legal proposals, after adoption, should be implemented in 2017.

The draft bill on local governments has not been approved by the House of Representatives and the implementation deadlines remain vague. The reform is key to improve Public Financial Management since it foresees the implementation of a common accounting and reporting framework for all local government. A road map for the implementation of the local government's reform was also submitted to the Parliament.

6. OVERALL CONCLUSION

Based on the Commission 2016 autumn forecast, the structural improvement in 2016 and 2017 is projected to be compliant with the minimum linear structural adjustment to ensure sufficient progress towards compliance with the debt criterion.

Following an overall assessment of the DBP, the planned structural adjustment is in line with the required adjustment path towards the MTO in 2016. However, following an overall assessment based on the Commission 2016 autumn forecast there is a risk of significant deviation from the adjustment path towards the MTO in 2017. Cyprus is projected to record a significant deviation from structural balance and expenditure benchmarks. The DBP for 2017 plans a major fiscal relaxation without compensatory measures as a result of a mix of policy measures, including the abolition of the immovable property tax, the expiration of the temporary contribution on public and private employees, and the cost of the switch to a professional soldiers' regime.