Malta:

Update of Stability Programme

2013 - 2016

Ministry for Finance
April 2013

The following symbols have been used throughout this document:

. . .	to indicate that data are not available;
—	to indicate that the figure is negligible;
0	to indicate that the figure is zero;
-	to indicate that data are not applicable or cannot be determined;
n/c	to indicate that there is no change in the data.

Figures may not add up due to rounding.

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Introduction

This Programme constitutes the fifth update of Malta's Stability Programme which was submitted in 2007. The first Update was submitted in December 2008. This Programme has been prepared in accordance with Council Regulation (EC) No. 1466/97 as amended by Council Regulation (EC) No. 1055/05 and Council Regulation (EC) No 1467/97 as amended by Council Regulation (EC) No. 1056/05.

This Programme is also in line with the new requirements of the Stability and Growth Pact, namely the amendments to Council Regulation (EC) No. 1466/97 by Council Regulation (EU) No 1175/2011 of the European Parliament and of the Council of 16 November 2011 and the amendments to Council Regulation (EC) No 1467/97 by Council Regulation (EU) No 1177/2011 of 8 November 2011. The programme also takes into account Council Directive 2011/85/EU of 8 November 2011 on the requirements for budgetary frameworks of the Member States.

The document is in line with the Specifications on the implementation of the Stability and Growth Pact and Guidelines on the format and content of Stability and Convergence Programmes, endorsed by the ECOFIN Council on 3rd September 2012.

This document was compiled by the Ministry for Finance, with an important contribution from the National Statistics Office as well as from other Ministries and entities. The programme was prepared in the main prior to the New Government administration coming into office mid-March and therefore on the basis of policies proposed in the November 2012 Budget Speech. The statistics underpinning the Programme were however updated.

The Programme includes seven sections: Chapter 1 presents Government's objectives for economic policy; Chapter 2 presents the main macroeconomic projections for the medium-term as well as the potential impact of a selection of structural reform measures; Chapter 3 outlines the overall fiscal policy strategy and updated budgetary plans for the current year, followed by a presentation of the medium-term fiscal projections and debt developments; the budgetary implications of major structural reforms featuring in the National Reform Programme are also outlined; Chapter 4 contains a sensitivity analysis of the budgetary projections as well as a comparison between the current forecasts and those presented in the April 2012 Update of the Stability Programme; Chapter 5 reviews the long-term sustainability of public finances; Chapter 6 analyses the quality of public finances, and finally Chapter 7 reviews the institutional features of public finances.

1. Overall Policy Framework and Objectives

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The ongoing restructuring of the Maltese economy underlines the continued resilience of the Maltese economy and its capacity to create jobs despite the disappointing pace of the global economic recovery. Nevertheless, economic conditions for 2012 have turned out to be worse than expected. In the Update of the Stability Programme of 2012, the Maltese economy was expected to grow at 1.5 per cent and was expected to be supported by a very modest growth among Malta's main trading partners. Real GDP growth among Malta's main trading partners turned out to be even weaker than expected, particularly due to a weaker performance in Italy, France and the UK. Nevertheless, the weaker growth in domestic demand, particularly the decline in consumer's expenditure, was the main contributor to the weaker than expected economic recovery in 2012.

It is worth pointing out that the negative growth in private consumption expenditure observed in 2012 does not appear to be explained by a weakening of fundamentals, with monetary conditions being supportive of higher consumer demand and compensation of employees rising by more than 4 per cent particularly as a result of rising employment. This indicates that the weak domestic demand experienced in 2012 was partly the result of uncertainty with consumers preferring to postpone consumption and increase their savings. As a result, the rather weak domestic demand conditions are expected to recover gradually over the medium-term.

More importantly, revised economic projections point to a weaker recovery in economic growth performance over the short to medium-term in line with the weaker growth prospects among Malta's main trading partners. It is worth pointing out, that whereas last year the spring European forecasts were pointing to a relatively robust growth among Malta's main trading partners of 1.5 per cent for 2013, more recent growth projections upon which the forecasts presented in this Programme are based, are likely to be closer to 0.5 per cent. The weaker recovery expected among Malta's main trading partners partly underlines the lower growth projections for 2013 and beyond in this Stability Programme.

The economic growth projections are relatively prudent when compared to the forecasts of international institutions such as the European Commission's winter economic forecast and the forecasts recently published by the Central Bank of Malta. The revised forecasts point to a slower recovery in the negative output gap supported primarily by domestic demand conditions.

The pace of economic growth coupled by mild inflationary pressures and population dynamics underline the budgetary projections presented in this Update. It is however worth pointing out that the deficit reduction expected in the short-term is primarily supported by structural measures with cyclical conditions expected to contribute only marginally to the reduction in the general Government budget deficit.

In 2012, a general Government budget deficit of 3.3 per cent of GDP was registered. This was partly the result of weaker than expected growth. But more importantly, the composition of growth also proved to be less tax rich. Indeed, the major slippage in the revenue side recorded in 2012 related to taxes on production and imports, which are relatively more sensitive to private consumption than to other components of the budget. This was partly mitigated by a higher than expected increase in taxes on income and wealth, consistent with a stronger growth in employment and a stronger than expected contribution from corporate tax revenue. From the expenditure side, compensation of employees and intermediate consumption of general Government increased in excess of what was anticipated. On the back of a higher absorption of EU funds, Government gross fixed capital formation increased in 2012, reaching a positive 3.1 per cent of GDP. This level of public investment is deemed to provide a more meaningful support to economic activity both in the short-term and the long-term.

Going forward, a structural fiscal consolidation effort is expected to underline the reduction in the deficit from 3.3 per cent of GDP in 2012 to 2.7 per cent of GDP in 2013. This is supported by a number of structural budget measures, among the most important are the pension reform initiatives. These are expected to contribute both to higher revenue in line with the gradual rise in social contributions and a lower rise in pension

expenditure as a result of the gradual rise in pension age. The correction in the deficit in 2013 is expected to be permanent with no major resort to one-off deficit reducing measures and on the back of unfavourable cyclical conditions. Government is committed towards an average annual structural improvement consistent with the requirements of the Stability and Growth Pact (SGP) until a balanced budget in structural terms is achieved. The medium term objective is however expected to be reached beyond the Programme period.

Amid the persistent tensions in international financial markets Government is committed to strengthen further the financial stability of the Maltese economy. Government believes that sound public finances, sustainable economic growth and a robust financial sector should provide investors with the confidence to continue investing in the Maltese economy. To this effect, Government is proposing a number of measures in this Programme to strengthen the fiscal framework, also in line with the new requirements of the SGP and the commitments under the Fiscal Compact. This will include the introduction of fiscal rules, the institution of a Fiscal Council and the launch of a more binding medium-term budgetary framework. Furthermore, the structural reforms highlighted in the National Reform Programme which are partly financed by public funds will also promote economic stability. Coupled with measures aimed at strengthening further the financial sector, these measures are expected to strengthen further what is already considered a sound and stable economy.

2. Economic Outlook

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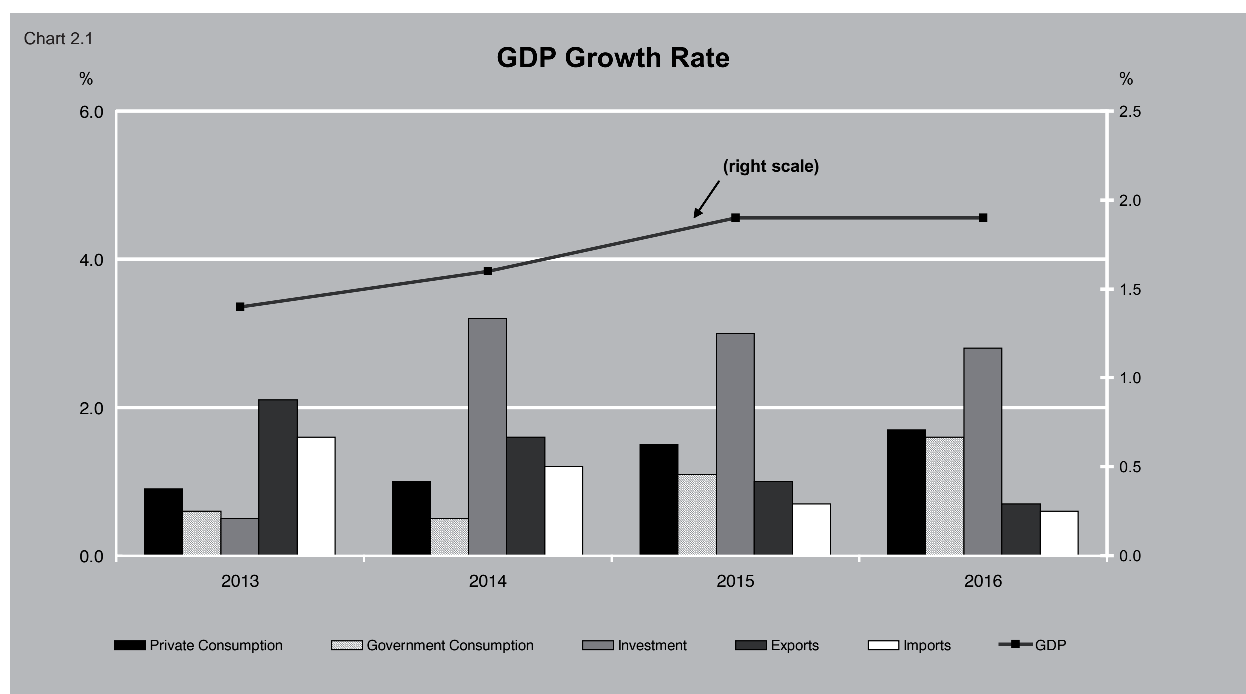
2.1 The Medium-Term Scenario

The problems that caused the international recession at the end of 2007 were due to deep structural faults in the form of fundamental imbalances that have built up for decades. Such deficiencies could not be resolved overnight and the adjustment is still ongoing. Nevertheless, in 2012 the Maltese economy continued to grow albeit at a slower rate where a slight contraction in GDP was registered in the first quarter of the year. This slower pace of growth can be partly attributed to the developments in the Euro Area where the loss of economic momentum was stronger than anticipated. However, on a more positive note, the risk of an outright credit crunch in the Euro Area as a whole has decreased. Nevertheless, the EU's economy is estimated to have contracted in 2012 and to marginally grow in real terms in 2013 according to the latest forecasts issued by the European Commission. However, growth is expected to pick up in 2014 on the back of a more sustained growth in both investment and consumption.

Despite the uncertainty in the international sphere, especially in the peripheral economies of the Euro Area, the Maltese economy still managed to register positive growth during 2012. Latest data released by the National Statistics Office (NSO) show that the economy expanded by 0.8 per cent in real terms during 2012 on a year-on-year basis mainly on the back of a strong performance in exports and in government final consumption expenditure. The external sector contributed 1.0 percentage point towards overall growth while domestic demand contributed 0.4 percentage points. Growth in the domestic sector was underpinned by growth in government expenditure which expanded by 5.5 per cent. On the other hand, there were contractions in both private consumption and in gross fixed capital formation which both registered declines of 0.6 per cent and 2.5 per cent, respectively.

In 2013, the Maltese economy is expected to continue growing at an expected growth rate of 1.4 per cent in real terms. This growth rate is expected to be underpinned by positive developments in both the domestic and the external sectors of the economy. Private consumption is expected to increase by 0.9 per cent while government expenditure is expected to increase by 0.6 per cent during 2013. Investment is also forecasted to increase marginally by 0.5 per cent mostly underpinned by increases in public investment. When compared to 2011, export performance in 2012 was also positive, albeit increasing at a slower pace of growth. This positive growth in net exports is expected to persist during 2013 with exports expected to increase by 2.1 per cent compared to an expected growth rate of 1.6 per cent in imports.



Main Macroeconomic Indicators

Table 2.1

	2011	2012	2013[1]	2014	2015	2016
GDP growth at current market prices (%)	3.8	3.0	3.3	3.8	4.2	4.3
GDP growth at constant (2000) prices (%)	1.7	0.8	1.4	1.6	1.9	1.9
Expenditure Components of GDP at constant (2000) prices (% change)						
Private final consumption expenditure[2]	3.3	-0.6	0.9	1.0	1.5	1.7
General government final consumption expenditure	3.8	5.5	0.6	0.5	1.1	1.6
Gross fixed capital formation	-14.1	-2.5	0.5	3.2	3.0	2.8
Exports of goods and services	0.8	5.2	2.1	1.6	1.0	0.7
Imports of goods and services	-2.0	4.4	1.6	1.2	0.7	0.6
Inflation rate (%)	2.5	3.2	2.0	1.6	1.7	1.8
Employment growth (%)	2.5	2.4	0.7	0.9	0.7	0.9
Unemployment rate (%)	6.5	6.4	6.6	6.4	6.1	5.7
Labour productivity (% change)	-1.1	-0.5	0.2	0.8	1.3	1.2
External Goods and Services Balance (% of GDP)	4.1	5.1	5.6	5.8	6.0	6.0

[1] Forecasts from 2013 onwards

[2] Includes NPISH final consumption expenditure

The composition of growth determinants from the expenditure side is expected to change for the 2014-2016 period, with a declining contribution from the external sector countered from an increasing contribution from domestic demand. Private consumption is expected to increase further in 2014 by 1.0 per cent and to increase thereafter for 2015 and 2016 by 1.5 per cent and 1.7 per cent, respectively.

Chart 2.1 illustrates the projected growth rate of GDP together with a detailed breakdown of the various expenditure aggregates. Table 2.1 presents the main macroeconomic indicators for the years 2011-2016. The figures for 2011 and 2012 have been published by the National Statistics Office (NSO), whilst figures from 2013 onwards are forecasts. The macroeconomic forecasts take into account the latest available data and are being provided in Tables 1a, 1b, 1c, and 1d of the Statistical Appendix.

2.1.1 Assumptions for Projections

The macroeconomic forecasts presented in this year's Update of the Stability Programme are based on the following assumptions:

- Economic activity in Malta's main trading partners is expected to increase by 0.5 per cent in 2013 followed by positive growth rates of 1.5 per cent in 2014 and by 1.8 per cent thereafter.
- Oil prices are assumed to remain relatively stable for 2013 at an average of US$111.1 per barrel (€85.4 per barrel) and to decrease marginally thereafter.
- Both short-term and long-term interest rates are assumed to remain broadly stable during the forecast period. The real effective exchange rate is also assumed to remain broadly constant for the remaining forecast period.

- It is being assumed that, in line with Government policy, Government employment follows a downward trajectory as Government restricts recruitment in non-essential categories.
- Changes in inventory are assumed not to contribute materially to GDP growth.

2.1.2 Risks to Outlook

The medium-term outlook for the global economy is one of steady growth. Nevertheless there are a number of factors that could restrain growth prospects.

The macroeconomic forecast is subject to developments in the global economy and to the Euro Area in particular and these in turn are subject to a degree of uncertainty. Among the most immediate risks is the possibility of a renewed escalation of the crisis in the Euro Area. Furthermore, weaker than expected global economic growth could impact adversely on Malta's main trading partners and as a result exports prospects will be negatively hit. Another downside risk stems from the possibility of heightened geopolitical uncertainty that could trigger a sharp increase in the price of oil. On the other hand, there are also a number of upside risks: growth might turn out stronger than projected, particularly in emerging economies which could help a more rapid recovery in Malta's main trading partners. Greater confidence stemming from successful policy measures and waning supply-side disruptions, if the risk premium in oil prices dissipates, could foster a more forceful rebound in investment. It is worth noting that the projections do not include the impact of a substantial investment in the energy sector. Such investment could also raise private investment in excess of what is being projected. A weaker euro exchange rate against the US Dollar and the UK Sterling would also make Maltese exports more competitive and boost external demand for Maltese output, however, it could also raise the cost of imported inputs. Projections are based on a continuation of wage moderation in the short-term supporting employment growth and a relatively mild (though stable) increase in private consumption. Overall, the risks surrounding the forecasts remain significant and are broadly balanced.

2.1.3 Private Final Consumption Expenditure

After the negative growth rate of 0.6 per cent in 2012, private consumption expenditure is expected to pick-up in 2013. Indeed, private consumption expenditure is forecasted to increase by 0.9 per cent in real terms in 2013, sustained by a positive performance in employment growth and a moderate appreciation of wages over the forecast horizon. In 2014, growth in private final consumption expenditure is expected to improve, increasing to 1.0 per cent and to significantly improve, increasing to 1.5 per cent and 1.7 per cent in 2015 and 2016, respectively.

2.1.4 General Government Final Consumption Expenditure

Growth in Government final consumption expenditure is projected to decelerate significantly and to increase marginally by 0.6 per cent in real terms in 2013, following the 5.5 per cent growth in 2012. This slower pace of growth in Government expenditure reflects the effort underway in terms of the fiscal consolidation strategy with special emphasis placed on the restraint of expenditure of a recurrent nature. Government final consumption is expected to increase by 0.5 per cent in real terms in 2014 and to grow further for the outer years of the forecast period with forecasted rates of 1.1 per cent and 1.6 per cent in 2015 and 2016, respectively.

2.1.5 Gross Fixed Capital Formation

Gross fixed capital formation is expected to increase only marginally during 2013 by 0.5 per cent in real terms as growth in private investment is still expected to remain negative while public investment is expected to improve. With regards to the outer years, investment is expected to continue expanding, with private investment becoming the major contributor to overall investment as growth in profits gains momentum and external demand is assumed to recover, albeit gradually to more positive levels.

2.1.6 External Balance of Goods and Services

During 2012, net exports continued to contribute positively to growth. This positive performance is expected to continue during the forecast period, albeit at a slower pace. Nevertheless it should be noted that growth in exports is not expected to be very strong over the short-to-medium term amid continued international uncertainty.

For 2013, exports are expected to increase by 2.1 per cent while imports are expected to grow by 1.6 per cent. The gap between exports and imports is expected to decrease over the forecast period with exports expected to increase by 1.6 per cent while imports are expected to increase by 1.2 per cent in real terms in 2014. Thereafter, net exports are expected to continue decreasing with exports expected to increase by 1.0 per cent and 0.7 per cent for 2015 and 2016, respectively while imports are expected to increase by 0.7 per cent and by 0.6 per cent in real terms, respectively for the same comparable period. Contribution from the external sector is expected to decelerate in 2013 and thereafter from 0.6 percentage points in 2013 to 0.2 percentage points in 2016.

2.1.7 Productivity and Employment Prospects

The labour force survey recorded a growth rate of 2.5 per cent in 2011 and a 2.4 per cent growth in 2012 in total employment, while growth in employment is expected to slow down in 2013 to around 0.7 per cent. An average employment growth of 0.8 per cent is consistent with a more moderate growth in exports and domestic consumption when compared to last year's projections. This is supported by a higher female employment rate, partly reflecting increased efforts from Government to increase female participation, and an increase in employment flexibility in terms of labour hours. It is notworthy that growth projections are not strictly comparable to last year due to structural alterations in the model involving employment and output projections carried out this year.

A slower than expected recovery with a persistent negative output gap in the short-term is consistent with a slower growth in employment. The growth in employment is however sustained by wage moderation expected over the forecast period except until 2015. Average wages are expected to grow moderately, with compensation per employee forecasted to grow by 0.7 per cent in 2013 and by around 1.1 per cent and 1.3 per cent in 2014 and 2015, respectively. However, compensation per employee is expected to recover in 2016 by 3.4 per cent. Given the increases in employment and developments in compensation of employees, labour productivity is expected to be positive over the forecasted period with an expected average growth of 0.9 per cent during the 2013-2016 period.

Growth in output is expected to be supported by the emerging growth sectors with the possibility of gaining market shares in industries such as pharmaceuticals, aircraft maintenance, remote gaming and the financial and related business services. These sectors will increasingly offset the decline of more traditional sectors of the Maltese economy and are likely to further increase the openness of the economy.

In 2013, the unemployment rate (based on the Harmonised definition) is expected to increase by 0.2 percentage points to 6.6 per cent and to decrease gradually thereafter over the forecast period to 5.7 per cent. Over the medium-term, this is supported by a weaker decline in the working age population when compared to employment growth.

2.1.8 Inflation

During 2012, recorded inflation (calculated as the twelve month moving average of the HICP) stood at 3.2 per cent with significant increases registered in restaurants and hotels, in food and in transport. These upward pressures are expected to persist during 2013, although at a slower pace. Inflation is expected to decelerate to 2.0 per cent in 2013 while for 2014 inflation is expected at 1.6 per cent. For the outer years, inflation is expected to remain stable at an average rate of around 1.8 per cent.

2.1.9 Comparison to Commission's Winter Forecast

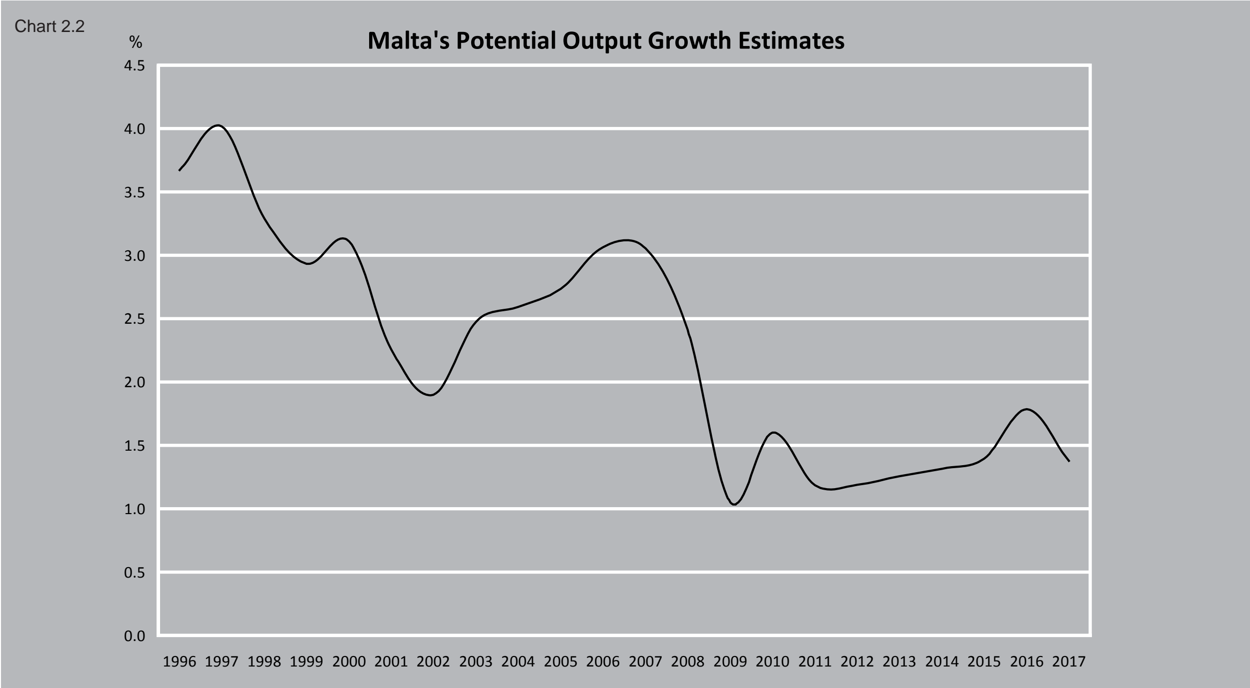
The winter forecasts published by the European Commission project a growth rate for Malta of 1.5 per cent in 2013 and to 2.0 per cent in 2014, as domestic demand gradually strengthens to become the main driver of growth. Forecasts for real GDP growth in 2013 presented in this Programme are 0.1 percentage points lower than the rate forecasted by the European Commission. This is attributed mainly to a higher expected net contribution from the external sector and a lower contraction in domestic demand than that recorded in the Commission's winter forecast. Both sets of forecasts are consistent with a domestically-led growth scenario. Growth forecasts for 2014 are 0.4 percentage points lower than those forecasted by the European Commission winter forecast, mainly due to lower domestic demand. Forecasts presented in this Programme are also lower when compared to the recent forecasts published by the Central Bank of Malta, as the latter projects a real growth rate of 1.4 per cent and 1.8 per cent for 2013 and 2014, respectively.

With regards to nominal GDP, the MFIN is expecting a growth rate of 3.3 per cent and 3.8 per cent for 2013 and 2014, respectively, being relatively cautious by 0.8 percentage points and 0.6 percentage points, respectively when compared to the European Commission's winter forecast.

2.2 Potential Output and the Output Gap

The estimation of potential output and the output gap[1] within this Update of the Stability Programme is based on the commonly-agreed Production Function method. The main differences between ECFIN and the Government's estimation pertain to differences in the macroeconomic forecasts and the working age population. Developments in the output gap are presented in Chart 2.2.

The first half of the past decade was characterised by a low rate of economic growth compared to the average rate of economic growth that had been registered in preceding years. Indeed, during the period 2001-2005, economic growth averaged 1.3 per cent. This slowdown in economic growth was underpinned by a combination of international developments and domestic factors. Following EU accession, the Maltese economy exhibited a notable improvement in growth prospects and during the period between 2006 and 2008, annual economic growth increased notably to around 3.5 per cent. This strong performance was however curtailed with the advent of the financial crisis in 2008 and the subsequent global recession, the effects of which are still currently impacting the world economy. As a result, during 2009, the domestic



[1] Defined as actual output less potential output as a per cent of potential output.

economy shrank by 2.6 per cent. On a positive note however, the Maltese economy exhibited a rather rapid recovery from the recession, and grew at a rate of 2.9 and 1.7 per cent during 2010 and 2011 respectively. The latter recovery was underpinned by a sustained strong performance in the external sector. During 2012, the recovery lost momentum and an economic growth of 0.8 per cent was registered since the impact of the crisis in the Euro area had a negative impact on the external sector's contribution to economic growth.

Average potential output growth, which is a measure of the growth potential of the economy, stood at 1.9 per cent during the period 2006 – 2012. This rate of growth is marginally lower than the average potential growth rate pertaining to the period 2000 – 2005. It is pertinent to point out that the rate of growth of potential output decelerated markedly from the year 2009 onwards. This deceleration is expected to reach a through in 2011, and to exhibit a marginal gradual increase over the forecast period. This slower growth rate in potential output was underpinned by lower contributions from both potential labour input, mainly from a lower contribution of average hours worked and a lower contribution from the capital factor. Over the forecast period 2012 – 2016, average potential growth is expected to hover around the 1.4 per cent level, mainly underpinned by positive developments in the labour market, largely through a higher participation rate, and improvements in total factor productivity. Investment activity is however expected to remain subdued in the short term.

The output gap, is defined as the difference between actual and potential output, expressed as a ratio of potential output. The gap is indicative of the cyclical developments prevailing in the Maltese economy. Following a number of years where the Maltese economy operated with a positive output gap, the output gap turned negative in 2003. Actual output remained below the potential level up to 2007, when the output gap turned positive. However, following the international recession and the subsequent contraction of the domestic economy in 2009, the output gap turned negative yet again. Indeed, in 2009 the output gap is estimated to have declined to a negative of 2.0 per cent. In the subsequent three years, although the negative gap between potential and actual output contracted, the output gap remained negative and is estimated to have stood at to a negative 0.7 per cent in 2012.

During the forecast period the output gap is estimated to continue closing down steadily until the year 2015. In the outer years of the forecast period the output gap is expected to remain positive with the Maltese economy registering a rate of economic growth that is slightly above potential.

2.3 Potential Growth and Structural Reforms

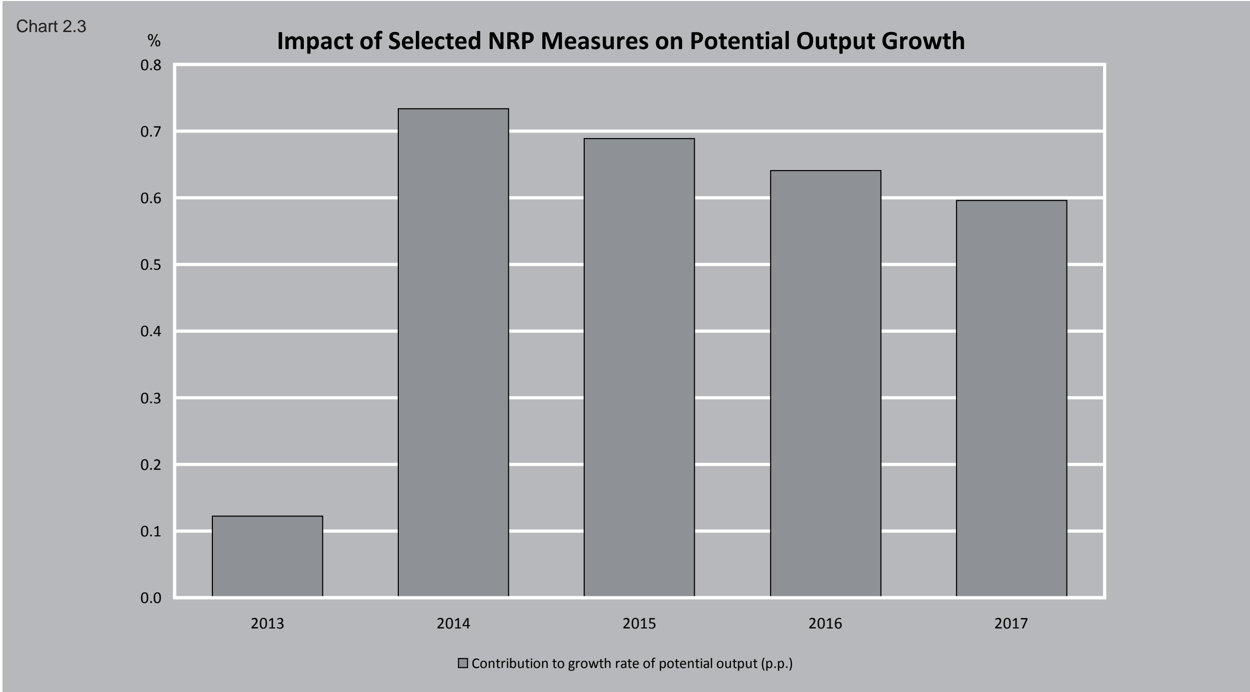
On-going and planned structural reforms have an important impact on the country's potential output. In an attempt to counteract the negative impact of global economic slowdown on Malta's potential output growth, the Maltese Government has since introduced a number of measures aimed at enhancing the capacity of the Maltese economy to generate sustainable growth. In fact, from 2012 onwards Malta's potential output is expected to follow an upward trend, peaking at 1.8 per cent in 2016.

This section presents estimates of the impact of planned new measures as outlined in this year's NRP on Malta's potential output. However, estimates presented in this section include only a selection of measures for which the impact was quantifiable. These include Microinvest, the Microgurantee scheme, B-Start, tax incentives for licensed hotels, and selected measures related to CSR 5, which include the electricity interconnector, the development of an electricity distribution network and the use of smart meters.

The estimates were generated on the basis of a commonly-agreed method which is based on a Cobb-Douglas production function. However, it must be noted that the estimation of the output gap is subject to an element of uncertainty since potential growth is not directly observable while actual GDP is subject to revisions. Given the uncertainty surrounding output gap estimates, due care must be taken in interpreting their size and evolution.

Chart 2.3 shows that in 2013 these measures will account for around 0.12 percentage points of the growth

rate in Malta's potential output. This is expected to increase to 0.73 percentage points in 2014 and then to follow a moderate downward trend until it reaches 0.60 percentage points in 2017. A detailed discussion on the included measures is presented in NRP 2013.



3. General Government Balance and Debt

3. General Government Balance and Debt

After reaching a peak in 2008, the general Government deficit narrowed gradually, reaching 2.8 per cent of GDP in 2011, below the 3 per cent of GDP reference value. Accordingly, the Council of the European Union decided that the excessive deficit situation in Malta had been corrected.

During 2012, the deficit-to-GDP ratio increased by 0.5 percentage points to 3.3 per cent of GDP on the back of an unexpected worsening of economic conditions and a negative output gap. Although above 3 per cent of GDP, the ratio remains close to the reference value. As is explained in more detail in this Chapter, developments in 2012 were influenced by several factors which impinged negatively on public finances. Nonetheless, the increase in the general Government balance above the 3 per cent of GDP reference value is expected to be temporary and exceptional. Indeed, over the medium-term, the general Government deficit is expected to decline below the reference value even if one excludes one-off deficit reducing items.

Government's fiscal policy objective remains that of ensuring a sustainable fiscal position by gradually but consistently reducing the fiscal imbalance, to reach a balanced budget in the realistically shortest time possible. Fiscal consolidation is necessary to ensure the sustainability of Government's financial position, thus securing a stable macroeconomic framework, as well as to re-establish the role of fiscal policy as an instrument for economic stabilisation purposes. Achieving a sustainable fiscal position is essential to regain the necessary fiscal flexibility that would spur long-term economic growth. In this context, the decline in the ratio of general Government deficit-to-GDP is expected to be sustained and the fiscal imbalance is projected to be reduced further from 2.7 per cent in 2013 to 0.8 per cent by 2016.

Government's fiscal policy is founded on various pillars. The envisaged fiscal consolidation will be primarily supported by a stable macroeconomic environment. It is imperative that the economy continues to diversify and increase its growth potential, propelled by higher labour market participation and employment, higher productive investment and increases in productivity. Growth needs to continue to be supported by a sound financial sector which is prudent and which functions within a strongly regulated framework that inspires confidence. As documented in the National Reform Programme (NRP) 2013, structural reforms are expected to sustain the economic growth prospects of the Maltese economy. The sustainability of public finances will also be aided by a strengthened national fiscal framework. Details on the latter are included in Chapter 7 of this Programme. Government spending will be reviewed to ensure the achievement of improved efficiency in public spending, reduce waste and ensure value for money, thus ensuring greater financial discipline and fiscal accountability in the public sector. Moreover, Government is strengthening and stepping up its efforts towards curbing fiscal abuse and to increase efficiency in revenue collection. This shall be achieved through the strengthening and hastening of the process of consolidating the various functions of Government revenue into one authority in order to improve efficiency in tax collection.

Government will continue to aim for a balanced structural budget as its medium-term objective (MTO). However, this target will be reached beyond the Programme period. Nevertheless, every effort will be made to ensure that the fiscal consolidation strategy outlined in this Programme is achieved.

An improvement in the primary surplus projected over the medium term, together with positive growth prospects and the retention of sustained investor confidence, should ensure improvements in the debt dynamics. In this respect, the debt-to-GDP ratio is expected to peak at a level of 74.2 per cent in 2014 and exhibit a downward trajectory thereafter, reaching a level of 70.0 per cent of GDP by 2016. Over the Programme period, the proportion of short-term debt is expected to average 4.2 per cent and hence remain at relatively low levels, in line with the recent past. Moreover, during the period 2012 – 2016 the share of maturing stocks in total Government debt is expected to range between a maximum of 9.5 per cent in 2014 and a minimum of 6.4 per cent in 2015.

3.1 Fiscal Developments in 2012

The general Government deficit narrowed gradually, reaching 2.8 per cent of GDP in 2011, below the 3 per cent of GDP reference value. Accordingly, following an overall assessment, and having regard to the European Commission recommendation, the Council concluded that Malta took effective action to bring down the general Government deficit below 3 per cent by 2011, and decided that the excessive deficit situation in Malta had been corrected.

During 2012, the deficit-to-GDP ratio increased by 0.5 percentage points to 3.3 per cent of GDP, which although above the 3 per cent of GDP threshold, remains close to the reference value.

3.1.1 General Government Revenue

In 2012, the general Government revenue-to-GDP ratio increased by 1.2 percentage points of GDP to 40.5 per cent on account of a higher tax revenue ratio. The latter increased from 27.0 per cent of GDP in 2011 to 27.7 per cent in 2012, mainly reflecting developments in the ratio of current taxes on income and wealth. The latter contributed to an increase of 0.9 percentage points in the revenue-to-GDP ratio, mainly underpinned by higher receipts from income tax paid by both individuals and companies. While the ratio of capital taxes-to-GDP remained relatively unchanged, the ratio of taxes on production and imports contributed to a decrease of 0.2 percentage points, partly offsetting the increase in the tax revenue ratio. The decrease was mainly underpinned by lower proceeds from motor vehicle registration tax, following a drop in the registration of cars in 2012, as the ratio of value-added type taxes increased only marginally.

Furthermore, marginal increases were recorded in the ratio of social contributions, property income and 'other' revenue, mainly underpinned by higher receipts from other capital transfers and investment grants.

3.1.2 General Government Expenditure

The ratio of general Government expenditure increased by 1.8 percentage points of GDP from 42.1 per cent in 2011, reflecting higher ratios recorded for gross fixed capital formation, social payments, wages, intermediate consumption and capital transfers. These were partly offset by lower expenditure ratios for 'other' expenditure.

The increase in the ratio of gross fixed capital formation from 2.5 per cent of GDP in 2011 to 3.1 per cent in 2012 is mainly underpinned by higher outlays by Extra Budgetary Units (EBUs), particularly in relation to education. Other notable increases were recorded in respect of a flood relief project, the oncology centre and information technology related outlays for the public service.

The increase in the ratio of social payments from 13.4 per cent in 2011 to 13.9 per cent in 2012 was mainly underpinned by a 0.4 percentage points increase in social transfers other than in kind. The latter mainly reflected higher outlays on retirement and widows pensions, partly stemming from the higher cost-of-living-adjustment due in 2012 (€4.66) when compared to 2011 (€1.16).

The ratio of compensation of employees to GDP increased by 0.3 percentage points in 2012, mainly on account of higher expenditure on wages and salaries of public administration and EBUs, in particular in relation to education, human health and residential care activities. This includes the impact of the sectoral and public service collective agreements which were finalised during 2012.

An increase in the ratio of intermediate consumption from 6.4 per cent of GDP in 2011 to 6.7 per cent in 2012 was mainly underpinned by increases in capital expenditure classified under this component of expenditure. Furthermore, higher expenditure related to programmes and initiatives, mainly underpinned by expenditure on street and road lighting and medicines and surgical materials also contributed towards a higher ratio in intermediate consumption. Higher expenditure was also recorded on school transport.

The ratio of capital transfers to GDP increased by 0.3 percentage points in 2012, mainly underpinned by the equity acquisition in the national airline as part of the ongoing restructuring process. Meanwhile, the ratio of 'other' expenditure to GDP marginally offset the increase in the ratio of Government expenditure, as the former decreased from 1.7 per cent of GDP in 2011 to 1.3 per cent in 2012 mainly on account of revenue accruing from the concession fee payable by the local lottery operator, which is recorded as negative expenditure.

3.2 The Medium-Term Budgetary Outlook

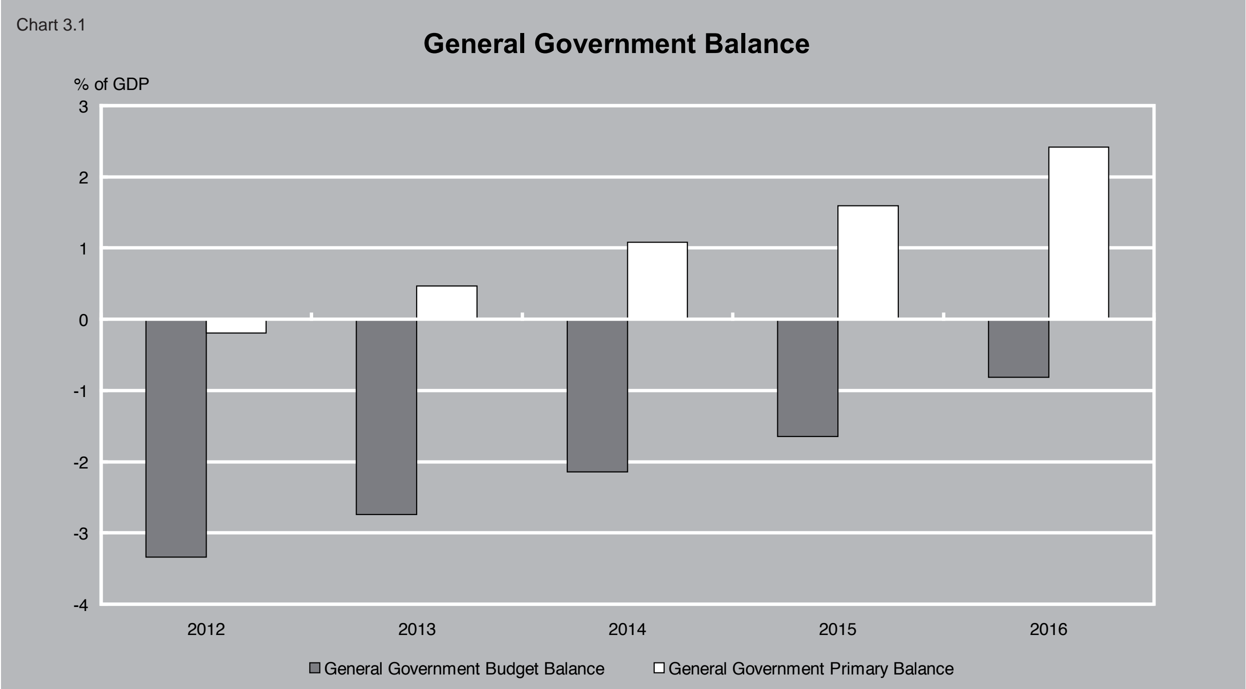
Over the medium-term, the general Government deficit as a per cent of GDP is expected to follow a declining trajectory. In fact, the general Government deficit ratio is expected to decrease from 3.3 per cent of GDP in 2012 to 0.8 per cent in 2016. Table 2a in the Statistical Appendix presents general Government revenue and expenditure projections for the 2013-2016 period.

Without policy intervention, as illustrated in Table 2b in the Statistical Appendix, the revenue ratio is expected to increase by 2.8 percentage points to 42.1 per cent of GDP in 2013 and increase further to 43.3 per cent of GDP by 2015 before declining to 41.9 per cent in 2016. Meanwhile, without policy intervention, the expenditure ratio is expected to increase to 45.1 per cent of GDP by 2014, and to recede to the levels recorded last year in the outer years of the Programme period. Developments in revenue and expenditure at unchanged policies mainly reflect developments in capital projects financed from EU investment grants. Since such revenue flows correspond to similar increases in expenditure, these only have a marginal impact on the fiscal balance.

In view of the overarching goal of ensuring the sustainability of public finances over the medium-term, the natural developments in revenue and expenditure will be supported with policies which have a positive impact on the deficit-to-GDP ratio. A more detailed analysis of Government's fiscal policy over the medium-term framework is presented in the next section.

3.2.1 The Medium-Term Fiscal Strategy

Over the medium-term, the general Government deficit to GDP ratio is expected to follow a declining trend as the increase in the general Government balance above the 3 per cent of GDP reference value is expected to be temporary and exceptional. Indeed, it is to be noted that in 2012, revised GDP figures suggest that actual



growth in GDP fell short of the potential growth rate and a negative output gap is expected to persist until 2014. Over the medium-term, GDP growth is however expected to exceed potential growth with the output gap closing gradually by 2015. Moreover, as the economic recovery becomes more sustained as from 2013, the deficit is expected to fall below the 3 per cent reference value to 2.7 per cent of GDP. Components of expenditure of a recurrent nature are expected to remain relatively stable, while the pension reform initiative legislated in 2006 is expected to lead both to revenue increases in terms of national insurance contributions as well as lowering pension expenditure, thus putting public finances on a more sustainable footing. Revenue is also expected to rebound, in particular as the loss of revenue from subdued economic activity in specific sectors last year is expected to be recovered in 2013. Details of Government's fiscal strategy are illustrated in Table 3.1.

Discretionary Factors Underpinning Fiscal Consolidation

(percentage points of GDP)

Table 3.1

	2013	2014	2015	2016
Main Measures Impacting on Revenue				
Fiscal consolidation measures	0.06	0.18	–	–
Revision in excise duty on fuel	0.06	–	–	–
Revision in excise duty on cement	–	–	–	–
Revision in excise duty on cigarettes and tobacco	–	0.02	–	–
Structural measures	–	0.17	–	–
Growth enhancing measures	-0.17	-0.17	-0.24	–
Widening of the income tax rates	-0.17	-0.17	-0.24	–
Measures promoting a sustainable environment	-0.13	–	–	–
Revision in the registration tax of private vehicles	-0.13	–	–	–
Social cohesion measures	0.16	0.16	0.16	0.16
Pension reform initiatives	0.16	0.16	0.16	0.16
Other measures	0.16	0.04	0.02	–
Efficiency in revenue collection	0.16	0.04	0.02	–
Total [1]	0.06	0.23	-0.10	0.14
Main Measures Impacting on Expenditure				
Fiscal consolidation measures	–	0.14	–	–
Structural measures	–	0.14	–	–
Social cohesion measures	0.24	0.26	0.25	0.24
Pension reform initiatives	0.27	0.26	0.25	0.24
Revision in the minimum rate of children's allowance	-0.03	–	–	–
Other measures	-0.57	-0.21	-0.57	–
Equity acquisition in Airmalta plc	-0.57	-0.21	-0.57	–
Total [1]	-0.34	0.19	-0.33	0.23

Note: positive represents a decline in the deficit-to-GDP ratio

[1] Figures may not add up due to rounding

The general Government deficit is expected to decline further as Government's fiscal policy objective remains that of ensuring a sustainable fiscal position by gradually but consistently reducing the fiscal imbalance. Indeed, the decline in the ratio of general Government deficit-to-GDP is expected to be sustained and the fiscal imbalance is expected to be reduced further from 2.7 per cent in 2013 to 2.1 per cent and 1.6 per cent in 2014 and 2015, respectively. The general Government balance will decline further to 0.8 per cent of GDP in 2016.

The envisaged fiscal consolidation will primarily be aided by a strong macroeconomic environment and a strengthened national fiscal framework. Nonetheless, Government spending will also be reviewed to ensure the achievement of improved efficiency in public spending, reduce waste and ensure value for money, thus ensuring greater financial discipline and fiscal accountability in the public sector in particular public entities and Local Councils. Moreover, Government is strengthening and stepping up its efforts towards curbing fiscal abuse and to increase efficiency in revenue collection. This shall be achieved through the strengthening and hastening of the process of consolidating the various functions of Government revenue into one authority in order to improve efficiency in tax collection. In this context, it is nonetheless worth noting that the formal budget consultation process undertaken with the general public and interested stakeholders will be initiated in the coming months. As a result of this consultation process, the strategic policy direction will be translated into more specific budgetary measures.

3.2.1.1 The 2013 Budget

The Budget for 2013 was first presented to Parliament on 28 November 2012. However, the 2013 Appropriation Act was not approved by Parliament during the vote on 10 December 2012. Accordingly, the then Minister of Finance, the Economy and Investment authorised the Accountant General, by means of a warrant dated 12 December 2012, to incur limited expenditure during the first four months of 2013, as set out in the Financial Administration and Audit Act (Cap.174). Revenue forthcoming during the aforementioned period continued to be accounted for according to regulations.

Moreover, some Budget measures were put on hold, in particular the revisions in taxation. Subsequently, the 2013 Budget was re-presented to Parliament on 8 April 2013 and approved two days later by all Members of Parliament. The newly elected Government retained the same framework of the Budget presented in November, although the macroeconomic and fiscal projections were revised to reflect the most recent developments.

As outlined in the 2013 Budget, Government is pursuing the implementation of a number of measures aimed at reducing the fiscal deficit, in particular measures impacting on revenue. As regards revenue increasing measures, the revisions to the excise duty on the consumption of petroleum, on cigarettes and tobacco products, as well as on cement, entered into force with the re-presentation of the Budget for 2013 in April 2013. Collectively, these measures are estimated to have a positive fiscal impact amounting to 0.06 percentage points of GDP.

Further to the revisions in the income tax regime in recent years, the 2013 Budget provided for the widening of the income tax bands for single and joint tax computations, and for parents supporting minors who are not gainfully employed. However, this will be implemented gradually in a manner that will limit the negative impact on public finances. In 2013, this measure is expected to exert a negative impact on public finances amounting to 0.17 per cent of GDP.

The environment constitutes an important consideration in Government's policy. In this context, the 2013 Budget announced further incentives for cleaner private vehicles. In 2013, the shift in consumer preference towards cleaner private vehicles, which incur a lower registration tax, is expected to result in lower revenue from this measure amounting to 0.13 per cent of GDP.

The Budget for 2013 also continued to strengthen social cohesion through the increase in the minimum rate for children's allowance. This policy measure is expected to exert a negative impact on public finances amounting to 0.03 per cent of GDP in 2013.

Other measures outlined in the 2013 Budget included the exemption from the transfer tax or stamp duty payable in respect of the transfer of immovable property by way of donation or causa mortis from parents to their children, which property is intended to be used or developed by the same children as their sole residence. Moreover, the Budget for 2013 also provided for an increase in the stamp duty ceiling for first time buyers at which a higher rate of stamp duty is applicable. These measures are not expected to exert a considerable fiscal impact.

3.2.1.2 Other Factors shaping Fiscal Consolidation over the Medium-Term

Demographic developments in Malta are not impervious to the dynamics of the ageing process faced by many developed countries, such that age-related spending is projected to increase in the coming decades. Nonetheless, the pension reform initiative legislated in 2006 is expected to lead both to revenue increases in terms of national insurance contributions as well as lowering pension expenditure, thus putting public finances on a more sustainable footing. Throughout the Programme period, the reform in the pension system is estimated to result in additional revenue from social contributions amounting to around 0.16 per cent of GDP each year, whilst on the expenditure side, the pension reform is estimated to reduce expenditure between 0.24 per cent and 0.27 per cent of GDP annually.

Meanwhile, Government is continuously strengthening and stepping up its efforts towards curbing fiscal abuse and to increase efficiency in revenue collection. Increased efficiency in revenue collection, which primarily includes pecuniary incentives to reduce tax arrears, is expected to yield around 0.16 per cent of GDP in 2013. This mainly reflects multi-annual contractual agreements for the settlement of arrears due in monthly instalments. Further to the measures to improve tax collection efficiency, several other initiatives are being put in place to combat tax evasion and avoidance. This shall mainly be achieved through the strengthening and hastening of the process of consolidating the various functions of Government revenue into one authority in order to improve efficiency in tax collection.

Moreover, in view of the important function of Malta's national airline in supporting the local tourism industry, the ongoing restructuring of Air Malta will be sustained by a Government equity injection, which over the medium-term budgetary outlook is expected to amount to €98 million.

3.2.2 General Government Budgetary Prospects over the Medium-Term

3.2.2.1 Determinants of the 2013 Fiscal Outcome

The increase in the general Government balance above the 3 per cent of GDP reference value is expected to be temporary and exceptional. Indeed, during the current fiscal year, the general Government balance is expected to decline to 2.7 per cent of GDP, suggesting an improvement in the fiscal position of 0.6 percentage points of GDP. The projected decline in the fiscal imbalance mainly reflects a significant improvement in the revenue-to-GDP ratio, in part offset by the expected increase in the expenditure ratio.

As indicated in Table 3.2 and Chart 3.2, the noteworthy increase in the revenue ratio, which is expected to increase by 1.58 percentage points of GDP to 42.1 per cent in 2013, is mainly on account of buoyant tax revenue measures and 'other' revenue. The latter category is expected to contribute to a 0.73 percentage point decline in the 2013 deficit-to-GDP ratio, mainly on account of EU investment grants, reflecting the expected timing of implementation of projects financed from the Financial Framework for the period 2007-2013. However, as highlighted below, such inflows correspond to similar increases in outlays and thus have a predominantly neutral impact on the budget balance.

Analysis of the Adjustment in the Deficit-to-GDP Ratio
(percentage points of GDP)

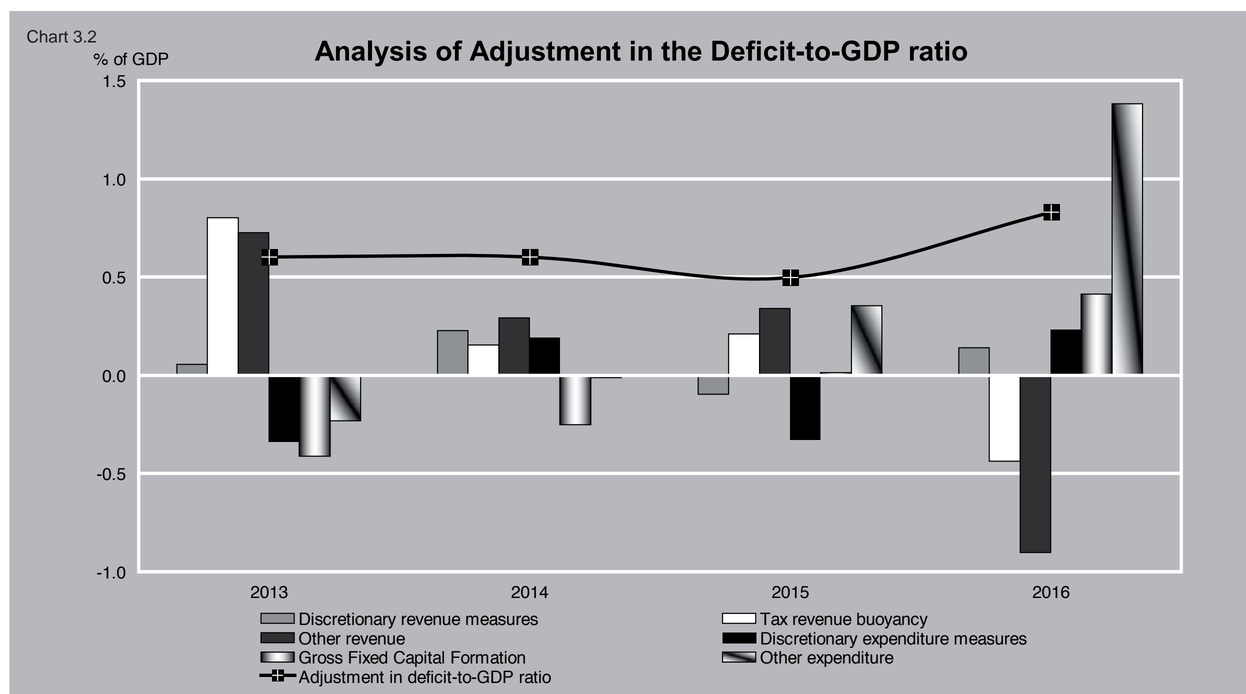
Table 3.2

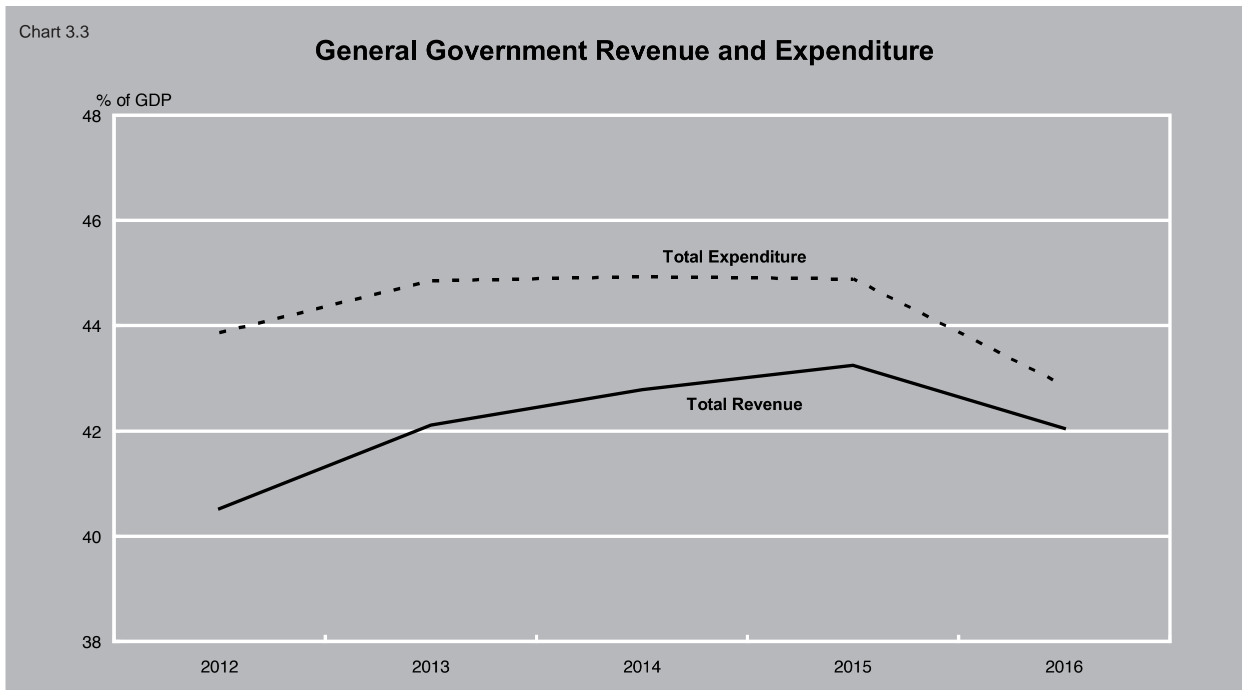
	2013	2014	2015	2016
Change in revenue ratio	1.58	0.67	0.45	-1.20
Discretionary factors underpinning fiscal consolidation	0.06	0.23	-0.10	0.14
Tax revenue buoyancy	0.80	0.15	0.21	-0.44
Other revenue	0.73	0.29	0.34	-0.90
Change in expenditure ratio	-0.98	-0.07	0.04	2.03
Discretionary factors underpinning fiscal consolidation	-0.34	0.19	-0.33	0.23
Change in Gross Fixed Capital Formation	-0.41	-0.25	0.01	0.41
Other expenditure	-0.23	-0.01	0.35	1.38
Adjustment in deficit ratio	0.60	0.60	0.50	0.83

Note: positive represents a decline in the deficit-to-GDP ratio

As the economic recovery becomes more sustained as from 2013, revenue is also expected to rebound, in particular as the loss of revenue from subdued economic activity in specific sectors last year is expected to be recovered in 2013. This is reflected in a positive tax revenue buoyancy of 0.80 percentage points of GDP. A sensitivity analysis of the fiscal projections to alternative macroeconomic assumptions is provided in Chapter 4 of this Programme.

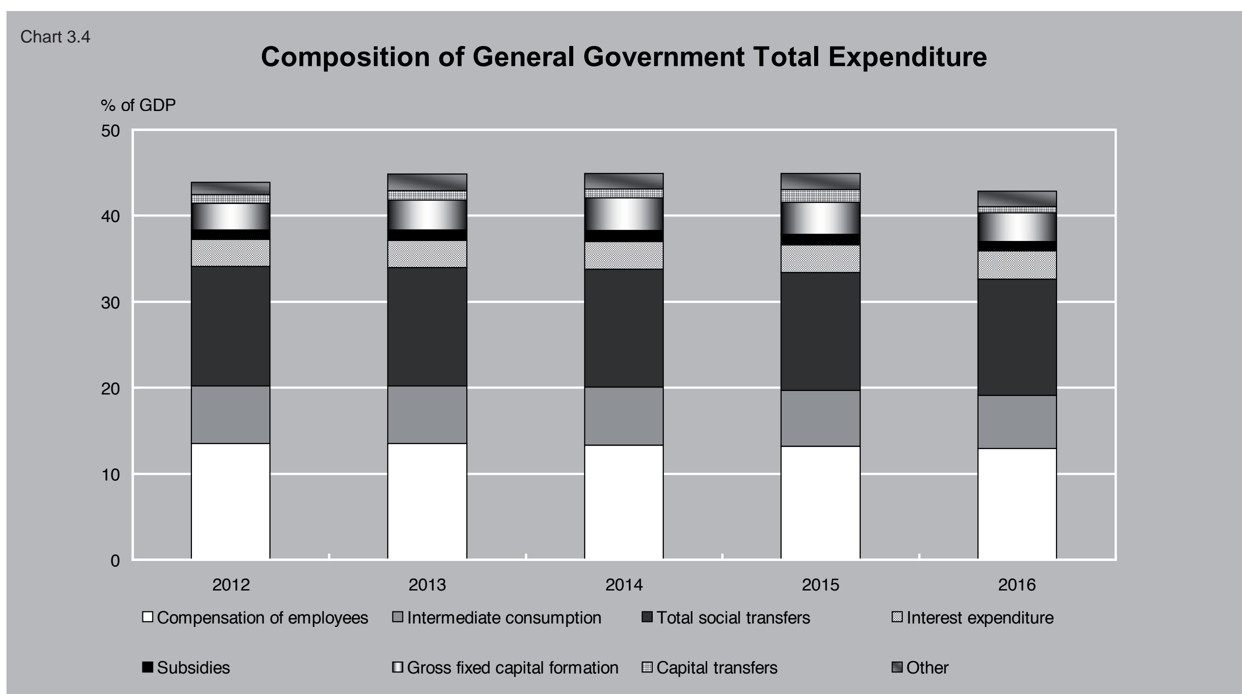
Discretionary revenue measures are expected to contribute marginally to the improvement in the fiscal outcome, as they are expected to improve the budget balance by 0.06 percentage points of GDP. Revenue accruing from enhanced efficiency in revenue collection and the additional revenue from social contributions as a result of the 2006 pension reform, are expected to contribute positively to the decline in the deficit-to-GDP ratio. Meanwhile, the main revenue increasing measures in the 2013 Budget, in particular the revision in excise duties, will be more than offset by the negative impact of revenue reducing measures, mainly reflecting the most recent widening in the income tax bands.





The ratio of general Government expenditure to GDP is expected to increase from 43.9 per cent in 2012 to 44.9 per cent in 2013, mainly on account of higher expenditure on gross fixed capital formation. The increase in this component of expenditure from 3.1 per cent of GDP to 3.5 per cent of GDP primarily reflects higher expenditure related to capital projects financed from EU funds under the 2007-2013 Financial Framework and thus corresponds to analogous increases in revenue, as highlighted above. Further increases are also expected in projects financed from national sources.

Discretionary expenditure measures are expected to worsen the deficit ratio by 0.34 percentage points of GDP, as the equity injection in Air Malta and the Budget measure allowing for the increase in the minimum rate of children's allowance are expected to more than offset the expenditure savings from the pension reform



initiative. In aggregate, these are expected to exert a negative effect of 0.34 percentage points of GDP on the fiscal deficit.

Meanwhile, changes in the other components of expenditure, net of the impact of the discretionary expenditure measures and of gross fixed capital formation, are expected to adversely affect the deficit ratio by 0.23 percentage points of GDP, mainly on account of higher subsidies and interest expenditure. Higher expenditure on subsidies mainly reflects a reclassification of part of the financial assistance to Enemalta from intermediate consumption to subsidies. This reclassification follows Government's assumed responsibility for Enemalta's social and environmental commitments.

3.2.2.2 The Fiscal Strategy for 2014

During 2014, the general Government deficit is projected to decline by a further 0.6 percentage points of GDP from 2.7 per cent to 2.1 per cent. The more restrictive fiscal stance projected for the next fiscal year is mainly attributable to an increase in the revenue-to-GDP ratio, whilst the ratio of total expenditure to GDP is expected to remain relatively stable. Indeed, on the expenditure side, most components of expenditure are expected to grow at the same rate as GDP growth. Savings from Government's restrictive policy on recruitment in the public sector will be offset by higher expenditure on gross fixed capital formation. Increases in the main items of tax revenue are expected to keep pace with the projected macroeconomic developments. In particular, the ratios-to-GDP of taxes on production and imports, capital taxes and social contributions are expected to remain relatively stable, whilst the ratio of current taxes on income and wealth is expected to increase marginally by 0.4 percentage points of GDP. The increase in the latter is driven by the projected factor distribution of income and is mainly attributable to the higher growth in profits expected over the medium-term. Meanwhile, the higher ratio of 'other' revenue to GDP is mainly on account of higher revenue from EU investment grants.

Government's policy in designing the measures underpinning fiscal consolidation strikes the right mix between expenditure-reducing and revenue-increasing measures. While both expenditure and revenue measures have the same impact on short-term fiscal consolidation, expenditure cuts are deemed less distortive to the long-term growth potential of the economy.

At this stage it is premature to provide additional details on the budgetary measures to be taken to achieve the budgetary objectives in 2014 particularly in view of the planned review of Government expenditure, and which will increase the efficiency and effectiveness of public spending, reduce waste and ensure value for money, thus ensuring greater financial discipline and fiscal accountability in the public sector, in particular in public entities and Local Councils.

3.2.2.3 General Government Budgetary Projections for 2015-2016

Government's fiscal policy objective in the outer years of the Programme period remains that of ensuring a sustainable fiscal position by gradually but consistently reducing the fiscal imbalance. Indeed, the decline in the ratio of general Government deficit-to-GDP is expected to be sustained and the fiscal imbalance is expected to be reduced further from 2.1 per cent in 2014 to 1.6 per cent and 0.8 per cent in 2015 and 2016, respectively.

The revenue ratio is expected to increase by 0.5 percentage points in 2015 to 43.2 per cent of GDP, and to decline to 42.0 per cent of GDP the following year. Developments in the revenue ratio primarily reflect the planned absorption of EU investment grants on account of the expected finalisation of projects financed from the Financial Framework for the period 2007-2013 as well as the commencement of the new Programme. Indeed, the tax burden is expected to remain relatively stable in the outer years of the Programme period.

Meanwhile, the ratio of general Government expenditure-to-GDP is expected to remain relatively unchanged in 2015 and to decline by 2.0 percentage points of GDP in 2016 to 42.9 per cent by the end of the Programme

period. No further equity injection in the national airline is planned beyond 2015, such that the decline in the ratio of capital transfers to GDP will contribute significantly to fiscal consolidation in 2016. Nonetheless, Government's strategy for stricter controls on expenditure outlays is also expected to contribute significantly to limit the increase in expenditure on compensation of employees and intermediate consumption below GDP growth.

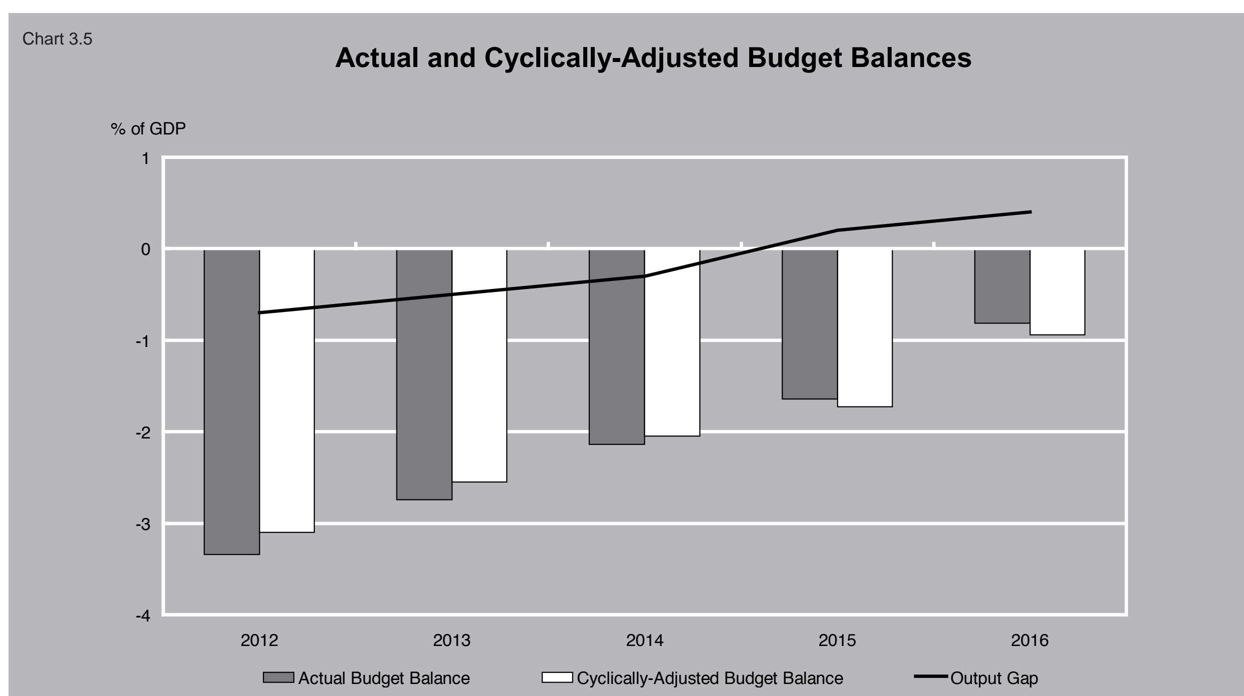
3.3 Structural Adjustment and the Medium-Term Objective

In line with the requirements of the revised Stability and Growth Pact (SGP), Malta will continue to aim for a balanced budgetary position net of one-off and temporary measures over the cycle as its medium-term objective (MTO). The achievement of a balanced structural position in the medium-term is necessary in order to ensure a stable and sustainable debt-to-GDP ratio and to make the necessary adjustments to finance the future cost of ageing. Although this target will be reached beyond the Programme period, Government remains determined to implement plans which meet the commitments for annual structural fiscal efforts arising from the newly-agreed frameworks for stronger fiscal governance within the EU.

As illustrated in Chart 3.5 and Table 5 in the Statistical Appendix, which present cyclical developments, an improvement is anticipated in the budget deficit from 3.3 per cent of GDP in 2012 to 0.8 per cent of GDP in 2016. When one corrects for the cyclical effects, the budget deficit improves from 3.1 per cent of GDP in 2012 to a deficit of 0.9 per cent of GDP in 2016. This should be seen in the context of an output gap which closes gradually and moves into positive territory over the medium-term. At this juncture, it is pertinent to note that since there is significant uncertainty surrounding the potential output and output gap estimates, a certain degree of caution is warranted in the analysis of the structural adjustment over the forecast period.

As presented in Table 3.3, the structural deficit (net of one-offs) is expected to decline from 3.2 per cent of GDP in 2012 to 1.0 per cent in 2016. Moreover, in compliance with the expenditure benchmark outlined in the SGP, the increase in general Government expenditure net of interest expenditure, expenditure on EU programmes fully matched by EU funds revenue and cyclical unemployment benefit expenditure, is expected to be below the prudent potential GDP growth over the medium-term horizon so as to ensure appropriate progress towards the MTO.

The reliance on one-off deficit reducing measures remains contained throughout the Programme period as



Fiscal Consolidation
(percentage points of GDP)

Table 3.3

	2012	2013	2014	2015	2016
General Government Balance	-3.3	-2.7	-2.1	-1.6	-0.8
One-off and other temporary measures[1]	0.1	0.2	0.1	0.1	0.1
General Government Balance net of One-offs	-3.4	-2.9	-2.2	-1.7	-0.9
Output Gap Estimates	-0.7	-0.5	-0.3	0.2	0.4
Cyclically-Adjusted Budget Balance	-3.1	-2.5	-2.0	-1.7	-0.9
Structural Balance	-3.2	-2.7	-2.2	-1.8	-1.0
Structural Adjustment	-0.3	0.5	0.6	0.3	0.8

[1] A plus sign means deficit-reducing one-off measures

the extent of one-offs declines from 0.2 per cent of GDP in 2013 to 0.1 per cent in 2014 thereafter remaining unchanged over the forecast horizon.

Over the medium-term forecast horizon, the structural deficit (net of one-offs) is projected to decline from 2.7 per cent in 2013 to 1.0 per cent in 2016, such that a structural effort averaging 0.5 per cent of GDP per annum is expected. The structural effort is marginally back-loaded with a higher structural effort targeted for the later years of the Programme period than in 2013. This follows the slower than anticipated growth and recovery prospects for 2013 and 2014 with the output gap verging in the positive territory only in the later years of this Programme period.

3.4 Comparison with the April 2012 Update of the Stability Programme

The worsening in the fiscal target for 2012 when compared to the target presented in the last year's Update of the Stability Programme is mainly underpinned by lower general Government revenue which impinged negatively on Government finances despite lower expenditure. As a result, the fiscal outturn in 2012 deteriorated from a deficit of 2.2 per cent of GDP to a deficit of 3.3 per cent.

The overall medium-term fiscal consolidation path is very similar to what was projected last year in both nominal and structural terms. However, the deficit targets differ in view of the worse than expected outcome in 2012.

In 2013, a higher deficit-to-GDP ratio of 2.7 per cent is being targeted, when compared to a target of 1.7 per cent presented a year earlier. This is mainly a result of higher expenditure and lower revenue when compared to the April 2012 Update, reflecting the more moderate macroeconomic environment over the Programme period presented in this year's Stability Programme when compared to the previous Update, as well as the impact of discretionary measures in 2013.

The deficit-to-GDP ratio for 2014 in this year's Update of the Stability Programme is expected to reach 2.1 per cent when compared to 1.1 per cent in the previous year's Update. This development is mainly the result

of higher expenditure developments which more than outweigh the increases in the revenue component.

Similar developments shaped the downward revision in the deficit-to-GDP ratio for 2015, which in this year's Update of the Stability Programme is expected be 1.3 percentage points higher than projected last year.

3.5 Debt levels and Developments

Government's core medium-term fiscal objective is that of restoring the trajectory of public finances to a sustainable path. This aim involves two main targets. Primarily this involves addressing the current imbalance in public finances, and secondly, the reduction of the debt-to-GDP ratio at a satisfactory pace.

Government's debt strategy remains that of ensuring that the financing needs of the public sector are met at the lowest possible cost while concurrently minimising medium and long-term interest rate risk. The Government's reliance on short-term funding is marginal, in that, in 2012, short-term debt accounted for 3.2 per cent of total Government debt. The latter is projected to increase marginally to 4.8 per cent by 2015. Furthermore, the share of maturing stocks in total Government debt is expected to remain rather stable over the forecast horizon. The latter ratio is expected to decline marginally from a level of 7.2 per cent in 2012 to 7.1 per cent in 2013. During 2014, an increase in the share of maturing stocks in total Government debt to a level of 9.5 per cent is envisaged. Thereafter, the latter is expected to exhibit a downward trajectory in the outer years of the forecast horizon.

3.5.1 Projected Debt Developments

The core items that underpin the projected debt dynamic and the extent to which the latter is sustainable are:

The Dynamics of Government Debt[(1)]

Table 3.4

Percentages of GDP	2012	2013	2014	2015	2016
Gross debt	72.1	74.2	74.2	72.7	70.0
Change in gross debt	1.8	2.1	0.0	-1.6	-2.6
Contribution to change in gross debt					
Primary Balance	0.2	-0.5	-1.1	-1.6	-2.4
Snowball Effect	1.1	0.9	0.5	0.2	0.2
Interest Expenditure	3.2	3.2	3.2	3.2	3.2
Real GDP growth	-0.6	-1.0	-1.2	-1.4	-1.4
Inflation Effect	-1.5	-1.3	-1.5	-1.6	-1.6
Stock-flow adjustment	0.6	1.7	0.6	-0.2	-0.4
p.m. implicit interest rate on debt	4.6	4.6	4.5	4.5	4.6

[(1)] Developments in the debt- to-GDP ratio depend on: $$\frac{D_t}{Y_t}-\frac{D_{t-1}}{Y_{t-1}}=\frac{PD_t}{Y_t}+\left(\frac{D_{t-1}}{Y_{t-1}}.\frac{i_t-y_t}{1+y_t}\right)+\frac{SFA_t}{Y_t}$$

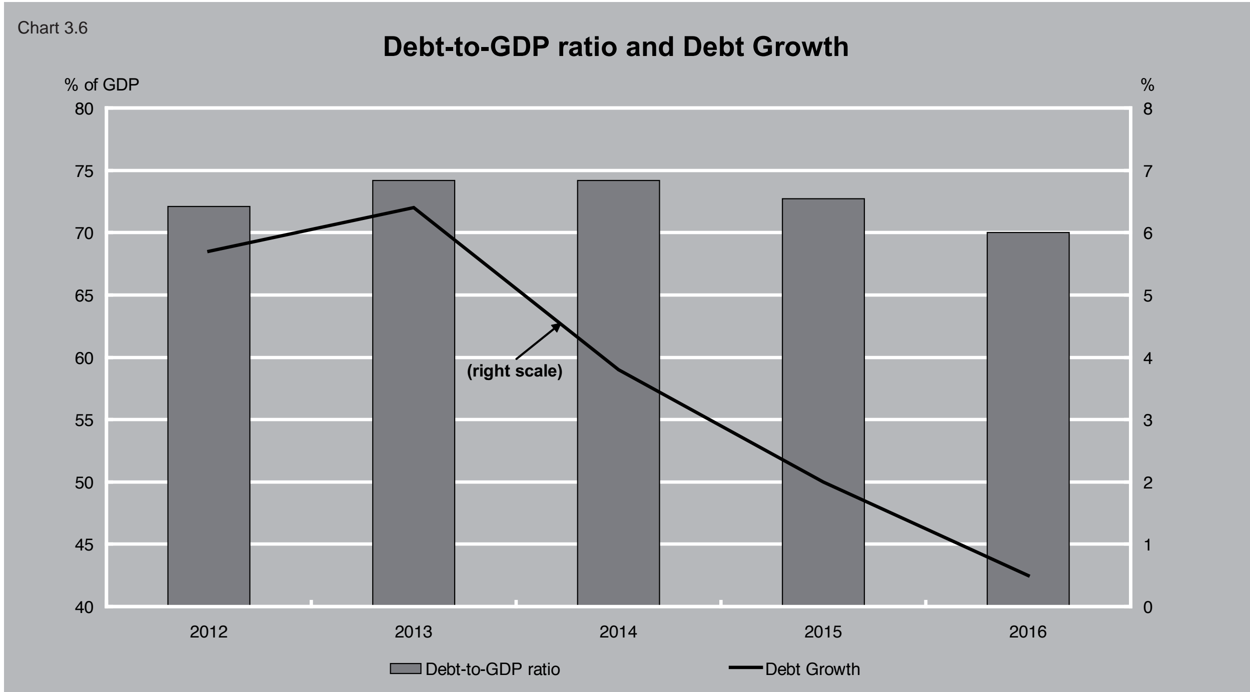
where t denotes a time subscript, D, PD, Y and SFA are the government debt, primary deficit, nominal GDP and the stock-flow adjustment respectively, and i and y represent the average cost of debt and nominal GDP growth.

Government's planned budgetary trajectory, interest and growth dynamics, and stock-flow adjustment items. In this regard, the negative primary surplus registered in 2012 had an expansionary impact on the debt ratio. Moreover, the moderation in economic growth during 2012 and 2013 is expected to give rise to a situation where the debt-to-GDP ratio will reach a peak in 2014. Thereafter, over the medium-term, a recovery in the underlying economic growth momentum and a positive primary surplus is expected to enable a decrease in the debt-to-GDP ratio from the year 2015 onwards. Developments in the debt ratio for the Programme period and the contributors to the trajectory path of the debt-to-GDP ratio are presented in Table 3.4 and Statistical Appendix Table 4.

During 2012, gross Government debt reached a level of 72.1 per cent of GDP. The ratio is expected to peak at 74.2 per cent of GDP in 2014 and thereafter exhibit a downward trend during the outlook period to reach an envisaged level of 70.0 per cent of GDP by 2016. Hence, during 2013, the debt-to-GDP ratio is projected to increase by 2.1 percentage points of GDP. This increase in the ratio is underpinned by the fact that reduction in the primary balance is not sufficient to offset the expansionary snowball effect on the debt-to-GDP ratio. Moreover during 2013, stock flow transactions are expected to have a notable expansionary impact on the ratio. During 2014, the debt-to-GDP ratio is expected to stabilise at the 74.2 per cent of GDP level. In the outer years of the forecast period, the debt to GDP is expected to exhibit a declining path reaching 70.0 per cent of GDP by 2016.

Over the forecast period, the projected reduction in the gross debt is mainly driven by a growing primary surplus and by nominal GDP growth, which are expected to more than compensate for the upward pressure that the interest, and to a lesser extent stock flow transactions, are expected to have on the debt-to-GDP ratio. The programme does not take into account proceeds from privatisation that may result from divestments of Government assets contributing to the decline in gross debt. Developments in gross Government debt are illustrated in Chart 3.6.

During 2012, the recorded negative primary balance resulted in an expansionary contribution to the debt ratio of 0.2 percentage points. Over the forecast period, however, this is expected to be reversed such that the primary surplus is expected to have a contractionary impact on the debt-to-GDP ratio especially in the outer years of the forecast horizon. This contractionary impact stemming from the contribution of the primary balance is expected to be of 0.5 percentage points in 2013 and increase further to a contribution of 2.4 percentage points by 2016.



The 'snowball effect' contributed to a notable increase in the debt ratio of around 1.1 percentage points during 2012, with the rate of nominal growth being insufficient to offset the expansionary impact of interest expenditure. This expansionary effect is expected to subside, even though remaining positive, in line with the envisaged improvement in the economic growth dynamics, especially in the outer years of the forecasting horizon.

Hence, during the outlook period, the expansionary contribution of interest expenditure on the debt ratio is expected at around 3.2 percentage points. Meanwhile, the contractionary contribution of real GDP growth is expected to increase from a level of 1.0 percentage points in 2013 to a level of 1.4 percentage points in 2016. The contribution of inflationary pressures towards the decline in the debt ratio is expected to hover around 1.5 percentage points over the forecast horizon.

The other factors contributing to changes in the debt-to-GDP ratio are outlined by the estimated Stock Flow Adjustment (SFA). In 2012, the SFA is estimated to have resulted in a 0.6 percentage point increase in the debt ratio. The main stock flow transactions during 2012 related to an equity injection in Malita plc and the European Stability Mechanism (ESM), a sizeable European Financial Stability Facility (EFSF) re-routing and a notable decline in cash holdings. During 2013, stock flow transactions are expected to result in a sizeable 1.7 percentage points expansion in the debt ratio. This is expected to be underpinned by an expansion of cash holdings and by an equity injection in the national airline and in the ESM. Beyond 2014, stock flow transactions are expected to have a rather marginal impact on the debt ratio.

3.5.2 Comparison with the April 2012 Update of the Stability Programme

The ratios of general Government debt-to-GDP presented in this Programme are expected to be higher than those presented in the previous Stability Programme Update. The expected worsening from the trajectory outlined in the previous Update is largely underpinned by revisions in the primary balance expected to be registered by Government. Moreover, a more subdued macroeconomic outlook for the period 2012 – 2015 than that envisaged in the preceding Update also partially explains the expected worsening in the trajectory of the debt ratio.

For 2012, the debt-to-GDP ratio was revised upwards by 1.8 percentage points. This revision reflects a more subdued fiscal performance than envisaged in last year's Update and a less robust macro-economic situation. The debt-to-GDP ratios for 2013 and 2014 were revised upwards by 5.5 and 6.8 percentage points, respectively.

In the 2012 Update, the debt-to-GDP ratio was expected to follow a downward path from a level of 70.3 per cent in 2012 to 65.3 per cent in 2015. This downward trajectory reflected a decrease of 1.6 percentage points in 2013 and a decrease of 1.3 percentage points in 2014. During 2015, the previous Update envisaged a decline of 2.1 percentage points in the debt-to-GDP ratio.

In contrast, in this Update of the Stability Programme, the debt-to-GDP ratio is estimated to decline to 72.7 per cent by 2015, with the annual reductions in the debt-to-GDP ratio being notably lower than previously envisaged.

3.6 Budgetary Implications of Major Structural Reforms

Ongoing and planned structural reforms have an important impact on Malta's potential output growth. The measures included in the NRP 2013 reinforce the measures presented in the NRP 2012 with the aim of improving Malta's GDP per capita whilst ensuring that the economy is on a sustainable fiscal and environmental path.

Government's reform efforts presented in the NRP 2013 focus on the themes of research and development,

Quantification of NRP Thematic Measures

Table 3.5

	New Measures	Timeline	2013	2014	2015	2016	EU Funds
			Net Cumulative Fiscal Impact (Eur million)				
Employment							
1	Child Development Centre	2013/2014	0.500	1.000			
2	Enhancing Employability through Training		1.606	1.628	0.140		2.869
3	National Apprenticeship Scheme Reform		0.650	0.650	0.650		
4	Active Youth for Employment Programme		0.601				
5	Support for youth voluntary work		0.600				
6	ETC Scheme to promote Youth Entrepreneurship		0.300				
7	JOB BRIDGE Programme		0.262	0.276			
Education							
1	New Scholarship Scheme	2013/2014	1.200	0.800			1.700
2	Support for Youth Organisations		0.080	0.100	0.120	0.120	
3	Youth cafés and Youth Centres (Hubs)		0.043	0.100	0.100	0.100	
Energy							
1	European Regional Development Fund (ERDF) Scheme for the purchasing of solar panels for enterprises	2013/2014		3.400			
2	Feed in tariffs for PVs not supported through other funding		5.00				
3	Scrappage Scheme	2013	0.500				
4	Autogas conversion scheme	2013	0.200				
Research and Development							
1	Internationalisation scoping exercise	2013	0.150				
2	Centre to Strengthen Research on Business and the Self-employed	2012/2014	0.824	0.341			0.990
Poverty Reduction and Social Inclusion							
1	Subsidised Rental Scheme – Rent Subsidy in Private Rented Residences	2012 - ongoing	0.800	0.800	0.800	0.800	
2	Service Pensions	2013 - ongoing	1.500				
3	Regeneration and Maintenance of Housing Estates (2 schemes)	2013 - ongoing	0.900	0.900	0.900	0.900	
4	Out-of-Home Care Programme	2013	0.550				
5	Schemes to support home adaptation works – (A) Schemes for Persons with Disability	2013 – 2014	0.085	0.085			
6	Schemes to support home adaptation works – (B) Schemes for Repairs and Improvements	2012 – 2014	0.250	0.250			
7	Residential Home for Youth	2013	0.150				
8	Independent Living	2012 – 2014	0.030	0.030			
9	Expansion of Fostering Services in Gozo	2013	0.036				
10	Therapeutic Facility	2013	0.150				
11	Gender Balance in Decision- Making (MSDC)	2013 - 2015	0.086	0.357	0.153		0.506
	TOTAL		17.053	10.717	2.725	1.920	6.065
	% of GDP		0.24	0.15	0.04	0.02	

energy, education, poverty reduction and social inclusion as well as measures aimed at improving the country's competitiveness. A segment of the new measures presented in the NRP 2013 for the period 2013-2016 are expected to cost around €32.4 million. Of these, €6.1 million are expected to be financed through EU funds such that the total net outlay by the Maltese Government during this four-year period amounts to an estimated €26.4 million. Table 3.5 shows that these expenditures amount to 0.24 per cent and 0.15 per cent of GDP in 2013 and 2014, respectively.

Research and Development

Some of the more important measures which can enhance the country's potential output relate to research and development. Within this context, the Maltese Government is preparing an innovation strategy for smart specialisation, setting up a centre to strengthen research on business (and the self-employed) as well as an internationalisation scoping exercise.

Employment

As in recent years, Government recognises that the participation of females in the labour market needs to be encouraged further. Adding onto already existing measures, Government is planning to develop a regional public child development centre in Gozo as well as introducing parenting credits. In addition, Government is also employing a number of measures aimed at enhancing employability for those already participating in the labour market as well as aspiring participants. Related measures will include short courses, traineeships, an apprenticeship scheme and an active youth for employment programme. Meanwhile, measures aimed at increasing the participation rate of people with disability include the JOB BRIDGE programme which seeks to assist them in building the competence and necessary skills to adapt to the job market.

Energy

A number of measures are expected to be implemented in the coming years to meet Malta's energy and environmental targets, including switching from liquid fuel oils to gas to meet Malta's increasing demand for electricity, the promotion of opting for solar water heaters and roof insulation and the encouragement of small and cleaner modes of transport, amongst others.

Education

With regards to education, the Maltese Government launched an early school leavers strategy and will also be reviewing and updating the National Curriculum. Furthermore, new scholarship schemes will be made available and further training and development will be encouraged.

Poverty and Social Inclusion

Finally, Government's efforts towards a more inclusive society and a more equitable distribution of gains from economic development include income tax deductions for fees paid for residency services in private community homes, subsidised rental schemes and the establishment of therapeutic facilities amongst many other measures.

Measures that Enhance Competitiveness and Economic Growth and Euro Plus Pact Measures

A number of measures aimed at enhancing competitiveness and economic growth are also being put forward in the NRP 2013. These include the revision of income tax brackets, the Micro Guarantee Scheme, MicroInvest and tax incentives for licenced hotels. Euro Plus Pact measures include the justice reform, an action plan for greening the economy, enabling innovation through legislative and regulatory development, as well as a strategy and action plan for the promotion and support of the social enterprise sector.

4. Sensitivity Analysis and Comparison with the 2012 Update of the Stability Programme

4. Sensitivity Analysis and Comparison with the 2012 Update of the Stability Programme

4.1 Sensitivity Analysis

International developments that took place during the last years served to further highlight the level of fluctuations and adjustments that continuously take place in the global economy. The Maltese economy, being such a small open economy, is particularly sensitive to these external developments especially, given the prevailing uncertainty in relation to the downward risks with respect to the degree of the global recovery, remaining imbalances in the Euro area and higher prices of oil. Thus, it is important to present the potential implications of alternative developments on the Maltese economy covering the 2013-2016 forecast period.

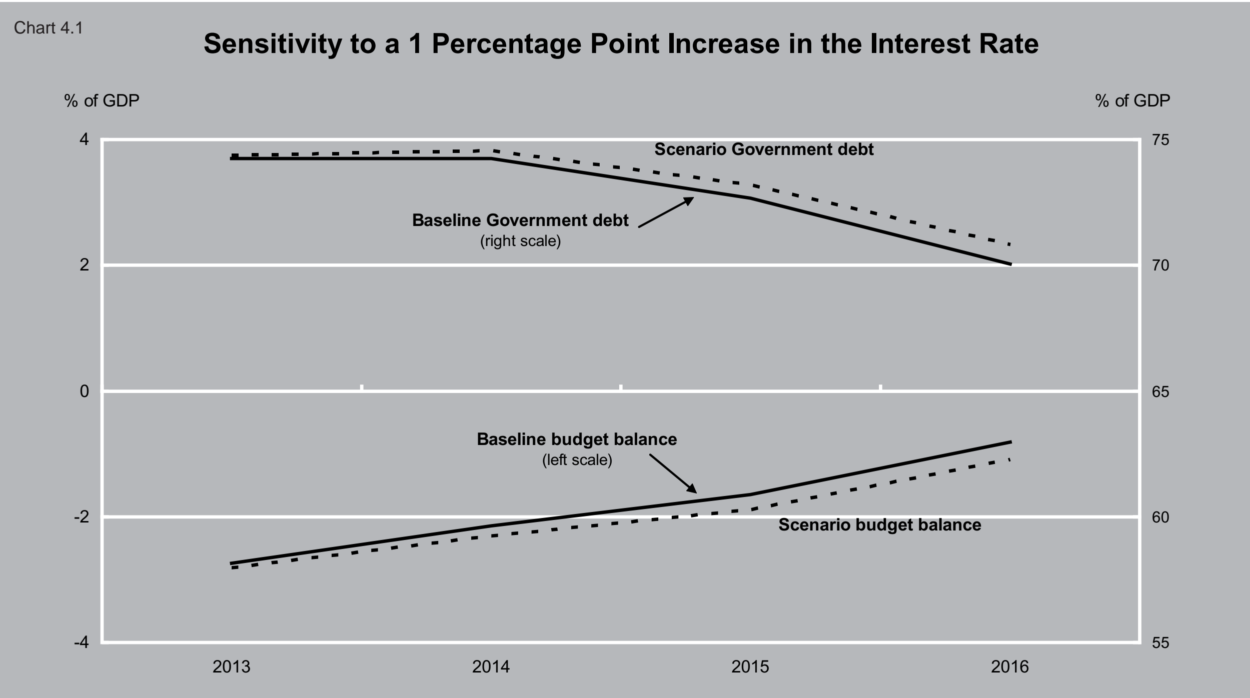
This Chapter presents three alternative sensitivity scenarios with 2013 considered as the first year of the forecast. The first sensitivity scenario simulates an increase in the interest rate, the second scenario explores the implications of a decrease in economic activity in Malta's main trading partners, while the third sensitivity scenario simulates a lower rate of economic growth. All three scenarios are considered decidedly relevant at this particular junction and the results of the different scenarios are presented in terms of the effect of the deviation from the baseline on the Gross Domestic Product, general Government budget deficit, and general Government debt. These sensitivity analyses are illustrated in Charts 4.1, 4.2 and 4.3.

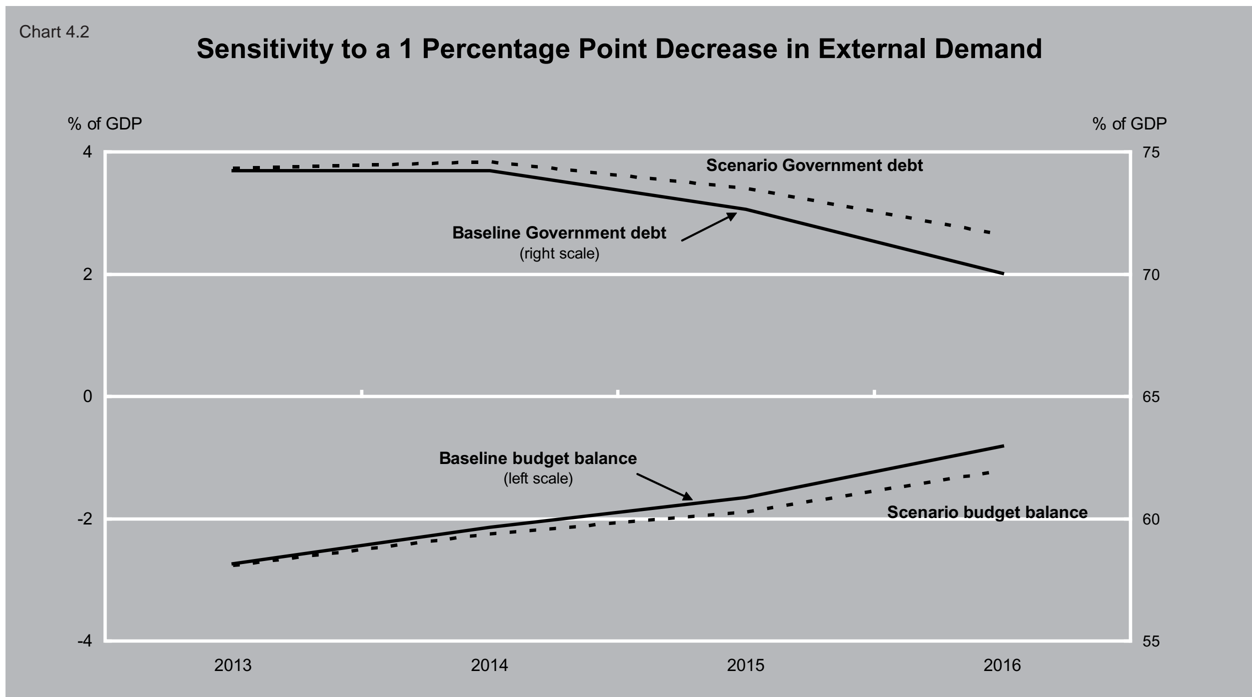
It is also important to bear in mind that estimates are subject to considerable uncertainty chiefly among them the response of economic agents, whose responses could differ from those exhibited in the past under different circumstances, and thus should be considered only as indicative. Secondly, these estimates are based on the assumption that there is no fiscal policy response to the changed budgetary position over the forecasted period.

4.1.1 Sensitivity to Interest Rate Fluctuations

Interest rates fluctuate as a result of the changing economic environment with expectations about profitability and investment playing a major part. Presently, both short-term interest rates as well as long-term interest rates are at very low levels, thus there is the risk that interest rates will increase over the short and medium-

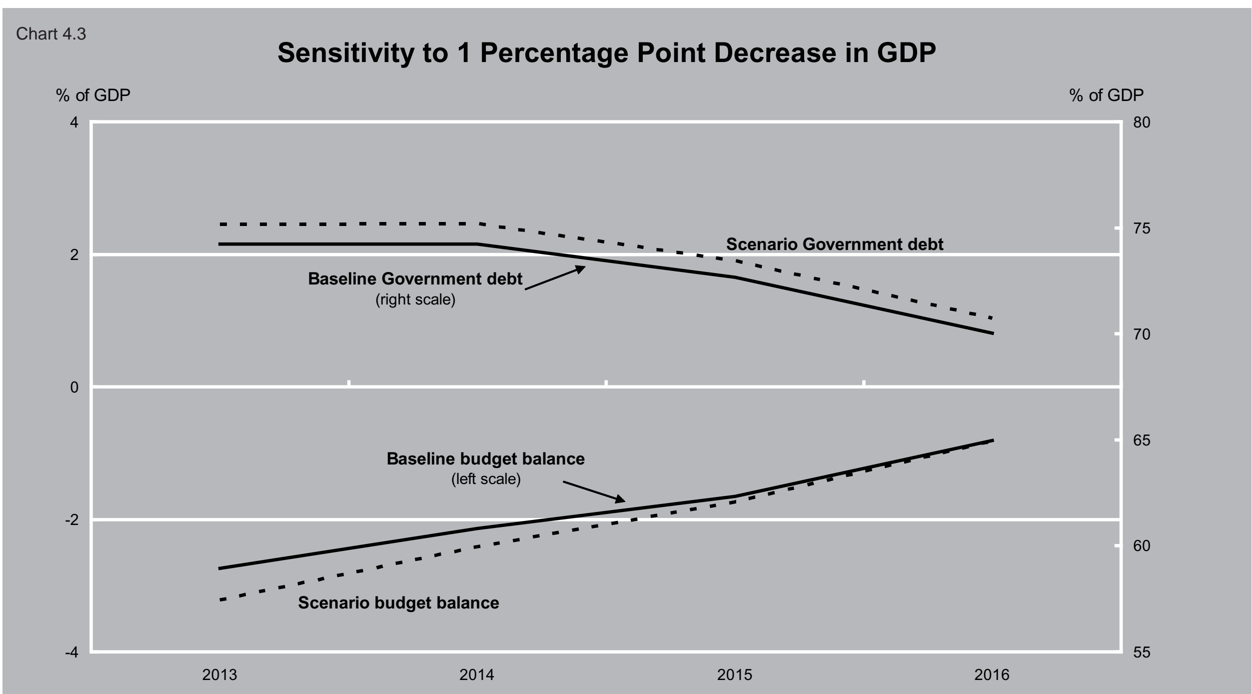
Chart 4.1





term. This scenario explores the implication of an increase in interest rates which will be expected to affect economic activity through the real and monetary sectors.

A priori an increase in the interest rate implies an added cost of capital financing as well as a higher opportunity cost. The net effect of these changes depends on the degree of elasticity of the components of output to changes in the interest rate. Government finances are also directly affected by the change in the interest rate through its impact on components of revenue and expenditure that are sensitive to economic activity as well as the effect of changes in the interest rate on the debt servicing costs. However, taking into account the relatively low share of short-term debt in total General Government debt in Malta, changes in the interest rate are mainly expected to affect the debt servicing costs in relation to the rolling-over of past long-term debt and new issues of stock. In view of this, the impact of a change in the interest rate on the deficit and debt positions is expected to be moderate.



This scenario is modelled as an increase of 1 percentage point in the interest rate between 2013 and 2016. As a result of this change in the interest rate, economic growth is expected to decrease marginally by 0.1 percentage points in 2013 and remain unchanged thereafter. Furthermore, this increase in the interest rate will result in a deterioration of the budget balance of 0.1 percentage points of GDP in 2013 and a further deterioration of around 0.2 percentage points in both 2014 and 2015. In 2016, the deficit is expected to increase further by 0.3 percentage points. These changes in the budget balance are attributable to an increase in total expenditure which amounts to around 0.4 per cent by the end of the forecast period while the impact on the total revenue is negligible. As a consequence, Government debt-to-GDP ratio is envisaged to increase by around 0.1 percentage points and 0.3 percentage points in 2013 and 2014, respectively. At the end of the forecast period the ratio is expected to deteriorate by a further 0.8 percentage points when compared to the baseline.

4.1.2 Sensitivity to Change in External Demand

The recovery of the global economy could be weaker in the short-term due to a combination of various factors including slower restoration of consumer and producer confidence in Malta's main trading partners. Given the openness of the domestic economy and the presence of downward risks, it is of particular relevance to carry out a sensitivity analysis to changes in external demand. This section investigates a scenario where external demand declines by 1 percentage point in the first year and throughout the forecast horizon until 2016.

A negative shock in external demand for domestically-produced goods and services is expected to generate a decrease in aggregate demand and consequently in output. Additionally, the negative demand for exports will be amplified as it affects the rest of the domestic economy through the multiplier effect. On the other hand, in view of the high degree of import-content of domestically produced goods and services, the effect of a decline in demand for exports on output and on economic growth is expected to be partly offset by a subsequent decrease in imports.

The simulated fall in external demand is expected to lower the rate of economic expansion by around 0.5 percentage points by the end of forecast period when compared to the base scenario. This negative shock is expected to impact only marginally during the first two years under consideration but it is expected to result in a worsening in the budget deficit of 0.2 percentage points in 2015 and by a further 0.4 percentage points by 2016. The developments in the budget balance mainly reflect a decline in total revenue of around 0.7 per cent while the impact on total expenditure is largely negligible. The subsequent worsening of the budget balance will impact adversely on the Government debt-to-GDP ratio, where the ratio is expected to increase by around 1.6 percentage points by the end of the forecast period.

4.1.3 Sensitivity to Change in the Growth Rate of Real Gross Domestic Product

Consumer confidence is responsive to both local and international developments. If the anticipated recovery does not take place consumer confidence can be negatively affected. This would entail higher savings by consumers and consequently less private consumption. This subsection models a 1 percentage point decline in GDP. It is assumed that this increase in the growth rate of real GDP is stimulated through a contraction in private final consumption expenditure, resulting in lower demand for goods and services. This decline in demand results in lower domestic output as well as lower demand for imports of goods. The latter is expected to partly offset the negative effects of the decline in private consumption.

This scenario will result in a decline in GDP of around 1 percentage point decline in GDP in 2013 and consequently the budget balance will be worse off by around 0.5 percentage points during the same year. However, the impact on the budget balance is expected to narrow and become negligible by 2015. Given this scenario, total revenue is expected to shrink by 0.9 per cent upon impact, though by the end of the forecast period total revenue is relatively unchanged over the baseline scenario. On the other hand, the increase in consumption is expected to have a negligible impact on total expenditure by the end of the forecast period. The Government debt-to-GDP ratio is expected to increase by 0.9 per cent upon impact and the impact

is expected to decrease marginally at the end of the forecast period to 0.7 per cent when compared to the baseline scenario.

4.2 Comparison with the Projections in the 2012 Stability Programme

Economic Growth

Since the last Update of the Stability Programme, the global economy underwent several changes. The fragile recovery from the global crisis that had started in 2009 has been negatively affected by sharp commodity price increases and by increased uncertainties about the resolution of the sovereign debt crisis in the Euro area. This, together with other developments had a significant impact on the local economy and as a result expectations about macro-economic developments had to be revised. Thus, this Programme presents revisions to the growth outlook projected compared to the Programme presented in 2012.

In the last Update of the Stability Programme, a real growth rate of 1.5 per cent was forecasted. However, actual growth for 2012 was 0.8 per cent, 0.7 percentage points lower than that forecasted. On the other hand, in nominal terms the actual growth rate for 2012 was 3.0 per cent compared to 3.6 per cent which was forecasted in the last Update.

There were notable changes in the composition of growth during the 2012-2016 period. In 2012, the contribution of the external sector to economic growth turned out to be more positive than previously forecasted. On the other hand, the contribution of the domestic sector was 0.4 percentage points compared to the 0.9 percentage points expected in the last Update, stemming from sharp revisions in the growth of private consumption and in Gross Fixed Capital Formation (GFCF). For 2013, both the contribution of the domestic sector and the external sector were revised downwards by 0.3 percentage points. On the other hand, for 2014 and 2015, the contribution of the external sector was revised significantly downwards. Meanwhile the contribution of the domestic sector was revised downwards for 2014 by 0.1 percentage points but upwards for 2015 by 0.4 percentage points as growth is expected to be more domestically-led when compared to the previous Update of the Stability Programme.

Private consumption expenditure for 2012 was 1.5 percentage points lower than expected, as consumption growth registered was negative. However, private final consumption expenditure is expected to recover for this year although at a slower pace than the rate forecasted in the last Programme. For 2013 and 2014, the growth rates in this expenditure component were revised to 0.9 per cent and 1.0 per cent, a revision of 0.5 percentage points and 0.2 percentage points, respectively. Private consumption expenditure for 2015 and 2016 is expected to grow by 1.5 per cent and 1.7 per cent, respectively.

The forecast for growth in Government consumption expenditure for 2012 was 4.1 percentage points higher than the rate projected in the last Programme. This was mainly due to higher outlays on compensation per employee and intermediate consumption. For 2013, Government consumption expenditure was also revised upwards by 0.8 percentage points mainly due to higher intermediate consumption expenditure. There was also an upward revision in 2014 of 0.9 percentage points whilst for 2015 government consumption expenditure was revised upwards from -0.9 per cent to 1.1 per cent. Public consumption for 2016 is expected to increase by 1.6 per cent on a year-on-year basis.

The most notable changes in the expenditure components during 2012 were registered in the gross fixed capital formation. Indeed, during 2012 this component turned out to be 2.9 percentage points lower than expected in the last Update. For 2013, this component was revised downwards by 1.1 percentage points while for 2014 and 2015, the outlook for GFCF was revised downwards by 0.8 percentage points when compared to the last Update. The outlook for this component is that it will increase by 2.8 per cent in 2016 on a year-on-year basis.

Actual exports and imports turned out to be higher for 2012 when compared to the last Update. On the other hand, a downward revision in exports and imports was carried forward to the end of the forecast period when compared to the last Update, although the revision in exports was more accentuated than that in imports. Indeed, exports were revised by 0.0 percentage points and minus 2.0 percentage points for 2013 and 2014, respectively while growth in imports was revised by 0.3 percentage points and by minus 1.8 percentage points in 2013 and 2014, respectively. For 2015, figures for growth in exports and imports were revised downwards by 2.8 percentage points and by 2.4 percentage points, respectively. Growth in exports and imports for 2016 is expected to stand at 0.7 per cent and 0.6 per cent, respectively, with the contribution of net exports to growth declining over the forecast period to 0.2 percentage points in 2016.

Inflation and Employment prospects

The inflation rate in 2012 was 3.2 per cent, 0.9 percentage points higher than expected in the last Update. This was mainly due to higher increases than expected in the price of services and unprocessed food. For 2013, the inflation rate is forecasted to be lower than expected during the last Update, from 2.4 per cent to 2.0 per cent. There is also a downward revision of 0.6 percentage points and 0.5 percentage points for the outlook in inflation for 2014 and 2015, respectively. For 2016, the inflation rate is forecasted at 1.8 per cent.

Employment growth turned out better than anticipated in 2012. Indeed, growth in employment was 1.4 percentage points higher than forecasted. On the other hand, the outlook for employment growth for 2013 and 2014 was revised downwards by 0.9 percentage points and 0.7 percentage points, respectively. The unemployment rate for 2013 and 2014 has been revised upwards by 0.3 percentage points and by 0.1 percentage points, respectively. Furthermore, for 2013 and 2014, labour productivity has been revised by minus 0.2 percentage points and 0.4 percentage points, respectively.

5. Sustainability of Public Finances

5. Sustainability of Public Finances

According to the latest Eurostat projections, Malta's population will undergo major demographic changes due to low fertility rates, steady increases in life expectancy and the retirement of the 'baby-boom' generation. These changes are expected to pose economic budgetary and social challenges, with the demographic changes affecting Malta's growth potential. This will also lead to pressures to increase public spending, hence making fiscal sustainability a major policy challenge.

This Chapter provides an assessment of Malta's long-term sustainability of public finances for the period 2010-2060 on the basis of the projections of the Ageing Working Group (AWG) within the Economic Policy Committee (EPC). It provides an overview of the pension system in Malta and an analysis of the expenditure projections. Besides pensions, the projections cover other age-related expenditure items including health care, long-term care, education and unemployment benefits for the period 2010-2060. The long-term projections that result from this exercise provide an indication of the timing and scale of economic changes that would result from an ageing population under a 'no-policy change' scenario. The projections show where, when, and to what extent, ageing pressures will accelerate as the baby-boom generation retires and the average life span continues to increase. Hence, the projections are helpful in highlighting the immediate and future policy challenges posed for governments by demographic trends.

5.1 Long-term Budgetary Projection Results for Malta

This section provides an analysis of the long-term sustainability of public finances for Malta for the period 2010-2060 on the basis of commonly agreed assumptions for the EU Member States. In particular, the pension outlays projections incorporate the latest changes to the Social Security System, in particular the reform law enacted during December 2006. The model used in projecting pension expenditure was the World Bank's Pension Reform Options Simulation Toolkit (PROST) 12. Statistical Appendix Table 7 shows the expenditure components of the long-term budgetary projections as a percentage of GDP for the period 2010-2060 and the assumptions used.

5.1.1 Assumptions Applied

In modelling pensions, the PROST input files were updated in order to incorporate the AWG-EPC assumptions. These assumptions included the real GDP growth rate, labour productivity (growth rate per hour), inflation rate, labour participation rate by age and gender, unemployment rate by age and gender, population (EUROPOP2010), fertility rate by age, mortality rate by age and gender, and net migration by age and gender. A number of variables included in the assumptions as provided by the AWG-EPC were not incorporated in the PROST workings for the pension projections, primarily due to the fact that such variables are not required as PROST inputs. Accordingly, the budgetary projections for Malta covering the period up to 2060 include the following two main sets of assumptions:

As regards the **demographic** evolution, the fertility rate for Malta is projected to increase slightly from 1.4 children in 2010 to around 1.6 children in 2060. Life expectancy at birth for men is projected to increase from 77.6 years in 2010 to 84.9 years in 2060, whilst in the case of women it is expected to rise from 82.3 years in 2010 to 88.9 years in 2060. This implies that despite some convergence, female life expectancy in 2060 is projected to remain around 4 years higher than that of males. Meanwhile, life expectancy at 65 years for both males and females is projected to increase by 5.2 years between 2010 and 2060. Net migration inflows as a share of total population are projected to remain relatively stable as from 2019 at around 0.1 per cent.

With respect to **macroeconomic** assumptions, potential GDP growth rate is assumed to increase from 1.4 per cent in 2010 to around 2 per cent by 2020, thereby declining to 1.4 per cent by 2040. It is assumed to decline further to 0.8 per cent by 2050 and increase slightly to 0.9 per cent by 2060. The unemployment rate (15-64 years) is assumed to record marginal declines along the projection period decreasing from 7.0 per cent in 2015 to 6.6 per cent in 2060. The female participation rate (15-64 years) is assumed to increase from

43.0 per cent in 2010 to 57.0 per cent by 2035, remaining relatively stable at around that level thereafter. The male participation rate (15-64 years) is assumed to increase from 77.7 per cent in 2010 to 83.4 per cent by 2030 and to decline gradually to 82.4 per cent by 2060.

5.1.2 Demographic Developments

Population projections (EUROPOP2010) indicate that population in Malta by 2060 will be both smaller and older.[1] Total population is projected to rise from around 413,000 in 2010 to around 417,000 in 2030, and to decline thereafter to around 387,000 by 2060. As shown in Table 5.1**,** the age structure of the Maltese population is projected to change significantly. The share of the very young people (aged 0-14 years) in the total population is projected to decline. From an economic perspective, the most significant change concerns the working-age population (aged 15-64 years), which reflects the share of the population that will bear the financial 'burden' of the elderly. From a share of 69.4 per cent in 2010, this ratio will subsequently fall to 61.7 per cent by 2030 and reach 55.8 per cent in 2060. By contrast, the share of the elderly population (aged 65+ years) in total population will increase steeply from 15.1 per cent in 2010 to 31.2 per cent by 2060.

The dynamics of the ageing process could be better appreciated by analysing the developments in the relative share of the elderly to the working-age population. These dependency ratios relate the number of individuals that are likely to be "dependent" on the support of others for their daily living – youths and the elderly – to the number of those individuals who are capable of providing such support. The key indicator of age dependency in Table 5.1 relates the number of individuals aged less than 15 years and of those aged 65 and over to the population aged 15-64 years. Two other indicators are presented in Table 5.1: the youth-dependency ratio (for individuals aged less than 15 years) and the old-age-dependency ratio (for persons aged 65 years and more), both calculated relative to the number of individuals aged 15-64 years.

The youth dependency ratio (0-14 year bracket as a percentage of the 15-64 year bracket) is projected to

Total Population, by Selected Age Groups

Table 5.1

Age	**2010**	**2020**	**2030**	**2040**	**2050**	**2060**
0-14 yrs	64,127	62,191	58,738	52,605	51,516	50,501
15-64 yrs	286,364	267,385	256,901	252,370	235,020	215,813
65+ yrs	62,379	86,088	100,992	102,082	110,113	120,621
Total	412,870	415,664	416,631	407,057	396,649	386,935
0-14 yrs	15.5	15.0	14.1	12.9	13.0	13.1
15-64 yrs	69.4	64.3	61.7	62.0	59.3	55.8
65+ yrs	15.1	20.7	24.2	25.1	27.8	31.2
Youth dependency ratio (0-14 yrs/15-64 yrs)	22.4	23.3	22.9	20.8	21.9	23.4
Old-age dependency ratio (65+ yrs/15-64 yrs)	21.8	32.2	39.3	40.4	46.9	55.9
Total dependency ratio	44.2	55.5	62.2	61.3	68.8	79.3
Support ratio (15-64 yrs/65+ yrs)	4.6	3.1	2.5	2.5	2.1	1.8

Note: Figures may not add up due to the rounding

Source: EUROPOP2010, Eurostat

record a marginal increase during 2010-2020 and to decline from 22.9 per cent in 2030 to 20.8 per cent in 2040 thereby increasing to 23.4 per cent by 2060. The old-age dependency ratio (65+ year bracket as a percentage of the 15-64 year bracket) is projected to increase consistently from 21.8 per cent in 2010 to 55.9 per cent in 2060, an increase of 34.1 percentage points. Thus, by 2060, the total dependency ratio, which is the combined burden of these two components of the economically active population, will amount to 79.3 per cent, which means that every person in the working-age population will have to support around 0.8 non-active persons compared to 0.4 non-active persons in 2010. As a result of these demographic developments, the support ratio (persons in the 15-64 years bracket as a proportion of persons aged 65+) declines from 4.6 in 2010 to 1.8 in 2060. This means that while in 2010 there were around 5 persons of working-age for every person that reached pension age, by 2060 this ratio will decrease to around 2 persons of working-age for every person of pensionable age.

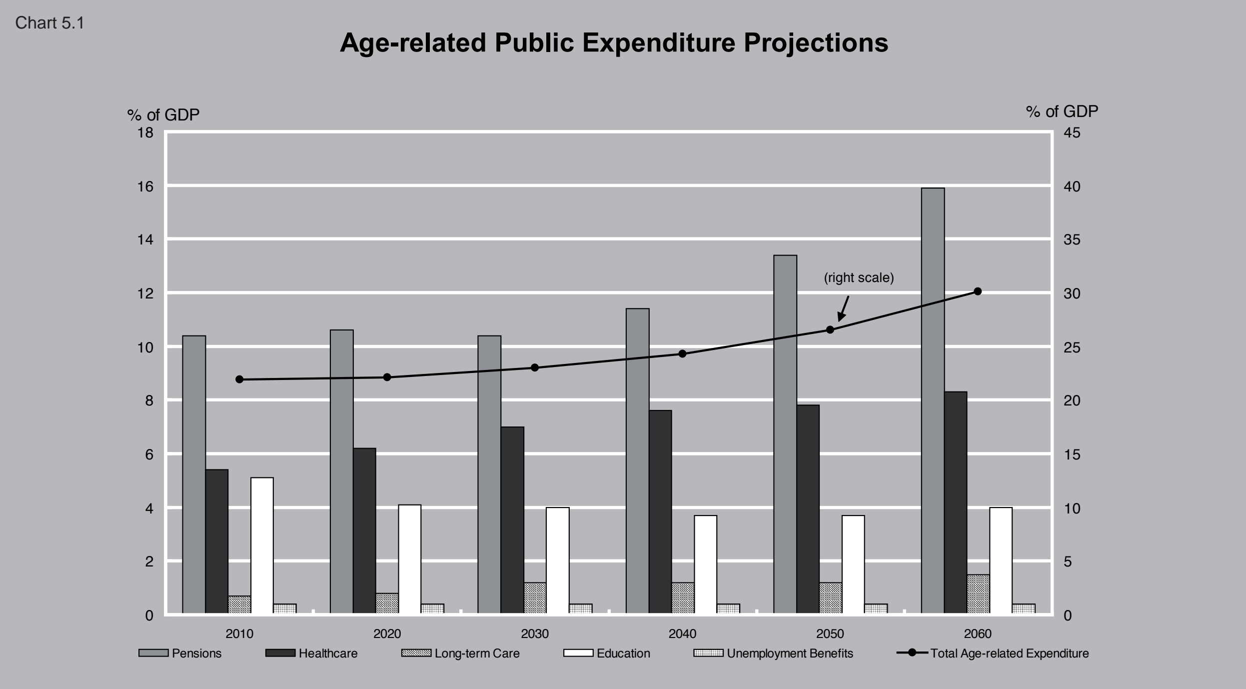
5.1.3 Age-related Public Expenditure

Age-related spending including pensions, health care, long-term care, education and unemployment benefits in Malta is projected to increase by 8.2 percentage points of GDP over the period 2010-2060. Chart 5.1 shows the age-related public expenditure as a share of GDP for this projection period.

Public expenditure on pensions is presently the most important age-related government expenditure item, and is projected to remain so also in the future. Pension projections cover the contributory pension benefits (which mainly include pensions related to retirement pension, survivorship and invalidity), the non-contributory old-age pension paid under the Social Security Scheme and Treasury Pensions. At present, private pensions play a rather minor role as regards pension provision for the old-aged persons. The coverage of pension schemes is different from the previous round of budgetary projections, since in this round the pension projections include also the expenditure on non-contributory old-age pension, the payment of bonuses[2] to pensioners, as well as the Treasury Pensions[3]. Over the projection period 2010-2060, pension expenditure in Malta is projected to rise from 10.4 per cent of GDP in 2010 to 15.9 per cent of GDP by 2060. The increase in old-age pension expenditure is driven by the ageing process, consistent with projected demographic developments. At the same time, one notes that the parametric changes introduced in the pension reform also contribute to raise expenditure, especially after 2030. The increase in the pension age, the increase in the contribution period for full pension eligibility and the changes to the benefit formula contribute to lower the projected increase in pension expenditure. However, at the same time the more dynamic indexation of the ceiling on pensionable income, the statutory changes to indexation for old-age pensions and the introduction of

Chart 5.1

Age-related Public Expenditure Projections



the guaranteed national minimum pension for persons retiring from 2026 onwards contribute to increase expenditure pressure.

Another important contributor to the increase in age-related spending is healthcare. Projections indicate that Malta is projected to record an increase of 2.9 percentage points of GDP in health care and an increase of 0.8 percentage points of GDP in long-term care during the period 2010-2060. This increased spending on health care and long-term care is primarily due to an ageing society and an increase in life-expectancy at birth over the projection period. On the other hand, public spending on unemployment benefits as a share of GDP is projected to remain relatively unchanged at 0.4 per cent between 2010 and 2060. Additionally, education spending is projected to decrease by 1.1 percentage points of GDP during the projection period in light of the projected changes in the population of persons in education.

5.2 Focus on Pension Reforms

As a result of the demographic developments, the outlays on pensions paid by Government will rise over the coming decades leading to a worsening in the balance of the current system. In light of these developments in December 2006, the House of Representatives adopted a series of parametric reforms (Act No. XIX of 2006) to the definition of pension age, retirement before pension age, the full rate of two-thirds pension calculation formula, the maximum pensionable income and the crediting of contributions as provided for under the previous legislative framework, aiming at enhancing the sustainability of the pension system whilst improving the adequacy of the pension enjoyed by retirees in the future. Further detail on the pension system in Malta and the key pension reform parameters are provided in Appendix 5A.1.

As a continuation of the pension reform process, in 2010, the Pensions Working Group (PWG) was tasked with the responsibility to carry out a Report "reviewing Part V of [the Social Security Act] ... with a view of achieving further adequacy, sustainability and social solidarity" as required by Article 64B of the Social Security Act. The PWG submitted its report to the House of Representatives during December 2010. A public consultation process followed during May and June 2011. Following discussions in the House of Representatives, public consultation was held during May and July 2011. During 2012, the Post-Consultation Report on the Pensions Reform was discussed at the Malta Council for Economic and Social Development with a further consultation process with all interested social partners. Following the feedback received from the social partners, the PWG submitted its final report to Government for consideration in August 2012.

During 2012, Government has also started implementing some of the recommendations outlined in the Post-Consultation Report. In particular, the proposal to set up a Pensions Strategic Unit within the Department of Social Security was approved and the recruitment process has already been initiated. In addition, the Commission on Financial Literacy and Retirement Income was set up with the objective of designing and implementing a financial literacy strategy for Malta. Furthermore, it should be noted that with regards to the introduction of a third pillar of private pensions, legislation has already been approved by Parliament and will come into force in due time. Moreover, it should be highlighted that Malta has recently undergone a change in administration, which is currently in the process of evaluating developments in the area of pensions prior to considering further steps in the reform of the pension system.

Appendix

5A.1 The Pension System in Malta

The current pension scheme in Malta is based on the Social Security Act, Chapter 318 of the Laws of Malta. The Act provides for two basic schemes, the Contributory Scheme, and the Non Contributory Scheme. In the Contributory Scheme, the basic requirement for entitlement is that specific contribution conditions are satisfied. In the Non Contributory Scheme, the basic requirement is that the conditions of the means test are satisfied.

The Non Contributory Scheme has made possible the allocation of more than one benefit at the same time, thus providing simultaneous coverage in those cases where more than one contingency is present. Through the process of targeting, this scheme has succeeded in the provision of additional assistance to certain specific categories such as, in the case of persons with a disability, in the case of single parents, as well as in the case of the family as a single unit.

The Contributory Scheme is universal since it practically covers all strata of the Maltese society. Within this scheme, employees, self-occupied and self-employed persons acquire social insurance rights through the payment of a weekly contribution as laid down by the Social Security Act.

Contributions are payable by all gainfully occupied persons between the age of sixteen and their pension age.[4] The scheme allows for different types of contributions in order to extend coverage to all types of persons in employment, including employed persons and self-occupied persons[5]. For each person, a tripartite contribution is payable: the employed person, the employer and the State each pay 10 per cent of the basic salary of the employee; with the contribution capped to the Maximum Pensionable Income that stood at €17,116 in 2010, that is, around 18 per cent higher than the average wage. The rate of contributions by self-occupied persons is shared by the State and self-occupied persons, whereby the self-occupied pays 15 per cent and the State pays 7.5 per cent of their annual income that is subject to the same ceiling that applies for employees.

5A.1.2 Key Pension Reform Parameters

This section focuses on the key pension parameters of the old-age pension (also known as the Two-Thirds Pension Scheme) that were addressed in the pension reform in December 2006. Table 5A.1 provides an outline of selected parameters of the pension reform.

The Definition of Pension Age

One of the main parametric changes announced in the reform concerns changes to the statutory pension age. Prior to the reform, pension age stood at sixty years for females and sixty-one years for males. Following the implementation of the reform, pension age was raised to sixty-five years, however, a number of provisos apply:

- In the case of a person born on or before the 31 December 1951, pension age is sixty-one years for the males while for females pension age is sixty years;
- In the case of a person born during the calendar years 1952-1955, pension age is sixty-two years;
- For persons born during the period 1956-1958, pension age shall be sixty-three years; for persons born in the period 1959-1961, pension age shall be sixty-four years.

Retirement before the Pension Age

Prior to the enactment of the reform, the full weight of a pension was payable to a person who has paid or has been credited with a yearly average of fifty contributions over a thirty year contributions period upon

Pension Reform: Summary of Selected Measures

Table 5A.1

	Pension Age			
	Before		After	
	Males	Females	Males	Females
2010	61	60	61	60
2013	61	60	62	62
2018	61	60	63	63
2022	61	60	64	64
2026	61	60	65	65

	No. of Contributory Years for Full-Pension Entitlement	
Before		30 years
After	Born on or before 31 December 1951	30 years
	Born between the years 1952 to 1961	35 years
	Born on or after 1 Janaury 1962	40 years

	Calculation of Pensionable Income
Before	Best 3 out of last 10 years for employed persons Last 10 years for self-occupied persons
After	No change for persons born before 1962 For persons born on or after 1962 pension determined as the yearly average of the basic wage/salary/net income/net earnings of the best 10 years within the last 40 years

	Minimum Pension
Before	4/5ths of the National Minimum Wage for a couple 2/3 of the National Minimum Wage for any other person
After	Establishment of the Guaranteed National Minimum Pension payable at a rate that is not less than 60 per cent of the National Median Income

reaching pension age. Fewer years of contribution resulted in linearly reduced pensions, with the minimum years of contributions paid required to collect a pension currently set at ten years. Following the reform, a person who has attained the age of sixty-one years but has not yet attained pension age, can after attaining sixty-one years of age claim a pension in respect of retirement if such person is no longer gainfully occupied. It is necessary that since reaching his eighteenth birthday, the claimant has had a total of:

- 2,080 (or 40 years) paid or credited contributions in the case of a person born on or after the 1st January 1962, or
- 1,820 (or 35 years) paid or credited contributions in the case of a person born during calendar years 1952-1961.

Pensionable Income

Prior to the enactment of the pension reform law, the pension was determined on the basis of the yearly average of the basic wage[6] during the best three years of the last ten years in the case of employees while

the best ten years were taken into consideration for self-occupied persons. Under the reform law, in the case of a person born on or after the 1 January 1962, the pension is determined by taking the yearly average of the basic wage/salary/net income/net earnings as the case may be, during the best ten calendar years within the last forty years immediately preceding his retirement or invalidity. In determining pensionable income, past wages and incomes are updated with the COLA granted with respect to those years.[7]

Pension Formula

Prior to the reform, the pension formula for the two thirds pension was as follows:

$$Contribution_Average * (2/3) * Pensionable_Income - Service_Pension$$

where the Contribution Average was determined as the average of two averages with the first average being the average weekly contribution over the last ten years prior to retirement (Avg_Cont10) and second being the average weekly contribution paid during a maximum of twenty years falling prior to the last ten years before the retirement of an insured person (Avg_Cont20):

$$Contribution_Average = \frac{(Avg_Cont_{10} + Avg_Cont_{20})/2}{50}$$

Therefore, prior to the enactment of the reform, the full rate of the Two-Thirds Pension was equal to two-thirds of pensionable income for a claimant who has paid or been credited with a yearly average of fifty contributions over a period of thirty years. Under the reform law, the period of contribution was changed as follows:

(i) thirty years in the case of a person born on or before the 31 December 1951;

(ii) thirty-five years for a person born during calendar years 1952-1961; and

(iii) forty years in the case of a person born on or after the 1 January 1962.

For a person born on or after the 1 January 1962, the yearly average of contributions required for the purposes of awarding a Two-Thirds Pension is assessed on any period of forty years between the first day of his contribution year in which he reaches the age of eighteen and the last day of his last complete contribution year before the beginning of his benefit year.

The Maximum Pensionable Income

Prior to the reform, the maximum pensionable income was fixed by law and was revised in recent years in line with the COLA. Following the reform, in the case of a person born on or before the 31 December 1961, whose retirement occurs on or after the 1 January 2007, the basic wage/salary/net income/net earnings and the resultant pensionable income, does not exceed €16,207.78 increased by such sum as the Government may award as a cost of living increase.

The following provisions stand: (i) for a person born on or before the 31 December 1951, the resultant pensionable income including any such cost of living increase does not exceed the sum of €17,470.30; (ii) in the case of a person born during calendar years 1952-1961, the resultant pensionable income including any such cost of living increase does not exceed the sum of €20,964.36.

In the case of a person born on or after the 1 January 1962 whose retirement occurs on or after the 1 January 2007, the resultant pensionable income does not exceed: (i) €16,207.78 increased by such sum that the Government awards for the cost of living, in respect of the years 2007-2010; (ii) €16,207.78 increased on the 1 January of each year between 2011-2013 by one third of the difference between the sum referred to above and €20,964.36; (iii) €20,964.36 increased annually by 70 per cent of the percentage increase in the

national average wage for the previous calendar year, plus 30 per cent of the inflation rate for that same year. This applies as from the 1 January 2014.

The Guaranteed National Minimum Pension

Changes were enacted to the National Minimum Pension, which stood at 4/5ths of the National Minimum Wage for a couple and 2/3rds of the National Minimum Wage for any other person. Following the enactment of the reform law, a person born on or after the 1 January 1962 who is not entitled to a Service Pension is entitled to a Guaranteed National Minimum Pension (GNMP) which is payable at a rate that is not less than 60 per cent of the National Median Income. The exact rate is determined by the Minister in charge of the Department of Social Security with the concurrence of the Minister responsible for Finance. In any case, the rate of GNMP cannot be less than that declared for the preceding year.

Crediting of Contributions

The categories of persons to whom credit of contributions is allowed has been extended to include persons born on or after the 1 January 1962, who have the legal care and custody of a child who is less than six years old, or ten years old in the case of a child suffering from a serious disability. Crediting of contributions may be claimed for a maximum period of two years in the case of a parent who has stopped working to take care of his/her child, extended to four years in the case of a child suffering from a serious disability. An adoptive parent is also able to claim such credits. Credits may be claimed for every child, with no distinction between employed and self-employed persons. The claimant is bound to have worked a minimum number of years equal to the duration of the crediting period. In the case of a parent's death, the latter proviso ceases to apply.

Pension Indexation

Persons born before the 1 of January 1962 (including present retirees) have their pension updated on the basis of the COLA as well as any increases in wages presently awarded through collective bargaining to the occupation or salary scale previously occupied by the person in retirement. Following the pension reform, persons born after the 1 of January 1962 have their pension updated annually by such a sum that corresponds to 70 per cent of the increase in the national average wage and 30 per cent of the inflation rate as published by the National Statistics Office.

Ministerial Powers and Responsibilities

The Minister in charge of the Department of Social Security will, within intervals not exceeding five years, prepare a report reviewing the workings regarding the Retirement Pensions together with recommendations for achieving further adequacy, sustainability and social solidarity. This first report was submitted in 2010. The Minister, in concurrence with the Minister of Finance has the power to make and vary any regulations requiring persons who have not reached pension age and their employers as the case may be, to make contributions into Mandatory Second Pension Funds. Such regulations may provide for the rate of contribution payable, method and frequency of payment. Second Pension funds shall be governed by the Special Funds (Regulation) Act (Cap. 450). The Minister may in conjunction with the Minister for Finance provide exemptions from income tax in respect of contributions made by any person to Third Pension funds. These funds will be governed by the Special Funds (Regulation) Act (Cap. 403) as applicable.

Other reforms

Moreover, the Maltese Government also introduced changes to the regime regulating the award of the invalidity pensions and the review procedure. The new regime was implemented over the course of 2007 after the necessary legislative and organisational changes were instituted. These measures introduced a new medical review process for this benefit and amongst the measures involved one finds:

(i) A change in the application format - starting including more medical data and further responsibility on the part of the claimant to prove his case. No invalidity pension is issued for life and each case is subject to regular reviews. All cases are reviewed every three to four years, where updated medical evidence is requested from the beneficiary.

(ii) Change in the current medical panel system - under the new system, the Department of Social Security has recruited medical practitioners through an Expression of Interest to act as a Medical Review Team. The Team's main function is to advise the Director (Social Security) on the medical aspects of invalidity claims.

(iii) Establishment of a specific medical criteria for the award of benefits - achieved by establishing "Impairment Tables" that provide the basic guidelines under which that Medical Review Team would decide on work-related impairment for invalidity pension.

(iv) Establishment of an independent systems audit - the establishment of a medical audit for benefit claims awarded and rejected on medical grounds, in order to establish whether such benefits have been awarded correctly.

Changes were also made to minimum period of sickness prior to payment of invalidity pension benefit which is now set at three months. However, this waiting period does not apply in the case of sudden severe or terminally-ill persons. During 2012 Government has also introduced a psycho-social assessment which is carried out by a multi-disciplinary panel to ascertain the working capacity of persons making claims for social benefits as a result of work incapacity.

Footnotes:

[1] Demographic assumptions based on EUROPOP2010 do not necessarily fully reflect the views of the AWG neither as a group nor of individual Member States or national statistical offices. The Maltese authorities have expressed reservations on EUROPOP2010.

[2] The bonuses covered in the projections include the full Cost Of Living Adjustment (COLA) granted to all employees and pensioners – a flat-rate compensation for inflation computed on the basis of a base wage that in 2010 stood at around 63 per cent of the average wage. Other bonuses covered in the projections include flat-rate amounts granted to employees and pensioners at the end of each quarter.

[3] Treasury Pensions cover principally pensions and allowances to Public officers who joined the Public Service of Malta prior to 15th January 1979, thereby making it a closed pension scheme. This category covers also pensions and allowances under the Widows' and Orphan's Pensions Act, the Personal Injuries (Emergency Provisions) (Cap. 111), and pensions specially authorised.

[4] Contributions are also payable by pensioners in gainful employment that retired after 5 of January 2008. Pensioners who retired earlier than this date are allowed to work without prejudicing their pension rights in the ages of 61 years to 65 years without paying social security contributions, subject to a ceiling on earnings equivalent to the national minimum wage. For this group, ceiling on earnings is removed at the age of 65 years and no further contributions are due.

[5] A self-occupied person is defined by the Social Security Act as "person who is engaged in any activity through which earnings exceeding €910 per annum are being derived".

[6] The basic wage refers to the gross wage or salary that is payable to an employed person by or on behalf of his employer excluding any remuneration for overtime, any form of bonus, any extra allowances, any remuneration in kind and commissions.

[7] COLA is a flat rate increase in wages and pensions (the latter granted in full as from Budget for 2008) that reflects the uprating of the basic wage (€177.61 per week in 2011) to the average Retail Price Index inflation measured as the 12 months moving average recorded in September of that year. In 2011, the basic wage was around 16% higher than the National Minimum Wage that came into effect on 1 January 2011.

[8] The Social Security Act defines the 'service pension' as a pension or any allowance awarded to a person at any time before and after 1 April 1978 that is payable by or on behalf of his employer with respect to past services in Malta or abroad. A change made over the years is that if the person's service pension is less than two-thirds of pensionable income then the person is awarded an Increased Retirement Pension that is equivalent to the difference between two-thirds of pensionable income and the service pension.

6. Quality of Public Finances

6. Quality of Public Finances

6.1 Policy Strategy

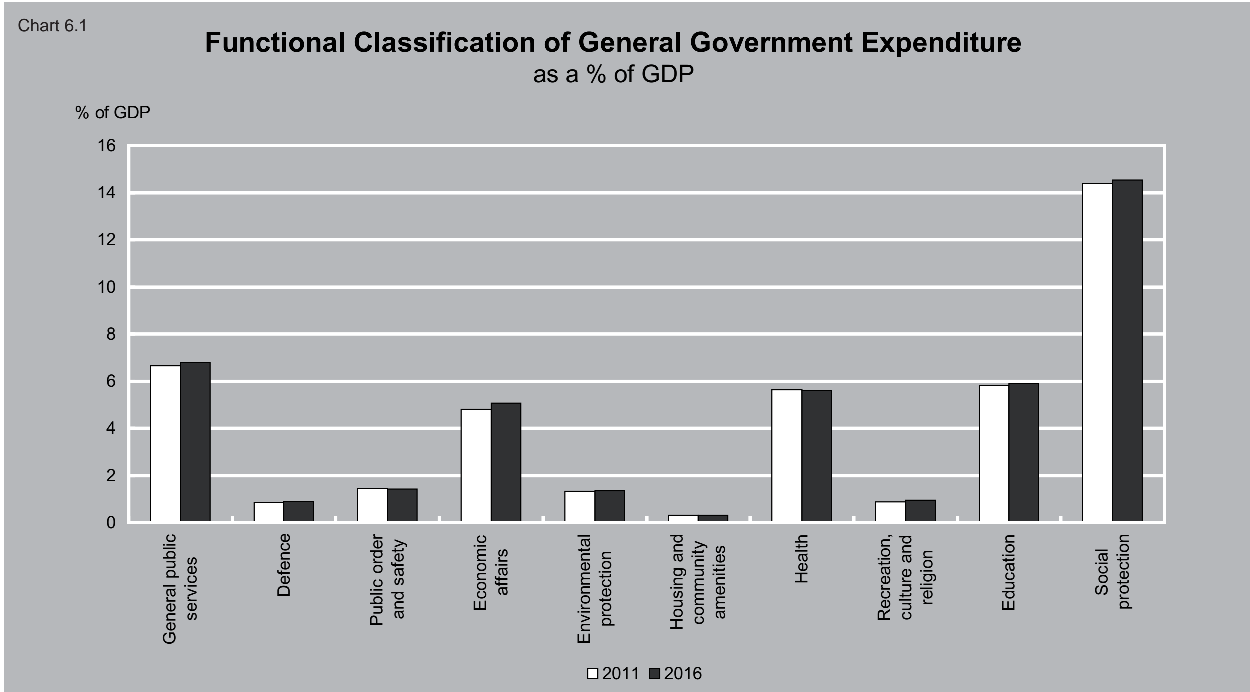
An improvement in the efficiency and effectiveness of public spending is crucial towards the attainment of a growth friendly fiscal consolidation strategy to which the Government is committed. Raising the efficiency and effectiveness of public spending provides Government with two opportunities; that of maintaining the level of spending by using fewer resources, or alternatively, improving outcomes while keeping inputs constant. Furthermore, Government's fiscal policy strategy towards increasing efficiency and effectiveness from the revenue side is achieved through the promotion of macro-economic incentives, and through spending such revenue in line with the Government's priorities. Reprioritisation of spending areas, as well as a reconsideration of appropriate policy instruments, may therefore be essential for the improvement in the efficiency and effectiveness of public finances. Government aims to examine all spending to make sure there is no unnecessary over-spending, and that each euro is spent in the best possible way, thus ensuring full utilisation of financial resources.

6.2 Composition, Efficiency and Effectiveness of Expenditure

6.2.1 Composition of Expenditure Systems

The ratio of total expenditure to GDP is expected to follow an upward trend, increasing from 42.1 per cent of GDP in 2011 to 42.9 per cent in 2016. This development is underpinned by higher absolute levels of expenditure components when compared to the increase in economic growth. Chart 6.1 displays general Government expenditure by functional classification as a percentage of GDP, while the corresponding data is presented in Statistical Appendix Table 3.

The increase of 0.8 percentage points in total general Government expenditure as a percentage of GDP during the period under review is underpinned by an increase of 1.0 percentage point in capital expenditure, supported by the absorption of EU funds. The increase in capital expenditure is expected to be partially offset by a projected decline in current expenditure from 38.9 per cent of GDP in 2011 to 38.7 per cent in 2016. Higher expenditure in the form of capital expenditure is deemed to be more growth friendly, since it supports economic growth in the longer term.



Over the 2011-2016 period, the ratios of expenditure to GDP of all categories are projected to increase, except for expenditure on Public Order and Safety, Environmental Protection, Housing and Community Amenities, and Health categories, the ratios of which are expected to remain constant at 1.4 per cent of GDP for both Public Order and Safety, and Environmental Protection, and 0.3 and 5.6 per cent of GDP respectively for the remaining categories. On the other hand, marginal increases of 0.1 percentage points in 2016 when compared to 2011 are expected in the ratios of expenditure to GDP for the General Public Services, Defence, Recreation, Culture and Religion, Education, and Social Protection categories which are expected to reach shares of 6.8, 0.9, 1.0, 5.9 and 14.5 per cent of GDP respectively in 2016. The ratio of Government expenditure to GDP for the Economic Affairs category is expected to increase by 0.3 percentage points reaching 5.1 per cent in 2016 when compared to 2011.

On an absolute level between 2011 and 2016, total general Government expenditure is expected to increase by 22.3 per cent. The highest increase in expenditure is expected to be in the Recreation, Culture and Religion category, which is projected to register an increase of 32.7 per cent over the period. The expenditure level on Defence is also projected to increase by 27.9 per cent over the forecast horizon. It is to be noted, however, that expenditure on the aforementioned two categories each comprises only a marginal 2 per cent in total general Government expenditure, thus having only a negligible effect on the overall level of expenditure.

Taking into account their respective shares in total general Government expenditure, noteworthy contributions to the increase in expenditure over the period 2011-2016 are expected in the Social Protection, General Public Services, Economic Affairs, Education, and Health categories, which on an absolute level are projected to register increases of 21.3, 22.6, 27.0, 21.5, and 19.3 per cent respectively.

In 2011, the composition of Government spending shows that the categories with the largest shares in total general Government expenditure were the Social Protection (34.2 per cent), General Public Services (15.8 per cent), Education (13.8 per cent), Health (13.4 per cent), and Economic Affairs (11.4 per cent). In total these made up 88.6 per cent of total general Government expenditure, and their share is expected to decrease only marginally to 88.5 per cent in 2016. The uppermost increase in the share of total Government expenditure in 2016 is expected in respect to the Economic Affairs category which is expected to make up 11.8 per cent of total Government expenditure in 2016, a 0.4 percentage points increase when compared to its share in 2011. Conversely, the biggest declines in the share of total Government expenditure in 2016 are expected in the Health and Social Protection categories, which are forecasted to decline by 0.3 percentage points to reach 13.1 and 33.9 per cent in 2016, respectively, when compared to 2011.

6.2.2 Efficiency and Effectiveness of Expenditure Systems

Musgrave (1959) identifies three distinct functions for public spending; an allocative role, a distributional role and a stabilisation role. Within the allocative role, public spending should be directed towards the provision of public goods deemed as market failures due to lack of clearly defined property rights, externalities, incomplete information, high transaction costs, or non-increasing returns to scale. The second role of government as identified by Musgrave (1959) is concerned with distributional issues, where public spending is directed towards adjusting the distribution of welfare to be just and fair. Through stabilisation, the third role of government, public spending should be directed to address unconstrained market forces in the long run. While public spending toward the allocative function of government is linked directly to the goal of enhancing economic growth, spending under the distributional role and the stabilisation role also influences the economic growth performance.

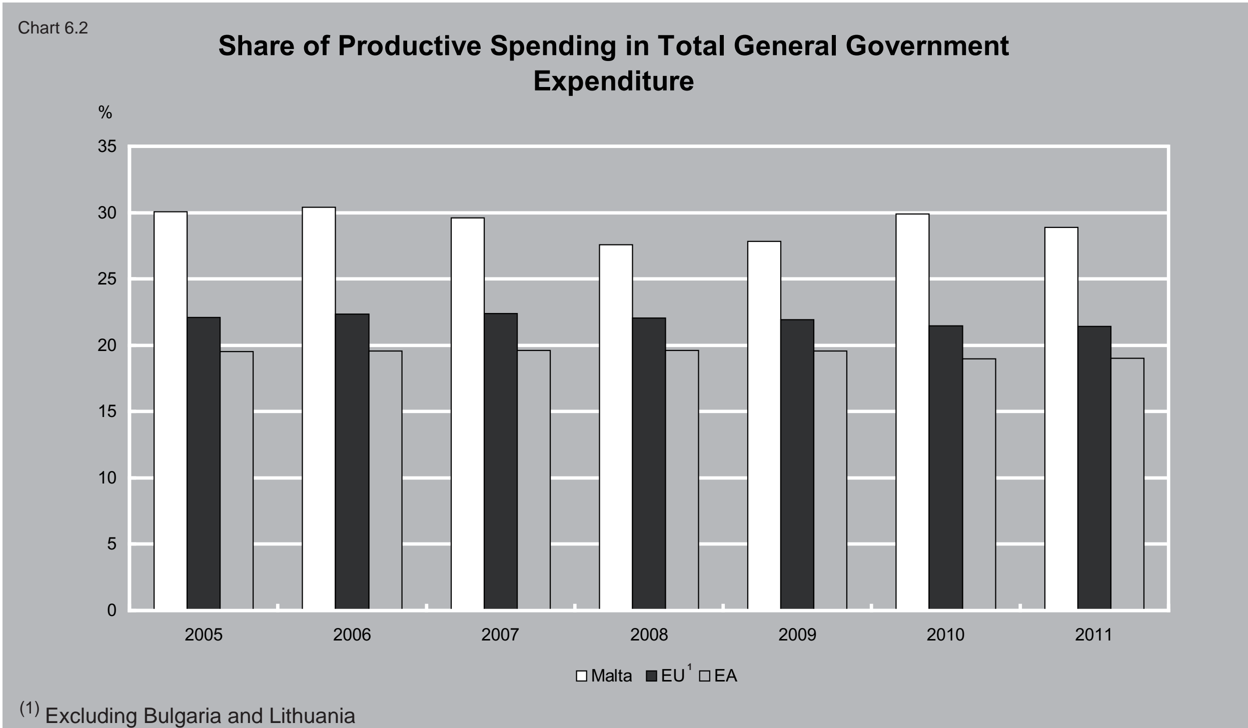
In the presence of market failure, public spending, becomes an important determinant of long-term economic growth. However, empirical literature on the relationship between the size of government and economic growth is a divisive one. Bayraktar and Moreno-Dodson (2010) both from the World Bank[1], tried to explain the conflicting results through country sample selection and expenditure classification. They concluded that public spending can be a significant determinant of growth for countries that are capable of using expenditures for productive purposes. Moreover, productivity of several public spending types depends not only on their

growth-promoting effects but also on the institutional and economic environment of a country (Pitlik and Schratzenstaller, 2011)[2]. However, even though the theoretical concept is quite clear, determining empirically which types of government spending should be counted as productive is less obvious.

Bayraktar and Moreno-Dodson (2010) separate total spending into productive and unproductive expenditure, on an a-priori criterion based on the expected impact of public spending items on the private sector production function; that is, whether a-priori the category of spending is expected to be relevant for the decision making of private investors. The authors identify general public services, defence, education, health, housing, transportation, and communication as expenditure components relating to productive Government spending which have a positive impact on growth potential through their effects on the factors of production. Nevertheless, in order to account for additional country specific characteristics, as well as other factors that may affect growth potential, as iterated by the World Bank, the definition of productive spending should be tailored and adapted at the individual country level.

Following a review of the above considerations, and taking account of data availability constraints, the following items were classified as productive public expenditure categories: Education, Health, Housing and Community Amenities, and Environmental Protection. These were netted of social benefits and social transfers in kind and interest payments, as these are not deemed to contribute to economic growth. It is to be noted that the following analysis is not directly comparable to the analysis carried out in last year's Update of the Stability Programme, as this year's analysis deductes interest payments from the productive public expenditure components as established earlier.

When comparing the share of the aforementioned components of productive expenditure categories in total general Government expenditure across 25 EU Member States (Lithuania and Bulgaria were excluded due to data availability constraints) for the period 2005-2011, Malta stands above the average for European Union (EU) and Euro Area (EA) countries for all years covered in the period under review. In fact, the average share of productive spending with respect to total Government spending in Malta averaged 29.2 per cent. In comparison, using the same definition of productive spending, the share of the latter in total Government expenditure averaged 22.0 per cent and 19.4 per cent, respectively for the EU and the EA during the same period. Such notable performance for Malta is due to better shares of productive spending in the Education, Health, and Environmental Protection categories. Chart 6.2 portrays the share of productive government spending as a share of total spending in Malta vis-à-vis the EU and the EA over the period 2005-2011.



Moreover, Government's efforts towards improving the efficiency and effectivness of expenditure systems feature highly in the fight against abuse in Government spending and the improvement in the allocation of Government expenditure. To this end, the Government seeks to examine spending so as to make sure there is no unnecessary over-spending and ensure the efficient use of scarce resources.

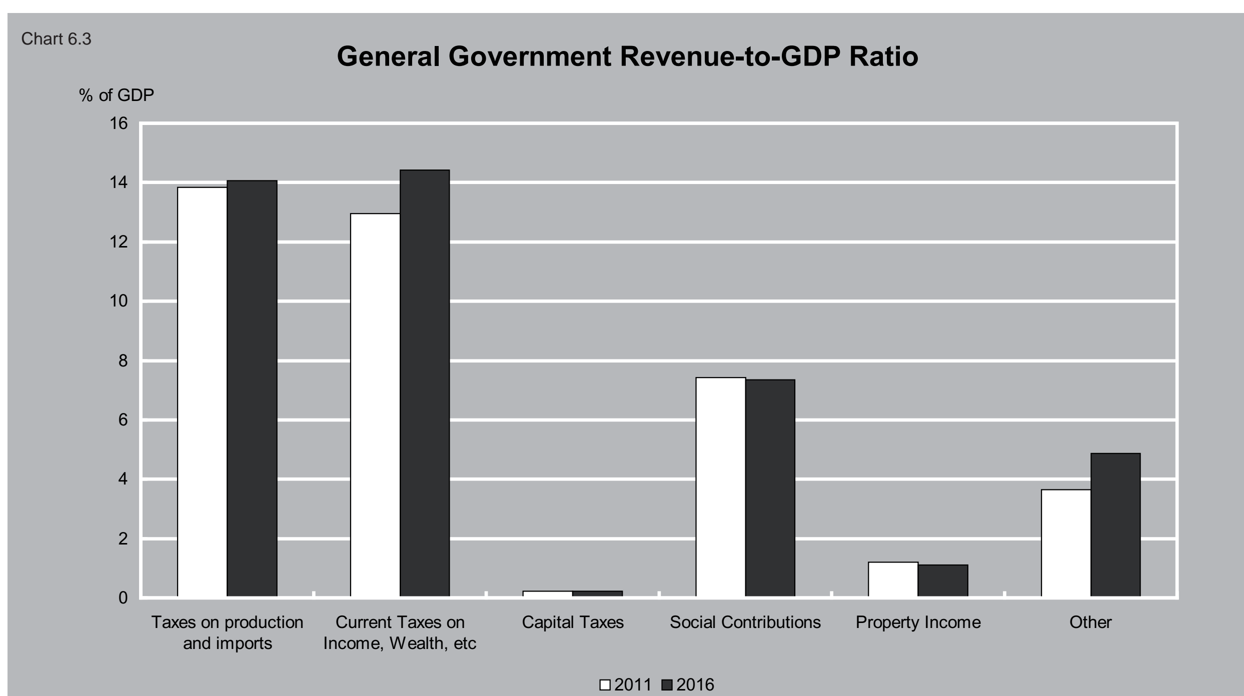
6.3 Structure and Efficiency of Revenue Systems

6.3.1 Structure of Revenue Systems

One way of supporting economic growth is through a reliable and reputable fiscal policy. To this end, Government strives to improve revenue collection and to use taxation as a policy tool to stimulates economic growth and productivity. The following analysis of the structure of revenue systems is based on the 2011-2016 period, during which, total general Government revenue is expected to rise by 28.5 per cent in 2016 when compared to 2011. Chart 6.3 and Statistical Appendix Table 2a portray the revenue-to-GDP ratios of the various revenue components.

General Government's revenue is comprised largely of tax revenue, which represented 68.8 per cent of total general Government revenue in 2011. Taxes on production and imports and current taxes on income and wealth represent the major components of tax revenue, comprising roughly half of total income from taxes. An additional component of tax revenue having a negligible effect on total tax revenue is revenue from capital taxes. This is followed by a lesser, but still significant share of revenue from social contributions which, for 2011, represented 18.9 per cent of total revenue.

The general Government revenue-to-GDP ratio is expected to increase slightly from 39.3 per cent in 2011 to 42.0 per cent in 2016, mainly reflecting an increase of 1.7 percentage points in the tax revenue-to-GDP ratio from 27.0 per cent in 2011 to 28.7 per cent in 2016. The increase in the tax revenue-to-GDP ratio mainly reflects an increase of 1.5 percentage points in the ratio of taxes on income and wealth. The ratios of general Government revenue from social contributions and property income to GDP are expected to decrease marginally by 0.1 percentage points, reaching 7.4 per cent and 1.1 per cent, respectively, in 2016 when compared to that registered in 2011. Conversely, the ratio of the 'other' revenue component is expected to increase by 1.2 percentage points in 2016, reaching 4.9 per cent mainly attributable to increases in other capital transfers and investment grants as a ratio to GDP.



The share of tax revenue in total general Government revenue is expected to decline marginally from 68.8 per cent in 2011 to 68.3 per cent in 2016. This is mainly attributable to a forecasted decline in the share of taxes on production and imports of 1.8 percentage points which more than outweigh the increase of 1.3 percentage points in taxes on income and wealth during the same period. Revenue from capital taxes contributes marginally to total tax revenue, the share of which is expected to decline marginally to 0.5 per cent in 2016 when compared to a share of 0.6 per cent registered in 2011. The shares of revenue from social contributions and property income are expected to decline by 1.4 and 0.4 percentage points respectively in 2016 when compared to 2011, reaching 17.5 per cent and 2.6 per cent respectively. Conversely, the share of revenue from the remaining 'other' revenue category is forecasted to reach 11.6 per cent in 2016, thus increasing by 2.3 percentage points over the share registered in 2011. This comprises mainly increases in other capital transfers and investment grants pertaining to the absorption of EU funds.

6.3.2 Efficiency and Effectiveness of Revenue Systems

It is to be noted that the increase in direct taxes on income and wealth as a share af GDP is expected to take place despite the downward revision in the top income tax rate for a number of income earners. This suggest that the increase in the ratio of taxes on income and wealth is mainly due to an increase in the tax base. Such increases are not distortive on economic activity. On the other hand, the pension reform initiatives underline an increase in the average effective social contribution rate. Nevertheless, it should be pointed out that Malta still enjoyes a relatively low social contribution rate. Indeed whilst social contributions in Malta represent 7.5 per cent of GDP, the simple average amongst the EU Member States is of 11.9 per cent of GDP. As a result, Malta still enjoys one of the lowest tax wedge on labour cost.

Moreover, in the Budget for 2013, Government has again made available fiscal incentives to encourage labour force participation, in addition to schemes which provide more family friendly measures. Such tax policies also promote the formation of human capital, which in turn also helps improve the labour supply.

Government is also undertaking a series of measures so as to enhance revenue collections, particularly through strengthening schemes which allow for the collection of tax arrears, while allowing more time for the settlement of tax payments.

Footnotes:

[1] Nihal Bayraktar and Blanca Moreno-Dodson (2010), 'How can public spending help you grow? - An empirical analysis for developing countries', Policy Research Working Paper 5367. (The World Bank, Poverty Reduction and Economic Management Network, Office of the Vice President).

[2] Pitlik Hans and Schratzenstaller Margit (2011), 'Growth Implications of Structure and Size of Public Sectors', WIFO Working Papers Number 404.

7. Institutional Features of Public Finances

7. Institutional Features of Public Finances

Whilst Malta has thus far displayed a relatively high degree of resilience to the international turmoil, the great recession and the numerous financial crises which have preceded it provide a clear case for the need to control dangerous debt dynamics. Government acknowledges the important role that national fiscal frameworks may play in sustaining budgetary retrenchment. There is also scope for fiscal policy to smoothen business cycles in Malta whilst recognising that such a tool may have limitations in a small open economy. If anything, a counter-cyclical fiscal policy should promote stability, preserve the long term sustainability in public finances and reduce the risk of a loss of confidence in the sovereign debt markets. There is also a need to preserve public investment which is essential for long-term growth, and to strengthen the medium to long term budgetary planning. In this context, the newly reformed EU fiscal framework provides a good basis for reforming the Maltese fiscal framework.

The revised EU fiscal framework includes the enhanced Stability and Growth Pact (SGP) which places greater emphasis on the correction of debt dynamics and the introduction of an expenditure benchmark aimed at ensuring that Government revenue emanating from unsustainable asset price developments is used for fiscal consolidation rather than to finance expenditure measures. It also includes the directive on national budgetary frameworks which foresees stronger and more independent accounting and statistics, the strengthening of forecasting processes, the application of numerical fiscal rules and the institution of medium term budgetary frameworks with multi-annual fiscal targets.

The fiscal compact further provides for the institution of a rules-based fiscal framework in national legislation with a balanced budget rule to be enshrined in the Constitution and fiscal rules to be monitored by an independent body or a body endowed with functional autonomy.

As part of the two-pack, the common provisions for monitoring and assessing budgetary plans of Euro Area Member States ensures further fiscal policy coordination with the presentation of draft national budgets prior to the annual budget legislation and the publication of the national medium term budgetary plan together or as part of the Stability Programme. Independent bodies will have a central role to play in the macroeconomic projections and in fiscal surveillance. The regulation defines more clearly what is meant by independent bodies. These can be “structurally independent” bodies or bodies endowed with “functional autonomy”. On functional autonomy the regulation states that such bodies should:

1. be ‘functionally autonomous’ from the budgetary authorities
2. be underpinned by national legal provisions
3. be free from interference and free to communicate publicly
4. have meritocratic nomination procedures
5. be adequately resourced
6. have access to the necessary information to carry out its mandate

On the independence of macroeconomic forecasts, the regulation indicates that such forecasts can be either produced by independent bodies as defined above or endorsed by independent bodies.

Whilst the EU fiscal governance framework provides a strong starting point for the reform of the fiscal governance framework, it is imperative that the framework addresses the country specificities and is tailored to meet the country’s needs and characteristics. However, the success of the new fiscal governance framework will always depend on a stronger political will to abide by it and to comply with the spirit of the framework and therefore it is deemed imperative that Maltese civil society at large, and the Maltese Parliament in particular, understands the rationale for such reforms, its strengths and limitations and takes ownership of such reforms.

The Ministry for Finance has finalised the necessary research on fiscal frameworks and fiscal councils. This should aid policy makers to deliberate on the appropriate framework for Malta subject to the EU regulations to which Malta is already committed whilst respecting in full the democratic process which needs to support these structural fiscal reforms. The analysis has focused on three major elements of reform, namely, fiscal rules, fiscal institutions and a medium term budgetary framework. Together with the strengthening of fiscal accounting and statistical frameworks the three elements need to work together to strengthen Malta's fiscal framework.

7.1 Fiscal Rules

Fiscal rules may be defined as a permanent constraint on fiscal policy in terms of a summary indicator of fiscal performance such as Government budget deficit, debt or a component of the budget. They are indeed institutional mechanisms aimed at supporting fiscal credibility and discipline. The analysis prepared by the Ministry for Finance has evaluated the performance of alternative fiscal rules under the different economic conditions that have prevailed in Malta since 2004. The rules were judged on two main performance indicators: (i) their ability to ensure a rapid correction of unsustainable fiscal positions through fiscal consolidation and (ii) their counter cyclical properties aimed at ensuring higher consolidation efforts in good times whilst avoiding economically disruptive fiscal adjustments in bad times.

No single rule was found to be optimal for Malta under the two sometimes conflicting conditions. However, a combination of the SGP rule stipulating a minimum cyclically-adjusted fiscal consolidation effort of 0.5 percentage points per annum coupled with the application of an expenditure benchmark and the application of escape clauses in 'exceptional circumstances' as defined under the SGP appears to be most promising for Malta. This would support the establishment of a balanced budget position in compliance with the new clause that will be introduced in the Constitution. Such a combination of rules would also ensure full consistency with the SGP. Despite some limitations, this framework also has the added advantage of using an existing framework which has been to a large extent tried and tested. The proposed framework also satisfies the debt reduction criteria stipulated in the recently reformed SGP.

Naturally, a rules-based framework is a desirable but not sufficient condition for fiscal sustainability. A rules-based framework has clear limitations particularly in a small open economy vulnerable to significant exogenous shocks. Whilst the size of fiscal multipliers in Mata are limited, the exposure to external shocks can be exacerbated in a monetary union where monetary policy cannot accommodate the idiosyncratic economic conditions in a recession and especially when fiscal policy is excessively coordinated among the euro area Member States. Under such conditions, counter-cyclical fiscal policy is less efficient yet more desirable for a small open economy. To achieve the same level of economic stabilisation through fiscal policy during a recession, a higher fiscal stimulus is needed in an open economy than in a closed economy. In this context there is a need to apply fiscal rules in an intelligent manner in order to take into account such country specificities.

7.2 Fiscal Institutions

The need to apply fiscal rules in an intelligent manner, complying with the spirit of the rules but avoiding an overly mechanical application and interpretation of fiscal rules means that the monitoring of fiscal rules should be entrusted to a competent fiscal institution which has the capacity to evaluate the economic conditions and not just the accounting conditions underlying fiscal developments.

Fiscal institutions can take various forms. In view of the inherent country-specific conditions and minimum requirements for an effective fiscal institution for Malta, five alternative policy recommendations were considered. These options balance the need for autonomy of a fiscal institution with the need to give the necessary apparatus for a proper fiscal policy evaluation possibly through forecasting processes and finally the need to avoid resource duplication as much as possible.

7.2.1 Option 1: Minimalist Approach: Monitoring Only

A minimal approach for an independent fiscal institution would simply require the institution to be responsible at national level for monitoring compliance with the fiscal rules with no responsibility whatsoever for evaluating the fiscal stance against the economic conditions let alone of forecasting macroeconomic aggregates or fiscal variables. Such a fiscal institution would tend to interpret the rules strictly but mechanically. This would be the major flaw of such an approach. The main advantage of this option is that it completely removes the need for economic judgement and therefore the credibility of the fiscal institution can hardly ever be questioned.

7.2.2 Option 2: Minimalist Approach: Monitoring + Evaluation

A second option for an independent fiscal institution is to monitor and analyse forecasts which are presented by the Ministry for Finance, alongside monitoring the compliance with fiscal rules. Whilst the fiscal institution would not be required to produce its own forecasts it would be able to evaluate the forecasts presented by the Ministry for Finance and present its finding to Parliament and publish its assessment. In order to evaluate these forecasts it would have to compare these forecasts with alternative forecasts. It would need to be given the faculty to probe deeper into these forecasts and request the necessary information from the Ministry, including access to confidential information. In this context the fiscal institution would need to be given access to the assumptions underlying the Ministry for Finance's forecasts together with a clear evaluation of the impact of discretionary policies and the projections under a no-policy-change scenario. It could also request sensitivity analysis. Resource duplication is minimised and the extra resources required to perform an investigative function will not be overbearing on a small administration.

7.2.3 Option 3: Monitoring, Forecasting and Evaluation Approach

The ability of a fiscal institution to produce its own set of forecasts strengthens the institution's oversight function. Therefore a third option would allow the fiscal institution to carry out its investigative functions while producing its own macroeconomic and fiscal projections, independently of the Government. The independent institution would therefore be required to prepare macroeconomic and fiscal forecasts for advisory purposes, so as to analyse the Ministry's forecasts, and then to present its own analysis. This option improves the autonomy of the fiscal institution and can greatly enhance the effectiveness of its investigative role but may create costly duplication of resources in a small administration.

7.2.4 Option 4: Monitoring, Partial Forecasting and Evaluation Approach

Given resource limitations in terms of the size of the administrative apparatus and limited specialised human resources, duplication of resources when reforming the fiscal institutional framework should be minimised in the case of Malta. Thus, a hybrid of the third option for an independent fiscal institution can be considered whereby the institution would be required to solely prepare aggregate fiscal projections, while using the macroeconomic forecasts of the Ministry for Finance as a baseline. In this way, the function of the fiscal institution would be to evaluate the consistency of the fiscal projections prepared by the Ministry for Finance with the macroeconomic forecasts. Whilst the Fiscal Institution would not be responsible to replicate the macroeconomic forecasts of the Ministry it would still be able to evaluate them as in Option 2. Under this option, duplication of resources is not eliminated completely (since two sets of fiscal projections will be made) but minimised (in the case of macroeconomic projections). Moreover the fiscal projections carried out by the fiscal institution need not duplicate entirely the function of the Ministry for Finance to determine the distribution of the available fiscal resources by ministry and function.

7.2.5 Option 5: Total Independence Option

The final alternative would be for the Ministry for Finance to completely farm-out the macroeconomic and fiscal projections to the mandate of an independent institution. This means that the fiscal institution will be responsible to produce independently the macroeconomic projections to be used in the budget together with the fiscal variables driven by the economic cycle. The independent institution performing the forecast

function is typically enshrined in legislation but could well be carried out within Government structures by giving functional autonomy to parts of the Ministry for Finance through administrative measures. This option would completely eliminate the duplication of resources which may be very costly for a small administration. It would also support a high level of autonomy. The Ministry for Finance would retain the more political role of implementing the political priorities of the Government subject to the financial envelope available. Whilst in principle it is possible to separate the political function from the purely technical function, in practice this could prove to be more difficult. Technical assumptions may encroach on the political process under the responsibility of the Ministry for Finance. The experience with such technocratic processes in other countries (for instance in Italy and Greece in recent years) suggest that these can only work if there is a strong political will to go along this route, with in-built accountability measures meant to preserve the democratic process. Consensus within Parliament and support from civil society would in this case be indispensable.

These five alternative options are currently under consideration and an independent Fiscal Council will be set up by the end of this year. Although definite decisions in this regard are still to be taken, the Fiscal Council will as a minimum need to be entrusted with the evaluation of Government's fiscal projections to guarantee more transparency in the budgetary process and prudence in the macroeconomic forecasts.

The Fiscal Council should prevent an overly mechanical interpretation of the rules in favour of an economic interpretation and make the best use of escape clauses that may be detrimental to economic policy making in a vulnerable, open economy like Malta's. To this effect, the Fiscal Council should be staffed by seasoned economists.

Given that some element of economic judgement will remain essential for good policy making in a small open economy, it is thus necessary that the Fiscal Council has political support for its role, with the institutional set-up agreed by a two-thirds majority in Parliament. A clear and achievable mandate consistent with the resources at its disposal, and access to relevant information consistent with its functions and mandate are also imperative. The Fiscal Council should be adequately supported by the resources necessary to perform its mandate.

The Fiscal Council will perform a vital task in the democratic process and therefore should be accountable for its actions to Parliament and the Maltese Constitution. The Fiscal Council will report to Parliament twice a year in line with the European Semester: following the publication of the Budget and following the publication of the Stability Programme. These reports will be published and presented to Parliament. Government will as a minimum be obliged to comply with recommendations presented by the Fiscal Council or explain the differences in line with the requirements of the EU fiscal framework. Furthermore, sanctions beyond reputational costs may be considered at a later stage. The Fiscal Council will play a vital role in communicating the rather complicated budgetary process to the general public. It should establish a direct link with the press, promote financial literacy and also provide scope for training in financial journalism. Detailed reports should be supplemented by shorter and less technical reports which can be understood by the general public.

Ultimately fiscal policy should remain a political process and the Fiscal Council should avoid -as much as is reasonably possible- interfering with the will of the democratically elected institutions unless through a delegated authority conceded by these same institutions. Thus, whatever the option chosen for Malta, the role of the Ministry for Finance remains crucial in the budgetary process. Indeed, the role of the Ministry for Finance should be strengthened further in order to ensure that the advice of fiscal institutions can be applied within the whole Government structures. In particular, the Ministry for Finance retains an important role in the operation of a multi-annual medium term budgetary framework; the third pillar of this evaluation of fiscal frameworks in Malta.

7.3 The Medium Term Budgetary Framework

A credible and effective medium term budgetary framework needs to create the right balance between control and discipline on the one hand and flexibility on the other hand. Whilst certain expenditure overruns are inevitable, lack of proper planning and foresight often leads to sizeable overruns whilst the lack of a multi-annual budgetary framework leads to persistent overruns. Indeed, whilst medium term budgetary targets are presented in Malta's annual Stability Programme, such targets are currently non-binding and subject to subsequent annual budgetary processes.

This practice shall be reformed in line with the requirements of the EU fiscal framework. In order to take into account (i) the diverse nature of fiscal policy in Malta (including the economic stabilisation, sustainable growth, and income redistribution function), (ii) the degree of uncertainty in projecting expenditure components, and (iii) the statutory political commitments which have shaped the social contract between the State and Maltese citizens over time, a rolling three-year budget framework will be established. The Stability Programme will determine the overall budgetary allocation for the three-year period. This will be consistent with the fiscal rules in place, the provisions of the SGP and on the basis of prudent macroeconomic and fiscal projections. Specific [legal/administrative] provisions will be put in place in order to ensure that the medium term budget will be preserved and overruns prevented. The medium term budget should distinguish between the following five budgetary aggregates or headings:

1. Cyclical expenditure
2. Statutory expenditure commitments
3. Debt service payments
4. Capital expenditure
5. Ministerial allocation

Different rules and provisions will apply to each heading. These rules will determine a priori spending priorities and will govern the planning process, delineate the scope for reallocation of expenditure over time or across headings and functions, establish specific ceilings or floors, establish limits to overspending or under spending, and also rules which preserve automatic stabilisers when these apply.

Nonetheless, the risk with any medium-term expenditure framework is that it could become a mechanical exercise which is not adequately responsive to the needs and priorities of the Government or to the challenges encountered by Ministries and Departments which manage a complex and diverse range of programmes.

7.4 Further Considerations

The analysis carried out by the Ministry for Finance contributes towards devising a stronger fiscal framework adaptable to Malta's circumstances and thus promotes long-term fiscal sustainability whilst preserving a stabilisation function for fiscal policy. It is however important to highlight that the success of any reform of the fiscal framework will ultimately depend on the political will to implement reform commitments. It is thus important to achieve a sufficiently high level of political consensus on the necessary reforms, which is indeed desirable in order to ensure the widest possible political ownership of the process. Whilst a number of minimum requirements and options have been evaluated, these still need to be negotiated at a political level. It is however also worth pointing out that there is consensus from both the Government and the Opposition to ratify the fiscal compact which, as indicated earlier in this Chapter, provides for the institution of a rules-based fiscal framework in national legislation with a balanced budget rule to be enshrined in the Constitution and fiscal rules to be monitored by an independent body or a body endowed with functional autonomy, in line with the analysis carried out by the Ministry for Finance.

Statistical Appendix

Macroeconomic Prospects

Table 1a

Percentages unless otherwise indicated	ESA Code	2012[1]	2012	2013[2]	2014	2015	2016
1. Real GDP	B.1g	5,000.7	0.8	1.4	1.6	1.9	1.9
2. Nominal GDP	B.1g	6,755.9	3.0	3.3	3.8	4.2	4.3
Components of real GDP							
3. Private consumption expenditure[3]	P.3	3,187.0	-0.6	0.9	1.0	1.5	1.7
4. Government consumption expenditure	P.3	1,024.9	5.5	0.6	0.5	1.1	1.6
5. Gross fixed capital formation	P.51	647.5	-2.5	0.5	3.2	3.0	2.8
6. Changes in inventories and net acquisition of valuables (% of GDP)	P.52+P.53	-111.5	-2.2	-2.2	-2.2	-2.1	-2.1
7. Exports of goods and services	P.6	5,222.0	5.2	2.1	1.6	1.0	0.7
8. Imports of goods and services	P.7	4,969.3	4.4	1.6	1.2	0.7	0.6
Contribution to real GDP growth							
9. Final domestic demand		4,859.4	0.4	0.8	1.1	1.5	1.8
10. Change in inventories and net acquisition of valuables	P.52+P.53	-111.5	-0.5	0.0	0.0	0.0	0.0
11. External balance of goods and services	B.11	252.7	1.0	0.6	0.5	0.3	0.2

[1] €million

[2] Forecasts from 2013 onwards

[3] Includes NPISH final consumption expenditure

Price Developments

Table 1b

Percentages unless otherwise indicated	ESA Code	2012[1]	2012	2013[2]	2014	2015	2016
1. GDP deflator		120.1	2.2	1.9	2.2	2.3	2.4
2. Private consumption deflator		116.3	1.8	2.0	1.6	1.7	1.8
3. Harmonised Index of Consumer Prices		118.91	3.2	2.0	1.6	1.7	1.8
4. Public consumption deflator		118.8	1.9	3.9	3.5	3.2	2.8
5. Investment deflator		146.3	5.3	1.9	2.7	2.7	2.7
6. Export price deflator (goods and services)		133.4	-0.3	2.0	2.0	3.3	3.5
7. Import price deflator (goods and services)		134.7	-0.2	2.5	2.2	3.5	3.5

[1] Index (base 2005 unless otherwise indicated)

[2] Forecasts from 2013 onwards

[3] Average 2005=100

Labour Market Developments

Table 1c

Percentages unless otherwise indicated	ESA Code	2012	2012	2013[1]	2014	2015	2016
1. Employment, persons[2]		171.4	2.4	0.7	0.9	0.7	0.9
2. Employment, hours worked[4]		344,034	2.4	0.7	0.9	0.7	0.9
3. Unemployment rate[5]		11.8	6.4	6.6	6.4	6.1	5.7
4. Labour Productivity, persons[6] (€)		29,176	-0.5	0.2	0.8	1.2	1.2
5. Labour Productivity, hours worked[7] (€)		14.5	-0.5	0.2	0.8	1.2	1.2
6. Compensation of employees (€million)	D1	3,043.2	4.2	2.0	1.9	1.9	4.1
7. Compensation per employee (€)		17,755	2.9	0.7	1.1	1.3	3.4

[1] Forecasts from 2013 onwards

[2] Occupied population, domestic concept national accounts definition

[3] Thousands

[4] Annual actual hours (LFS Data)

[5] Harmonised definition, Eurostat; levels

[6] Real GDP per person employed

[7] Real GDP per hour worked

Sectoral Balances

Table 1d

Percentages of GDP	ESA Code	2011	2012	2013	2014	2015	2016
1. Net lending/ borrowing vis-à-vis the rest of the world of which:	B.9	0.8	1.8	4.0	4.7	5.9	5.2
Balance on goods and services		5.1	6.3	5.6	5.8	6.0	6.0
Balance of primary incomes and transfers		-5.3	-6.0	-4.7	-4.6	-4.1	-4.1
Capital account		0.9	1.5	3.2	3.6	4.1	3.3
2. Net lending/ borrowing of the private sector	B.9	-2.6	-4.7	1.3	2.6	4.3	4.3
3. Net lending/ borrowing of general Government	EDP B.9	-2.8	-3.3	-2.7	-2.1	-1.7	-0.8
4. Statistical discrepancy		0.6	3.1	0.0	0.0	0.0	0.0

General Government Budgetary Prospects

Table 2a

Percentages of GDP		ESA code	2012[1]	2012	2013	2014	2015	2016
Net Lending (EDP B9) by sub-sector								
1.	General Government	S13	-225.9	-3.3	-2.7	-2.1	-1.6	-0.8
2.	Central Government	S1311	-224.9	-3.3	-2.7	-2.1	-1.6	-0.8
3.	State Government	S1312	-	-	-	-	-	-
4.	Local Government	S1313	-0.9	0.0	0.0	0.0	0.0	0.0
5.	Social security funds	S1314	-	-	-	-	-	-
General Government								
6.	Total revenue	TR	2,738.0	40.5	42.1	42.8	43.2	42.0
7.	Total expenditure	TE[2]	2,963.9	43.9	44.9	44.9	44.9	42.9
8.	Net lending / borrowing	EDP B9	-225.9	-3.3	-2.7	-2.1	-1.6	-0.8
9.	Interest expenditure	EDP D41	212.8	3.2	3.2	3.2	3.2	3.2
10.	Primary balance[3]		-13.0	-0.2	0.5	1.1	1.6	2.4
11.	One-off and other temporary measures[4]		7.1	0.1	0.2	0.1	0.1	0.1
Selected Components of Revenue								
12.	Total Taxes (12=12a+12b+12c)		1,871.0	27.7	28.6	28.8	28.9	28.7
12a.	Taxes on production and imports	D2	919.9	13.6	14.4	14.3	14.3	14.1
12b.	Current Taxes on Income, Wealth, etc.	D5	934.9	13.8	13.9	14.3	14.4	14.4
12c.	Capital Taxes	D91	16.1	0.2	0.2	0.2	0.2	0.2
13.	Social Contributions	D61	504.3	7.5	7.4	7.4	7.4	7.4
14.	Property Income	D4	89.8	1.3	1.3	1.2	1.2	1.1
15.	Other[5]		272.9	4.0	4.8	5.3	5.7	4.9
16=6.	Total Revenue	TR	2,738.0	40.5	42.1	42.8	43.2	42.0
p.m.:	Tax Burden (D2+D5+D61+D91-D995)[6]		2,397.2	35.5	36.3	36.5	36.7	36.4
Selected Components of Expenditure								
17.	Compensation of employees + intermediate consumption	D1+P2	1,366.4	20.2	20.2	20.1	19.7	19.1
17a.	Compensation of employees	D1	914.8	13.5	13.5	13.3	13.2	12.9
17b.	Intermediate consumption	P2	451.6	6.7	6.7	6.7	6.6	6.2
18.	Social payments (18=18a+18b)		938.7	13.9	13.7	13.7	13.7	13.5
	of which Unemployment benefits[7]		25.6	0.4	0.4	0.4	0.3	0.3
18a.	Social transfers in kind supplied via market producers	D6311, D63121, D63131	52.1	0.8	0.8	0.8	0.8	0.8
18b.	Social transfers other than in kind	D62	886.6	13.1	12.9	12.9	12.8	12.7
19=9.	Interest expenditure	EDP D41	212.8	3.2	3.2	3.2	3.2	3.2
20.	Subsidies	D3	74.6	1.1	1.2	1.3	1.2	1.1
21.	Gross fixed capital formation	P51	207.6	3.1	3.5	3.7	3.7	3.3
22.	Capital transfers		71.0	1.1	1.1	1.0	1.5	0.7
23.	Other[8]		92.6	1.4	1.9	1.8	1.8	1.8
24=7.	Total Expenditure	TE[2]	2,963.9	43.9	44.9	44.9	44.9	42.9
p.m.:	Government consumption (nominal)	P3	1,447.1	21.4	21.3	21.2	20.8	20.2

[1] €million

[2] Adjusted for the net flow of swap-related flows, so that TR-TE=EDP B9

[3] The primary balance is calculated as (EDP B9, item 8) plus (EDP D41, item 9)

[4] A plus sign means deficit-reducing one-off measures

[5] P11+P12+P131+D39+D7+D9 (other than D91)

[6] Including those collected by the EU and including an adjustment for uncollected taxes and social contributions (D995), if appropriate

[7] Includes cash benefits (D621 and D624) and in kind benefits (D631) related to unemployment benefits

[8] D29+D4 (other than D41)+ D5+D7+P52+P53+K2+D8

No policy change projections

Table 2b

Percentages of GDP		2012[1]	2012	2013	2014	2015	2016
1.	Total revenue at unchanged policies	2,641.7	39.3	42.1	42.6	43.3	41.9
2.	Total expenditure at unchanged policies	2,947.7	43.6	44.5	45.1	44.6	43.1

[1] €million

Amounts to be excluded from the expenditure benchmark

Table 2c

Percentages of GDP	2012[1]	2012	2013	2014	2015	2016
1. Expenditure on EU programmes fully matched by EU funds revenue	97.2	1.4	2.8	3.2	3.7	2.9
2. Cyclical unemployment benefit expenditure[2]	0.0	0.0	0.0	0.0	-0.0	-0.0
3. Effect of discretionary revenue measures	-	-	0.2	0.2	0.0	0.0
4. Revenue increases mandated by law*	84.8	1.3	-0.1	0.0	-0.1	0.1

[1] €million

[2] Estimate based on the sensitivity of expenditure to the output gap

*Revenue increases mandated by law are assumed to be equal to the budget measures and pension reform intiatives

General Government Expenditure by Function

Table 3

	Percentages of GDP	COFOG Code	2011	2016
1.	General public services	1	6.7	6.8
2.	Defence	2	0.9	0.9
3.	Public order and safety	3	1.4	1.4
4.	Economic affairs	4	4.8	5.1
5.	Environmental protection	5	1.3	1.4
6.	Housing and community amenities	6	0.3	0.3
7.	Health	7	5.6	5.6
8.	Recreation, culture and religion	8	0.9	1.0
9.	Education	9	5.8	5.9
10.	Social protection	10	14.4	14.5
11.	Total Expenditure	TE	42.1	42.9

General Government Debt Developments

Table 4

Percentages of GDP	ESA Code	2012	2013	2014	2015	2016
1. Gross debt		72.1	74.2	74.2	72.7	70.0
2. Change in gross debt ratio		1.8	2.1	0.0	-1.6	-2.6
Contributions to changes in gross debt						
3. Primary balance		0.2	-0.5	-1.1	-1.6	-2.4
4. Interest expenditure	EDP D.41	3.2	3.2	3.2	3.2	3.2
5. Stock-flow adjustment		0.6	1.7	0.6	-0.2	-0.4
p.m. implicit interest rate on debt(1)		4.6	4.6	4.5	4.6	4.6

(1) Proxied by interest expenditure divided by the debt level of the previous year.

Cyclical Developments

Table 5

Percentages of GDP	ESA Code	2012	2013	2014	2015	2016
1. Real GDP growth (%)		0.8	1.4	1.6	1.9	1.9
2. Net lending of General Government	EDP B.9	-3.3	-2.7	-2.1	-1.6	-0.8
3. Interest expenditure	EDP D.41	3.2	3.2	3.2	3.2	3.2
4. One-off and other temporary measures[1]		0.1	0.2	0.1	0.1	0.1
5. Potential GDP growth (%)		1.2	1.3	1.3	1.4	1.8
contributions:						
- labour (hours)		0.4	0.4	0.3	0.3	0.6
- capital		0.0	0.0	0.1	0.1	0.2
- total factor productivity		0.8	0.8	0.9	1.0	1.0
6. Output Gap		-0.7	-0.5	-0.3	0.2	0.4
7. Cyclical Budgetary Component		-0.3	-0.2	-0.1	0.1	0.1
8. Cyclically-Adjusted Balance (2-7)		-3.1	-2.5	-2.0	-1.7	-0.9
9. Cyclically-Adjusted Primary Balance (8+3)		0.1	0.7	1.2	1.5	2.3
10. Structural Balance (8-4)		-3.2	-2.7	-2.2	-1.8	-1.0

[1] A plus sign means deficit-reducing one-off measures

Divergence from the April 2012 Stability Programme

Table 6

Percentages of GDP	ESA Code	2012	2013	2014	2015	2016
Real GDP growth						
Previous update		1.5	2.0	2.0	2.1	…
Current update		0.8	1.4	1.6	1.9	1.9
Difference		0.7	0.6	0.4	0.2	-
General Government net lending	EDP B.9					
Previous update		-2.2	-1.7	-1.1	-0.3	…
Current update		-3.3	-2.7	-2.1	-1.6	-0.8
Difference		1.1	1.0	1.0	1.3	-
General Government gross debt						
Previous update		70.3	68.7	67.4	65.3	…
Current update		72.1	74.2	74.2	72.7	70.0
Difference		1.8	5.5	6.8	7.4	-

Long-term Sustainability of Public Finances

Table 7

Percentages of GDP	2010	2020	2030	2040	2050	2060
Total Expenditure	-	-	-	-	-	-
of which: age-related expenditures	21.9	22.1	22.9	24.3	26.5	30.1
Pension expenditure*	10.4	10.6	10.4	11.4	13.4	15.9
Social security pensions**	-	-	-	-	-	-
Old-age and early pensions	5.8	6.7	7.2	8.5	10.8	13.3
Other pensions (disability, survivors)	4.6	4.0	3.3	2.9	2.6	2.7
Occupational pensions	-	-	-	-	-	-
Health care	5.4	6.2	7.0	7.6	7.8	8.3
Long-term care	0.7	0.8	1.2	1.2	1.2	1.5
Educational expenditure	5.1	4.1	4.0	3.7	3.7	4.0
Other age-related expenditures: (Unemployment benefits)	0.4	0.4	0.4	0.4	0.4	0.4
Interest expenditure	-	-	-	-	-	-
Total revenue	-	-	-	-	-	-
of which: property income	2.2	2.2	2.1	2.0	2.0	2.0
of which: from pensions contributions	8.8	8.9	8.9	8.6	8.5	8.3
Pension reserve fund assets	-	-	-	-	-	-
of which: consolidated public pension fund assets	-	-	-	-	-	-
Labour productivity growth	1.0	1.7	1.8	1.8	1.7	1.5
Real GDP growth	1.4	1.9	1.9	1.4	0.8	0.9
Participation rate males (aged 20-64)	83.0	85.4	88.5	87.5	87.0	87.3
Participation rate females (aged 20-64)	44.9	53.3	59.3	59.9	59.7	60.2
Total participation rates (aged 20-64)	64.3	69.7	74.3	74.1	73.9	74.3
Unemployment rate (aged 15-64)	6.9	6.8	6.7	6.6	6.6	6.6
Population aged 65+ over total population	15.1	20.7	24.2	25.1	27.8	31.2

* The coverage of pensions in Malta has been widened in this round compared to the 2009 Ageing Report. Alongside the pensions covered in the Ageing Report 2009, this round covered also Treasury pensions, the non-contributory old-age pension and the bonus associated with respective contributory and non-contributory benefits.

** Malta's two-thirds pension included under the pension expenditure category

Note: Figures may not add up due to rounding

Contingent liabilities

Table 7a		% of GDP
	2011	**2012**
Public guarantees	16.3	17.6

Basic Assumptions

Table 8

	2012	2013	2014	2015	2016
Short-term interest rate (annual average)	0.8	0.8	0.8	0.8	0.8
EUR/USD exchange rate (annual average)	1.3	1.3	1.3	1.3	1.3
GBP/EUR exchange rate (annual average)	0.8	0.9	0.8	0.8	0.8
Malta’s main trading partners growth	0.3	0.5	1.5	1.8	1.8
Oil prices, (Brent, USD/barrel)	111.6	111.1	111.6	109.4	109.4