PUBLIC FINANCES, BUDGETARY DEVELOPMENTS AND PLANNED CHANGES IN THE EU AND IN CYPRUS

A slow recovery after the crisis

All European Union countries have been affected between 2008 and 2010 by the economic and financial crisis and after a contraction in 2009 in every EU country, except Poland, growth returned in 2010 in all but five peripheral countries. While in 2010 several countries continued to support their economies through discretionary measures, other countries had less room for manoeuvres given their underlying public finance situation trying to consolidate them. In 2011 this consolidation is being stepped up, with all euro area Member States improving their underlying budget balance through fiscal tightening.

In the EU 27, because of lasting weaknesses to the public finances, debt is forecast to rise from 59.0% of GDP in 2007 to 83.3% in 2012. For the euro area the corresponding figures are in increase from 66.3% to 88.7%. On the other hand, EU Member States are required by the Treaty to ensure that their government deficits do not exceed 3% of GDP and that their debt levels should be declining below 60% promoting, in parallel, long-term sustainability.

Consolidation plans

The Stability and Convergence Programmes (SCPs) set out Members States' budgetary strategies to meet the requirements in the EDPs and their progress towards meeting Medium Term Budgetary Objectives (MTOs) over the coming years. In early 2011, the newly introduced European Semester allows for policy advice to be received by Member States ahead of the approval of their 2012 budgets.

According to the "2011 Report on Public Finances in EMU", the coming years will be difficult, in part because the imprudent policies of the years before the crisis have left their sign. Further, the provisions of the Stability and Growth Pact (SGP) were not sufficient to ensure that prudent policies were pursued.

Reform of the budgetary surveillance

As a result of the weakness identified in the pre-crisis EU-level budgetary surveillance, the Commission has proposed a reform package with the aim of reforming both the preventive and the corrective aims of the GDP. The objective of this reform should improve the Pact's ability to ensure strong public finances with the introduction of sanctions and two new enforcement mechanisms, at least for the euro area countries. At the time, when an excessive deficit is identified by the Council, the euro area country in question may already become liable to a non-interest-bearing deposit. It may also be upgraded to a fine, if the country is later found not to have taken sufficient action in response to the initial recommendations to correct the excessive deficit.

Nevertheless the EU rules cannot be effective without national decision-making supporting them, so a new directive on national fiscal frameworks is part of the reform process.

ESM and debt sustainability in the EU

Alongside the assistance programmes and the temporary vehicles for delivery funds, the euro area Member States have put together the permanent European Stability Mechanism (ESM) offering financial assistance to countries facing difficulties financing their debt on the financial markets.

It is important for the Member States to be able to assess sustainability and for this purpose, new methodologies are being developed providing a probability distribution of the impact of the banking crisis on the public finances or using country-level fiscal reaction functions which assess how government deficits have in the past reacted to the debt level by a number of macroeconomic and institutional determinants.

The EU and its Member States have provided financial support to a number of Member States facing problems in meeting their international payment obligations or financing their debt. Certainly, it has to be fulfilled the condition that they implement a closely monitored programme of economic adjustment based on a Memorandum of Understanding. The main objective of the assistance programmes is to restore market confidence in a Member State by correcting financial, external and fiscal imbalances, maintaining banking sector stability, increasing potential growth and restoring competitiveness. These changes involve income and social security policies for the restoration of competitiveness with social buffers, as well as structural reforms that boost the economy’s capacity to produce, save and export for the medium-term recovery.

The QUEST model

QUEST is a global macroeconomic model developed by the Commission. Parameters such as country size, openness, government sector size and effective tax rates are calibrated to average values for EU Member States. The QUEST model distinguishes firm, household and government sectors and on the expenditure side, a clear distinction is made between government consumption, government investment and transfers. On the revenue side, the model distinguishes between tax from labour, consumption and capital.

The comparison of alternative consolidation scenarios demonstrates that fiscal consolidation should be implemented in a timely manner, as this contains the already accumulated debt stock. The possible delay of the consolidation to the medium or long term may lead to debt levels that cannot be serviced anymore through tax revenues.

Recent economic development in Cyprus and challenges

The moderate recovery of Cyprus economy after experiencing in 2009 the first economic contraction in 35 years, by 1.75%, is foreseen to grow by 1.5 % in 2011 and 2.4% in 2012. Cyprus faces a set of interrelated policy challenges: i) reducing the high general government structural deficit and ensuring the long term sustainability of public finances in view of the demographic population ageing; ii) restructuring the economy with emphases on high-skilled jobs and training of the low-skilled groups; iii) ensuring wage and price adjustment to regain and sustain competitiveness; iv) promoting innovation and ICT capacity mainly in the private sector and v) improving efficiency of public spending and ensuring a reallocation of public expenditure towards growth-enhancing items including weaknesses in energy and transport infrastructure.

According to Cyprus Stability Programme, the cumulative reduction of the deficit amounts to 3.7% of GDP up to 2014 and it is solely expenditure based. The Programme foresees that the headline deficit will improve gradually from a target of 4 GDP in 2011 to 2.6% in 2012, which is the deadline set by the Council for the deficit correction. The Stability Programme update projects a continuation of the reduction in the budget deficit until the end of the programming period.

However, the Medium – Term objective, (MTO) which the Stability Programme reaffirms as a balanced budget, will not be met during the period and the budgetary outcomes could turn out worse than projected in the programme. Moreover, the timely implementation of fiscal consolidation measures and the practice of adopting supplementary budgets during the course of the year may arise risks. Given the large size of the banking sector and the challenging economic and financial environments, the strengthening further the framework of banking supervision to ensure early detection of risks, would be necessary to safeguard the sector is stability and its growth.

The national targets derived from the Europe 2020 headline targets are likely to contribute positively to strengthen productivity and potential output growth and to enhance the competitiveness in Cyprus economy. Further, the country's strategic objective to create high productivity jobs would benefit from a reorientation of the education and training system to match with labour market demand adapted to knowledge better competition. Boosting effective competition and setting prices that reflect social costs levels would improve the sustainability and efficiency of services.

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