



Convergence Programme

of the

Republic of Cyprus

2005-2009

Ministry of Finance



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**CONVERGENCE PROGRAMME
OF THE
REPUBLIC OF CYPRUS**

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INTRODUCTION

In accordance with the Council's Regulation (EC) 1466/97, the Republic of Cyprus submitted its first Convergence Programme (CP) in May 2004. This is the second update of the CP, drawn up in accordance with the updated guidelines set out in the "Guidelines on the format and content of the Stability and Convergence Programmes (2005 Code of Conduct)".

The fiscal consolidation effort, which begun in 2004, continues to be the key focal point of this Programme. As with the previous CP, this updated one focuses on the achievement of a three-fold goal: to adhere to the Council's Recommendation under Article 104(7) to abrogate the excessive deficit procedure in 2006; to proceed with the consolidation of public finances over the medium term so as to achieve a close-to-balance budgetary position and place the government debt-to-GDP ratio on a distinct downward path bringing it under the reference value; and to ensure sustainability in public finances over the long term, taking account of the impact of an ageing population on the government's expenditures and revenues.

The overriding objective of economic policy is to enhance long-term growth and the standards of living of all citizens, maintain macroeconomic stability, introduce structural changes, which improve the functioning of the market, and to ensure that the government sector provides adequately and efficiently services to the public. Against this background, fiscal policy ought to focus more on growth, through the redirection of resources to growth-enhancing activities and prioritization of expenditure programmes. A more efficient and leaner government that can tackle effectively these challenges will be important in this process.

The fiscal consolidation efforts will be underpinned by a robust macroeconomic framework and a prudent monetary policy. The resurgence of economic activity in 2004 is expected to gather pace over the period 2006-2009, creating conditions conducive to fiscal consolidation. With the negative output gap closing gradually, fiscal policy will remain broadly restrictive, in cyclically-adjusted terms, over the Programme horizon. Moreover, given the full employment conditions prevailing in the economy the fiscal stance is expected to be compatible with the pursuance of conditions of internal and external economic stability.

Following the submission and evaluation of the last CP, and owing to the successful fiscal consolidation efforts of the Government, Cyprus applied and was admitted in the Exchange Rate Mechanism II (ERM II) in May 2005. A credible fiscal consolidation plan aiming at ensuring fiscal discipline in a medium- and long-term perspective is even more crucial now with the participation of Cyprus in ERM II, and the plans for euro adoption by 1st January 2008. Although a safety margin has already been incorporated in the design of the fiscal consolidation programme, the Government stands ready to introduce additional corrective measures, should this be warranted by adverse developments resulting from lower-than-expected economic growth and/or delays or failures to implement any of the envisaged fiscal measures.

As with the previous update, this CP has also been extensively discussed with the political parties and social partners and their proposals were taken into account during the compilation of this CP, in order to gain broad political support. Furthermore, the

Council of Ministers has reviewed all the fiscal consolidation measures and has endorsed all the requisite actions that need to be taken for their implementation. This CP, and the incorporated fiscal measures, will be submitted to the House of Representatives for discussion. The Government of the Republic of Cyprus considers the fiscal targets set out in the Programme as feasible, credible and binding. The Ministry is monitoring closely the progress made to date and is actively pursuing the remaining measures which are to be implemented. In this respect, an implementation timetable has also been included in this Programme.

The CP was prepared by the Ministry of Finance in cooperation with the Central Bank of Cyprus and the Planning Bureau.

1. OVERALL POLICY FRAMEWORK AND OBJECTIVES

Safeguarding macroeconomic stability and fostering sustainable economic growth, under conditions of full employment and a healthy balance of payments position, continue to be the overriding objectives of economic policy. While achieving a sound fiscal position in the short and medium term is a key policy priority, the overall policy framework attaches considerable importance to long-term growth and the enhancement of the growth potential of the Cypriot economy. Despite the relatively good performance of the economy, as exemplified by the fulfilment of several key Lisbon targets, efforts to reform further labour and product markets, in line with the country-specific Broad Economic Policy Guidelines' (BEPGs') and Cyprus' Lisbon Programme, will be intensified.

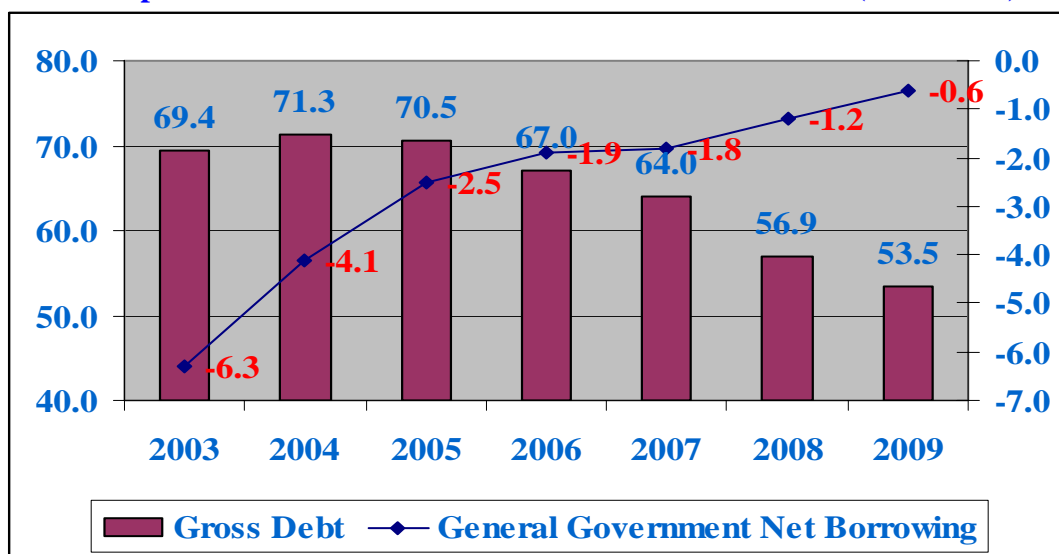
Fiscal Policy

To ensure that the excessive deficit is eliminated, a front-loaded adjustment took place in 2005 and will be followed by a more gradual, but steady, improvement in cyclically-adjusted terms over the remaining programme period 2006-2009. As a result of the over-achievement of the initial fiscal target of the May 2004 Programme—with the deficit having been reduced to 4.1% of GDP in 2004 instead of the original target of 5.2% of GDP—this Programme foresees, in the first instance, compliance with the deficit criterion by the end of 2005 through a reduction in general government net borrowing to 2.5% of GDP and, thereafter, a further reduction of the deficit to 0.6% of GDP by 2009. Based on these targets a cumulative adjustment of around 1.9% of GDP in nominal terms, 1.5% of GDP in cyclically adjusted terms, and 2.4% of GDP in cyclically-adjusted terms net of one-off measures is envisaged over the period 2005-2009.

In line with the above, the general government debt, which peaked in 2004 as a percentage of GDP, will steadily decline. The Programme foresees a reduction of the general government debt from 71.3% of GDP at the end of 2004 to 53.5% of GDP by 2009, significantly below the 60% reference value. A primary surplus is expected to emerge in 2005 and peak by the end of the Programme horizon to approximately 1.7% of GDP. The strong growth performance and smaller fiscal deficits, as well as the phasing out of accumulated sinking fund deposits, explain the projected path of the debt ratio.

With regard to the country specific medium-term objective of a close-to-balance budgetary position, this Programme targets a fiscal deficit of 0.6% of GDP by the end of 2009. This is based on a cautious and conservative set of assumptions which, among other factors, incorporate likely deterioration to Cyprus' net position vis-à-vis the EU budget after 2006 with the envisaged adoption by the EU of the Financial Perspective for 2007-2013. The achievement of the medium-term objectives of Cyprus depends crucially on the continuation of the fiscal consolidation effort and more specifically on containing the growth of public expenditures below the nominal GDP growth, and on improving tax performance.

Graph 1: General Government Balance and Gross Debt (% of GDP)



Lax and delayed implementation of policy measures outlined in the Pre-accession Economic Programmes of 2002 and 2003 highlighted a number of deficiencies in fiscal governance, which needed to be tackled in a medium-term perspective. To address these problems, the Authorities reached a preliminary agreement with the IMF for a technical assistance programme, targeting the strengthening of best practices of fiscal management. The recommendations will be examined and adopted by the Government.

To gain broad political support the Government of the Republic of Cyprus initiated a dialogue with the political parties and social partners. These consultations preceded the preparation of this Programme, with a view to creating sufficient support that would facilitate its successful implementation. During the consultations the key policy objectives and proposed policies were outlined and analysed to the political parties and social partners. The comments and suggestions provided during these consultations were taken into account in the final version of this Programme. Subsequently, the Programme has been submitted to the Council of Ministers, for approval on December 13th, 2005. The revised CP will be sent to the House of Representatives for discussion within the Parliamentary Committee on Finance and Budgets. This procedure described is expected to increase national ownership for the Programme, thus facilitating its implementation.

Monetary and Exchange Rate Policy

Historically, monetary and exchange rate policies in Cyprus have been geared towards maintaining macroeconomic stability and low inflation, in part, through the pegging of the Cyprus pound to an anchor currency, be it a basket of currencies until 1992 or a single currency, the ECU/euro, since 1992. As suggested by the overall positive economic performance of the country, particularly in the last two decades, where high growth, low unemployment and relatively stable inflation rates were recorded, the policy of using the exchange rate as a means to contain inflation and to anchor inflationary expectations has served the economy well, not only in terms of

safeguarding price stability, but also by providing a stable macroeconomic environment, which is conducive to long-term growth.

With the participation of the Cyprus pound in ERM II, the monetary policy framework remains effectively unchanged. The fact that the Cyprus pound has been pegged to the ECU during 1992-98, and subsequently to the euro, without any tensions, suggests that the economy can cope inside a fixed exchange rate regime, provided policies remain prudent and focused on the objective stated in this Programme. With this updated Programme the Authorities underscore their commitment to adopt the euro by 1st January 2008 and to continue with policies which will ensure fulfilment of the Maastricht criteria.

Structural Reforms

The promotion of structural reforms will enable Cyprus to develop a robust and flexible economy, exhibiting the desired resilience to external shocks, while enhancing the efficiency of the market mechanism and raising the production potential of the economy.

The programme of structural reforms, outlined in detail in the national Lisbon Strategy, aims at creating a dynamic and competitive economy that will deliver high growth and living standards for the citizens of Cyprus. The key areas where reforms are needed are the following:

- 1. Structural reforms targeting at enhancing competition and improving the overall business climate*

Structural policies will be directed at further enhancing the functioning of the market mechanism and raising employability, mainly through upgrading of the quality of human capital. In addition, reforms are needed to increase the flexibility of the economy and support external competitiveness, as well as to enhance competition and improve the overall business climate.

- 2. Increase the diversification of the economy*

More investment should aim at further diversifying the economy, which is dominated by services and in particular by tourism. This partial dependence on tourism renders the economy vulnerable to exogenous economic, and geopolitical shocks. Further diversification of the economy will enhance its production base and make the economy more resilient and competitive.

- 3. Promote R&D and innovation and facilitation of ICT diffusion*

In order to support long-term growth, a key priority of the Government is to boost investment in physical and human capital. This requires higher capital spending, as well as more expenditure on education and research and development (R&D). It is widely accepted that R&D and innovation and the wider utilisation of information technology are key in attracting foreign direct investment, boosting productivity and growth.

4. Upgrading of basic infrastructures

Upgrading of the physical infrastructure network—which, considering the country’s relatively high standard of living, remains underdeveloped in some areas — is central in this ambitious attempt and should proceed swiftly but in accordance with environmental concerns.

5. Further human capital development

Enhancing of physical and human capital is key in raising productivity and boosting the economy’s potential growth. Development of human capital is especially important in an economy dominated by the services sector. Rapid changes in the communication and information-technology sectors and structures of production as well as the organisation of work and the labour market require constant upgrading of the educational and training systems, as well as more emphasis on lifelong learning.

2. ECONOMIC OUTLOOK

World Economy¹/Technical Assumptions

Growth in the EU, particularly the United Kingdom, is expected to moderate somewhat in 2005–06. This will be offset by higher-than-expected growth in Middle Eastern and CIS countries, particularly Russia, owing to increased oil revenues. Thus, while there may be some moderation in the demand for Cyprus' tourist product from the United Kingdom, this is likely to be offset by greater demand from Middle Eastern and CIS countries, including Russia, for merchandise and non-tourist services exports, including outlays on business services. In the medium-term demand prospects, particularly from the United Kingdom, look promising, taking into account past trends.

The projections are based on the assumption of an unchanged exchange rate against major currencies from the average level of October 2005. It is assumed that the price of crude oil (Brent crude) will average \$58 per barrel in 2005, and will remain at \$60 per barrel in 2006 and 2007. In subsequent years crude oil prices are assumed to fall to \$55 per barrel.

As regards interest rates, the Convergence Programme assumes that interest rates in Cyprus will continue to fall in 2006 and 2007 and converge towards the lower level of interest rates in the Eurozone, which are assumed to rise in accordance with the Commission's forecasts.

Cyclical Developments and Current Prospects

The economy of Cyprus has performed relatively well during the last few years, in spite of the challenging external environment. After a slowdown in 2002-03, growth—supported by private consumption growth, and a small, though non-negligible, contribution from investment—has accelerated and is forecast to reach 4.1% in 2005.

The sluggish recovery in the EU, the weakening UK economy, the rise in the price of oil in the international markets and, to a lesser extent, the small real effective appreciation of the exchange rate have moderated somewhat the growth of exports of goods and services. Hence, GDP continued to drift below potential, particularly in the service sector, where the impact of the slowdown has been more pronounced.

Private consumption continued to expand unabated, albeit at a somewhat slower pace compared to 2004. The strong growth of consumption, which is forecast to reach 4.5% in 2005, is attributed to declining interest rates, a buoyant credit market, and to further employment and real wage gains. Similarly, investment growth is set to slow down to 4.5% in 2005, after a particularly strong year in 2004, and will continue to be driven by construction, and, to lesser extent, investment in machinery and equipment. Public consumption is expected to expand around 2% in 2005,—in line with

¹ The key assumptions on the external environment are based largely on the 2005 Autumn Forecasts of the European Commission (Table 8).

projections in the previous update of the Convergence Programme—after declining sharply in 2004.

Exports have picked up and are forecast to increase by 5.2% in 2005, compared with 4.5% the previous year. A solid export performance should continue to propel the recovery in the near term, on the back of firm private consumption and investment growth. Tourists arrivals have recovered from the low levels experienced in 2002-03 and have continued to rise steadily in 2005, while bookings for the coming winter and summer seasons are markedly higher compared with a year earlier. Exports of goods expanded rapidly, mainly as a result of buoyant re-export activity, and are estimated to increase by some 27 percent in nominal terms. The continuing growth of services, other than tourism is a significant development and reflects the evolving diversification of the economy.

With the unemployment rate at 5½% of the labour force, based on the labour force survey, labour market conditions remained tight. Labour shortages in a number of sectors (e.g. in the sectors of hotels and restaurants, trade and construction and at the occupational level in technical and low skilled occupations) have been addressed by an increased supply of foreign and Turkish Cypriot workers. Nominal wages increased by around 5%, broadly in line with productivity and price trends.

Inflation remained subdued, despite large increases in oil prices and considerable fluctuations in exchange rates, and it is expected to average 2.1% in 2005 based on the harmonised definition. The contribution of rising oil prices, which is estimated not to exceed 1 percentage point for 2005, has been significant but has not as yet spilled over to wage developments leaving core inflation around 2%.

Narrow money (M1) increased by 16% in September 2005, compared with 10.2% in the same period of the previous year, while M2 expanded by an annual rate of 7.6%, similar to the growth in 2004. With fiscal consolidation on track, and the pound strengthening as a result of strong capital inflows, interest rates were lowered by a total of 125 basis points on several occasions. The 3-month interbank rate averaged 4.50% over January-September 2005 compared with 4.74% in 2004. Since the beginning of the year long-term government bond yields fell by almost 200 basis points to their lowest level since October 2003. In its most recent statement (2 December 2005) the Monetary Policy Committee (MPC) of the Central Bank of Cyprus (CBC) highlighted the balance of risks with, on the one hand, the satisfactory growth in economic activity and thus the upside risks to inflation and, on the other hand, the increased foreign exchange inflows that exerted pressure on the Cyprus pound. Based on the above, along with the decision of the European Central Bank to raise interest rates by 25 basis points, the MPC decided to maintain the official interest rates unchanged.

The Central Bank of Cyprus (CBC) lowered the reserve requirement on Cyprus pound deposits from 6.50% to 5.75% on 1 September and further to 5.0% on 1 November 2005. This development was in line with the harmonisation (by means of gradual reductions) of the reserve requirement in Cyprus to the level required by the ECB by 2007 (currently 2%). The aforementioned reduction in the reserve requirement boosted bank liquidity, and led to interventions by the CBC, via auctions for the acceptance of deposits, in order to absorb surplus liquidity.

Table I: Selected Economic Indicators

<i>annual % change</i>	2003	2004	2005	2006
Real GDP growth rate	1.9	3.8	4.1	4.2
Inflation rate (National CPI)	4.1	2.3	2.5	2.5
Inflation rate (GDP deflator)	5.3	2.8	2.7	2.8
Core inflation ²	2.5	2.5	2.0	2.0
HICP	4.0	1.9	2.1	2.0
Unemployment rate (registered)	3.5	3.6	3.8	3.7
Unemployment rate (Labour Force Survey) ³	4.1	4.7	5.3	5.2
Current account balance (% of GDP)	-2.5	-5.6	-5.5	-4.9

The current account is expected to record a deficit of some 5.5% of GDP in 2005. The rather persistent deficit masks a number of diverse, but offsetting external developments. The significant rise in oil imports arising from higher oil prices (assumed in 2005 to average \$58 per barrel), estimated at around 55% compared to the previous year, is expected to be largely offset by an anticipated substantial reduction in car imports and an acceleration in the growth of receipts from merchandise exports⁴.

On services account, receipts from tourism have increased somewhat for the first time in four years and prospects for 2006 appear promising, based on bookings for the winter and summer seasons. In addition, the rate of growth of revenues from international business activities in Cyprus, as well as the performance of other export services, such as business services and banking are promising.

Medium-term Scenario 2006-2009

The Convergence Programme is based on a medium-term macroeconomic scenario, that takes into account the positive effects stemming from the implementation of fiscal and structural reforms and other policies included in the National Lisbon Programme, and the new Strategic Development Plan for 2007-2013. The following key assumptions are made:

- Tourist arrivals will increase by 5%, and per capita tourist spending by around 3% in nominal terms annually over 2006-09⁵.

² As a proxy for core inflation, the consumer price index, excluding fresh fruit and vegetable items, petroleum products and indirect taxes (including VAT) is used.

³ The LFS unemployment rate refers to the second quarter of each year.

⁴ Car imports soared in 2004 owing to a significant reduction in excise taxes.

⁵ This implies that the total number of tourist arrivals will reach 3 million by 2009 and total receipts from tourism will amount to some 13,7% of GDP, compared with 13,2% in 2005 and 21% in 2000.

- Nominal earnings will rise by 4% per annum and real earnings by 2% during 2006-2009, in line with prospective productivity gains. Hence, real unit labour costs will fall by some ½ percentage points over the same period.
- Employment will expand by 1½% per annum, above the assumed rate of growth of the population, as a result of an increasing inflow of foreign and Turkish Cypriots workers.
- Public sector employment will expand by some 1% annually in 2006 –2009.

Based on these assumptions it is forecast that GDP will expand by an average of 4.2%, thus closing the output over by the end of the programming period. With growth at, or somewhat above, potential the unemployment rate will ebb to 4½% by 2009 (LFS definition).

It is envisaged that exports and to a smaller extent domestic demand—reflecting mainly a buoyant investment activity and a strong growth of private consumption—will be the main drivers of growth in the medium term. Exports of goods and services are forecast to rise by around 6% per annum in constant prices on the back of buoyant tourist demand and improvements in the quality of the tourist product, which will boost revenues and profit margins. Exports of services, other than tourism, are expected to continue to perform well, expanding at an annual rate of some 8% in real terms over 2006–09. Private consumption will continue to grow at around 4% per annum on account of wage and employment gains and low interest rates. Investment will expand by 6% per annum—compared with an average increase of 5¼ % in 2000–04; low interest rates and a stable macroeconomic environment, prospective euro adoption by 2008, liberalisation in a number of sectors (e.g., energy and communications), and plans to upgrade physical infrastructure in various segments of the economy, will keep investment activity buoyant in the near to medium term.

In contrast, Government consumption growth will moderate as a result of the implementation of the fiscal consolidation programme which, inter alia, envisages stricter controls on public sector employment growth, in addition to the containment of current expenditures. More specifically, government final consumption is expected to increase by around 2.5% in real terms over the period 2006-09, as compared to 2.8% during 2000-04.

From the sectoral viewpoint, the private tertiary sector will continue to be the main engine of growth given that the comparative advantages of Cyprus favour the development of these types of activities. The share of the service sector as a whole to GDP is anticipated to grow further and reach 77.5% in 2009, as compared with 76.6% in 2005, whereas the share of both the primary and secondary sectors would correspondingly decline from 3.8% and 19.7% in 2005 to 3.4% and 19.1% in 2009, respectively. Within the service sector, continuing restructuring and diversification are expected, with an increased shift towards export-oriented private services in the areas of communications, finance, business services, private education and health. These will benefit from the abolition of all restrictions on direct and portfolio investment not only for EU residents, but also for residents of third countries, the removal of impediments to free market access in the utilities sectors and the utilisation of the comparative advantages of Cyprus.

In the labour market the medium-term scenario envisages further employment gains, mainly resulting from increased participation of foreign workers, a slow (long-term)

increase of the participation rate of, mainly, female Cypriot workers and old aged. With the gainfully employed population increasing by 1½% per annum, registered unemployment is expected to decline to 3.3% of the labour force by 2009, while the unemployment rate based on the LFS will also fall to 4.5% from 5.3% in 2005. In general, labour market conditions are expected to remain tight but the projected increase of foreign and Turkish Cypriot workers will help ameliorate shortages in various sectors.

Productivity growth will accelerate to almost 3 percent in the medium term, as a result of the strong investment undertaken in recent years, which will bring about greater utilisation of new technologies. Real earnings will rise by 2%, and nominal unit labour costs will increase by some 1½ % over the same period, below anticipated inflation.

Monetary developments, which will continue to reflect trends in the real economy, remain consistent with the goal of medium-term price stability. Based on the estimate for potential GDP growth roughly at 4% and of long-run inflation around 2%, and assuming that the velocity of circulation of money will continue to decline somewhat over the medium term, a simple quantity of money relationship suggests that the stock of broad money will expand by an average of 7½-8% annually. Large capital inflows and foreign currency borrowing by commercial banks could keep credit growth at even higher levels.

The current account deficit will narrow over the medium term to around 3% of GDP in 2009 from 5.5% in 2005. FDI flows will continue to finance, to a large extent, the current account deficit, thereby allowing official foreign exchange reserves to remain at comfortable levels.

Box 1. Risks to medium-term forecasts

Overall, the risks to the outlook seem to be fairly balanced over the medium term:

- The negative effects of a slow recovery in the EU—owing to a slowdown in the UK and France, and continued weakness in Germany—could be offset by strong economic performances in the CIS and Middle East regions;
- An unwinding of external imbalances and a dramatic fall in the value of the dollar, could weaken the Chinese economy and trigger a sizable drop in the price of oil, while at the same time cause a further real effective appreciation of the Cyprus pound;
- At the same time, weaker world growth could lower export growth, particularly in the services sector;
- The effects of fiscal and other structural reforms, and the positive impact from EU membership, may be underestimated implying a much-higher growth potential of the economy.

Sectoral Balances

While the fiscal deficit has been reduced significantly, the reported current account deficit, which remains at around 5½% of GDP, has been more persistent. Transitory as well as more structural reasons are behind the moderately high current account deficit. Accelerating oil prices have pushed imports of oil-related products

significantly higher, although this trend is expected to be reversed in the medium term. Conversely, higher investment and imports of capital goods have raised the underlying current account deficit. The increased profitability of foreign firms further contributes to the current account deficit through its impact on investment income. It is estimated that income outflows pertaining to re-invested earnings of foreign firms have reached 3% of GDP in 2004, and these flows are recorded simultaneously as investment outflows in the current account and FDI inflows in the financial account; in effect, suggesting an “underlying” current account deficit below 2% of GDP in 2004.⁶

Table 1d shows that while public sector savings are gradually rising, the net lending of the private sector will remain broadly unchanged over the Programme horizon. The process of real convergence will tend to sustain the deficit of the private sector and the current account deficit at somewhat low-to-moderate levels. The continued profitability of foreign investment will also keep the reported current account deficit higher.

Foreign direct investment (FDI) has been a significant source of financing of the current account deficit in recent years, reaching some 3% of GDP in net terms. The size of available financing for the current account deficit is encouraging, whilst its composition, which includes sizeable inflows in the form of reinvested earnings, constitutes an additional strong indication of the sustainability of the current account deficit.

Growth Implications of “Major Structural Reforms”

The structural reforms proposed within the framework of the National Lisbon Programme will contribute towards enhancing the growth potential of the economy via a quantitative and qualitative upgrading of the factors of production—labour and capital (basic infrastructure and higher private investment),—as well through enhanced technological change and efficiency gains, resulting from a more efficient functioning of the market mechanism. The preservation of the growth potential at satisfactory levels would make possible the achievement of a satisfactory rate of growth of the economy under conditions of price stability, and would contribute positively towards further bridging the gap to the more advanced member states of the EU.

⁶ In 2002, Cyprus introduced a methodological revision to the Balance of Payments reporting in line with IMF’s BPM5 standards. The most important feature of the revision was the change in the residency definition, whereby the large international business sector having physical presence in Cyprus has been included in the residents’ category. This has significantly boosted exports of services and at the same time led to significantly higher reinvested earnings, which are recorded as higher inflows of foreign direct investment and as outflows on the income balance. The higher, than previously reported, export of services is also attributed to the improvement in the quality of data due to the newly introduced method of collecting detailed information through the banking sector.

3. GENERAL GOVERNMENT BALANCE AND DEBT 2005-2009

Policy Strategy

The Government's main policy goal is to continue with the implementation of its fiscal consolidation programme, which targets a general government net borrowing position well below the reference value of 3% of GDP. The policy of reaching a "close-to-balance" position in the medium term, will create a safety margin for the full operation of automatic stabilizers in the event of an economic slowdown, and will stabilise debt dynamics ensuring a significantly lower debt-to-GDP ratio by the end of 2009. At the same time, the Programme is consistent with the continuous efforts of the Government, within the Lisbon Framework, aimed at enhancing the growth potential of the economy and creating an open, competitive and business friendly environment.

The anticipated reduction of public debt is a key policy objective in light of the pressures on public expenditure, which will emerge as a result of population ageing. The recent extension of the retirement age in the public sector and the planned parametric reforms in the Social Security Funds, will improve considerably their financial viability and facilitate the smooth operation of the welfare system over the coming decades.

Ultimately, the adoption of a firm and credible medium-term fiscal strategy and the achievement of a tangible and sustainable improvement in public finances will support the goal of preserving price stability and the competitiveness of the Cypriot economy in the long run.

Adherence to the Stability and Growth Pact, among other things, requires Member States to abide by the country-specific medium-term objectives and, in doing so, ensure a minimum annual fiscal adjustment of at least 0.5% of GDP, net of one-off and other temporary measures. Taking into account, on the one hand, improvements in public finances over the preceding two years and, on the other hand, the sustained negative impact of higher oil prices on public expenditures and the recently adopted social measures, this Programme targets a nominal deficit figure of 1.2% of GDP for 2008 and 0.6% of GDP in 2009, in accordance with the country-specific medium-term objective for Cyprus.

The pace of consolidation corresponding to the country-specific medium-term budgetary objective for Cyprus is appropriate given the projected near- and medium-term outlook for the economy, whilst the composition of adjustment favours the development needs of the economy and allows for the implementation of structural reforms which are needed to boost the long-term growth potential of the economy. Indeed, the factors entering the design of the specific medium-term budgetary objective include, in addition to the quality of the overall macroeconomic framework, the possibility of dealing with adverse cyclical developments and the impact of structural reforms, as well as the needs of the government in terms of investment and other growth-enhancing expenditures (Box 2).

The decision to adopt the euro as soon as possible, following the entry of the Cyprus pound in ERM II on May 2, 2005 and the design of the fiscal consolidation

programme are mutually supportive. Indeed, firm implementation of the fiscal consolidation programme is considered key, prior to the introduction of the euro in Cyprus.

The main elements of the fiscal consolidation strategy, which was launched in 2004 and which still constitutes the basis for this updated Convergence Programme are:

1. Containing, through prioritization, of public expenditure increases below nominal GDP growth;
2. Moderate public sector employment growth;
3. Moderate public sector contractual salary increases;
4. Containing the growth of current transfers and social benefits to the rate of inflation, and redirecting them to better target the needs of the truly disadvantaged groups;
5. Introducing, following intensive discussions and an agreement with the stakeholders, parametric reforms to the social security system with a view to safeguarding its long term fiscal sustainability.
6. Enhancing tax effectiveness, through measures to combat tax evasion;
7. Regularisation of dividend income policy for semi-governmental organizations ;
8. Issuance of title deeds for buildings erected with minor irregularities.

The envisaged fiscal adjustment strategy places emphasis on strengthening revenues, without resorting to new taxes. Key in this campaign is the effort to discourage tax evasion and improve tax collection and ensure that the provision of government-provided services is priced correctly, and in line with actual costs and market trends. These efforts will be underpinned by continuing efforts to modernise the budget management system, drawing from a relevant technical assistance project with the International Monetary Fund (IMF).

Durable progress in terms of public finances is also crucial in sustaining the nominal convergence process and maintaining low interest rates. Indeed, long-term interest rates have also exhibited a downward trend, falling by over 200 basis points since the beginning of the year. Although the entry of the Cyprus pound in the ERM II, acted as a catalyst in reducing the differential between interest rates of the euro area, the improved fiscal position was a key factor. Reduction of interest rates and risk premia, will contribute towards lowering government spending on interest payments and allowing expenditure to be redirected to more productive areas.

Medium-term Objectives

In line with these commitments and objectives and the obligation to meet the country-specific medium-term objective (MTO) for the general government net borrowing—which has been estimated at around -0.5% of GDP (Box 2),—the fiscal adjustment scenario entails a steady improvement in government balances over 2006-09. The general government deficit is expected to decline by 0.6 percent of GDP in 2006, to 1.9% of GDP, and to further fall by 0.1 percentage points in 2007. The slower improvement in 2007 is due to the anticipated deterioration of the net position of Cyprus vis-à-vis the EU budget, following the commencement of the financial framework for the period 2007-2013, which coincides with the termination of the provision of compensating grants through the EU budget, equivalent to 0.5 percent of GDP. The deficit will be reduced by another 1¼ percent of GDP over the remaining time horizon (2008-2009). Consequently, and also owing to the phasing out of the debt-financed sinking fund deposits, gross public debt will decline to 67% of GDP in 2006 and to below 55% of GDP by 2009, from 70.5% of GDP in 2005.

The cyclically-adjusted balance will improve steadily to 0.2% of GDP by 2009, implying a cumulative adjustment of some 1.5 percent of GDP over the Programme period, while net of one-off measures the cyclically-adjusted balance will improve by some 2.4 percent of GDP, or by little more than 0.5 percent of GDP annually.

Table II: Components of Fiscal Adjustment

<i>in percentage points of GDP</i>	2004	2005	2006	2007	2008	2009	Total Adjustment 2006-2009
Expenditure measures	-1.8	0.2	-1.9	-0.1	-1.0	-1.1	4.1
<i>One-off expenditure measures</i>	-	-	-	-	-	-	-
Revenue measures	0.4	1.7	-1.2	0.0	-0.4	-0.5	-2.1
<i>One-off revenue measures</i>	1.0	0.9	-	-	-	-	-
General Government Net Borrowing	-4.1	-2.5	-1.9	-1.8	-1.2	-0.6	2.0

Note: The figures may not add up to the total due to rounding effects.

Box 2. Cyprus: Country Specific Medium-Term Budgetary Objective (MTOs)

The European Council agreed on March 20th, 2005 that, in light of the increased economic and budgetary diversity in the EU “the medium-term budgetary objectives (MTOs) should be differentiated for individual Member States to take into account the diversity of economic and budgetary positions and developments as well as the diversity of risks to the sustainability of public finances”. It was therefore agreed to develop medium-term objectives which:

1. provide a safety margin with respect to the 3% deficit limit;
2. ensure rapid progress towards sustainability; and
3. taking the above into account, allow room for budgetary manoeuvre as well as addressing the needs for public investment.

Furthermore, it was decided that until specific criteria and the modalities for taking into account of the implicit liabilities corresponding to population ageing were appropriately established, “MTOs should be differentiated and may diverge from hitherto established closed to balance or in surplus target for individual Member States on the basis of their current debt ratio and potential growth, while preserving sufficient margin below the reference value of -3% of GDP”. Additional provisions were established for euro-area, and ERM II, Member States requiring the country-specific MTOs to lie in a “range between -1% of GDP for low debt/high potential growth countries and balance or surplus for high debt/low potential growth countries”.

In this respect, Cyprus may be categorized as a country with a relatively high level of debt as a percentage to GDP— although a significant share is covered by sinking finds in the form of liquid assets accumulated for the gradual redemption of long-term loans,—but exhibiting an above-average potential growth. Cyprus’ MTO was determined taking into account the following three elements:

(i) The general government debt ratio which, in the case of Cyprus, is forecast to decline somewhat to 70.5 percent of GDP in 2005 and below the reference value by 2008.

(ii) Long-term potential growth of some 3%.

The Code of Conduct stipulates that “*potential growth should be assessed in a long-term perspective on the basis of the projections produced by the Working Group on Ageing attached to the Economic Policy Committee*”. These projections are made on the basis of commonly agreed assumptions. The latest estimate of the average annual potential growth for the Cyprus economy up to 2050 is calculated to be of the order of 2.9%, being the second highest among the EU-25.

(iii) A safety margin of some 1% of GDP with respect to the reference value of 3% of GDP.

It is clear from the Council report that a country-specific MTO should be set at a level, which ensures a sufficient safety margin against breaching the 3% ceiling. The Code of Conduct stipulates that “*such a safety margin is assessed for each Member State taking into account past output volatility and the budgetary sensitivity to output fluctuations*”. The safety margin can be assessed against the so-called ‘minimum benchmarks’. The minimal benchmark corresponds to the cyclically-adjusted budget balance which allows a country to allow automatic stabilisers work freely without risking breaching the 3% of GDP reference value, under normal cyclical circumstances. In the case of Cyprus, the overall budgetary sensitivity to the cycle was estimated at 0.39 with a representative output gap of the order of 2¾ percent of potential output, leading to a minimal benchmark of around 1.9% of GDP. This indicates that the safety margin in the case of Cyprus is 1.1 p.p. of GDP.

On the basis of corrective measures incorporated in the Programme, a cumulative adjustment of 1.9 percent of GDP is forecast over 2006-09. Expenditure containing measures are set to account for the bulk of this adjustment, contributing a cumulative 4.1 percent of GDP over the programming period. The developments on the revenue side are adversely affected by the fact that no receipts are anticipated from one-off operations, such as the tax amnesty and also from lower EU budgetary transfers from 2007 onwards. The aforementioned shortfalls will be offset by revenues accruing from improved tax compliance and administration and other revenue-enhancing measures, resulting in a cumulative adjustment of -2.1 percent of GDP over the same period. The improvement resulting from cyclical developments is likely to be small, contributing on average around 0.1 percent of GDP annually over the programming period. In 2006 expenditure containing measures are forecast to yield savings of 1.9 percent of GDP, whereas on the revenue side there will be a deterioration by some 1.2 percent of GDP.

Table III: Adjustment Path in reaching the Medium-term Objective

<i>in percentage points of GDP</i>	2004	2005	2006	2007	2008	2009	2005-2009 Total Adjustment
General Government Net Borrowing	-4.1	-2.5	-1.9	-1.8	-1.2	-0.6	
Annual Adjustment		1.6	0.6	0.1	0.6	0.6	1.9
Cyclically adjusted balance net of one offs	-4.3	-2.6	-1.5	-1.4	-0.9	-0.2	
Annual Adjustment in structural terms net of one offs		1.7	1.1	0.1	0.5	0.7	2.4

Actual Balances and Implications of the Forthcoming Budget

General government finances exhibited a considerable improvement in 2004 with net borrowing falling from 6.3% of GDP in 2003 to 4.1%. On account of financial transactions, explained later in the CP, general government gross debt increased to 71.3% of GDP compared with 69.4% in 2003 (Table V). Expenditure cuts equivalent to some 2 percent of GDP, and to a lesser extent, higher tax receipts were crucial in this effort. More specifically, the favourable outcome of 2004 can be attributed, mainly, to the following factors:

- Reduction of defence expenditures (0.8 percent of GDP).
- Containment of agricultural subsidies (0.2 percent of GDP).
- No granting of contractual salary increases with retroactive effect (0.5 percent of GDP).
- Proceeds from the sale of mobile telecommunication licences (UMTS) (0.3 percent of GDP).
- Receipts from the implementation of a tax amnesty (0.7 percent of GDP).
- Better-than-anticipated performance of direct taxation (1.0 percent of GDP).

The above measures amounting to 3.9 percent of GDP were partially offset by the fact that in 2003 a one-off revenue measure amounting to 1.8 percent of GDP and

representing dividend income on the past accumulated profits of semi-governmental organisations did not reoccur in 2004.

Considering that the economy continued to operate below potential, the fiscal stance in 2004 remained highly contractionary with the cyclically adjusted deficit narrowing by 2.4 percent of GDP. A larger adjustment is seen in the cyclically-adjusted balance net of one-off and other temporary factors, which shows an improvement of more than 3 percent of GDP.

The better-than-expected fiscal performance in 2004, meant that the adjustment effort needed to reduce the fiscal deficit below the 3% reference value by 2005 could be scaled back, hence, allowing some room for the Government to enhance social spending and provide targeted financial assistance to groups particularly affected by higher energy prices.

The general government deficit for 2005 is projected to decrease both in absolute terms and as a percentage to GDP, to 2.5% of GDP compared with a target of 2.9% of GDP in the previous CP, resulting in an improvement of 1.6 percent of GDP compared with 2004.

The sustained recovery of economic activity, in tandem with intensified efforts to consolidate the fiscal position, was behind the improved fiscal outlook in 2005. Real GDP growth reached 4.1%, compared with 3.8% in 2004, while the composition of demand was favourable to public finances. Indicatively, during the first nine months of the year, direct taxes showed an increase of approximately 21%, excluding one-off and other temporary measures, compared to the corresponding period of the previous year. The tax amnesty contributed revenues of approximately 1 percent of GDP, in addition to the receipts from 2004; overall, the tax amnesty generated revenues of some 1.5 percent of GDP in 2004 and 2005, and it is anticipated that it will lead to a substantial broadening of the tax base, thereby indirectly contributing to higher revenues on a permanent basis.

The anticipated outcome for 2005 will be adversely affected by the introduction of a series of, for the most part, temporary fiscal measures, which were intended to alleviate the negative effects of rising oil prices, and to enhance social cohesion. Overall additional spending amounting to 1.3 percent of GDP was approved in supplementary budgets enacted in 2005.⁷ The estimates and projections presented in this Programme take into account the supplementary budgets enacted this year, including all the aforementioned new measures. The first set of measures is temporary and is addressed towards low income groups, such as pensioners with monthly income not exceeding £500, public assistance recipients and inhabitants of mountainous areas. The estimated impact on the 2005 budgetary outcome of these measures is approximately 0.13 percent of GDP. The second set includes both temporary and permanent measures of similar magnitude in 2005 and less than 0.1 percent of GDP from 2006 onwards. This latter set of measures is broader in terms of coverage and basically provides a one-off allowance to pensioners with monthly income below £225 and other public assistance recipients, as well as a permanent increase of the monthly allowance granted to National Guard conscripts, and the permanent extension of the eligibility for the motherhood allowance. Additionally, a

⁷ This amount was slightly lower in 2004, at around 1 percent of GDP.

new refund scheme is currently being introduced, due to the amendment of the VAT legislation, which widened the value added tax base through the levying of VAT of 15% on the total market price of new buildings sold. Specifically, the value added tax base was extended to include the value of land used for development along with the real estate developers' profit margins. The new scheme will refund part of the VAT for the construction, or purchase, of the first family residence with an explicit restriction on permitted size. The estimated overall fiscal impact of these measures is anticipated to be neutral.

The budget for 2006 encompasses measures needed to fulfil the obligations undertaken in the 2004 and the current CP, as well as the recent policy initiatives discussed earlier. Fiscal adjustment measures outlined in this Programme—including annual expenditure ceilings on current and capital expenditure—have been maintained, transfers to semi-governmental organisations have been frozen at 2005 levels, while overtime allowances have been reduced by approximately 30%. Indeed, given the lack of one-off measures either on the revenue, or expenditure sides, the adjustment effort in 2006 requires a stricter implementation of the fiscal consolidation programme.

The general government deficit is projected to stay below the relevant Maastricht criterion, attaining the country's minimal benchmark of 1.9% of GDP in 2006 and implying a significant improvement compared to 2005: policy adjustment measures are estimated to contribute 0.6 percent of GDP in nominal terms, or 1.1 percent of GDP in structural terms excluding the effects of one-off measures (Tables VI and VII).

Fiscal Consolidation Programme 2006-2009

The Government is committed to a firm and timely implementation of the fiscal consolidation programme for the period 2006-2009. The objective is to maintain the effort so as to reach a close-to-balance position, consistent with the country-specific medium-term objective of 0.6 % of GDP by 2009, and to steadily improve the primary surplus to around 1.7% of GDP. Achieving these will put the debt-to-GDP ratio on a distinct downward path, leading to a reduction of the general government gross debt to 53.5% of GDP by the end of 2009.

In order to achieve these objectives the Ministry of Finance has prepared a set of measures, which, upon implementation, will improve substantially the structural position of the general government. The timetable of implementation of the proposed fiscal consolidation measures as well as their impact as a percentage to GDP on general government net borrowing are outlined in the table below⁸.

⁸ It should be noted that table IV contains the most important measures planned for the period 2005-2009, at micro level. Their impact has been taken into account and is hence consistent with the fiscal projections at macro level.

Table IV: Fiscal Consolidation Measures

Measures	Progress	Timetable	Envisaged impact on the deficit			
			2005	2006	2007	2008
Expenditure						
Maintaining a restrictive policy on general government sector employment growth, including the semi-governmental organizations. This policy provides that any employment increases covering the needs for the educational and health services and those arising from the implementation of the acquis will be limited.	<p><u>Public Service:</u> This measure is being implemented through the Budget, albeit with some exceptions, as some posts were created to cover the needs of the educational and health service. The impact of these additional posts will be marginal, as it will be largely offset by a corresponding reduction on temporary employment.</p> <p><u>Semi-Governmental Organizations:</u> This measure is being implemented through their budgets.</p>	2005-2009	-	-	-0.1	-0.1
Adoption of a restrictive policy in providing salary increases to civil servants and employees of local authorities and semi-governmental organisations.	The Ministry of Finance proposed a package, which provides for contractual salary increases in the public sector and semi-governmental organisations. These contractual salary increases are 0% for 2004-2005, 2% for 2006 and 1% for 2007. This proposal was made in conjunction with the gradual extension of the retirement age in the public sector from 60 to 63 years of age. The restrictive policy will be maintained over the period 2008-2009.	2008-2009	-	-	-	-
Maintaining a ceiling on the growth rate of <u>current expenditures</u> to 2% Stabilising	This measure has also been incorporated in the compilation of the 2006 Budget with minor exceptions. The introduction of specific	2005-2009	-	-0.8	-0.1	-0.1

Republic of Cyprus: Convergence Programme 2005-2009

Measures	Progress	Timetable	Envisaged impact on the deficit			
			2005	2006	2007	2008
agricultural subsidies and transfers to semi-governmental organizations at the level of 2005 in nominal terms. However depending on the developments of public finances, a small increase of subsidies as well as transfers to semi-governmental organisations dealing with sports and culture may be examined and considered positively.	ceilings on the growth rate of current expenditures is anticipated to be followed during the compilation of the budgets of 2007-2009, according to the economic conditions prevailing at the time and taking into account the obligations derived from the SGP.					
Maintaining a ceiling on the annual rate of increase of <u>capital expenditures</u> up to 6% in 2006	This measure has also been incorporated in the compilation of the 2006 Budgets. The introduction of specific ceilings on the growth rate of capital expenditures is anticipated to be followed during the compilation of the budgets of 2007-2009, depending on the economic conditions prevailing at the time and taking into account the obligations derived from the SGP.	2005-2009	-	-	-	-
Maintaining a ceiling on the rate of growth of current transfers (pensions, monetary allowances etc.) in accordance to the rate of inflation with a minimum annual rate of increase of 2%.	This measure has been incorporated in the compilation of the 2006 Budget. Ceilings on the growth rates of current transfers are anticipated to be introduced also during the compilation of the budgets of 2007-2009, depending on the economic conditions prevailing at the time, taking into account the obligations derived from	2005-2006	-	-0.1	-0.1	-0.1

Republic of Cyprus: Convergence Programme 2005-2009

Measures	Progress	Timetable	Envisaged impact on the deficit			
			2005	2006	2007	2008
	the SGP and on the policy of enhancing the social policy exercised by the Government.					
Abolition of the unemployment benefit granted to retired public and private sector employees.	There is no consensus for the implementation of the measure. The government intends to continue the dialogue between the political parties and social partners with the purpose of achieving consensus.	-	-	-	-	-0.1
Increase of the retirement age of public sector employees from 60 to 63 years of age.	The gradual extension of the retirement age to 63 years of age for civil servants with the exception of educational service employees is being implemented. Consultations are underway for extending the application of the measure to the educational service and semi-governmental organisations. Currently, an additional extension of the retirement age to 65 years of age is not viewed as realistic.	2005-2008	-0.1	-0.2	+0.2	-0.1
Intensification of the dialogue with respect to the proposal for removing the right of retirement at the age of 63 years and specifying the pensionable age limit for the Social Insurance Fund to 65 years of age	A study was undertaken by the ILO's actuarial experts recommending parametric reforms essential for making the Fund viable. Consultations are underway between the stakeholders for the implementation of the measure. Concurrently, various alternative measures are considered such as the increase of the contribution rates of employees and self-employed persons in order to improve the financial viability of the scheme.	This measure requires consensus to be implemented. The aim is to implement the measure as soon as possible.	-	-	-	-
Adjustment of the contribution levels to the Social Security Funds of specific	A bill to this effect has been prepared and submitted to the Attorney's General Office for legal vetting.	2006	-	-0.1	-	-

Republic of Cyprus: Convergence Programme 2005-2009

Measures	Progress	Timetable	Envisaged impact on the deficit			
			2005	2006	2007	2008
occupations (self employed) and aligning them to their real levels of income.						
Increase of the public sector employees' contribution rates to the level of private sector employees (from 3,2% to 6,4% of gross earnings and a corresponding decrease from 9,4% to 6,3% of the government's contribution on gross earnings) without introducing any changes to the retirement benefits of public sector employees.	This measure when introduced will apply to civil servants appointed after the date of introduction of the said measure.	Consensus for the implementation of this measure appears to be difficult to attain.	-	-	-	-
Reduction of compensation for overtime work in the public sector.	This measure has been implemented with the compilation of the 2006 Budget, whereby overtime allowances were cut back by 30% compared to the level of 2005.	2006 This policy will be sustained during the compilation of the budgets for 2007-2009.	-	<-0.1	-	-
Reduction of net interest payments brought by the reduction of stock of debt due to the running down of sinking fund deposits.	The measure is being implemented through the approval of a corresponding bill that is allowing the gradual running down of sinking fund deposits.	2005-2008	-	-0.1	-	-0.3
Introduction of specific income criteria, establishing eligibility for certain social benefit schemes such as child allowances and educational grants,	A proposal has been prepared by the Ministry of Finance to this effect, which will be discussed by the relevant parties in the first half of 2006.	November 2006	-	-	-0.2	-

Republic of Cyprus: Convergence Programme 2005-2009

Measures	Progress	Timetable	Envisaged impact on the deficit			
			2005	2006	2007	2008
simultaneously with the introduction of measures combating tax evasion so that the beneficiaries of the means tested schemes will be those that are really in need.						
One-off social measures introduced		2005	0.3	-0.3		
Impact of Expenditure Measures			0.2	-1,7	-0.3	-0.8

Republic of Cyprus: Convergence Programme 2005-2009

Measures	Progress	Timetable	Envisaged impact on the deficit			
			2005	2006	2007	2008
Revenues						
Introduction of a betterment charge on land appreciation due to zoning changes	A study to this effect is being undertaken in cooperation between the Ministry of Finance and Interior. Delays were witnessed due to technical difficulties in the application of the measure.	-	-	-	-	-
Increase of land and survey fees for issuing title deeds, mortgaging, acquiring and inspecting immovable property.	A Bill has been prepared by the Ministry of Interior and was submitted to the House of Representatives but it was then withdrawn in order to avoid the proposed amendments by the House that would have had a negative impact on public finances. Consequently, the issue was raised again to the political parties and agreement was reached in resubmitting the bill.	This measure is expected to be implemented during the first quarter of 2006.	-	0.2	-	-
Taxation on non-developed land inside Town Planning areas	A study to this effect is being undertaken in cooperation between the Ministry of Finance and Interior. Delays were witnessed due to technical difficulties in the application of the measure.	-	-	-	-	-
Introduction of a mobile telecommunication tax	This measure will be replaced by a measure of an equivalent fiscal impact.	-	-	-	-	-
Improving the tax efficiency of the Revenue Collecting Departments	A law to this effect was enacted by the House of Representatives last July providing for increased penalties in cases of non-compliance and also empowering the Director of the Inland Revenue to obtain banking information on request for tax purposes.	The Law on the disclosure of banking information (bank secrecy) to the tax authorities came into force as from January 1 st , 2005.	-	0.2	0.1	0.1

Republic of Cyprus: Convergence Programme 2005-2009

Measures	Progress	Timetable	Envisaged impact on the deficit			
			2005	2006	2007	2008
	An additional legislation has been enacted in November 2005 requiring self employed persons to compile audited accounts, introducing self assessment and the compulsory issue of receipts and invoices.	2006				
Legislation governing the settling of taxes arising from past years' undisclosed income (tax amnesty).	The legislation governing the process of disclosing income of previous years that was not disclosed (tax amnesty) was enacted by the House of Representatives in July 2004. The measure has been implemented.	2004-2005	0.9	-0.9	-	-
Amendment of the legislation concerning the issuance of title deeds for buildings erected with minor irregularities	Legislations were enacted in July 2004 and March 2005 by the House of Representatives covering the buildings erected prior to and post 1990 respectively. The measure is being implemented.	2006	-	0.3	-	-
Regularisation of dividend income policy for semi-governmental organizations	In 2004 an ad-hoc transfer was made from the profitable semi-governmental organisations to the central government representing the dividend income for that year. Currently, a bill is being legally vetted by the Attorney General's Office providing for the regularisation of dividend income policy of these organisations.	1 st quarter of 2006. The measure will be implemented throughout the programming period.	0.4	0.3	-	-
Revaluation of individual property at current market prices in contrast	A study is being undertaken by the Ministry of Interior with the aim of revaluating gradually individual	January 2008	-	-	-	-

Republic of Cyprus: Convergence Programme 2005-2009

Measures	Progress	Timetable	Envisaged impact on the deficit			
			2005	2006	2007	2008
to the estimated values calculated at 1980 prices currently applied for the purpose of estimating property taxes.	property owned at current market prices with priority given to urban areas. This measure is introduced in order to replace the above three measures that are being abandoned. The fiscal impact of this measure will counterbalance the fiscal impact of the measures being abandoned.					
Improved utilization of government property	A study is underway establishing the changes that need to be introduced, thus enabling the appropriate utilization of government property.	2007	-	-	-	-
Adjustment of contributions to the Social Security Funds of specific occupational groups in order to align them to their level of income	A bill has been prepared to that effect and has been submitted to the Attorney's General Office for legal vetting.	2006	-	-	-	-
Other revenue enhancing measures e.g. widening of the vat tax base			0.4	-	0.4	-
Proceeds for the sale of mobile telecommunication licences		2004	-0.3	-	-	-
Compensating expenditure transfers from the EU Budget		2004-2006	0,2	-	-0,5	-0,1
Impact of Revenue Measures			1.6	0.1	0.0	0.0
Total Adjustment from Revenue and Expenditure Measures			1.4	1.8	0.3	0.8

As can be seen from the table above, which depicts the impact of the most important measures on the revenue and the expenditure side as a percent to GDP, the bulk of the adjustment emanates from the containment of expenditures below the growth of nominal GDP. On the revenue side, the projections are somewhat conservative, as extraordinary increases in tax revenues witnessed in 2005 in certain categories of both direct and indirect taxation are not taken into account. Two key measures account for the bulk of the adjustment on the revenue side both of which are planned for 2006: (i) the regularisation of the dividend income policy for semi-governmental organisations estimated at 0.7 percent of GDP in 2006, and corresponding amounts thereafter, and (ii) the one-off issuance of title deeds for buildings erected with minor irregularities estimated to provide an additional 0.3 percent of GDP annually for a period of three years. Also, improved tax compliance, resulting from the enactment of amending legislation concerning self-employed individuals and on account of the recent tax amnesty, is estimated to yield additionally 0.3 percent of GDP by 2007. With the exception of revenues accruing from the issuance of title deeds, the remaining measures will raise revenues on a permanent basis. In view of the aforementioned measures amounting to 1 percent of GDP, the target for a general government deficit of 1.9% of GDP in 2006 appears attainable.

Although the medium-term fiscal plan envisages a cumulative adjustment of some 1.9 percent of GDP over 2006-09, a better outcome may be achieved if all measures and policies illustrated in Table IV above are implemented in the specified time framework. Hence, this Programme takes a conservative approach in the design of the medium-term fiscal framework and allows sufficient room for delayed or unsuccessful reforms, without jeopardising the announced fiscal targets.

Table V: General Government Consolidated Accounts

as a percent of GDP	2003	2004	2005 est.	2006 proj.	2007 proj.	2008 proj.	2009 proj.
Current Revenue	39.1	39.5	41.2	40.0	40.0	39.6	39.1
Current Expenditure	41.4	39.5	39.8	37.9	37.8	36.8	35.8
Interest Payments	3.5	3.2	3.2	3.1	3.0	2.6	2.3
Current Balance	-2.3	0.0	1.4	2.1	2.2	2.8	3.3
Capital Expenditure	4.0	4.1	4.0	4.0	4.0	4.0	3.9
General Government Net Borrowing	-6.3	-4.1	-2.5	-1.9	-1.8	-1.2	-0.6
Primary Balance	-2.8	-0.9	0.7	1.2	1.2	1.4	1.7
Government Gross Debt	69.4	71.3	70.5	67.0	64.0	56.9	53.5

Table VI: Cyclical Developments

as a percent of GDP	2004	2005 est.	2006 proj.	2007 proj.	2008 proj.	2009 proj.
GDP growth at constant prices	3.8	4.1	4.2	4.2	4.2	4.3
Net Borrowing of General Government	-4.1	-2.5	-1.9	-1.8	-1.2	-0.6
Net Interest payments	3.2	3.2	3.1	3.0	2.6	2.3
Potential GDP growth, % change	4.0	4.0	4.0	4.0	4.0	4.0
GDP output gap ⁹	-2.0 ¹⁰	-2.0	-1.9	-1.7	-1.5	-1.1
Cyclical budgetary component	-0.8	-0.8	-0.7	-0.7	-0.6	-0.4
Cyclically-adjusted balance	-3.3	-1.7	-1.2	-1.1	-0.6	-0.2
Cyclically-adjusted primary balance	-0.1	1.5	1.9	1.9	2.0	2.1

Table VII: Cyclical Developments and one-off measures

as a percent of GDP	2003	2004	2005 est.	2006 proj.	2007 proj.	2008 proj.	2009 proj.
Cyclically-adjusted balance	-5.7	-3.3	-1.7	-1.2	-1.1	-0.6	-0.2
Cyclically-adjusted primary balance	-2.2	-0.1	1.5	1.9	1.9	2.0	2.1
One-off revenue measures	1.8	1.0	0.9	0.3	0.3	0.3	-
Cyclically-adjusted balance net of one-off and other temporary measures	-7.5	-4.3	-2.6	-1.5	-1.4	-0.9	-0.2
Structural Improvement		3.2	1.7	1.1	0.1	0.5	0.7
Cyclically-adjusted primary balance net of one-off and other temporary measures	-4.0	-1.1	0.6	1.6	1.6	1.7	2.1

⁹ As a percent of potential GDP.

¹⁰ The output gap in 2004 of a magnitude of 2% emanates from the below potential growth in previous years and in particular in 2002-2003.

Structural Balance and Fiscal Stance

During the economic slowdown in 2002-03 output growth slumped and production fell significantly below full capacity. While the economy recovered subsequently, it continues to operate below capacity, especially in the manufacturing and service sectors. The fiscal position, which had been relatively weak during those years, worsened markedly and the fiscal deficit surged to 6.3% of GDP in 2003. To provide a clearer picture of the underlying fiscal position since then, the analysis must take into account the cyclical position of the economy relative to its full capacity, or potential level, and to distinguish between permanent and one-off measures which have been introduced, or are planned.

One-off measures

To address the weak underlying fiscal position, the Government took action to bring the deficit below 3 percent of GDP, including with a series of one-off measures. In 2003-05 the one-off revenue measures amounted to 3.7 percent of GDP and included, the dividend income resulting from the accumulation of profits for a period of years by the semi-governmental organizations (1.8 percent of GDP in 2003), revenues accruing from sale of UMTS licences (0.3 percent of GDP in 2004), a penalty imposed by the Competition Protection Commission (0.1 percent of GDP in 2004) and the implementation of the abovementioned tax amnesty (1.5 percent of GDP in 2004-05) (Table VII). Over the remainder of the programming period, the one-off measures which are anticipated to materialise include the issuance of title deeds for buildings erected with minor irregularities, which will have an impact of 0.3 percent of GDP per annum over the period 2006-2008.

The cyclically-adjusted balance

As a result of one-off and permanent measures the fiscal stance turned restrictive and the cyclically-adjusted balance displayed a substantial improvement in 2004. The structural deficit fell from 5.7% of GDP in 2003 to 3.3% the year after, and is expected to decline further to 1.7% of GDP in 2005 and to 1.2% of GDP in 2006 (Table VII). This improvement continues throughout the remaining years, and as a result the structural deficit is forecast to decline to 0.2% of GDP by 2009. This analysis, which assumes that the potential GDP growth of Cyprus is currently around 4%, factors out the business cycle effects on revenues and expenditures by means of the deviation from the calculated potential output.¹¹

A similar path is also anticipated for the cyclically-adjusted balance net of one-off measures (Table VII). The cyclically-adjusted balance net of one-off measures was slashed by 3.2 percent of GDP in 2004 compared to the previous year and by 1.7 percent of GDP in 2005 resulting in an estimated structural deficit, net of one-off measures,

¹¹ Efforts have been made to estimate the cyclically-adjusted balance of the general government fiscal stance, based on projections of potential output derived from a study carried out by the University of Cyprus.

around 2.6% of GDP in 2005. The adjustment effort continues throughout the period 2006-2009 and the cyclically adjusted balance, net of one-off measures, is forecast to decline from a deficit of 1.5% of GDP in 2006 to 0.2% by 2009. Overall, the cyclically-adjusted balance net of one-off measures is forecast to improve on average by a little more than 0.5 percent of GDP annually over the period 2006-09.

Debt Levels and Developments

Stock - Flow Adjustment

Presentation of the stock-flow adjustment has become an integral part of fiscal surveillance and the preparation of convergence programmes in the EU. This exercise allows reconciliation of debt and deficit figures and provides insights into practices followed during the compilation of public finances, which reflect important institutional characteristics of fiscal management.

Table VIII presents the key elements of the stock-flow adjustment for the period of 2004-2005 and projections covering 2006-2009. The figures presented in this Table enable us to reconcile the debt and deficit developments presented in this convergence programme. The main operations refer to the accumulation of financial assets, which cover two types of operations and are key in understanding debt dynamics in Cyprus. Firstly, the accumulation of Government deposits, equivalent to 1.8 and 1.3 percent of GDP in 2004 and 2005 respectively, reflects a past tendency to over-finance the government borrowing requirements as well as operations related to the sinking fund account, but is also due to better-than expected fiscal outcomes for these years. Secondly, over the period of 2006-09 debt-reducing transactions reflect the running down of accumulated sinking fund deposits held at the Central Bank. As debt matures in 2006-2009 the Government will use these deposits to redeem debt obligations totalling 6.3 % of GDP.

Table VIII: Sources of Stock-Flow Adjustment

	2004	2005	2006	2007	2008	2009
Difference due to time of recording:cash and accruals						
1. Differences in the recording of revenue and primary expenditure (accounts receivable and payable) and statistical discrepancies	0,3	0,0	0,0	0,0	0,0	0,0
2. Difference between cash and accruals interest expenditure	0,0	0,0	0,0	0,0	0,0	0,0
3. Total (1+2)	0,3	0,0	0,0	0,0	0,0	0,0
Accumulation of financial assets						
4. Liquidities	1,8	1,3	-0,8	-0,6	-4,3	-0,3
5. Securities other than shares	0,0	0,0	0,0	0,0	0,0	0,0
6. Loans	0,2	0,0	0,0	0,0	0,0	0,0
7. Shares and other equity	0,0	0,0	0,0	0,0	0,0	0,0
8. Of which: privatization proceeds	0,0	0,0	0,0	0,0	0,0	0,0
9. Total (4+5+6+7)	2,0	1,3	-0,8	-0,6	-4,3	-0,3
10. Pm. Total excluding privatization proceeds and liquidities (9-8-4)	0,0	0,0	0,0	0,0	0,0	0,0
Valuation effects and residual adjustments						
11. Redemption effects	0,0	0,0	0,0	0,0	0,0	0,0
12. Exchange rate adjustment	0,1	0,0	0,0	0,0	0,0	0,0
13. Other	0,0	0,0	0,0	0,0	0,0	0,0
14. Total (11+12+13)	0,1	0,0	0,0	0,0	0,0	0,0
15. STOCK-FLOW adjustment (3+9+14)	2,4	1,3	-0,8	-0,6	-4,3	-0,3

Debt Levels and Developments

With the recent revision of the Stability and Growth Pact, the evolution of public debt has been brought to the forefront of fiscal surveillance and policy coordination. Countries with higher-than-average debt levels will be subject to more strict procedures, while other countries will be in a position to sustain small scaled fiscal deficits, if these are deemed to be temporary in nature. Additionally, as was discussed in the previous section, this increased emphasis on debt requires a careful and transparent presentation of the evolution and relationship between, debt and deficits over time.

The level of government debt, excluding intra-governmental debt, rose to 71.3% of GDP in 2004. Implementation of the aforementioned fiscal consolidation measures will lead to a gradual reduction of public debt to 53.5% of GDP by 2009. A large share of this, equivalent to some 7% of GDP, corresponds to debt issued for the accumulation of assets of the sinking fund which, as has already been mentioned, is steadily being run-down and anticipated to be eliminated by 2009.

The anticipated ebbing of the debt-to-GDP ratio is mainly attributed to a significant improvement of the primary balance and to the aforementioned decumulation of sinking fund deposits. The primary balance is estimated to turn into surplus of some 0.7% of

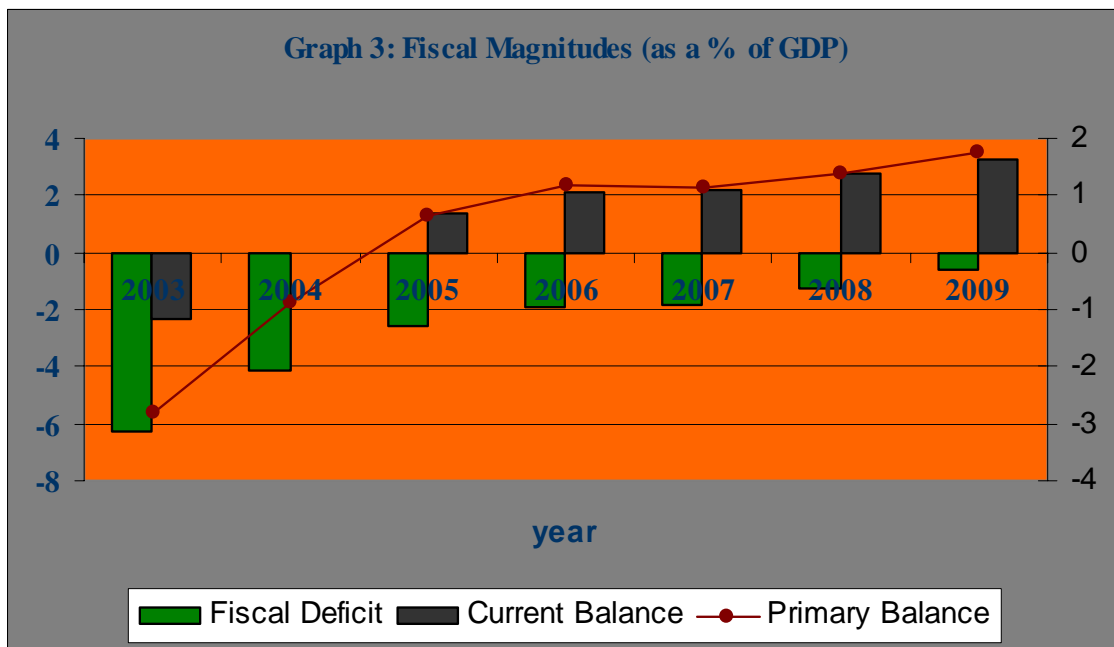
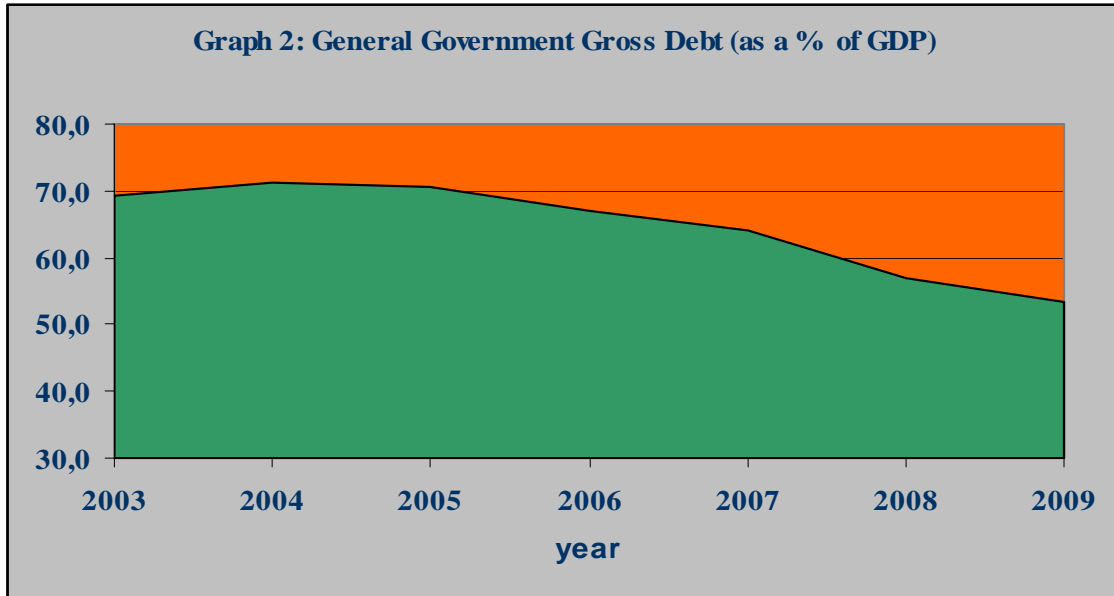
GDP in 2005 and to improve further over the programming period to around 1.7% of GDP by 2009.

Domestic financing conditions worsened in 2004, due to the political uncertainty related to the referendum in April 2004 on the Annan Plan for a political settlement of the Cyprus problem, and exacerbated by the absence of an active secondary market for government paper. With higher interest rates domestically, financing of the general government deficit was achieved mainly through a 10-year Eurobond issue of €500 million (EMTN). With fiscal consolidation on track, and owing to the entry of the Cyprus Pound into ERM II and an improvement in the market sentiment both domestically and among foreign investors, demand for government paper picked up and interest rates declined significantly.

In 2005 expectations for lower interest rates, fueled in part by the widely anticipated ERM II entry, led investors to shift from short- to long-term bonds and interest rates on 10-year paper fell by some 200 basis points. Interest rates were eventually lowered in the first half of 2005 by a cumulative 125 basis points (25 basis points on February 25, 50 basis points on May 20 and 50 basis points on June 9) and are expected to continue along this declining trend throughout the programming period until convergence is achieved with European rates. Owing to the improved conditions domestically, the government is expected to cover its borrowing requirement through domestic borrowing in 2005 and additionally repay part of its foreign debt obligations; in 2005 foreign debt amounted to 24,6% of total.

During the programming period, the Government intends to undertake additional borrowing in the Eurobond market to cover, mainly, refinancing requirements. During the programming period two EMTN bonds outstanding will expire (June 2006 and July 2008, €280 million and €350 million euros respectively). The Government aspires to limit foreign currency exposure to a ceiling of 30% of net total public debt until the formal circulation of euro notes and coins.

The share of short-term debt will be maintained at a level around 10% of total net public debt.



In 2005, as part of the effort to abide to the Stability and Growth Pact, the Government has renewed its efforts to improve public debt management so as to achieve better financing terms and hence achieve faster consolidation of public debt. As part of this effort, the Government will formulate a medium- and long-term strategy. By the end of 2005 it is expected that an ad hoc technical committee will submit its final report to the Minister of Finance providing proposals for institutional changes. The Government will consider these proposals and will adopt measures to ensure that, before the introduction of the euro, the current institutional and legal framework of the government securities market is reformed and becomes more flexible and streamlined and allows the market to

function efficiently and provide a better environment for both the government and investors.

Although, the Central Bank is responsible for debt management, in practice policies are formulated and implemented in collaboration with the Ministry of Finance, which is the issuer of debt and as such, it reserves the right to decide the timing and amounts and terms of debt issuance. The short-term objectives of the current debt management strategy are the following:

- Achieve a timely flow of information between the responsible government departments and the Central Bank in order to achieve the smooth financing of the Governments' financial obligations. Information sharing has been improved, following the introduction of a computerised system providing on line information on the transactions of central government and social security funds.
- Put in place procedures and tools that will help in tackling unforeseen contingencies. The options available to the government are now being studied.
- Lengthen the maturity of government debt so as to improve the terms of borrowing.¹²

The medium, to long-term, objective is reform the present debt management system so as to be able to adapt to changing market conditions, including the introduction of the euro. To proceed with these reforms a number of priorities have been identified, and include:

- Creating a new institutional and legal framework for the primary and secondary market for government debt and introducing a primary dealership system.
- Creating and maintaining channels of communication with other market participants and interested parties, especially foreign investors and institutions.
- Increasing the technical competence of the staff regarding debt management.
- Improving decision-making mechanisms, in order to better respond to the changing market conditions.

¹² There has been a significant improvement this year, as investor interest for 10 and 15 year bonds has increased considerably and allowed the government to increase the issues of these bonds. In 2004, 10 and 15 year bonds accounted for 13% of domestic bonds outstanding, in 2005 they accounted for 21%.

Table IX: General Government – Debt Developments

as a % of GDP	ESA code	2004	2005	2006	2007	2008	2009
Gross Debt Level		71.3	70.5	67.0	64.0	56.9	53.5
Change in Gross Debt		1.9	-0.8	-3.5	-3.0	-7.1	-3.4
<i>Contributions to Change in Gross Debt</i>							
Primary Balance		-0.9	0.7	1.2	1.2	1.4	1.7
Interest Payments	D41	3.2	3.2	3.1	3.0	2.6	2.3
Nominal GDP Growth	B1g	6.7	6.9	7.1	6.6	6.7	6.8
Stock-flow adjustment		2.4	1.3	-0.8	-0.6	-4.3	-0.3
Of which:							
Privatization receipts		-	-	-	-	-	-
Liquid financial assets		7.7	7.0	6.5	5.4	0.7	0.2
Net financial debt		63.6	63.5	60.5	58.6	56.2	53.3
p.m. implicit interest rate on debt		4.62	4.50	4.39	4.44	4.10	4.11

Balance by Sub-Sectors of General Government

The General Government sector in Cyprus comprises of the central government, the local authorities and the social security funds. The central government accounts for the bulk of the general government deficit, with the local authorities responsible for a marginal deficit of 0.1% of GDP as most of their operations and investment programmes are financed by transfers from the central government (Table X).

The social security system, which is based on a pay-as-you-go principal, has recorded surpluses¹³ reaching 3 percent of GDP in 2004, thus reducing the overall general government deficit.¹⁴ The sizeable surplus of the social security fund is attributed to the fact that, presently, contributions outpace expenditure on pensions. This is expected to reverse in the long term, as discussed in Chapter 6, unless parametric changes are introduced over the next few years.

Table X: General Government Budgetary Developments by Sub-Sector

in percent of GDP	ESA code	2004	2005	2006	2007	2008	2009
<i>Net lending (B9) by sub-sectors</i>							
1. General Government	S13	-4.1	-2.5	-1.9	-1.8	-1.2	-0.6
2. Central Government	S1311	-7.1	-5.6	-5.0	-4.7	-4.1	-3.3
3. State Government	S1312	-	-	-	-	-	-
4. Local Government	S1313	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1
5. Social Security Funds	S1314	3.2	3.2	3.1	3.0	2.9	2.8

¹³ The government as an employer and as a contributory party to the whole scheme contributes annually approximately 2.8 percent of GDP.

¹⁴ Interest earned by the Social Security Funds on debt issued by the Central Government is consolidated.

Budgetary implications of “major structural reforms”

The initiatives to be promoted within the framework of the implementation of the Lisbon Programme are financed through:

- National resources;
- Public Private Partnerships; and
- EU funds.

More specifically, the proposed policies require national funds amounting to 1.6% and 1.9% of GDP in 2005 and 2006, respectively, and similar amounts thereafter. It is noted in this respect, that for the overwhelming majority of the measures and actions planned for 2005 and 2006, and included in the Lisbon Programme, the relevant budgetary provisions have been included in the Budget Law for 2005 and the Budget Bill for 2006.

Moreover, it is noted that important infrastructural projects, such as airports, marinas, storage depots for petroleum products and a receiving-regasification terminal for liquefied natural gas will be undertaken through public private partnerships. Furthermore, a number of infrastructural projects in the area of transport will be co-financed from the Cohesion Fund, whereas a number of measures and actions aiming at enhancing the production base of disadvantaged areas and increasing the employability possibilities of long-term unemployed will be co-financed from the EU Structural Funds, under the current EU programming period. In the next programming period of the EU (2007-2013), it will be the objective to co-finance a number of infrastructural projects in the areas of transport and the environment as well as measures and actions in other areas via the various instruments of the EU Cohesion Policy.

4. SENSITIVITY ANALYSIS OF THE GENERAL GOVERNMENT BALANCE AND DEBT

Alternative Scenarios and Risks

The baseline, medium-term, projections presented in this Programme are based on a balanced-risk assessment, as discussed earlier. It is assumed that, while there are both upside and downside risks to the central projection, global growth—driven by robust performances of China and the US and a gradual steady recovery in Japan—will remain strong, world trade will continue to expand and growth in the euro area and the EU will pick up owing to a strengthening of domestic demand.

A number of potentially factors should be taken into account when assessing the risks to the baseline scenario:

- The possibility of higher oil prices in 2006 could hold back the recovery in the EU and Japan, and slowdown growth in the US and could significantly dent domestic confidence and private consumption growth.
- An unwinding of external imbalances, combined with a sharp depreciation of the US dollar, could trigger a world-wide slowdown of economic growth. Such an adjustment could be significant if it further affects on the housing markets in the US and the UK.
- Geopolitical tensions in the Middle East, or elsewhere, could hold back the ongoing recovery and have an impact on growth.
- Finally, estimation of potential GDP is affected by uncertainty regarding contributions from total factor productivity, as well as labour and capital, and the utilisation levels for factors of production. The baseline scenario assumes a 4 percent potential GDP growth over the medium term. A lower rate would result in lower growth rates, with important implications regarding fiscal policy.

Sensitivity of Budgetary Projections to Different Scenarios and Assumptions

To assess the sensitivity of the projected general government deficit and debt figures, alternative assumptions for real GDP growth rates and interest rates have been incorporated in three distinct scenarios. All simulations assume that, while automatic stabilisers would be allowed to operate fully, expenditure targets would not be altered.

Assumption 1: Real GDP growth is half a percentage point higher annually compared with the baseline scenario. Other things being equal, the government deficit would be some 0.2 percent of GDP lower at the beginning of the programming period reaching 0.8 percent of GDP by the end of the programming period, thus resulting to a surplus of 0.2% of GDP by 2009. The public debt to GDP ratio would decline by an additional 2.7 percent of GDP compared with the baseline scenario.

Assumption 2: Real GDP growth is half a percentage point lower annually compared with the baseline scenario. Other things being equal, the government deficit would be some 0.2 percent of GDP higher at the beginning of the programming period reaching 0.9 percent of GDP by the end of the programming period, thus resulting to a deficit of 1.5% of GDP by 2009. The public to GDP debt ratio would higher by an additional 2.8 percent of GDP higher compared with the baseline scenario.

Table XI: Three Scenarios for Public Finances

<i>in percent of GDP</i>	2005	2006	2007	2008	2009	2005-2009 5- year average
<u>Central Scenario</u>						
GDP	4.1	4.2	4.2	4.2	4.3	4.2
General Government Balance	-2.5	-1.9	-1.8	-1.2	-0.6	
General Government Debt	70.5	67.0	64.0	56.9	53.5	
<u>Upper Scenario (GDP growth 0.5 of a percentage point higher)</u>						
GDP	4.6	4.7	4.7	4.7	4.8	4.7
General Government Balance	-2.3	-1.5	-1.2	-0.5	0.2	
General Government Debt	70.2	66.4	62.8	55.0	50.8	
<u>Lower Scenario (GDP growth 0.5 of a percentage point lower)</u>						
GDP	3.6	3.7	3.7	3.7	3.8	3.7
General Government Balance	-2.7	-2.3	-2.4	-1.9	-1.5	
General Government Debt	70.8	67.6	65.2	58.8	56.3	

Assumption 3: Interest rates remain some 50 basis points above baseline each year during 2005-2009. In this case, the government deficit would be some 0.4 percent of GDP higher in 2009, and the government debt to GDP ratio would be larger by 1.0 percent of GDP by the end of the programming period.¹⁵ The impact of a rise in interest rates on government debt is moderated by the fact that a considerable share of debt is based on fixed interest rate contracts.

Table XII: Scenario with Higher Interest Rates Cumulative Differential

in percentage points of GDP with respect to the reference scenario	2005	2006	2007	2008	2009
General Government Net Borrowing	0.0	0.1	0.2	0.3	0.4
General Government Gross Debt	-	0.1	0.3	0.6	1.0

¹⁵ In this scenario real GDP growth is assumed to remain unchanged even though higher interest rates could be expected to have a moderating effect on real economic growth.

The sensitivity analysis presented here confirms the importance of growth assumptions on the outcome of the general government deficit and debt figures. Accordingly, the envisaged consolidation path is highly dependent on the realisation of the projected growth rates.

Comparison with Previous Update

Compared with the forecasts presented in the previous Convergence Programme, and as a consequence of persistently higher oil prices, GDP growth has been revised downwards to 4.0–4.2% over the medium term. In 2005, the negative impact of higher oil prices on economic activity will be offset by better-than-expected tourist arrivals and income from other services; based on data from two quarters for this year, GDP will expand by 4.1%, in line with previous estimates. Inflation will be somewhat higher, than had been anticipated, while developments in the labour market seem to be close to predictions.

The fiscal position is likely to be considerably better compared to forecasts presented in the previous CP and the budget, with the general government deficit estimated some 0.4 percent of GDP lower, or at 2.5% of GDP, in 2005. As a result of the ongoing economic recovery, and with a firm implementation of the fiscal consolidation measures described above, the general government net borrowing is projected to fall to around 1.9% of GDP in 2006, some 0.2 percent of GDP higher than had been anticipated, largely as a result of the negative impact of higher oil prices. The general government debt-to-GDP ratio is predicted to fall in 2006 to around 67.0% of GDP as a result of the emergence of a primary surplus, and the running down of sinking fund deposits. This forecast compares favourably to the prediction of 69.2%, which was reported in the last updated Convergence Programme of 2004-2008. Starting from a lower base, public debt is projected to decline to a lower level by 2009.

Table XIII: Divergence from Previous Update

as a percentage of GDP	ESA code	2004	2005	2006	2007	2008	2009
<i>GDP Growth</i>							
Previous Update	B1g	3.6	4.0	4.4	4.5	4.5	n.a.
Latest Update	B1g	3.8	4.1	4.2	4.2	4.2	4.3
Difference		0.2	0.1	-0.2	-0.3	-0.3	
<i>Actual Budget Balance</i>							
Previous Update	B9	-4.8	-2.9	-1.7	-1.5	-0.9	n.a.
Latest Update	B9	-4.1	-2.5	-1.9	-1.8	-1.2	-0.6
Difference		0.7	0.4	-0.2	-0.3	-0.3	
<i>Gross Debt Levels</i>							
Previous Update		74.9	71.9	69.2	65.7	58.1	n.a.
Latest Update		71.3	70.5	67.0	64.0	56.9	53.5
Difference		-3.6	-1.4	-2.2	-1.7	-1.2	

5. QUALITY OF PUBLIC FINANCES

Policy Strategy

Within the framework of the National Lisbon Strategy of Cyprus, the Authorities have devoted considerable attention to improve the quality of public finances. Achievement of the long-term goals set out in the Lisbon Agenda requires an improvement in the quality of the public finances and public expenditure management systems, but also a tax system, which is supportive of the supply side of the economy. The promotion of a growth- and employment-oriented and efficient allocation of resources is key in this respect; hence, policies will aim at increasing the share of government expenditure in growth-enhancing categories, such as education, research and development, physical infrastructure as well as to other policy priorities pursued within the framework of the National Lisbon Programme. The formulation and implementation of budgetary policies in a medium-term framework would allow better implementation of policies, incorporated in the Convergence and National Lisbon Programmes of Cyprus.

Developments on the Expenditure Side

To achieve the targets of the Lisbon strategy and keep the fiscal consolidation programme on track the Government will:

- Maintain the already high share of capital expenditure to GDP;
- Control current expenditure in nominal terms;
- Limit significantly subsidies.

Considerable progress has been achieved at improving the quality of government expenditure. Sizable cuts in defence spending, agricultural subsidies and grants to semi-governmental organizations have been accomplished. Stricter controls on current expenditures have freed resources for spending on education and investment. Towards this end, development outlays and spending on education have increased by some 1-1¼% of GDP since 2002, while R&D spending also increased significantly. Government expenditure on information technology also increased significantly to some 0.3% of GDP in 2004.

Developments in the composition of government expenditure shown in Table 2 reveal that general government expenditures in the categories of collective consumption, subsidies and social transfers have declined as proportions of GDP since 2003. Furthermore, the government budget for 2006 shows continued relative declines in these current expenditure components; indeed, government policy requires that the growth of certain key current expenditure components be limited to 2% in 2006.

In contrast, government outlays on capital expenditures have been rising in recent years, increasing from 3.9% of GDP in 2002 to 4.9% of GDP in 2004, and are estimated to increase to 5.2% in 2005. Development expenditures comprise mainly outlays on the upgrading and construction of physical infrastructure including roads, water utilities and

rural facilities as well as purchases of capital equipment and ancillaries by the education and health sectors.

In addition, total expenditure on education increased from 4.2% of GDP in 2000 to 5.2% in 2004 and is set to increase further to 5.5% of GDP in 2005. Although, Research and Development (R&D) expenditure recorded a similar trend, rising from 0.26% of GDP in 2000 to 0.4% of GDP in 2004, its level is still relatively low.

In view of the considerable importance the Government attaches to raising the level of resources channelled to growth-enhancing expenditure categories such as infrastructure, R&D, computerization, e-government, education and health, it is planned that government expenditures on such activities be raised by some of 6% per annum over the medium-term.¹⁶ A further increase in expenditure in these categories will be financed by public and EU resources, as well as through public-private partnerships.

A more detailed presentation of plans in these areas, including the budgetary implications, is included in the National Lisbon Programme of Cyprus.¹⁷

Developments on the Revenue Side

(a) Taxation system

Efforts have been made also to design the tax and benefits systems, which promote higher growth potential through more investment and employment. As a result of a broad tax reform implemented from 2002 to 2004, a more growth-oriented and efficient tax system was introduced. Marginal income tax rates were reduced substantially, while compliance with the EU Code of Conduct of Business Taxation was accomplished. For indirect taxation there was a harmonization of the tax base and the adoption of the minimum levels of excise and VAT rates prescribed by the *acquis*. The tax reform, while shifting the tax burden from direct to indirect taxation, reduced the tax burden on capital and labour, contributing positively towards the creation of a more favourable business environment and of incentives to work.

The present system and structure of taxation rates is considered as being appropriate to encouraging the efficient allocation of resources and enhancing the growth of output and employment. The taxation of labour income is low so as to promote labour demand, while the level of unemployment benefits is sufficient to provide adequate economic support. However, with the limited duration of unemployment benefits being confined to 156 working days there is an incentive for those unemployed to seek work.

¹⁶ Several initiatives have been launched, which aim at promoting e-Government and the provision of on-line services to the public in line with the EU strategic framework on the "European Information Society 2010". Other initiatives include the promotion of the creation of a technology park, the establishment of a research and training centre in co-operation with Harvard University and the setting up of the Cyprus Research and Educational Foundation.

¹⁷ [http://www.mof.gov.cy/mof/mof.nsf/8E92793044D511FDC22570B50032B321/\\$FILE/LISBONSTRATEGYTEXTFINAL.doc](http://www.mof.gov.cy/mof/mof.nsf/8E92793044D511FDC22570B50032B321/$FILE/LISBONSTRATEGYTEXTFINAL.doc).

(b) Revenue collection

Despite the fact that the tax system is fairly simple and the tax burden relatively low, tax collection remains a key challenge. Following the tax reform, policies have focused on the need to improve tax collection and encourage tax compliance. A tax amnesty has yielded considerable revenues and is expected to help tax compliance collection in the future.

Tax administration services are being strengthened with a series of measures designed to facilitate the collection of taxes and discourage tax evasion. The following measures have been introduced in two amending legislations approved in January and November, 2005:

- Partial lifting of bank secrecy has commenced and is expected to improve the tax authorities' ability to obtain information on individual cases;
- New law provisions enable the tax authorities to persecute the management of corporations in cases of delays in tax payment;
- Stiffer fines for past-due tax returns and payment of taxes have been introduced;
- Introduction of an on-line tax-submission system (Taxisnet);
- Introduction of a self-assessment system for self-employed individuals. This would require payment of taxes concurrently with the submission of a tax return.
- Compulsory submission of tax returns for all persons earning more than the tax-free threshold;
- Compulsory maintaining of accounting records by companies, and self-employed individuals earning income above a certain threshold;
- A further increase of penalties for late submission of tax returns.

6. SUSTAINABILITY OF PUBLIC FINANCES

The long-term sustainability of the public finances is necessary to provide a solid base to support a continuous and satisfactory growth of the Cyprus economy. Accordingly, an exercise was carried out to assess long-term fiscal sustainability of the public finances. In conducting this exercise particular attention was focused on the projected impact of the ageing population process on the long-term evolution of the government finances.

Demographics

According to the demographic projections prepared by the Cyprus Statistical Service, the population in the Government-controlled area is expected to reach 816,406 by 2050 compared with 705,539 in 2002. The number of those aged 15-64 years amounted to 471,531 in 2002 or 67% of the total population and is projected to rise by 5.7% by 2050 and reach 498,264, equivalent to 61% of the total population in that year. For those aged above 65 years, their number is projected to increase by 179% by 2050, and account for 28% of the total population in 2050 compared with 12% in 2002. These projected demographic changes would result in the old age dependency ratio rising unfavorably from 17% in 2002 to 46% in 2050. In addition, the significant deceleration in the growth of the working age population would adversely affect the growth of the labour supply. This development would only to a limited extent be offset by net inflows of migrants.

Macroeconomic Assumptions

As a basis for the following scenarios it is assumed that the medium-term budgetary objective for the general government deficit will be achieved through the timely implementation of the fiscal consolidation programme outlined above in Chapter 3. That is, the net borrowing of the general government will have been reduced to 0.6% of GDP by 2009. It is assumed that the underlying fiscal position will remain unchanged thereafter.

The macroeconomic assumptions of the Government of Cyprus have been employed for the baseline scenario together with the related demographic projections to prepare the budgetary projections for Cyprus. These macroeconomic assumptions are as follows:

- **Male and female participation rates:** male labour force participation rates are projected to rise gradually from of 81% in 2002 to 84% by 2050. Female participation rates are expected to increase steadily over the long-term rising from 61% in 2002 to 71% in 2050.
- **Employment growth:** based on the demographic projections prepared by the Cyprus Statistical Service covering 2006 to 2050 and assuming a gradual small increase of the employment rate of the female population and of old age persons and a small net migration, it is estimated that the annual employment growth would slow down, from 2.4% in 2000, to about 1.2% by 2005, to 0,8% by 2010, to 0,2% by 2020 and remain constant thereafter;

- **Annual labour productivity:** annual increases are projected to accelerate from 2.6% in 2000, and 2.1% in 2005, to 3.0% by 2010 owing to the positive effects of envisaged structural reforms and greater utilization of advanced technologies. Thereafter, it is assumed that productivity gains would be maintained at an average of around 3% per annum;
- **Real wage and salary incomes:** these are projected to grow approximately in line with real GDP.
- **Real GDP growth:** reflecting both the projected growth rates of labour productivity and employment, GDP is projected to grow at an annual rate of 4% from 2005 to 2009, then decelerate to 3,2% by 2020, and thereafter be maintained at 3%.
- **Inflation:** the annual rate of inflation is projected to average 2,5% in 2005 and 2006 and to decline to 2% per annum in the following years.
- **Interest rates:** A nominal rate of interest of 5% is assumed on government borrowing, increasing to 6% if the government debt to GDP ratio exceeds 100%, and to 7% if it exceeds 200%.
- **Other government expenditure and revenues:** initially, it is assumed that government expenditure and revenues as a ratio to GDP, excluding expenditures for old age pensions, health care and interest payments and pension revenues, would remain constant after 2009.

For reasons outlined later these assumptions differ from the commonly agreed assumptions prepared by the Commission for the AWG of the Economic Policy Committee.

Social security and non-reform scenarios

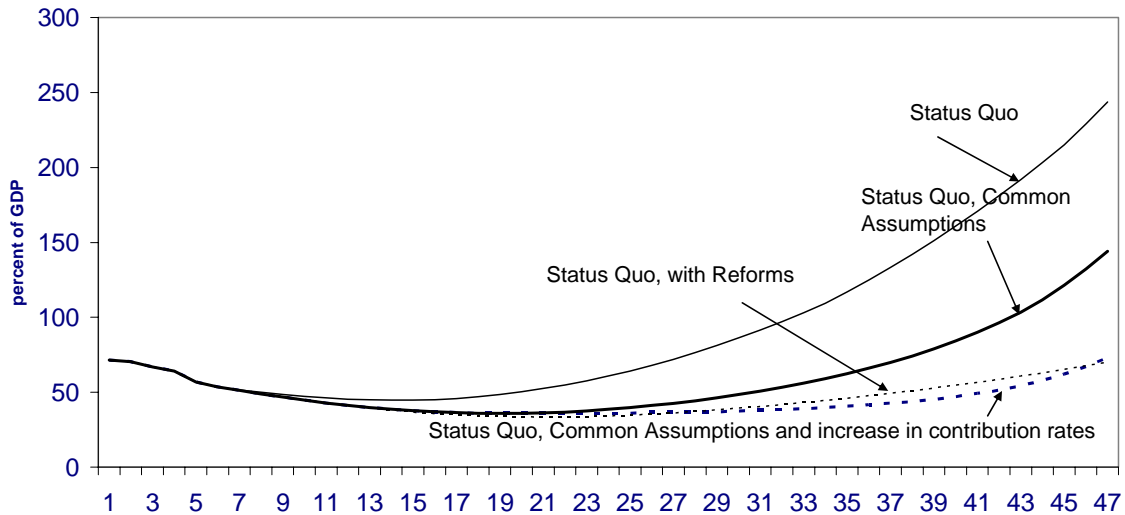
(a) Baseline scenario with national assumptions

Without any policy adjustments to the current social security system and assuming that the National Health System will be introduced by 2008, the projections show increasing deficits in the social security fund accounts by 2020 and the beginning of a rise in the government debt to GDP ratio (see graph 4).

The projections show that under an unreformed pension system, expenditure on pension payments will eventually exceed contributions to the general Social Insurance Fund, while thereafter reserve assets of the Social Security Fund will diminish and become negative by 2025, adversely affecting investment earnings and therefore revenues of the pension scheme. Indeed, the government debt-to-GDP ratio soars to nearly 250% by 2050. This clearly is an unsustainable situation with the exponential growth of debt and interest payments overwhelming the government finances.

It is revealed that the ageing of the population of Cyprus places pressures on the government budget, particularly through the rising proportions of GDP required for government expenditure on old-age pensions and, to a lesser extent, on health care. Apart from population ageing a decisive factor leading to an increase in pension payments over the coming decades is the gradual maturing of the pensions scheme. The more the earnings-related insurance scheme, that began in 1980, approaches maturity, the higher the replacement rate of pensions will be.

Graph 4: Debt Dynamics Based on Alternative Scenarios



Other pension expenditures financed from the general government budgets such as outlays from the central government and local government employees pension schemes will expand over the long-term in line with the ageing of the population. Pension and related expenditures included in the general government accounts are shown in Table XIV below. These additional expenditures will also place pressures on the government finances, which add to the necessity of effecting parametric reforms over the full range of pension schemes impacting on the evolution of government finances.

(b) Baseline Scenario using Commission assumptions

A baseline scenario using the demographic projections and macroeconomic assumptions of the Commission the so-called commonly-agreed assumptions, which differ markedly from the national assumptions used above for the actuarial exercise (see Table XV) was also undertaken. The results of this scenario are considerably more favourable, showing that pension payments for the Social Security Fund do not exceed pension revenues until around 2040, and that the overall government debt to GDP ratio falls steadily toward 30% until around 2032 and does not exceed 40% until around 2045 (see Graph 4).

However, the Cyprus authorities consider the assumptions of the Commission as being on the optimistic side especially as to the growth of the working-age population, albeit based importantly on large annual net inflows of migrants and high labour participation rates. In this connection, it is noted that under the baseline scenarios that the Commission's assumptions lead to the number of contributors to the Social Insurance Scheme rising from 344,000 in 2004 to over 459,000 in 2030, whereas the actuarial exercise showed contributors increasing to 377,000 in 2030, that is a difference of nearly 82,000 or 22% in 2030.

Table XV: Differences in Assumptions between National Authorities¹⁸ and Commission¹⁹

<i>annual percentage growth rate</i>	2005	2010	2020	2030	2050
Employment Growth					
National	1.9	0.7	0.2	0.0	0.0
Commission	0.9	1,9*	0.4	0.1	-0.3
Labour Productivity					
National	2.1	3.2	3.0	3.0	3.0
Commission	2.4	2,9*	3.0	2.7	1.7
Real GDP					
National	4.1	4.0	3.2	3.0	3.0
Commission	3.3	4,9*	3.4	2.8	1.2
Total Labour participation rates					
National	69.0**	69.4**	69.0**	69.7	76.6
Commission	73.4	76.8	81.2	81.6	80.7
* Average for three years centered on 2010					
** Actuarial projections made in 2004 have been slightly adjusted to reflect latest actual results.					

Health

Similarly with the relatively high-income elasticity of health expenditure, the planned introduction of a National Health Scheme by 2008, which foresees no fee at the point of consumption, and the prospective increase of demand for cost-intensive health care, especially of the old aged and the ageing population, there is expected to be relatively large increases in health care expenditures. However, the introduction of a National Health Scheme is also expected to lead to saving, inter alia, through the implied competition pressure on the public hospitals to become more efficient, efficiency gains through the anticipated improvement of primary health care, saving due to the introduction of the concept of the family doctor and the introduction of the global

¹⁸ Assumptions made by the Ministry of Finance in the Convergence Programme 2004-2008 and by the actuarial service of the International Labour Organization in their 2003 actuarial exercise on Cyprus.

Figures for 2005 and 2010 have been modified to reflect the latest national projections.

¹⁹ Demographic projections and macroeconomic assumptions made by the European Commission for the Economic Policy Committee's Ageing Population Work Group.

budgeting concept for the National Health Scheme. The total impact of these factors on the evolution of health expenditure over the long-term is difficult to assess.

For the purpose of this exercise, projections were undertaken, based on the assumption that health care expenditure would exhibit a GDP growth elasticity of 1.1 between 2005-2010, which would decrease thereafter, gradually, to 1.03 by 2050, reflecting efficiency gains through the introduction of the National Health Scheme. Furthermore, based on the agreement between the Government and the social partners on the contribution rate of the Government (4.55% of earnings), employers (2.55% of earnings) and employees (2% of earnings), it was estimated that the Government will cover roughly 52.5% of the total health care expenditure (including its contribution as employer) after the introduction of the National Health Scheme, planned to take place by 2008.

Based on the above-mentioned assumptions, it is estimated that the Government healthcare current and capital expenditure would rise from the current 3.2% of GDP to 4.3% by 2050.

Policy Reform Options of the Pension Scheme

It emerges that over the long term, policy reforms are essential, especially for the pension scheme, with a view to securing long-term fiscal sustainability. The Government has been focusing on the following reform options, which are serving as a basis for discussion between the Government and the social partners. These are as follows:

- gradual increase of the normal pensionable age from currently 63 to 65 years over the period 2005-2010; the scope of further increasing the pensionable age to 67 years will be examined at a later stage;
- indexing of the lower band pensions to a price index, instead of the wage index, as is currently the practice;
- increasing the number of years of contribution required for eligibility to the old age pension from 10 to 15.

An actuarial exercise based on these parametric reforms based on national assumptions revealed that an increase of the normal pensionable age to 65 years, combined with indexing of the lower band pensions based on the CPI and increasing the number of years of contribution required for eligibility to the old age pension from 10 to 15 years would lead to a considerable reduction in pension expenditures from the Social Insurance Scheme as compared with the non-reform scenario. The main driving force in lowering pension expenditures is the indexing of lower band or basic pensions to the CPI instead of wage earnings, that effectively redistributes income away from pensioners. More specifically, as a result of the above reforms total pension revenues will exceed total pension expenditures until 2030, with pension assets being run down thereafter in an accelerating decline (Table 7). However, this scenario is not viable as well over the long term and may require changes in social security contribution rates as well.

Given this unsatisfactory outcome for the long-term for the social security accounts and overall government finances according to the actuarial exercise based on first tier parametric reforms, and even for the very long term of the baseline or status quo scenario based on “optimistic” Commission assumptions (see graph 4), consideration is being given to raising contribution rates to the Social Insurance Funds so as to stabilize the ratio of pension reserve assets to GDP above 35%, while at the same time maintaining the government debt to GDP ratio significantly below 30%. It is noteworthy that a phased increase of contribution rates should be viewed as normal as the Social Insurance Scheme is maturing in line with partially funded pension schemes, such as the one in Cyprus. This possibility was already foreseen when the Social Insurance Scheme was originally designed.

Thus, a new reform scenario involving the application of a phased rise in contribution rates to the general Social Insurance Scheme as from around 2025 to the baseline scenario, using the Commission assumptions, was undertaken to keep the reserves of the pension scheme at prudent levels and maintaining the ratio of government debt to GDP below 30%.

The results of this scenario, reveal a relatively sustainable long-term fiscal situation, with the impact of the rise in the total contribution rates from the current level of 14.3% of insurable earnings to 16.3% by 2025, to 17.3% by 2030, to 19.3% by 2035, to 19.3% by 2040, and to 20.3% by 2040 neutralizing the adverse effects of the maturing pension scheme and of population ageing on the government accounts. The level of pension assets are maintained above 35% of GDP and the government debt to GDP ratio is kept below 30% only rising above this level just before 2050.

It should be stressed that the foregoing scenario (status quo, with Commission assumptions and increases in contribution rates) does not include the first tier parametric reforms, including the indexing of lower band pension to the CPI instead of wage earnings and is considered to be predicated on optimistic Commission assumptions. To safeguard against financial risks resulting from these assumptions failing to materialize, it would be necessary at least to effect essential, yet feasible, first tier reforms, such as the raising of the retirement age from 63 to 65 years under the general Social Insurance Scheme, and to increase the number of years of contribution required for eligibility for old age pensions from 10 to 15. The reform requiring the indexing of lower band pensions to the CPI is considered difficult as it would seriously erode the future income of the poorer pensioners and could be either omitted from the package of desired reform measures or modified without damaging the long-term fiscal sustainability, especially if the more optimistic trends are realized.

It is important also to undertake parametric reforms in other pension schemes affecting the government finances, so as to contain their budgetary impact at current levels. In this respect, the retirement age for civil servants was extended from 60 to 63 years on July 1, 2005 and negotiations on raising the retirement age of teachers and other groups of public sector employees are also proceeding.

Conclusion

To recapitulate on the results and assumptions of the foregoing exercises on long-term fiscal sustainability. A sustainable long-term fiscal position will only be secured if:

- the medium-term budgetary objectives are achieved through the timely and resolute implementation of the fiscal consolidation programme. That is, net general government borrowing should be no more than 0,6% of GDP by 2009 and the ratio of government debt to GDP should be well below 60% and on a distinct downward path;
- prudent fiscal policies are continued and extended beyond 2009, with no significant changes in the structural deficit;
- employment rates of working age males continue to rise over the long-term and employment rates of working age females and elderly workers register large increases, at least up to 2030;
- first tier parametric reforms are undertaken involving a gradual raising of the normal retirement age from 63 to 65 years and an increase in the number of years of contribution required for eligibility for the old age pension from 10 to 15;
- second tier parametric reforms that would entail a phased and considerable raising of social security contribution rates over the period 2025 to 2050 are undertaken so as to stabilize the ratio of pension reserve assets to GDP above a level of 35% and keep the debt to GDP ratio below 30%; and
- the budgetary impact of other pension-schemes, such as the central government employees' scheme, is stabilized by parametric measures.

7. INSTITUTIONAL FEATURES OF PUBLIC FINANCES

Budgetary Procedures, including public finance statistical governance

By law, the fiscal year in Cyprus corresponds to the calendar year, while Article 167 of the Constitution places the responsibility for the preparation of the comprehensive budget on the Minister of Finance. Under Article 81 of the Constitution, the budget then has to be brought before in the House of Representatives at least three months before the commencement of the financial year, i.e., by September 30 of each year, and it is to be voted upon by the House not later than December 31 of each year (Box 3). Accordingly, the Ministry of Finance issues the budget circular by the end of March. The budget circular outlines the various parameters for budget preparation for the guidance of the line ministries. A separate, parallel circular is issued by the Planning Bureau for the development expenditure component of the budget, within the ambit of a five year strategic development plan drawn up by the Planning Bureau (Box 4). The budget is presented on a line item basis. The budget and accounts classification are consistent and mainly based on an administrative classification, whereas a classification a classification by economic category of expenditures is also presented.

Box 3. The Budget Preparation Calendar		
Due dates	Activities	Legal basis
The fiscal year is set on a calendar-year basis by the Constitution. The main steps in the process are as follows:		
End-March	Budget circular issued to ministries detailing the basic parameters	Administrative instructions of the Ministry of Finance and the Planning Bureau
20 May	Line ministries submit budget proposals to Ministry of Finance	Administrative instructions of the Ministry of Finance and the Planning Bureau
June to late September	Budget discussion between line ministries and Ministry of Finance	Administrative instructions of the Ministry of Finance and the Planning Bureau
Early September	Submission to the Council of Ministers for discussion and approval	
30 September	Ministry of Finance submits budget proposals approved by the Council of Ministers to the House of Representatives	Art. 81 of the Constitution
October to December	Discussion of the proposed budget in the Parliamentary Committee of Finance and Budgets and in plenary session; budget approval	
1 January (next year)	Commencement of budget approved by the House of Representatives	Art. 81 of the Constitution

Box 4. Budget Preparation Process

Until 1998, the government used to present four separate budgets—the Ordinary Budget, the Development Budget, the Special Relief Fund for the Displaced and Affected persons and the Defence Fund. By order No. 48.868 of December 16, 1998, the Council of Ministers approved the consolidation of all four budgets, although the presentation is still in two separate sections for the ordinary and the development expenditures.

The budget circulars of the Ministry of Finance (ordinary expenditure category) and the Planning Bureau (development expenditure category) specify the date for submission by the line ministries of their proposals to the Ministry of Finance (e.g., May 20, 2005 for the 2006 budget) and the Planning Bureau (e.g., May 14, 2005 for the 2006 budget), and the date when the Ministry of Finance, in turn, has to submit the combined budget documents to the House of Representatives. The budget circulars also detail the parameters for the preparation of budget estimates as based on the Convergence Programme. It also details various budgetary cuts to be made—for instance, the budget circular No.13.23.002 issued in May 2005, specifies that a 30 percent cut be made in overtime allowances, while the increase in current expenditures is capped at 2 percent; the rate of increase was limited to 6 percent for development expenditure and to 2½ percent for social benefits. However, no reference to estimated revenue inflows is made at this stage.

All investment programmes and projects are described in the explanatory memorandum accompanying the development expenditures part of the budget. A limited number of expenditure subheads in the budget's development part are marked with a dagger (+), indicating that expenditure cannot be incurred until full details of the project have been provided to the Planning Bureau and an "Authority to incur Expenditure" has been issued by the Minister of Finance. The final approval for de-dagging rests with the Minister of Finance upon advice from the Planning Bureau.

Dagging is applied when implementing line ministries have not provided adequate project information by the time the budget is submitted to the House of Representatives or when more time is needed to analyze and evaluate the project (in case of new project proposals). Dagging is also used as a mechanism to monitor monthly cash flows of large projects, in which case cash releases are made after periodic implementation reviews in the course of the year.

Implementation of National Budgetary Rules

The net lending of general government is determined in accordance with the provisions of the Excessive Deficit Procedure and the ESA-95 guidelines and targets are set with a view of meeting the Maastricht deficit and debt criteria, controlling the public debt more generally and ensuring the long term sustainability of the social security funds. The government monitors the general government balance/net lending consistently (on a quarterly basis), and also tracks such indicators as the general government primary and structural balances (in the context of the semi-annual fiscal notifications to the European Commission) and the balance of the consolidated central government and social security funds (monthly). The deficits of municipalities and communities are not systematically monitored.

Through budget circulars, the Ministry of Finance and the Planning Bureau indicate to the line ministries the broad policy guidelines for the budget formulation for the coming year with regard to the recurrent and the development items in the budget, respectively.

While a general review of macroeconomic policies is available in the Finance Minister's budget speech and the accompanying report on economic developments, and a broad consensus exists on the macroeconomic goals, the budget remains essentially based on an incremental budgeting mechanism for expenditure items and only a consolidated revenue forecast based on existing tax policies is prepared. A short document summarizing the economic developments in the previous year and the prospects for the coming year is prepared by the Planning Bureau and the Ministry of Finance each year. This document discusses broadly the international and domestic economic developments including details of the inflation rate and the fiscal deficit and presents a brief sectoral analysis. Despite being derived from the CP and following the latter's objectives, neither this document nor the strategic development plan (Box 5) are linked clearly and explicitly to the CP.

Box 5. Development Planning

The Planning Bureau is the government agency responsible for the country's development policy. The Bureau prepares a medium-term development plan in close cooperation with all ministries, departments, and agencies involved. The development plan reflects the government's medium-term development priorities, and relates only to the development portion of the budget.

The strategic development plan in principle is prepared for a five-year period. The plan discusses the development programmes of the government and the main semi-government organisations, and assesses the major schemes proposed by the various line ministries. The first part of the document is devoted to a discussion of the overall development strategy, and includes sections on recent economic developments and the current economic situation, the broad development strategy and the medium-term macroeconomic framework. The strategic plan devotes a relatively smaller part to economic developments and analysis. The second part, which takes up the larger portion of the document, presents in general terms the priorities and strategies in the various development areas and the associated projects.

Under the CP, a medium-term projection is prepared as part of the fiscal policy planning and budgeting exercise, and forecasts of the main economic aggregates, including the parameters affecting the social security fund and health expenditure, are prepared. The Ministry of Finance examines the impact of policies on the budget balance and also estimates the general government overall, primary and structural balances in the context of the CP. The CP preparation calendar is now broadly aligned with the budget preparation calendar, which could facilitate their further integration (see Box 3 above).

The government in June 2002 adopted the basic fiscal rule of zero borrowing from the Central Bank, which is also enshrined in the Central Bank law. Since EU accession, the government follows the requirements of the Stability and Growth Pact, combined with quantitative limits on the growth of most current expenditures up to 2 percent, and for capital expenditure up to 6 percent.²⁰ There is an understanding that the local levels of government have to present a balanced budget to the Ministry of the Interior.

²⁰ Special provisions introduced the following specific expenditure limits: no increase for grants to semi-governmental organizations; containment of defence outlays to around 1 percent of GDP annually; and

The Accountant General has issued detailed financial and accounting regulations to guide Heads of Departments and Independent Services and accounts officers in the maintenance of accounts. The government has recently set up a financial and management accounting system (FIMAS) in the treasury. The system appears to have the capacity to monitor expenditures on a monthly basis and on a programme basis. The system also has the capacity to check payments against budget allocations and record commitments (Box 6). In combination with strict payment authorization procedures, this ensures strong ex-ante control. The system is also used for preparing the budget documents and the 2004 budget documents were the first to be prepared using the FIMAS system. The government operates a single account called the government general account and all revenues deposited in private banks are deposited into it within two days of collection. Transfer delays are watched by the Treasury and a system exists to collect interest on delayed payments into the government general account. The Central Bank of Cyprus provides the Treasury daily balances on the government general account.

Box 6. The FIMAS System

The FIMAS system is based on a 10 digit code supported by a further 10 digit analysis and a 10 digit transaction code, which allows generation of about 250 standard reports and a further number of customized reports at any hierarchical level, including on payments and commitments. FIMAS has a general ledger; includes expenditure control, budget preparation, costing and reporting modules; and maintains a database of outstanding government liabilities.

FIMAS could be used to strengthen commitment control. Clauses 11 & 12 of the Law for the Management of Revenues, Expenditures and of Accounting Systems of the Republic and Other Related Matters makes the controlling officers personally liable for ensuring that expenditures do not exceed allocations. In addition, Law No. 112 (1)/2002 makes the incurrence of any expenditure in excess of approvals a criminal offence. The government has also issued instructions (*Order No. 1568 of December 23, 2003, Para 3.1.5 and Arts. 73 and 74 of the Finance and Accounting Instructions issued by the accountant general*) to ensure recording of commitments.

The system covers all national and EU funds except those directly paid to citizens in the area of agriculture (channeled through the Cyprus Agricultural Payments Organization) but not local authorities or semi-government organizations. The consolidated central government budget and accounts classifications are uniform.

Other Institutional Developments in relation to Public Finances

In early 2005 the IMF was invited to undertake a report on the Observance of Standard and Codes (ROSC) for Cyprus and assess compliance with the IMF's "Code on Good Practices on Fiscal Transparency". The report concluded that "Cyprus has been making major progress in improving fiscal transparency, helped by the Government's efforts to

containment of the rate of increase of current transfers (pensions, monetary allowances) to the rate of inflation.

strengthen budget management system and comply with the *acquis communautaire*. As a result, the country now fully meets or even exceeds the Code's standards in many areas".

The IMF fiscal ROSC pointed out, however, that more progress was warranted in the areas of the public expenditure and financial management. To bring the management of public finances in line with best practices a number of initiatives have been taken, including the introduction of a comprehensive financial information and management system (FIMAS) from January 2004.

It was further noted that increasing amounts of resources were being used in public private partnership (PPP) projects. However, the risks for the public sector arising from PPP projects needed to be better assessed and identified. Reacting to this concern, the Cyprus authorities decided to develop adequate risk analysis systems and reporting, and monitoring mechanisms so as to better reflect risks and potential budgetary costs.

Furthermore, the Ministry intends to initiate the preparation of a medium-term budgetary framework (MTBF), which will take into consideration the medium-term targets and policies incorporated in the Convergence and the National Lisbon Programmes of Cyprus. Such a medium-term budgetary framework will improve the ability of the Government to prioritize programmes based on the needs of the economy, will tighten further public expenditure limits and minimize the scope for a mid-year reopening of the budget. The Authorities intend to introduce the multi-year budgetary framework with the preparation of the 2007 budget. To prepare for this ambitious and important task, the Government has already requested technical assistance from the IMF and it is expected that a team will visit Cyprus in early 2006 for this task.

Further "fiscal structural reforms" will lay down the key principles for the formulation of fiscal policy, integrate a multi-year budgetary process and set strict procedures on spending both for broad spending categories as well as for Ministries. The new policy framework will limit significantly the practice of mid-year, supplementary, budgets and will boost significantly the credibility of fiscal policy.

APPENDIX I: Tables

Table 1a: Macroeconomic Prospects

	ESA Code	Year 2004	Year 2004	Year 2005	Year 2006	Year 2007	Year 2008	Year 2009
		level	rate of change	rate of change	rate of change	rate of change	rate of change	rate of change
1. Real GDP	B1*g	5616.2	3.8	4.1	4.2	4.2	4.2	4.3
2. Nominal GDP	B1*g	7292.1	6.7	6.9	7.1	6.6	6.7	6.8
Components of real GDP								
3. Private consumption expenditure	P.3	3761.2	6.3	4.5	4.2	3.9	3.8	3.8
4. Government consumption expenditure	P.3	920.0	-4.8	2.1	2.8	2.1	2.4	2.7
5. Gross fixed capital formation	P.51	1102.6	10.7	4.5	5.2	5.8	5.8	5.9
6. Changes in inventories and net acquisition of valuables (% of GDP)	P.52 + P.53	88.9	1.6	0.7	0.5	0.4	0.0	-0.1
7. Exports of goods and services	P.6	2817.1	4.5	5.2	5.8	6.2	6.2	6.3
8. Imports of goods and services	P.7	3073.6	11.1	3.6	5.2	5.5	4.8	5.7
Contributions to real GDP growth								
9. Final domestic demand			5.2	4.2	4.2	4.1	4.1	4.1
10. Changes in inventories and net acquisition of valuables	P.52 + P.53		2.0	-0.8	-0.2	-0.1	-0.5	-0.1
11. External balance of goods and services	B.11		-3.4	0.7	0.2	0.2	0.6	0.3

Table 1b: Price Developments

	ESA Code	Year	Year	Year	Year	Year	Year	Year
		2004	2004	2005	2006	2007	2008	2009
		Level	rate of change	rate of change	rate of change	rate of change	rate of change	rate of change
1. GDP deflator		129.8	2.8	2.7	2.8	2.3	2.4	2.5
2. Private consumption deflator		124.4	2.2	2.5	2.5	2.1	2.0	2.0
3. HICP		124.5	1.9	2.1	2.0	2.0	2.0	2.0
4. Public consumption deflator		145.2	3.4	2.9	4.1	2.8	2.7	2.8
5. Investment deflator		126.5	4.2	3.7	3.5	3.1	2.7	2.5
6. Export price deflator (goods and services)		122.3	2.3	2.3	2.3	2.3	2.3	2.3
7. Import price deflator (goods and services)		119.4	2.1	4.0	2.0	2.0	1.9	2.0

Table 1c: Labour market developments

	ESA Code	Year	Year	Year	Year	Year	Year	Year
		2004	2004	2005	2006	2007	2008	2009
		Level	rate of change	rate of change	rate of change	rate of change	rate of change	rate of change
1. Employment, occupied population, domestic concept national accounts definition		331.4	1.9	1.9	1.5	1.4	1.5	1.5
2. Employment, hours worked								
3. Unemployment rate (%) - harmonised definition-Labour Force Survey			4.7	5.3	5.2	5.0	4.9	4.7
4. Labour productivity persons fulltime equivalent			1.9	2.1	2.7	2.8	2.7	2.8
5. Labour productivity hours worked								
6. Compensation of employees	D1		3.6	4.8	4.2	4.0	4.0	4.0

Table 1d: Sectoral Balances

% of GDP	ESA Code	Year 2004	Year 2005	Year 2006	Year 2007	Year 2008	Year 2009
1. Net lending/borrowing vis-à-vis the rest of the world	B.9	-4.8	-5.3	-4.7	-4.2	-3.2	-2.7
of which:							
- Balance on goods and services		-3.1	-3.1	-2.7	-2.3	-1.4	-1.0
- Balance of primary incomes and transfers		-2.5	-2.4	-2.2	-2.1	-1.9	-1.8
- Capital account		0.8	0.3	0.2	0.2	0.2	0.2
2. Net lending/borrowing of the private sector	B.9/EDP B.9	-0.7	-2.8	-2.8	-2.4	-2.0	-2.1
3. Net lending/borrowing of general government	B.9	-4.1	-2.5	-1.9	-1.8	-1.2	-0.6
4. Statistical discrepancy			optional	optional	optional	optional	optional

Table 2: General government budgetary prospects

	ESA code	Year	Year	Year	Year	Year	Year	Year
		2004	2004	2005	2006	2007	2008	2009
		level	% GDP	% GDP	% GDP	% GDP	% GDP	% GDP
Net lending (B9) by sub-sector								
1. General government	S.13	-298.8	-4.1	-2.5	-1.9	-1.8	-1.2	-0.6
2. Central government	S.1311	-520.2	-7.1	-5.6	-5.0	-4.7	-4.1	-3.3
3. State government	S.1312	-						
4. Local government	S.1313	-10.7	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1
5. Social security funds	S.1314	232.1	3.2	3.2	3.1	3.0	2.9	2.8
General government (S13)								
6. Total revenue	TR	2882	39.5	41.2	40.0	40.0	39.6	39.1
7. Total expenditure	TE	3180.8	43.6	43.8	41.9	41.8	40.8	39.7
8. Net lending/borrowing	EDP B.9	-298.8	-4.1	-2.5	-1.9	-1.8	-1.2	-0.6
9. Interest expenditure (incl. FISIM)	EDP D.41 incl. FISIM	234	3.2	3.2	3.1	3.0	2.6	2.3
pm. 9a FISIM		0	0.0	0.0	0.0	0.0	0.0	0.0
10. Primary balance		-64.8	-0.9	0.7	1.2	1.2	1.4	1.7
Selected components of revenue								
11. Total Taxes (11=11a+11b+11c)		1906	26.1	26.9	26.9	27.0	26.9	26.7
11a. Taxes on production and imports	D.2	1261.3	17.3	17.3	17.4	17.4	17.3	17.2
11b. Current taxes on income, wealth etc	D.5	593.6	8.1	8.7	9.5	9.6	9.5	9.4
11c. Capital taxes	D.91	51.1	0.7	0.9	0.1	0.1	0.1	0.0
12. Social contributions	D.61	569.1	7.8	7.8	8.1	8.1	8.1	8.0
13. Property income	D.4	52.4	0.7	0.8	0.7	0.6	0.6	0.6
14. Other (14=15-(11+12+13))		354.5	4.9	5.7	4.3	4.2	4.0	3.8
15=6. Total revenue	TR	2882	39.5	41.2	40.0	40.0	39.6	39.1
p.m.: Tax burden (D.2+D.5+D.61+D.91-D.995)		2475.1	33.9	34.7	35.0	35.1	34.9	34.7
Selected components of expenditure								
16. Collective consumption	P.32	737.9	10.1	9.9	9.5	9.0	8.7	8.3
17. Total social transfers	D62+D63	1483.4	20.3	20.5	19.9	20.1	19.7	19.3
17a. Social transfers in kind	P.31=D.63	598	8.2	8.1	8.5	8.7	8.7	8.9
17b. Social transfers other than in kind	D.62	885.4	12.1	12.4	11.4	11.5	10.9	10.4
18=9. Interest expenditure (incl. FISIM)	EDP D.41 incl. FISIM	234	3.2	3.2	3.1	3.0	2.6	2.3
19. Subsidies	D.3	83	1.1	0.6	0.6	0.5	0.5	0.4
20. Gross fixed capital formation	P.51	297.4	4.1	4.0	4.0	4.0	4.0	3.9
21. Other (21=22-(16+17+18+19+20))		345.1	4.7	5.5	4.8	5.2	5.4	5.3
22=7. Total expenditure	TE	3180.8	43.6	43.8	41.9	41.8	40.8	39.7
pm: compensation of employees		1072.5	14.7	14.5	14.4	14.2	14.0	13.7

Table 3: General government expenditure by function

% of GDP	COFOG Code	Year 2003	Year 2004	Year 2005	Year 2006	Year 2007	Year 2008	Year 2009
1. General public services	1	9.1	8.2	8.2	8.0	7.9	7.8	7.7
2. Defence	2	3.2	2.4	2.4	2.4	2.3	2.3	2.2
3. Public order and safety	3	2.0	2.0	2.0	2.0	2.0	2.0	2.0
4. Economic affairs	4	6.2	6.2	6.0	5.8	5.6	5.4	5.2
5. Environmental protection	5	0.0	0.0	0.0	0.0	0.0	0.0	0.0
6. Housing and community amenities	6	4.1	4.1	4.1	4.1	4.0	4.0	4.0
7. Health	7	3.2	3.2	3.2	3.2	3.2	3.3	3.3
8. Recreation, culture and religion	8	0.5	0.5	0.5	0.4	0.4	0.4	0.4
9. Education	9	5.7	5.8	5.8	5.8	5.8	5.9	5.9
10. Social protection	10	11.3	11.2	11.6	10.2	10.6	9.7	9.0
11. Total expenditure (= item 7=26 in Table 2)	TE	45.3	43.6	43.8	41.9	41.8	40.8	39.7

Table 4: General government debt developments

% of GDP		Year 2004	Year 2005	Year 2006	Year 2007	Year 2008	Year 2009
1. Gross debt		71.3	70.5	67.0	64.0	56.9	53.5
2. Change in gross debt ratio		1.9	-0.8	-3.5	-3.0	-7.1	-3.4
Contributions to change in gross debt ratio							
3. Primary balance		-0.9	0.7	1.2	1.2	1.4	1.7
4. Interest expenditure (incl. FISIM)		3.2	3.2	3.1	3.0	2.6	2.3
5. Stock-flow adjustment		2.4	1.3	-0.8	-0.6	-4.3	-0.3
of which:							
- Differences between cash and accruals		0.3	0.0	0.0	0.0	0.0	0.0
- Net accumulation of financial assets		2.0	1.5	-0.6	-0.4	-4.1	-0.2
- of which: privatisation proceeds		0.0	0.0	0.0	0.0	0.0	0.0
- Valuation effects and other		0.1	0.0	0.0	0.0	0.0	0.0
p.m. implicit interest rate on debt		4.62	4.81	4.71	4.74	4.38	4.40
Other relevant variables							
6. Liquid financial assets		9.0	10.3	9.5	8.9	4.6	4.3
of which: Sinking Fund Deposits		7.7	7.0	6.5	5.4	0.7	0.2
7. Net financial debt (7=1-6)		62.3	60.2	57.5	55.1	52.3	49.2

Table 5: Cyclical developments

% of GDP	ESA Code	Year 2004	Year 2005	Year 2006	Year 2007	Year 2008	Year 2009
1. Real GDP growth (%)		3.8	4.1	4.2	4.2	4.2	4.3
2. Net lending of general government	EDP B.9	-4.1	-2.5	-1.9	-1.8	-1.2	-0.6
3. Interest expenditure (incl. FISIM recorded as consumption)	EDPD.41+ FISIM	3.2	3.2	3.1	3.0	2.6	2.3
4. Potential GDP growth (%)		4.0	4.0	4.0	4.0	4.0	4.0
Contributions:							
- labour		n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
- capital		n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
- total factor productivity		n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
5. Output gap		2.0	2.0	1.9	1.7	1.5	1.1
6. Cyclical budgetary component		0.8	0.8	0.7	0.7	0.6	0.4
7. Cyclically-adjusted balance (2-6)		-3.3	-1.7	-1.2	-1.1	-0.6	-0.2
8. Cyclically-adjusted primary balance (7-3)		-0.1	1.5	1.9	1.9	2.0	2.1

Table 6: Divergence from previous update

	ESA Code	Year 2004	Year 2005	Year 2006	Year 2007	Year 2008	Year 2009
Real GDP growth (%)							
Previous update		3.6	4.0	4.4	4.5	4.5	n.a.
Current update		3.8	4.1	4.2	4.2	4.2	4.3
Difference		0.2	0.1	-0.2	-0.3	-0.3	
General government net lending (% of GDP)							
Previous update	EDP B.9	-4.8	-2.9	-1.7	-1.5	-0.9	n.a.
Current update		-4.1	-2.5	-1.9	-1.8	-1.2	-0.6
Difference		0.7	0.4	-0.2	-0.3	-0.3	
General government gross debt (% of GDP)							
Previous update		74.9	71.9	69.2	65.7	58.1	n.a.
Current update		71.3	70.5	67.0	64.0	56.9	53.5
Difference		-3.6	-1.4	-2.2	-1.7	-1.2	

Table 7: Long-term sustainability of public finances
(Based on the actuarial exercise)

% of GDP	2000	2005	2010	2020	2030	2050
Total expenditure	36.6	43.8	40.0	40.0	42.9	44.8
Of which: age-related expenditures	13.4	16.1	14.6	15.8	18.1	20.7
Pension expenditure	6.8	7.1	6.4	7.3	8.9	10.6
Social security pension	4.3	4.2	4.0	5.1	6.5	8.0
Old-age and early pensions	3.9	3.8	3.6	4.6	5.8	7.1
Other pensions (disability, survivors) ²¹	0.8	0.8	0.8	0.8	1.0	1.2
Occupational pensions (if in general government)	2.1	2.5	2.0	1.9	2.1	2.3
Health care	2.3	3.2	2.3	2.5	3.3	4.3
Long-term care						
Education expenditure	4.3	5.8	5.9	6.0	5.9	5.8
Other age-related expenditures	-	-	-	-	-	-
Interest expenditure	3.3	3.2	2.7	1.8	1.8	3.4
Total revenue	33.8	41.2	39.1	39.0	38.8	38.6
Of which: property income	0.9	0.8	0.6	0.6	0.6	0.6
<i>of which:</i> from pensions contributions (or social contributions if appropriate)	5.8	5.6	5.3	5.2	5.1	5.0
Pension reserve fund assets	37.0	37.7	39.1	39.2	28.4	-16.2
Of which: consolidated public pension fund assets (assets other than government liabilities)	1.0	1.0	1.0	1.0	1.0	1.0
Assumptions						
Labour productivity growth	2.7	2.1	3.2	3.0	3.0	3.0
Real GDP growth	5.0	4.1	4.0	3.2	3.0	3.0
Participation rate males (aged 15-64)	78.9	81.0	81.5	81.1	81.5	85.1
Participation rates females (aged 15-64)	52.5	56.0	56.4	56.0	57.7	67.5
Total participation rates (aged 15-64)	65.5	69.0	69.4	69.0	69.7	76.6
Unemployment rate	3.3	3.8	3.4	3.5	3.5	3.5
Population aged 65+ over total population	11.3	12.2	13.2	16.5	20.8	28.1

²¹ Includes social pensions amounting to 0.4% of GDP in 2004.

Table 8: Basic assumptions

	Year 2004	Year 2005	Year 2006	Year 2007	Year 2008	Year 2009
Short - term interest rate (annual average euro area)	2.1	2.1	2.5	3.0	3.4	3.5
Long-term interest rate (annual average euro area)	4.1	3.3	3.5	3.8	4.2	4.5
USD/€exchange rate (annual average (euro area and ERM II countries))	1.24	1.25	1.21	1.22	1.22	1.22
Nominal effective exchange rate of the Cyprus pound (% change) /1	1.0	0.5	-1.7	0.4	0.0	0.0
World excluding EU, GDP growth	5.6	5.1	4.9	4.6	4.5	4.5
EU GDP growth	2.5	1.5	2.1	2.4	2.4	2.5
Growth of relevant foreign markets /2	2.5	1.5	2.1	2.4	2.4	2.5
World import volumes, excluding EU	10.8	8.6	8.7	8.4	8.0	8.0
Oil prices, (Brent, USD/barrel)	37.8	58.0	60.0	60.0	55.0	55.0

1/ Technical assumption based on a fixed bilateral exchange rate vis-à-vis the euro, and allowing for small changes in the other major currencies as indicated in the table.

2/ Proxied by growth in the EU25.

APPENDIX II: THE BUDGETING SYSTEM IN CYPRUS

Constitutional Provisions

According to the provisions of Article 167 of the Constitution of the Republic of Cyprus, the Minister of Finance is responsible for the preparation for every financial year of a comprehensive Budget which, when approved by the Council of Ministers, is tabled before the House of Representatives for consideration and adoption.

According to the provisions of Article 81 of the Constitution, the Budget has to be introduced to the House of Representatives at least three months before the day fixed by law for the commencement of the financial year (1st January) and it is voted by the House not later than this day. In Cyprus the financial year coincides with the calendar year i.e. 1st January-31st December.

If, however, the Budget has not been adopted by the House by the first day of the respective financial year, to which it relates, the House may, by a Resolution, authorize the meeting of any expenditure required for a period not exceeding one month at any one time, but in any event not exceeding two months in the aggregate for the continuance of the public services shown in the Budget until the expiration of such a period. This is provided on the condition that the expenditure so authorized for any service may not exceed the proportion with respect to that period of the amount voted for that service (Head of Expenditure) in the Budget for the preceding financial year. In no case the expenditure under one Subhead may exceed the provision proposed under the same Subhead in the Budget for the new financial year under consideration by the House. Expenditure for new services and the filling of new posts before the adoption of the Budget by the House is not allowed.

The House of Representatives may or may not adopt any expenditure included in the Budget or any supplementary Budget Laws; it may not, however, increase the votes of expenditure or change the purpose intended of such votes. That is, the House can not initiate any proposal to increase expenditures or change their purpose of.

When the Budget is finally adopted by the House, it is enacted as the Budget Law for that particular year and it is published as such in the Official Gazette of the Republic. Then the Minister of Finance issues a General Warrant to the Accountant-General authorizing him to incur expenditure from the Budget.

Expenditure Budget

The Constitution provides for the preparation of one Budget. However it should be mentioned, that following the declaration of the Republic of Cyprus in 1960 two separate Budgets, the Ordinary and the Development Budget, were

introduced before the House of Representatives. The Ordinary Budget included all the current operational expenditures of the Government (Wages and Salaries, Operational Expenses etc.) while, the Development Budget covered the expenditures for the implementation of the various Development Programmes.

In 1975, following the Turkish Invasion, the Special Relief Fund for the Displaced and Affected Persons was established to handle swiftly and efficiently with the complex and severe problems that arose as a consequence of the Turkish Invasion of 1974. Expenditure out of this Fund covered mainly the creation of the necessary infra-structural works for the physical survival of the displaced and affected persons, the provision of the necessary social services and other assistance and their economic reactivation.

Originally, an independent Budget was set-up for the needs of the above Fund, which was then submitted, to the Council of Ministers for approval and subsequently to the House of Representatives for adoption.

Lastly, in 1984 the Defence Fund was established as the fourth Budget of the Republic, covering expenses relating to the national defence.

Following the decision of the Council of Ministers No.48.868 of 16th December, 1998, which approved the consolidation of all existing Budgets, the provisions of the Special Relief for the Displaced and Affected Persons Budget were incorporated into the consolidated Budget for 2000.

As we have already mentioned, following the decision of the Council of Ministers No.48.868 of the 16th December, 1998 as from 1st January 2000 the afore mentioned four Budgets of the Republic were incorporated into one, namely the consolidated Budget for 2000.

The Budget of the Republic contains the following information:

Expenditure:

- (a) Estimates of the Ordinary Expenditure, which is chargeable on the Consolidated Fund as defined by Article 166 of the Constitution.
- (b) Estimates of other Ordinary Expenditure, which has to be adopted by the House of Representatives.
- (c) Estimates of Development Expenditure, which is subject to adoption by the House of Representatives.
- (d) Estimates of Defence Expenditure.

Revenues:

- (a) Estimates of Revenue for the same year based on legislation already enacted or pending before the House, for adoption.

Supplementary Data:

- (a) A statement of Assets and Liabilities of the Republic at the end of the last completed financial year.
- (b) Estimated Balances of the Consolidated Fund at the end of the last completed financial year.
- (c) Loans to be granted by the Loan Commissioners – for Development Projects.
- (d) Salary Scales, the creation and abolition of posts, list of officers in control of expenditure votes and a list of officers responsible for the collection of revenue.

Preparation and Approval of the Budget

The Budget in respect of any financial year is prepared and considered on the basis of a policy determined in advance by the Minister of Finance and communicated to all Ministries, Departments and Independent Offices in the form of Circulars in March or early in April of the previous year. This policy aims, inter alia, at allocating of the scarce financial resources according to carefully established needs and priorities.

These circulars, one for the ordinary expenditure and one for the development expenditure of the Budget, give the basic guidelines specifying the fiscal policy framework to be followed within which the Ministries, Departments and Independent Offices should submit their proposals.

The circular for the category of development expenditure contains the main guidelines for the proper allocation of resources by order of priority and in accordance with the objectives set out in the five year Strategic Development Plans.

Budget proposals for the ordinary expenditure of the Budget are submitted to the Budget and Fiscal Control Directorate of the Ministry of Finance where they are checked, scrutinized and evaluated. They are then referred to the Estimates Committee of the Ministry of Finance where they are widely discussed, at meetings held especially for this purpose. Permanent-Secretaries of Ministries and Heads of Departments are invited to these meetings to give further details on their proposals.

The Estimates Committee decides on each proposal and makes a concrete recommendation thereon to the Minister of Finance. The Minister then considers each such proposal along with the relative recommendation and decides accordingly.

The development expenditure of the Budget for any particular year is, in effect, the public investment programme for that year; it constitutes in essence the main instrument for the implementation of the public investment component of the Strategic Development Plans.

The Estimates Proposals for the development expenditure of the Budget are submitted to the Planning Bureau where they are checked and evaluated from the planning and economic points of view. They are then referred to the Ad Hoc Committees on the Development Expenditure and are widely discussed by these Committees at meetings held especially for this purpose. Permanent-Secretaries of Ministries and Heads of Departments are invited to these meetings to support their proposals.

The Ad Hoc Committees on the Development Expenditure decide on each proposal and make a concrete recommendation thereon to the Minister of Finance. These recommendations are presented to the Minister of Finance in the form of a Draft Budget for consideration and final decision.

The Draft Budget incorporating the Minister's decisions is then compiled by the Budget Directorate of the Ministry of Finance incorporating the ordinary and the development expenditures and is subsequently submitted to the Council of Ministers for their consideration and approval.

When the Draft Budget is approved by the Council of Ministers it is then tabled before the House of Representatives for consideration and adoption, accompanied by two Explanatory Memoranda giving details and analysis on the disbursement of all votes of ordinary and development expenditures separately. The Committee on Finance and Budgetary Affairs of the House of Representatives evaluates the Draft Budget and arranges meetings with all Ministries and Independent Offices where general or specific questions of the Members of the Committee are answered. The Parliamentary Committee submits to the House a Special Report on the Budget. Before the Parliamentary debate on the Budget, the Minister of Finance addresses the House of Representatives. The purpose of this address is to brief the House on the situation of the economy during the preceding year and on the macro economic and sectoral policies to be followed, during the new financial year and on the future economic prospects.

Contingencies and Reserve

According to the Notes of the annual Budget Law, the provision under this Head is intended to be allocated to and reallocated from other Heads and Subheads on the authority of the Minister of Finance and it can be used in cases of exceptional, urgent and unforeseen expenditure.

The allocation from this Head to other Heads and Subheads is made by a Special Warrant issued by the Minister of Finance.

In the cases, where a Sub-head has been supplemented by the issue of a Special Warrant from the Head Contingencies and Reserve, the Minister of Finance may, with a new Special Warrant transfer back to contingencies the supplementary amount that remained unspent to be reallocated to other Heads and Sub-heads.

Budget Implementation

After the adoption by the House of Representatives, the Budget is enacted as the Budget Law for that particular year. Hence the implementation phase of the Budget, begins. A strict implementation exists, with funds being efficiently and effectively directed towards the services and purposes approved. By Law the Controlling Officers of votes have the responsibility for the disbursement of funds.

Under the provisions of Section 4(I) of the annual Budget Law, the Council of Ministers may authorize the provision of additional funds under any Subhead or Head of Expenditure against equivalent savings from other Subheads of the same Head and category of Expenditure provided that any saving caused by omission to perform any service or purpose shall not be regarded as a saving. It is also provided that any savings on Subheads 02000 "Officials of the Republic - Emoluments", 02100 "Emoluments of State Officers", 03001 "Travelling" and 03020 "Office Expenses" cannot be applied and spent in making up a deficiency in the sums spent for any of the said Subheads or for any other Subhead under the same Head and no saving on any other Subhead of the same Head can be applied and spent in making up a deficiency in the sums spent for any of the aforesaid Subheads.

The above mentioned transfer of funds is made by the issue of a Special Warrant by the Minister of Finance.

The Council of Ministers decided (Decision NO.3727 of 19th March 1964) to confer on the Minister of Finance under Section 3(1) of the Statutory Functions (Conferment of Exercise) Law (No. 23 of 1962) the authority to authorize expenditure by Special Warrant on the following conditions:

- (a) The Minister of Finance is authorized to sanction, without prior approval of the Council and on his own responsibility, additional provision under any individual Subhead and for any amount on the clear understanding that such additional provision –
 - (i) will not cause an excess on the Head of that Subhead, e.g. the extra sum required will be recovered from savings from other subheads of the same Head and in the case of exceptional, urgent and unforeseen expenditure from the Head "Contingencies and Reserve";
 - (ii) will not be of a nature as to raise a question of principle or involve a breach of some regulations;
- (b) The Minister of Finance should submit to the Council for covering approval of all the additional provisions so sanctioned at quarterly or shorter intervals, as the case may be; and

- (c) If for any reason the Minister of Finance was not prepared to approve an application for a Special Warrant, then the Minister concerned could ask that the matter be referred to the Council for a decision.

Under the provisions of Section 4(2) of the annual Budget Law, a statement, showing all Special Warrants issued and the circumstances under which they were issued, must be laid before the House within one month from the date of the Council's authority for their issue.

Special Warrants issued by the Minister of Finance can only be reported to the House after the Council's covering approval is obtained.

Special Warrants issued as a direct charge on the Consolidated Fund, in accordance with Article 166 of the Constitution, can be issued by the Minister of Finance, without any reference to the Council. Similarly these Special Warrants do not have to be reported to the House.

Under the provisions of section 4(3) of the Budget Law any excess of votes in contravention of the procedure described above is deemed to be as not legally made and the controlling officers of the votes under which the excess has been made, are held personally liable for any excess expenditure incurred or to be incurred.

Supplementary Appropriation

Under the provisions of Article 167(5) of the Constitution and the provisions of Section 4 of the annual Budget Law, supplementary appropriation by the House is required under the following circumstances:-

- (a) when no equivalent savings are available under other Subheads of the same Head of Expenditure;
- (b) when the additional expenditure has to be charged to a new Subhead even though equivalent savings are available under other Subheads of the same Head; in these cases the savings are shown on the relative bill; and
- (c) when the additional expenditure can not be met from funds approved under Head "Contingencies and Reserve".

Supplementary appropriation is made by the introduction by the Minister of Finance of a Supplementary Appropriation Bill to the House. As no Bill, however, can be introduced to the House without the prior approval of the Council, the matter must first be submitted to the Council for its approval.

On the enactment of the Bill by the House and on its publication in the Official Gazette as a Law, a Special Warrant is issued in the usual way. Such Special Warrant does not have to be reported to the House.

Daggered Votes – Procedure for de-daggering

In certain cases it is found necessary to restrict expenditure on a number of votes until the Ministry of Finance (for current expenditure) and the Planning Bureau (for development expenditure) have had the opportunity to examine the case/project programme/scheme in more detail and to assess the full financial impact of its implementation.

The above objective can be achieved by marking the votes in question with a dagger(+). No expenditure can be incurred from daggered votes unless funds therefrom are de-daggered by the Minister of Finance through the Budget and Fiscal Control Directorate of the Ministry of Finance.

Before funds can be de-daggered, the Ministry and or the Department concerned have to send full details of the project/programme/scheme to the Ministry of Finance and the Planning Bureau for ordinary and development expenditure respectively, for consideration. The final approval for de-daggering rests with the Minister of Finance.

Amendment Bills

Any other modification of the Budget during the year which is not related to Supplementary Appropriation i.e. change of a Title of Post, change of salary scale of a post, abolition of an existing post of votes or a change in the description of a Head or Subhead should be made with the submission of an amendment Bill to the Council of Ministers for approval and onward transmission to the House of Representatives for enactment.

An Amendment Bill is also required in the cases of an excess in an expenditure vote of past year's budget which had not been covered during the course of that particular year.