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COMMISSION OPINION

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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 2017 submitted on 17 October 2016 by Cyprus, the Commission has adopted the following opinion in accordance with Article 7 of Regulation (EU) No 473/2013.

4. The Commission opinion is to be seen in light of the latest economic and budgetary data. In this context, as indicated in the Commission recommendation for a Council Recommendation on the economic policy of the euro area as well as in the Commission Communication 'Towards a positive fiscal stance for the euro area', it is important that the aggregate fiscal stance of the euro area is positive and supports the ongoing recovery, while ensuring the long-term sustainability of national public finances.

5. Cyprus is subject to the preventive arm of the SGP and should preserve a sound fiscal position that ensures compliance with the medium term budgetary objective (MTO) of a structural balance of 0% of GDP. As the debt ratio was 107.5% of GDP in 2015, exceeding the 60% of GDP reference value, Cyprus is also subject to the transitional arrangements as regards compliance with the debt reduction benchmark during the three years following the correction of the excessive deficit (2016-2018). In this period, it should ensure sufficient progress towards compliance.

6. The macroeconomic projections underlying the Draft Budgetary Plan are assessed as broadly plausible, although nominal GDP growth in 2017 is higher. The Draft Budgetary Plan expects real growth to remain strong at 2.7% in 2016 and 2.8% in 2017 on the back of strong growth in the tourism sector and private consumption. Compared to the Stability Programme, real growth has been revised up, mainly due to a higher contribution from domestic demand. The Commission 2016 autumn forecast projects broadly similar real GDP growth of 2.8% in 2016, but somewhat lower growth of 2.5% in 2017, due to an expectation that growth in the tourism sector will be less strong. 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 forecasts underlying the Draft Budgetary Plan have been endorsed by the Fiscal Council in its 2016 autumn report published on 18 October.

7. The Draft Budgetary Plan projects a general government budget deficit at 0.3% of GDP for 2016, compared to a deficit of 0.4% of GDP planned in the latest Stability Programme. For 2017, it plans a deficit at 0.6% of GDP, which is slightly higher than the objective of 0.5% of GDP in the Stability Programme. This is due to an upward revision of expenditures by 0.3 percentage points of GDP compared to an upward revision of revenues by 0.2 percentage points of GDP. A (recalculated) structural deterioration of 1.9% of GDP is planned for 2017, higher than the deterioration of 1.2% forecast in the Stability Programme. This 0.7 percentage points difference is mainly due to an upward revision of the output gap in the Draft Budgetary Plan compared to the Stability Programme (which explains 0.5 percentage points), as well as to additional fiscal measures (i.e., the abolition of the immovable property taxes, which explains the remaining 0.2 percentage points).

The Draft Budgetary Plan projects a debt-to-GDP ratio of 108.3% of GDP in 2016 and an improvement to 105.3% of GDP in 2017 owing to the budget position and the positive denominator effect of nominal GDP growth. These projections are higher compared to the Stability Programme, but largely in line with the Commission 2016 autumn forecast, in which the revised 2015 nominal GDP led to slightly lower debt-to-GDP ratios over the forecast horizon.

The projected deterioration in the structural balance in 2016-2017 (1.6 percentage points and 1.9 percentage points, respectively) is accompanied by a more pronounced deterioration in the structural primary balance (1.9 percentage points and 2.0 percentage points for 2016 and 2017, respectively). This suggests that the falling interest expenditure helps the structural effort.

8. On the revenue side, the Draft Budgetary Plan includes a reduction of the immovable property tax burden by up to 75% for the year 2016 and its total abolition in 2017. The fiscal impact of this measure is estimated, in the Draft Budgetary Plan, at 0.3 percentage points of GDP in 2016 and 0.5 percentage points of GDP cumulative in 2017. The estimates of the budgetary impact of the measure appear plausible. The planned expiration of the temporary contribution on public and private employees' emoluments and increased military spending due to the professionalization of the military forces represent additional factors in expenditure increases. These two measures' combined budgetary impact is estimated at 0.6% of GDP in 2017, and is in line with the Commission 2016 autumn forecast.

In the Stability Programme, the deterioration of the fiscal position in 2017 is also explained by 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 0.4% of GDP.

9. The Commission 2016 autumn forecast projects a general government deficit at 0.3% of GDP for 2016, the same as the Draft Budgetary Plan, although for 2016, the Commission 2016 autumn forecast assumes lower total revenues by 0.4 percentage points of GDP compared to the Draft Budgetary Plan. This difference is due to lower taxes on production and imports and social security contributions offset partially by higher current taxes on income and wealth. Total expenditures are also lower in the Commission 2016 autumn forecast mainly due to lower compensation of employees and subsidies. For 2017, the Draft Budgetary Plan plans a headline deficit of 0.6% of GDP, somewhat higher than the Commission 2016 autumn forecast deficit of 0.4% of GDP. This difference can be explained by lower revenues in the Commission 2016 autumn forecast by 0.4 percentage points of GDP compared to the Draft

Budgetary Plan as well as lower expenditures by 0.6 percentage points of GDP compared to the Draft Budgetary Plan.

10. Following a correction of its excessive deficit in 2015, Cyprus is subject to the transition period under the debt rule for the subsequent three years (2016-2018). Based on an overall assessment of the Draft Budgetary Plan, Cyprus is making sufficient progress towards compliance with the debt criterion in 2016 and in 2017. According to the Commission 2016 autumn forecast, the projected change in the structural balance (-1.5% and -1.4% of GDP in 2016 and 2017, respectively) is in line with the requirement (-1.5% and -1.5% of GDP, respectively).

11. Cyprus registered a structural surplus of 1.6% of GDP in 2015, well above its MTO of a balanced budget in structural terms. According to the information provided in the Draft Budgetary Plan, with a (recalculated) structural balance estimated at a balanced position, Cyprus is expected to remain at its MTO in 2016. This is also confirmed by the Commission 2016 autumn forecast.

    For 2017, the (recalculated) structural balance is expected to turn into a deficit of 1.9% of GDP, pointing to a risk of a significant deviation from the requirement to be at a balanced budget in structural terms. According to the Draft Budgetary Plan, the growth rate of government expenditure, net of discretionary revenue measures, will exceed the applicable expenditure benchmark rate in 2017 (0.7%), also pointing to a significant deviation. Therefore, the overall assessment points to a risk of significant deviation in 2017, which is confirmed by the Commission 2016 autumn forecast.

12. The Draft Budgetary Plan contains measures taken in response to the country-specific recommendations issued in the broader area of public finances. In particular, secondary legislation to complete the new budgetary framework was adopted by the House of Representatives. The binding mechanism to contain the growth rate of the compensation of employees to nominal GDP growth rates is subject to approval by the House of Representatives. In addition, six bills regarding the public administration reform are under consideration in the relevant parliamentary committees. 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 of the SGP and subject to the transitional debt rule, is at risk of non-compliance with the provisions of the SGP. The Commission projects a significant deviation from the MTO in 2017. In particular, the Draft Budgetary Plan for 2017 plans a fiscal relaxation without compensatory measures, which leads to a risk of significant deviation from the adjustment path towards the MTO in 2017. In line with the Commission Communication 'Towards a positive fiscal stance for the euro area', the Commission therefore invites the authorities to take the necessary measures within the national budgetary process to ensure that the 2017 budget will be compliant with the SGP.

    The Commission is also of the opinion that Cyprus has made some progress with regard to the structural part of the fiscal country-specific recommendations issued by the Council in the context of the 2016 European Semester and invites the authorities to make further progress. A comprehensive assessment of progress made in the implementation of the country-specific recommendations will be made in the 2017 Country Reports and in the context of the country-specific recommendations to be adopted by the Council in 2017.

Done at Brussels, 16.11.2016

For the Commission
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Member of the Commission