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Assessment of action taken by Cyprus

in response to the Council Recommendation of 16 May 2013 with a view to bringing an end to the situation of excessive government deficit

{SWD(2013) 327 final}

1. EXCESSIVE DEFICIT PROCEDURE: BACKGROUND

On 13 July 2010, the Council decided in accordance with Article 126(6) of the Treaty on 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].

On 27 January 2011, the Commission (following an assessment of action taken by Cyprus, in line with Article 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.

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.

On 25 April 2013, the Council addressed a decision to Cyprus on specific measures to restore financial stability and sustainable growth ('the programme')[2].

In parallel the European Stability Mechanism (ESM) granted a financial assistance facility to Cyprus. In this context, a Memorandum of Understanding on Specific Economic Policy Conditionality (MoU) was signed on 26 April 2013 by the Cypriot authorities and the Commission, acting on behalf of the ESM.

On 16 May 2013, in accordance with Article 3(5) of Council Regulation (EC) No 1467/97, the Council concluded that effective action had been taken but that unexpected adverse economic events with major unfavourable consequences for government finances had occurred after the adoption of the recommendation in 2010, making the time limit set by the Council in July 2010 for the correction of the excessice deficit no longer achievable. The Council therefore adopted a revised recommendation under Article 126(7) TFEU (the 'revised EDP recommendation'), extending the deadline for the correction of the excessive deficit to 2016. It recommended that "In order to bring the headline government deficit below the 3% of GDP reference value by 2016, Cyprus should achieve the headline general government deficit targets of 6.5% of GDP in 2013, 8.4% of GDP in 2014, 6.3% of GDP in 2015, and 2.9% of GDP in 2016. To this end, Cyprus should rigorously implement the 2013 Budget Law and the agreed additional consolidation measures, which should amount to at least EUR 351mn in 2013. Cyprus should fully implement the fiscal measures for 2014 that were adopted in December 2012, amounting to at least 270mn EUR in 2014. Cyprus should monitor the budgetary effect of consolidation measures taken on a monthly basis and stand ready to preserve fiscal targets by taking additional measures in the event of underperformance of revenues or higher social spending, taking into account macroeconomic circumstances. Cyprus should maintain fiscal consolidation over the medium term, converging towards its medium-term budgetary objective of a balanced budget in structural terms, by containing expenditure growth, improving the structure of taxation and undertaking fiscal-structural measures".

[1] OJ L 186, 20.7.2010, p. 30.
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] Decision 2013/236/EU - OJ L 141, 28.5.2013.

2. ASSESSMENT OF EFFECTIVE ACTION TAKEN

The Council Recommendation of 16 May 2013 was based on the Commission 2013 Spring Forecast. The current assessment of effective action taken is based on the updated fiscal and macroeconomic projections in the context of the July review of Cyprus' programme (PF July). It takes into account the economic and budgetary developments since the revised recommendation under the Excessive Deficit Procedure (EDP) was issued.

According to the PF July, projections of the macroeconomic outlook in 2013-2016 remain largely unchanged with respect to the forecast underlying the revised EDP recommendation. Real GDP is expected to decline drastically by 8.7% in 2013 as a whole, unchanged compared to the Commission 2013 Spring Forecast. The envisaged contraction is driven by the immediate restructuring of the banking sector and its impact on net credit growth, the longer-lasting deleveraging of corporate and household balance sheets, the fiscal consolidation pursued, and the high degree of economic uncertainty which will strain domestic demand and investment. In addition, the temporary imposition of capital controls and withdrawal restrictions combined with the related uncertainty 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 in the two major financial institutions is expected to cause a loss of wealth, which will also affect private consumption and investment.

Overall, Cyprus has executed the 2013 Budget effectively in the first half of the year. The fiscal consolidation measures taken by the authorities with regard to direct taxes, e.g. the increase in the statutory corporate income tax rate and an increase in the tax rate applied to interest income, are expected to counteract the negative impact of wage cuts in both the private and the broader public sector to this tax category. The projection of indirect tax revenue is broadly unchanged, balanced between relatively resilient VAT collection and other indirect taxes that appear more sensitive to adverse macroeconomic circumstances over the coming quarters. On the expenditure side, the cautious execution of expenditure measures is expected to continue compensating for higher social payments driven by the increasingly difficult labour market conditions.

Against the background of these developments in the first two quarters of 2013, an updated projection of the fiscal accounts confirms that the underlying budgetary trends in the first half of 2013 remain in line with the adjustment path established in the EDP recommendation. However, the budgetary balance for 2013 is projected to be affected by the compensation for provident and retirement funds, which suffered losses on their uninsured deposits held in Cyprus Popular Bank (CPB). The Cypriot authorities committed to such compensation from the general government budget given the social welfare nature of provident and retirement funds[3]. This compensation should ensure comparable treatment with such funds in Bank of

[3] In the Memorandum of Understanding on Specific Economic Policy Conditionality for Cyprus' adjustment programme (as approved on 24 April 2013 by the ESM Board of Governors) was explicitly mentioned that "the 2013 deficit target may be revised to incorporate compensation for provident and retirement funds in Cyprus Popular Bank to ensure equal treatment with such funds in Bank of Cyprus following the conversion of deposits into equity". It was moreover agreed that "given the social welfare nature of provident and retirement funds, the Cypriot authorities will use the necessary amount out of programme financing for such compensation". For this purpose, indicative financing of close to 2.5% of GDP was earmarked for the third quarter of 2013 in the assessment of Cyprus' financing needs (note to the ESM pursuant to Article 13.1 of the ESM Treaty). At the time of adopting the Council recommendation, the budgetary impact of this compensation could, however, not be established with precision, since it would depend on the conversion rate to be determined for deposits in BoC. The primary and headline balance deficit targets for 2013 were therefore set without explicitly taking into account the budgetary impact of this compensation.

Cyprus (BoC) following the conversion of deposits into equity. Due to the compensation, the 2013 deficit is likely to be substantially higher than the government deficit of 6.5% of GDP recommended by the Council.

The first review mission under the programme established that the rate of compensation will be no larger than 52.5% of the total deposit balance held in CPB, based on a rate of conversion of 47.5% of deposits into equity in BoC. This implies that the total budgetary costs of compensation would amount to around 1.8% of GDP, of which about half can be released by the time of the second review of the adjustment programme. Based on the currently available information, it is expected that the budgetary commitment can be fully accounted for in 2013. In this case, the corresponding 2013 primary balance deficit would amount to around 4¼% of GDP and the headline deficit would amount to around 8½% of GDP, thus exceeding the 2013 target set in the 16 May Council Recommendation. The Cypriot authorities have committed to adopt the modalities of this scheme before the release of the second tranche of assistance, after review by and consultation of the programme partners. Due to its extraordinary one-off nature, the compensation for provident and retirement funds would not impact on the budgetary outcomes in the outer years, and the headline deficit for 2014 is projected to meet the EDP target of 8.4% of GDP. Further, the EDP deadline for correction of the excessive deficit in 2016 appears achievable based on currently available information.

The 16 May Council Recommendation focused on the headline balance targets and the bottom-up effort, given the exceptional situation of highly uncertain macroeconomic environment in Cyprus at that time, with structural balance estimates being more uncertain and subject to variation over time than under more stable macroeconomic conditions. Since Cyprus can be expected not to meet the 2013 target for the headline balance recommended by the Council, due to the budgetary impact of the compensation of pension funds, a careful analysis should be conducted in order to assess whether expenditure targets have been met and the planned discretionary measures have been implemented.

An in-depth bottom-up assessment of the implemented fiscal measures is of particular relevance in the case of Cyprus, since the Council Recommendation of 16 May 2013 explicitly specifies also the recommended amount of discretionary consolidation measures. An assessment of the consolidation measures that have a fiscal impact in the years 2013 and 2014 is therefore required to assess if Cyprus has taken effective action.

For 2013, the Council recommended that the agreed consolidation measures should amount to at least EUR 351mn (2.1% of GDP). These measures comprise first and foremost an increase in the statutory corporate income tax rate to 12.5%, an increase in the tax rate applied to interest income to 30%, and an increase in the bank levy to 0.15%. As part of the prior actions, the immovable property tax was increased substantially, further wage and pension cuts were implemented, social transfers were targeted and benefits to pensioners and for housing purposes were reviewed, and measures to control healthcare expenditure were introduced. Furthermore, the government streamlined social transfers by more than the EUR 113mn required. While these additional savings from social transfers were already included in the 2013 Budget Law, they were not taken into account for the fiscal projection underpinning the Council Recommendation of 16 May 2013. Hence, the agreed measures implemented amount to more than EUR 351mn for 2013.

For 2014, under the updated fiscal and macroeconomic projections, Cyprus would achieve a budgetary impact of more than the EUR 270mn recommended by the Council by fully implementing the agreed fiscal measures. The estimated direct deficit-reducing impact of the consolidation measures amounts to 2.2% of GDP. On the expenditure side, the biggest impact comes from a further cut of both public sector wages and pensions (by another 3%), measures to contain the growth in social transfers and health care expenditures, the extension of the scaled temporary contribution of up to 3.5% on wages and pensions and an increase in the contribution to the General Social Insurance Scheme for both employers and employees. However, most of the effort comes from the revenue side (1.6% of GDP) with further increases in indirect taxes (VAT and excise duties on energy) and increases in contributions on wages and pensions. The increases in 2013 in property tax, the tax on interest income and VAT reach their full-year effects only in 2014, contributing to the revenue-bias of the fiscal effort in that year.

In spite of their implementation, some measures on the revenue side are expected to underperform, in particular for 2013. For example, a shortfall will likely occur for the withholding tax for interest income, where for constitutional reasons, the increase was enacted only as of 29 April 2013 instead of 1 January 2013. Also the yield of the increase in the bank levy (paid by credit institutions) has been revised downwards, due to a change in legislation, which effectively reduced the tax base for 2013 in order to avoid financial institutions paying levy on a deposit base substantially higher than the current amount of deposits. With regard to the motor vehicle tax reform, generating additional revenues turned out more difficult than anticipated due to Cyprus' steeply deteriorating motor vehicle market, but it was agreed to cover the shortfall by compensatory measures.

Summing up, expenditure targets have been met, the discretionary measures on the revenue side have been implemented and the agreed consolidation measures are currently assessed to amount to more than the required EUR 351mn in 2013 and EUR 270mn in 2014. Thus, the in-depth bottom-up assessment of measures that have a fiscal impact in 2013 and 2014 suggests that Cyprus has taken effective action with regard to the 16 May Council recommendation.

The exceptional situation of highly uncertain macroeconomic environment in Cyprus makes it difficult to accurately estimate the fiscal effort in structural terms. Moreover, as noted in the analysis of the Commission services[4], swings in potential growth estimates are quite strong in the case of Cyprus, and the variation over successive forecasts in the contributions to potential growth from total labour, capital accumulation, and productivity (TFP) has been large. These shifts in estimated potential output and the highly uncertain macroeconomic conditions imply a corresponding impact on the estimated structural effort, even when no changes occur to the budgetary execution or the implementation of individual consolidation measures.

Nevertheless, the recommended headline balance targets under the April Programme Forecast implied an estimated structural fiscal effort of 1.3% of GDP in 2013 and of 0.3% in 2014. Under the updated July Programme Forecast a worse labour market projection impacts negatively on potential output which was revised downwards by 0.4 pp. in 2013 and 0.6 pp. in 2014. This, in turn, reduces the estimated output gap in both years. As a result, given the unchanged projection of real GDP growth, the cyclical component is estimated as less negative than in the April Programme Forecast. Thus, the structural improvement for 2013 and 2014 is slightly lower than implied in the 16 May Council Recommendation. Correcting for the revision of potential output growth, the fiscal effort improves to 1.3% and 0.4% for 2013 and 2014.

[4] Commission Staff Working Document accompanying the Recommendation for a Council Recommendation with a view to bringing an end to the situation of an excessive government deficit in Cyprus - SWD(2013) 176 final, 7.5.2013.

In contrast, tax revenue elasticities appear slightly lower in 2013 and slightly higher in 2014, compared to the April Programme Forecast, which leads to a reduction of the corrected fiscal effort in 2013 of 0.4% and an increase in 2014 of 0.3%. The assessment of the yield of certain revenue measures has been revised down for 2013. This includes those revenue measures, where the implementation was delayed and where the full-year effect therefore materialises only in 2014. Hence, while the agreed amount of total discretionary measures have been implemented by the Cypriot authorities, the downwards adjustment of the effect of discretionary revenue measures is predominantly driven by a shift in timing of revenue collection as several revenues foreseen for 2013 in the April Programme Forecast were shifted to 2014 in the July Programme Forecast.

Correcting for both of these effects, the fiscal effort amounts to 0.9% and 0.7% in 2013 and 2014. On average, the corrected fiscal effort for 2013-2014 is therefore in line with the implicitly recommended effort.

Given that the deviation from the headline target set in the 16 May Council Recommendation is explained by the extraordinary one-off compensation of provident and pension funds in CPB, no additional measures appear needed at this stage.

At present, Cyprus continues to rigorously implement the 2013 Budget Law and the agreed additional consolidation measures, which at this point in time are assessed to amount to slightly more than the required EUR 351mn in 2013 and at least 270mn EUR in 2014. The situation will have to be monitored closely and further corrective action would have to be taken early on if deviations from budgetary plans were to materialise. The total amount of fiscal policy measures required to underpin the 2014 budgetary targets will be assessed in the context of the 2014 Budget Law consultation. For 2015-2016, Cyprus should achieve a deficit in the 2015 general government primary balance of no more than EUR 344mn (2.1% of GDP) and a surplus in the 2016 general government primary balance of at least EUR 204mn (1.2% of GDP), which under the updated programme forecast will require further measures to be specified in the outer years.

Moreover, the implementation of the fiscal-structural measures specified in Decision 2013/236/EU will support the achievement of long-term sustainability of public finances. The fiscal-structural measures are far-ranging and comprise, inter alia, establishing a medium-term budgetary framework, undertaking reforms of the pension, health care and welfare system as well as the revenue administration, and ensuring improvements to the public finance management and the functioning of the public sector.

3. CONCLUSION

Based on currently available information, it appears that Cyprus has taken effective action towards correcting the excessive deficit by 2016 as recommended by the Council on 16 May 2013.

The current forecast suggests that, due to the compensation of provident and pension funds in Cyprus Popular Bank, the headline deficit target for 2013 will not be achieved. However, the underlying budgetary trends and the execution of the 2013 budget remain in line with the adjustment path established in the EDP recommendation. Given the extraordinary nature of the pension funds compensation, the EDP deadline for correction of the excessive deficit in 2016 appears achievable based on currently available information.

Further, an in-depth bottom-up analysis shows that Cyprus has adopted sizeable consolidation measures with a direct deficit-reducing impact in 2013 of around 4.5% of GDP and around 2.2% of GDP in 2014. In line with the Council Recommendation, Cyprus continues to rigorously implement the 2013 Budget Law, has met expenditure targets and implemented the agreed discretionary consolidation measures, which are assessed to amount to more than the required EUR 351mn in 2013 and EUR 270mn in 2014.