MFAC
MALTA FISCAL ADVISORY COUNCIL

An Assessment of the Half-Yearly Report 2016 published by the Ministry for Finance

A report prepared by the
Malta Fiscal Advisory Council

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Dear Minister

LETTER OF TRANSMITTAL

In terms of Article 13 of the Fiscal Responsibility Act, 2014 (Cap 534), I have the honour to present the overall assessment by the Malta Fiscal Advisory Council (MFAC) of the Ministry for Finance's 2016 Half-Yearly Report which was tabled in Parliament on 25 July 2016.

The Council notes that the official macroeconomic forecasts which had been presented in the last Budget and which were subsequently revised in the Update of Stability Programme of April, have been retained unchanged in the Half-Yearly Report. The Council welcomes the explanations provided in the Half-Yearly Report to justify the unchanged macroeconomic forecasts for 2016. On the basis of the available information by the cut-off date, namely the 2016 first quarter GDP statistics, and monthly inflation and labour market statistics, the Council considers these macroeconomic forecasts to be still plausible.

Turning to the fiscal projections, the Council notes that the original estimates presented in the Budget were revised in the Update of Stability Programme, to ensure consistency with the updated more positive macroeconomic outlook. This contributed to upward revisions to the expected revenues in 2016. Some upward corrections to the overall expenditure plans were also made, but these were partially dampened through new expenditure restraint measures. The Half-Yearly Report further fine-tuned the deficit and debt targets for 2016, through other upward corrections to the expected revenues and expenditures, on the basis of the latest developments in the Consolidated Fund.

The Council welcomes the fact that when compared to the Budget, the Half-Yearly Report confirms a more ambitious fiscal deficit target for 2016, with the latest projected deficit set at €70 million equivalent to 0.74% of GDP, against the original target of €102 million or 1.1% of GDP. The Council positively notes the Government's commitment that most of the additional revenue will be utilised for fiscal consolidation, whereby possible revenue windfalls over the Budget figures would be channelled into a faster decline in the deficit rather than to finance permanent expenditure initiatives. This is important so as to put the fiscal position on a sounder footing and to ensure that the fiscal rules, prescribed in the Stability and Growth Pact, are also fully respected.

The Council considers that the fiscal developments in the first six months of the year are generally conducive to the attainment of the 2016 fiscal targets. Overall, the Council's revenue plausibility assessment builds on the fact that the Council had already judged the revenue forecasts contained in the Update of Stability Programme to be within its endorsable range. Moreover, the revenue revisions indicated in the Half-Yearly Report are minimal and the macroeconomic projections underpinning such fiscal forecasts are still deemed to be plausible. With regard to the updated expenditure targets, the Council considers these to be attainable. At the same time, the Council notes that the actual spending as per cent of the approved Budget estimates for the year varies significantly across expenditure vote categories. The Council is aware of possible timing issues, as well as the practice whereby budget expenditure allocations can be re-allocated across ministries intra-year, in order to ensure that the overall targets are respected. It is important that such a practice would be accompanied by further savings which could be achieved on the basis of the findings emerging from the series of Comprehensive Spending Reviews.

The Council notes positively the progress made by the Ministry to explain better the drivers of variations in macroeconomic and fiscal forecasts across forecast vintages. The Council also welcomes the progress achieved in the collection of revenue arrears. Indeed, it is important that outstanding arrears, both for revenues and expenditures are kept under constant check.

The MFAC takes note that the Government's intention is to aim for an improvement in the structural balance of 0.8 percentage point of potential output, slightly more than the 0.6 percentage point which had been initially indicated in the Budget. The MFAC supports such a target which should enable the Government to correct for the 2015 shortfall in respect of the structural balance criterion. At the same time, it is also very important that expenditure growth is closely monitored not only to ensure that the targeted improvement in the structural balance is achieved but also to ensure that the expenditure benchmark is respected in 2016.

In this context, the Council would like to invite the Ministry to include in the Half-Yearly Report an explicit assessment of the plausibility of the forecast potential GDP growth and of the expected output gap conditions. This would help to reduce the possibility of a repetition of what had happened in 2015 when no improvement in the structural balance was achieved mostly as a result of significant deviations between the expected and the actual output gap conditions.

In terms of content to be included in the Half-Yearly Report, the Council considers that the Report broadly meets the requirements prescribed in Article 39 of the Fiscal Responsibility Act. However, Article 39 also requires more detailed information about the absorption of European Union funds and the results achieved. Such funds play an important role within the Budget, and the Council would therefore like to invite the Ministry to document progress in this regard more thoroughly in the Report.

Finally, the Council would like to express satisfaction at the ongoing constructive dialogue with the parties involved within the Ministry for Finance.

Yours sincerely

Rene Saliba
Chairman

Table of Contents

List of Tables

List of Charts

List of Diagrams

Abbreviations

CBM	Central Bank of Malta
COM	European Commission
DBP	Draft Budgetary Plan
EBU	Extra-Budgetary Unit
EFSF	European Financial Stability Facility
ESA	European System of National and Regional Accounts
EU	European Union
FRA	Fiscal Responsibility Act
GDP	Gross Domestic Product
HYR	Half-Yearly Report
MFAC	Malta Fiscal Advisory Council
MFIN	Ministry for Finance
MGS	Malta Government Stock
MTFS	Medium-Term Fiscal Strategy
NDSF	National Development and Social Fund
NSO	National Statistics Office
pp	percentage point
SGP	Stability and Growth Pact
USP	Update of Stability Programme

Executive summary

This Report provides an overall assessment by the Malta Fiscal Advisory Council on the Half-Yearly Report 2016 published by the Ministry for Finance on 25 July 2016, in line with the requirements prescribed in the Fiscal Responsibility Act. The Half-Yearly Report considers the macroeconomic and fiscal developments since the presentation of the last Budget in October 2015, and since the submission of the 2016 – 2019 Update of Stability Programme in April 2016.

In its Half-Yearly Report, the Ministry for Finance confirmed the nominal GDP forecast of 6.8% and real GDP forecast of 4.2%, for 2016 published in the Update of Stability Programme. Although more recent statistics have become available since the preparation of such forecasts, the Ministry for Finance considers that these do not point to any major re-assessment of the expected macroeconomic conditions with an impact on fiscal targets for the year. On the basis of the available information, namely the 2016 first quarter GDP statistics, and monthly inflation and labour market statistics, the Council concurs with such a view, given that at the time of preparation of this Report, it is not aware of any significant factor which could adversely impact the plausibility of these macroeconomic forecasts.

With regard to the fiscal projections for 2016, revisions were mainly undertaken at the time the Update of Stability Programme was published in April, with minor updates included in the Half-Yearly Report published in July. Accordingly, the 2016 updated target for the fiscal deficit has been set at 0.74% of GDP (equivalent to €70 million), whilst that for the public debt-to-GDP ratio has been set at 62.4%.

Both revenue and expenditure projections were scaled up significantly when compared to the 2016 Budget figures, in line with the Council's previous observations of the rather conservative revenue projections and the possibly ambitious expenditure restraint. The upward revenue revisions, equivalent to €103.5 million in the Update of Stability Programme, generally followed the updated stronger macroeconomic forecasts and the better than expected tax revenue outcome in 2015 as documented in the Annual Report 2015. A further €5.0 million upward revision was carried out in the Half-Yearly Report. On the other hand, the higher expenditure projections, up by €67.1 million in the Update of Stability Programme and a further €9.4 million in the Half-Yearly Report, were based on upward revisions to the expenditure calculations which were however partially dampened by additional restraint measures announced in the Update of Stability Programme. The Council notes positively that the Half-Yearly Report states "most of the additional revenue will be utilised for fiscal consolidation", and thereby possible revenue windfalls over the Budget figures are not expected to be used to finance permanent expenditure initiatives.

The Council considers that the updated revenue and expenditure projections can be attained. Indeed, on the basis of the information contained in the Half-Yearly Report, good progress has been made in relation to the fiscal targets for the year. The mid-year estimates indicate that the total revenue and total expenditure for general government respectively amounted to

47.2% and 47.3% of the targeted amounts for the whole year. As a result, during the first six months of 2016, the fiscal deficit (computed on the basis of the European statistical methodologies) was estimated at €39.2 million.

Overall, the Council's revenue plausibility assessment builds on a number of factors, including that it had already judged the revenue forecasts contained in the Update of Stability Programme to be within its endorsable range; the revenue revisions indicated in the Half-Yearly Report are minimal; and the macroeconomic projections underpinning such fiscal forecasts which were published in April 2016 are still deemed to be plausible. In the case of the updated expenditure targets, the Council notes that the actual spending as percentage of the approved estimates for the year, based on Consolidated Fund data, varies significantly across votes. However, the Council is aware that budget expenditure allocations can be re-allocated across ministries intra-year, in order to ensure that the overall cap is respected. Savings can be achieved on the basis of the findings emerging from the various Comprehensive Spending Reviews which have been carried out to date.

The Council notes positively the added fiscal transparency contributed by the Half-Yearly Report, which also highlighted the Ministry's follow-up to some of the Council's earlier recommendations.

Finally, the Council's Report includes a series of recommendations to boost transparency further, noting in particular the importance and usefulness of carrying out an explicit plausibility assessment with respect to the forecasts for potential GDP growth and the output gap, as these two variables play a significant role in the compliance with respect to the rules of the Stability and Growth Pact and the Fiscal Responsibility Act.

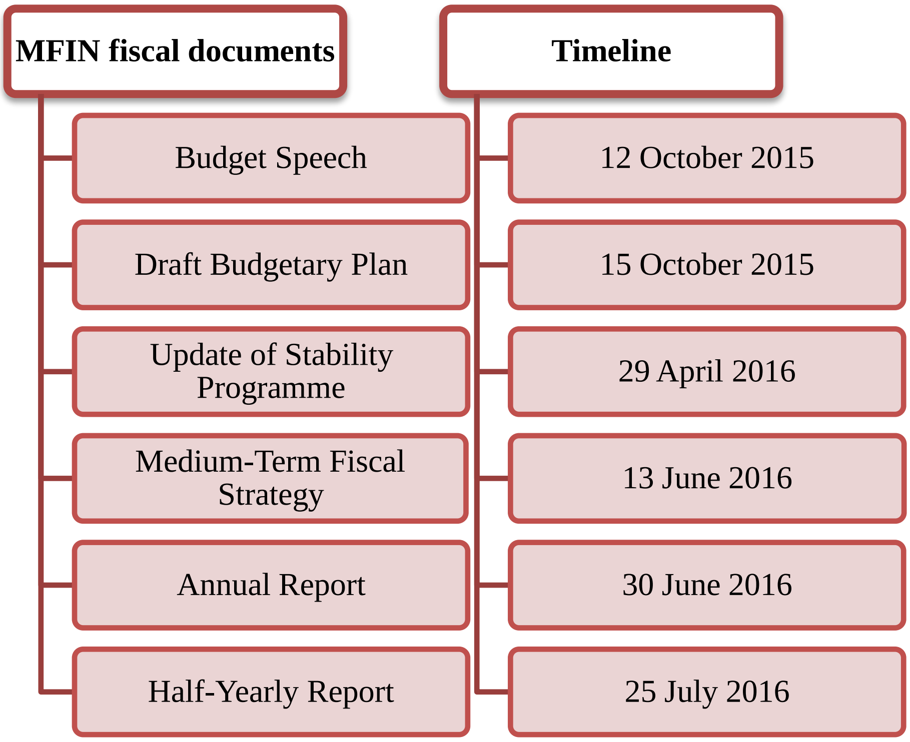
The Council considers that the HYR broadly meets the requirements prescribed in Article 39 (8) of the Fiscal Responsibility Act. However, the Council also draws attention to the fact that to ensure full compliance with the Fiscal Responsibility Act, detailed information about the utilisation of European Union funds needs to be published in the Half-Yearly Report.

1. Introduction

On 25 July 2016, the Ministry for Finance (MFIN) tabled in Parliament its second Half-Yearly Report (HYR), for 2016. This is in line with the requirements stipulated under Article 39 of the Fiscal Responsibility Act, 2014 (Cap. 534), henceforth referred to as the FRA.[1] The MFIN's HYR reviews the macroeconomic and fiscal developments since the presentation of the last Budget, on 12 October 2015, and since the submission of the 2016 – 2019 Update of Stability Programme (USP) to the European Commission (COM), on 29 April 2016.[2]

The HYR forms part of a series of documents which have become mandatory under the FRA, and which aim to boost fiscal transparency in Malta and promote greater accountability (see Diagram 1). The HYR enables the MFIN to put forward and explain any revisions to the macroeconomic and fiscal projections which are deemed necessary on the basis of the latest available information (see Diagram 2). In so doing, it allows Government to take corrective measures, if necessary, in order to ensure that the fiscal targets can be attained in line with the requirements of the FRA.

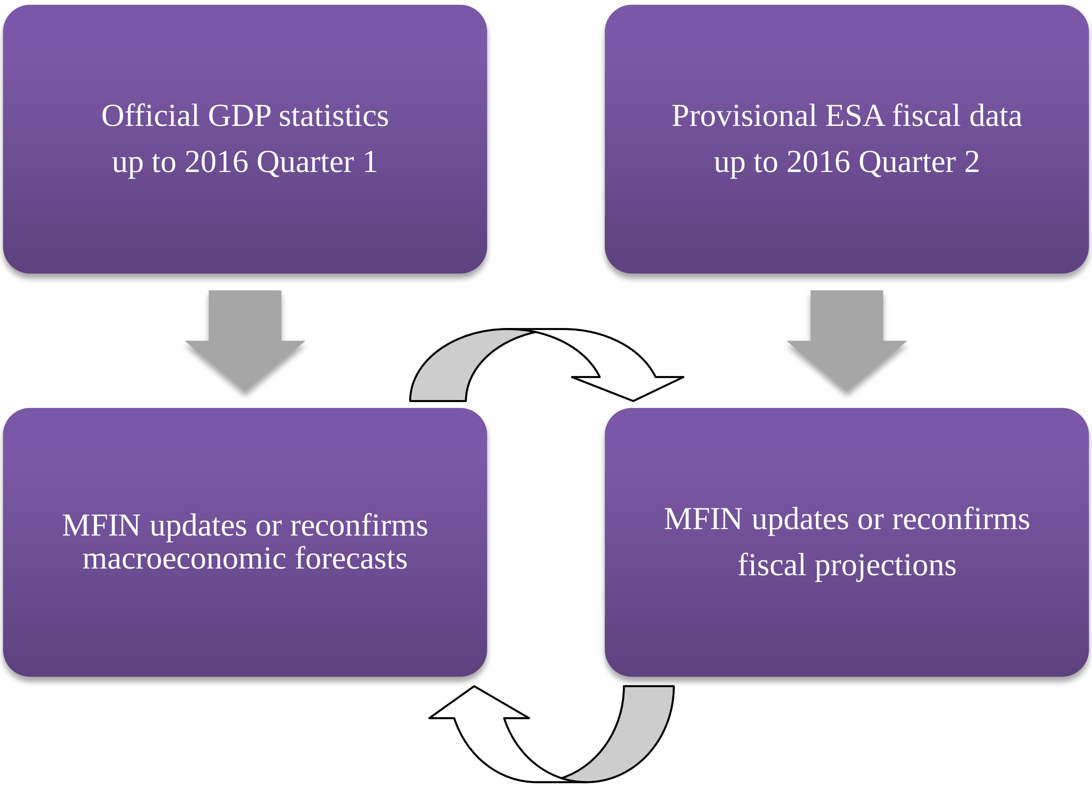
Diagram 1: Fiscal documents and their timeline



Source: MFIN

[1] Refer to Appendix 1 for the specific minimum content which must be included in the HYR.
[2] The same information presented to Parliament in the 2016 Budget documents was also submitted to the COM
[2] The same information presented to Parliament in the 2016 Budget documents was also submitted to the COM
on 15 October 2015, as Malta's Draft Budgetary Plan (DBP) for 2016, in line with the requirements of the European Semester. The USP also served as the Medium-Term Fiscal Strategy (MTFS) document.

Diagram 2: The process for the updating of Budget forecasts



Source: MFIN

In particular, the MFIN's HYR compares the 2016 USP macroeconomic forecasts to those contained in the 2016 Budget and confirms the former as Malta's latest official macroeconomic forecasts. The HYR also presents the analysis of the Consolidated Fund developments for the first half of the year. Furthermore, the HYR carries out a similar analysis based on the provisional fiscal data compiled according to the European System of National and Regional Accounts (ESA) methodology. The HYR then reproduces the USP updates to the Budget fiscal forecasts, and outlines some additional minor revisions, establishing the fiscal figures contained in the HYR as the latest official fiscal targets.

Article 13 of the FRA prescribes that the Malta Fiscal Advisory Council (MFAC) shall "analyse and issue an opinion and any recommendations pursuant to the Government's publication of the half-yearly and the annual report on the execution of the budget". The analysis undertaken by the MFAC, based on macroeconomic and fiscal information available up to the cut-off date of 26 August 2016, focuses predominantly on the ESA data since this is the data relevant to assess compliance with the fiscal rules.[3]

This Report proceeds as follows. Section 2 summarises how macroeconomic forecasts have changed from the time of the 2016 Budget to the presentation of the USP. Section 3 assesses

[3] ESA is an internationally compatible accounting framework of the European Union (EU) for a systematic and detailed description of an economy. For further details refer to http://ec.europa.eu/eurostat/statistics-explained/index.php/European_system_of_national_and_regional_accounts_-_ESA_2010.

the half-yearly developments in the ESA general government balance in relation to the yearly fiscal targets. Section 4 concludes with the MFAC's overall assessment and presents a number of final recommendations.

2. Macroeconomic update and assessment

Macroeconomic and fiscal projections depend critically on the information available at the time these are prepared. The cut-off dates for the macroeconomic projections contained in the latest Budget and in the USP were respectively 22 September 2015 and 23 March 2016 (see Table 1).

Table 1: Availability of macroeconomic and fiscal data

	2016 Budget	2016 USP	2016 HYR
Cut-off date	22 / 09 / 2015	23 / 03 / 2016	25 / 07 / 2016
	Availability by cut-off date		
GDP statistics	2015 quarter 2	2015 quarter 4	2016 quarter 1
ESA fiscal statistics	2015 quarter 2	2015 quarter 4	2016 quarter 2*

* Provisional estimates for 2016 quarter 2

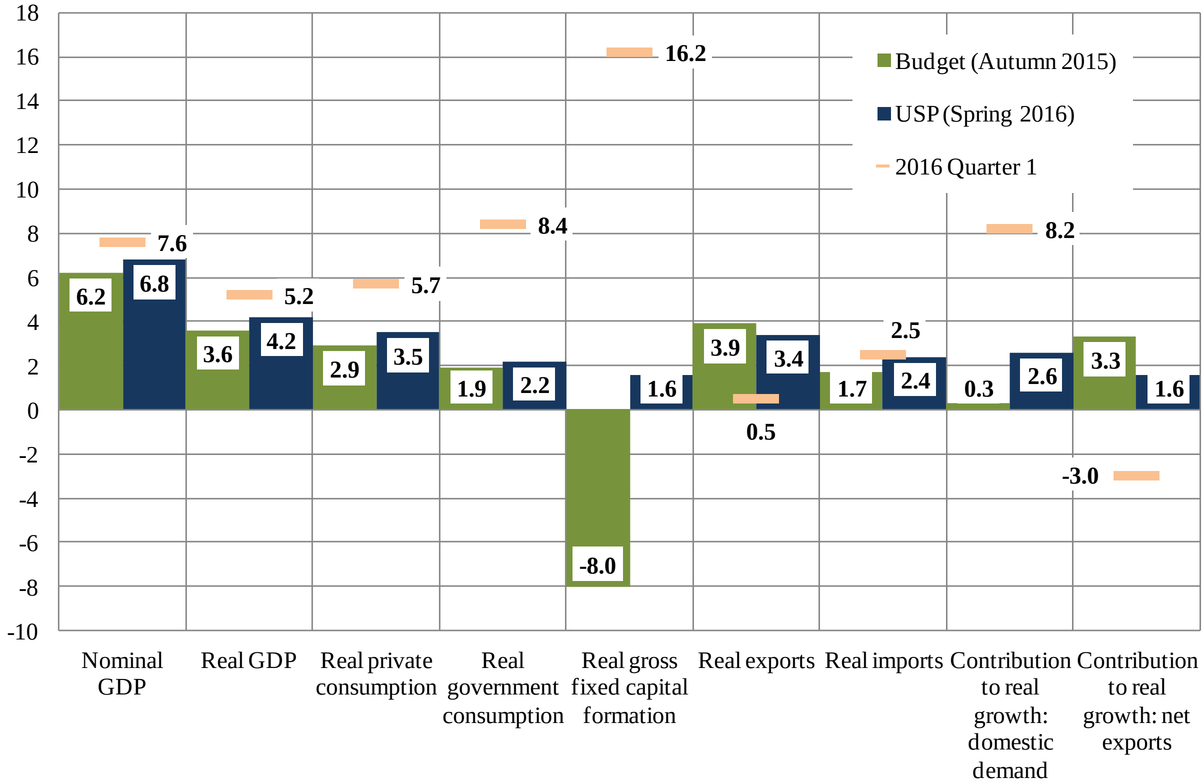
Source: MFIN

The Budget macroeconomic projections were thus based on the statistics for Gross Domestic Product (GDP) up to the second quarter of 2015, while the USP macroeconomic projections were based on the first GDP release for the whole of 2015. In turn, the ESA fiscal projections, which were published in the Budget for 2016, were produced on the basis of provisional statistics up to the first half of 2015.[4] The fiscal projections contained in the 2016 USP were subsequently based on NSO fiscal statistics up to the end of 2015.

The MFIN have undertaken some revisions to the macroeconomic forecasts between the Budget and the USP. The 2016 forecasts for nominal and real GDP growth were both increased by 0.6 percentage point (pp), respectively to 6.8% and 4.2% (see Chart 1). The composition of real growth across forecast vintages was changed, in favour of a larger contribution to growth stemming from domestic demand, instead of net exports. Whereas at the time of the Budget, domestic demand was anticipated to contribute only 0.3pp to real growth in 2016, this was raised to 2.6pp in the USP. On the other hand, the contribution to growth stemming from the net exports was scaled down from 3.3pp to 1.6pp between the two forecast rounds.

[4] The data for the first quarter was based on official statistics published by the National Statistics Office (NSO) while provisional estimates for the second quarter were prepared by the MFIN with the collaboration of the NSO.

Chart 1: 2016 GDP forecasts and turnout for 2016 Quarter 1 – year-on-year growth (%)



Source: MFIN

The swing in favour of domestic demand was driven by higher growth forecasts for both private and public consumption, as well as the updated forecast for gross fixed capital formation. In the latter case, the previous 8% expected decline was reversed to an increase of 1.6%, reflecting mainly updated information related to investment in the energy sector.[5] On the other hand, owing to the evolving external conditions, particularly the economic deceleration in the US and in China, export growth was revised slightly downwards from 3.9% to 3.4%. In contrast, import growth was revised upwards, reflecting the added import content of the higher domestic demand, particularly in the case of gross fixed capital formation.

The forecast for the annual inflation rate was reduced marginally, to 1.6% (see Table 2). With regard to the labour market, the forecast for employment growth was raised to 2.7% while that for the unemployment rate was lowered to 5.3%.[6] In turn, owing to the strong investment and buoyant labour supply, the potential GDP growth rate was lifted to 4.2% from 3.4%. Nonetheless, the output gap was increased from 0.6% to 1.6% of potential output.[7]

[5] This is based on the updated figures provided by the MFIN to correct for some inaccuracies contained in Table 1 of the HYR.

[6] The labour market forecasts in the DBP and in the USP use slightly different definitions, respectively based on the resident population concept and the national accounts concept.

[7] The output gap represents the difference between the level of actual and potential output expressed as a percentage of potential output. Although higher investment expands potential output, according to the USP calculations when compared to the Budget calculations, in 2016 actual output in absolute terms will increase by more than potential output, thereby widening the output gap.

Table 2: Other macroeconomic forecasts and updates – year-on-year growth (%)

	Budget	USP	Updates	and reference period
Inflation rate	1.8	1.6	1.0	May 2016
Employment growth	2.0	2.7	2.6	First quarter of 2016
Unemployment rate	5.6	5.3	4.9	First quarter of 2016
Potential GDP growth	3.4	4.2	-	
Output gap	0.6	1.6	-	

Source: MFIN

The plausibility of the USP macroeconomic forecasts as well as the associated risks, were already evaluated by the MFAC in its macroeconomic endorsement report, on the basis of the information available to the MFAC at that time.[8] Since the publication of the USP and the accompanying MFAC endorsement, the NSO has issued the revised estimates for the 2015 GDP and produced the first GDP estimates for the first quarter of 2016. More recent inflation (up to May 2016) and labour market statistics (for the first quarter 2016) were also released by the NSO by the HYR cut-off date.

Owing to seasonality factors, the small size and extreme openness of the Maltese economy, as well as the frequent official revisions in the historical time series of GDP, the information content of the quarterly GDP statistics may not be fully indicative of the eventual yearly outcome. Indeed, during the period 2012 and 2015, the first quarter vintage year-on-year nominal and real GDP growth estimates published by the NSO were generally lower (to varying extents) than the most recent provisional estimate for the annual outturn (see Table 3).[9]

Despite the availability of new GDP statistics post the USP cut-off date, the MFIN have maintained the macroeconomic forecasts for 2016 unchanged at 4.2%. This approach had also been followed by the MFIN in the 2015 HYR. In the 2016 HYR the MFIN stated that "at present the short term indicators do not point to a revision of the macroeconomic assessment."[10]

On the basis of the available information, namely the 2016 quarter 1 GDP statistics, and monthly inflation and labour market statistics, the MFAC is not aware of any significant

[8] Refer to the MFAC's report "An Assessment of the Macroeconomic Forecasts for the Maltese economy prepared by the Ministry for Finance in April 2016", available on www.mfac.gov.mt.

[9] The figures included in the Table may not be strictly comparable since they may be influenced by changes in the methodologies used to compile such statistics, namely the switch from constant 2000 prices to chain-linked volumes as well as the switch from ESA 95 to ESA 2010.

[10] HYR page 9. Indeed, on the basis of a preliminary assessment of the impact of the revised macroeconomic scenario on the fiscal projections as documented in section 3 of the HYR, the MFIN consider that the mid-year estimates of fiscal variables contained in the HYR already contain the effect of the most up-to-date macroeconomic information such that the benefits of a revised macroeconomic forecast exercise mid-year was considered inferior to the cost of a fully-fledged macroeconomic forecast exercise.

factor which would adversely impact the plausibility of the macroeconomic forecasts for 2016, as had been presented in the USP and as had been endorsed by the MFAC.

Table 3: Year-on-year GDP growth – Quarter 1 and Annual (%)

	Nominal GDP		Real GDP	
	Quarter 1	**Annual**	**Quarter 1**	**Annual**
2012	1.0	4.9	-1.0	2.9
2013	3.7	6.2	1.6	4.3
2014	5.0	5.5	3.5	3.5
2015	6.0	8.9	4.0	6.4

Note: The quarter 1 statistics are based on the first estimate produced by the NSO for the respective year (published by the NSO in its June release of that specific year). Annual statistics refer to the most recent estimates based on NSO News release 091/2016 published on 8 June 2016.
Source: NSO

The MFAC welcomes the MFIN's follow-up on its recommendation of stating explicitly the reasons whenever the previous round of macroeconomic forecasts is retained. The HYR acknowledges that economic activity for the first quarter of 2016 was in some instances stronger than that forecasted for the whole year, offering explanations to better interpret the differences and justify why in the MFIN's view it is acceptable to maintain the official macroeconomic forecasts unchanged, particularly since macroeconomic projections are used as input in the fiscal projections. Indeed, in line with the stance adopted in earlier forecast rounds, the MFIN maintained conservative macroeconomic forecasts in general.

During the first quarter of 2016 both nominal and real GDP grew faster on a year earlier than currently expected for the whole year (see Chart 1). The same applied to private consumption, government consumption and gross fixed capital formation (all expressed in real terms). Nevertheless, in the latter case, the MFIN stated in the HYR that achieving the forecast annual gross fixed capital formation for 2016 appears to be challenging in view of a base effect created by the revised figures for 2015.[11] On the other hand, the slower growth in real exports has been attributed by the MFIN to the developments concerning the re-export of fuel, which by its nature may exhibit quarterly volatility. Hence the real export growth envisaged in the USP may still be achievable. In turn, growth in imports has proceeded practically in line with the forecast. The contribution to real growth stemming from domestic demand was thus more buoyant than that indicated in the forecasts, while net exports contributed negatively instead of positively.[12] Meanwhile, inflation appears to proceed

[11] Although this fact might pose a downward risk to the forecast for gross fixed capital formation, the risk to the overall GDP forecast is more contained owing to the generally high import content of investment.
[12] This issue is not explored further in the HYR, in particular whether it could have any impact on the fiscal targets.

slightly below the forecasts while "employment indicators suggest that the labour market may once again surprise on the upside".[13]

The MFAC takes note that whilst "the Government monitors the macroeconomic situation on an ongoing basis, Government is still in the process of updating its economic outlook with respect to the latest developments."[14] The MFAC considers the plausibility and risk assessment of the macroeconomic forecasts outlined by the MFIN in the HYR to be valid. Macroeconomic forecasts serve as a backbone for policy making and therefore it is important that these reflect as best as possible the most likely outcomes.

Moreover, the MFAC considers important that the MFIN carry out an explicit type of plausibility assessment with respect to the forecasts for potential GDP growth and the output gap. This is important to better evaluate the robustness and identify any potential bias which may surround these key variables. This is particularly useful since the output gap plays a key role in the assessment of public finance commitments under the Stability and Growth Pact (SGP). This would also reduce the possibility of a repetition of what happened in 2015 when significant deviations between the forecasted output gap conditions (based on revised historical and forecast data for the relevant inputs) and the actual output gap conditions contributed to a shortfall in the required improvement in the structural balance.[15]

3. Assessment of the half-yearly developments in the general government balance and public debt

The 2016 HYR presents both the actual revenue and expenditure figures on a cash basis for the first half of 2016 as well as the provisional estimates for the same period in ESA terms. Compliance with the fiscal targets for SGP purposes is assessed on the basis of developments in revenues and expenditures measured according to the ESA. These ESA provisional estimates are based on the official data released by the NSO for the first quarter, combined with second quarter data estimated by the MFIN with the collaboration of the NSO. In the 2015 HYR, the same approach was adopted to derive the half-yearly fiscal figures based on ESA.

The MFAC considers the quality of the provisional 2015 ESA estimates prepared by the MFIN to be good, when considering that the differences compared to the official data were contained. Indeed, when compared to the ESA fiscal statistics for the first half of 2015, published by the NSO through News Release 106/2016 (the latest available by the cut-off date), the estimated figures reported in the 2015 HYR were within a close range. However,

[13] HYR page 9.
[14] HYR page 8.
[15] The methodology used by the MFIN to produce the estimates for the output gap is based on the common methodology adopted across the EU. The inputs are based on forecasts for key variables. As a result, if the actual values for the inputs differ significantly from the forecast values, the estimates for the output gap could differ significantly.

both revenues and expenditures were underestimated.[16] The MFAC is aware that the MFIN carry out an internal exercise to explore the possible reasons of such underestimation in order to improve further the quality of such estimates in the future. It would be useful if such reasons are explained in the HYR.

The 2016 HYR incorporates the revisions to the fiscal forecasts presented in the last Budget. The main revisions were undertaken at the time the USP was presented, although some further small revisions were also included in the HYR (see Table 4). Specifically, when compared to the Budget figures, total revenue was raised by €103.5 million in the USP and a further €5.0 million in the HYR. In turn, total expenditure was increased by €67.1 million in the USP and a further €9.4 million in the HYR. It is worth noting that the revenue and expenditure revisions were predominantly driven by updated calculations, with an additional €15 million in expenditure cuts being announced in the USP.[17] To some extent the upward revisions in the USP revenues and expenditures confirmed the MFAC's assessment of the Budget figures for 2016, where the MFAC had stated that on the basis of the forecasts contained in the Budget, in the case of some revenues "there appears to be an element of prudence" while the expenditure forecasts "embed a certain element of restraint".[18] Likewise the further upward adjustments included in the HYR are in line with the MFAC's assessment of possible "revenue and expenditure upward risks" identified with respect to the USP fiscal forecasts.[19]

Table 4: Revisions to the key fiscal aggregates for 2016 in ESA terms (EUR million)

	Budget	**USP**	**HYR**	**Change USP – Budget**	**Change HYR - USP**
Total revenue	3,602.8	3,706.3	3,711.3	103.5	5.0
Total expenditure	3,704.8	3,771.9	3,781.3	67.1	9.4
Fiscal balance	-102.0	-65.6	-70.0	36.4	-4.4
as % of GDP	-1.10%	-0.70%	-0.74%	0.40pp	-0.04pp
Gross debt	5,858.8	5,878.4	5,872.3	19.6	-6.1
as % of GDP	65.2%	62.6%	62.4%	-2.60pp	-0.20pp

Source: MFIN

16 In the 2015 HYR the MFIN had underestimated the actual total revenues for the first half of 2015 by 1.9%, indicating a certain element of prudence in the preparation of such estimates. In turn, total expenditures during the same period were underestimated by only 0.6%. As a result, the fiscal balance for the first half of 2015 was actually €19.3 million or 8.4% better than originally shown in the 2015 HYR. Focusing on the various items within the budget, on the revenue side, the major differences in absolute terms related to current taxes on income and wealth which were underestimated by €18.7 million, while in the case of expenditure, capital transfers and intermediate consumption were respectively underestimated by €12.1 million and €11.8 million.
17 Without the new measures to reduce expenditure by €15 million, the upward revision in expenditure would thus have been higher.
18 Refer to "An overall assessment of the Draft Budgetary Plan 2016", page 26, available on www.mfac.gov.mt.
19 Refer to "An Assessment of the Fiscal Forecasts for Malta prepared by the Ministry for Finance in April 2016", page 40, available on www.mfac.gov.mt.

The MFIN’s headline fiscal deficit target for the whole of 2016, which was initially set at €102.0 million in the Budget, was thus revised downwards to €65.6 million in the USP, but increased slightly, to €70.0 million in the HYR. Apart from the revisions driven by the updates to the macroeconomic forecasts in between the time the 2016 Budget was presented and the 2016 USP was submitted, the changes also factored in the fact that the Government plans to undertake a stronger fiscal adjustment in structural terms in 2016 when a structural effort of 0.8pp of potential output is targeted by MFIN against the 0.6pp minimum effort required by the SGP so as to compensate for the shortfall registered in 2015. In terms of percentage to GDP, the initial deficit-to-GDP target of 1.1% was lowered to 0.70% in the USP but increased slightly to 0.74% in the HYR, which nevertheless remains below that which had been indicated in the Budget.

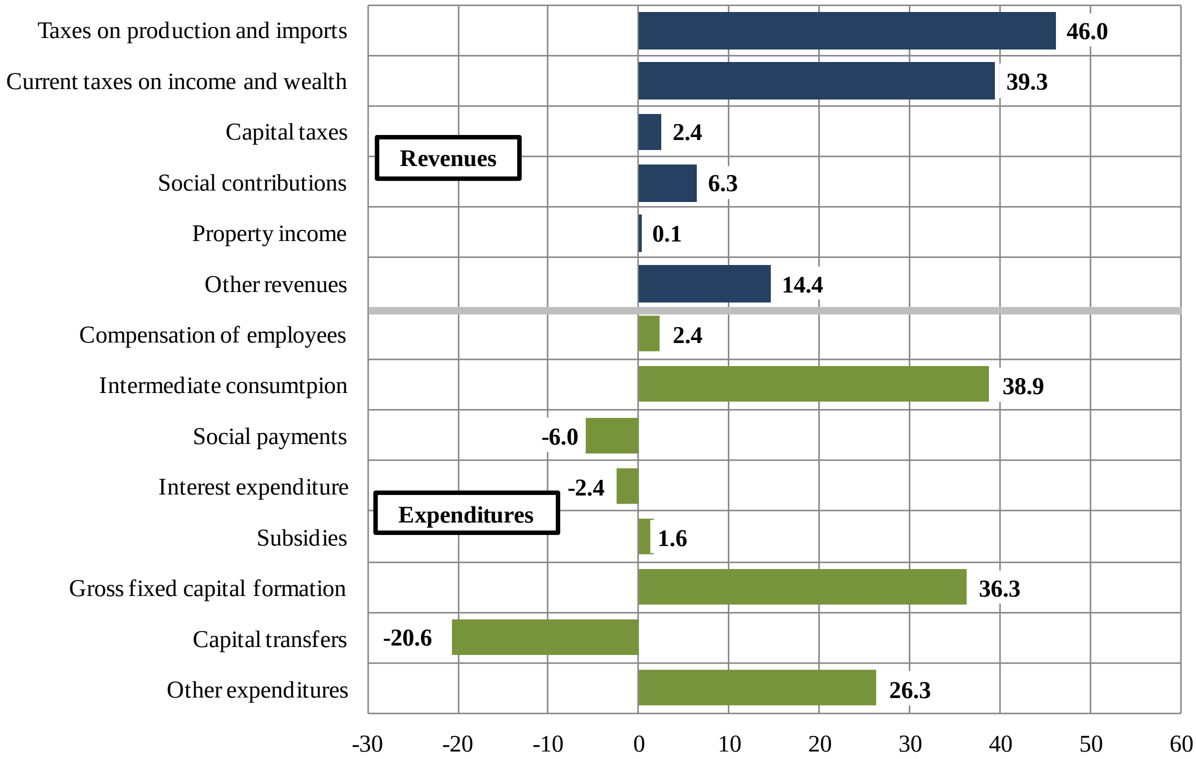
Despite the projected absolute improvement in the fiscal balance between the Budget and the USP, the forecast for gross debt had been increased by €19.6 million in the USP and scaled back by €6.1 million in the HYR. These revisions are mainly driven by changes to the pattern for cash holdings by the Government. In this respect, the MFAC invites the MFIN to clarify better its strategy for cash holding and on how such strategy contributes to ensure that financial resources are allocated optimally. The higher nominal GDP denominator also enabled the debt-to-GDP ratio to be lowered from 65.2% in the Budget, to 62.6% in the USP, and to 62.4% in the HYR.

At a component level, when compared to the Budget, all main ESA revenue categories in the HYR were revised upwards whereas in the case of expenditures, there were some offsetting revisions (see Chart 2).

Specifically, revenues from taxes on production and imports and current taxes on income and wealth were revised upwards, respectively by 3.7% and 3.1%, and are thus expected to yield an additional €46.0 million and €39.3 million. These revisions were mainly underpinned by the higher tax revenue recorded in 2015 in excess of what was anticipated in the autumn 2015 forecast, and upward revisions in the forecasts for household consumption, a strengthening of the property market and stronger growth in employment and wages.

On the other hand, the revisions to the expenditure forecasts were unrelated to the changes in the macroeconomic forecasts, owing to their generally discretionary nature. In absolute terms the largest upward revision to expenditure related to intermediate consumption. Around 70% of the adjustment was driven by higher expenditure needs of the Extra-Budgetary Units (EBUs). In this respect, the MFAC invites the MFIN to be vigilant about the financing needs of EBUs to avoid setting unrealistic targets, while at the same time maintain closer monitoring of expenditures by EBUs to ensure that these entities fully respect the targets agreed at the time of the Budget. Another factor contributing to the upward adjustment to intermediate consumption, of around €6 million, reflected a re-classification of expenditure on medicines and surgical material. However, the latter was deficit-neutral since correspondingly social payments were revised downwards by the same amount.

Chart 2: Updates to the ESA revenue and expenditure projections for 2016 (EUR million)



Note: figures show the absolute difference between the HYR and the Budget figures
Source: MFIN

In turn, the higher expected spending on gross fixed capital formation reflected predominantly an upward revision of capital expenditure by EBUs. New expenditure amounting to €28 million allocated from the National Development and Social Fund (NDSF) explains the upward revision to the 'other' expenditure category. These higher expenditures were partially dampened by the additional restraint measures specified in the USP, primarily in the form of lower capital transfers, which thus enabled a downward revision of this item of €20.6 million when compared to the Budget estimates. The MFAC re-iterates the importance of keeping expenditure growth under control in order to ensure that the expenditure benchmark, which forms part of the requirements under the SGP, is respected in 2016, after having been missed in 2015.

The HYR revenue projections for 2016 appear to be within a plausible range, on the basis of the estimated revenue turnout between January and June. Indeed, total revenue for the first six months represented 47.2% of the targeted amount (see Table 5). Owing to the different monthly revenue patterns, some deviation from the 50% benchmark is considered to be normal. Still, during this period, the intake from the various major ESA revenue components was reasonably close to the 50% benchmark in all instances.

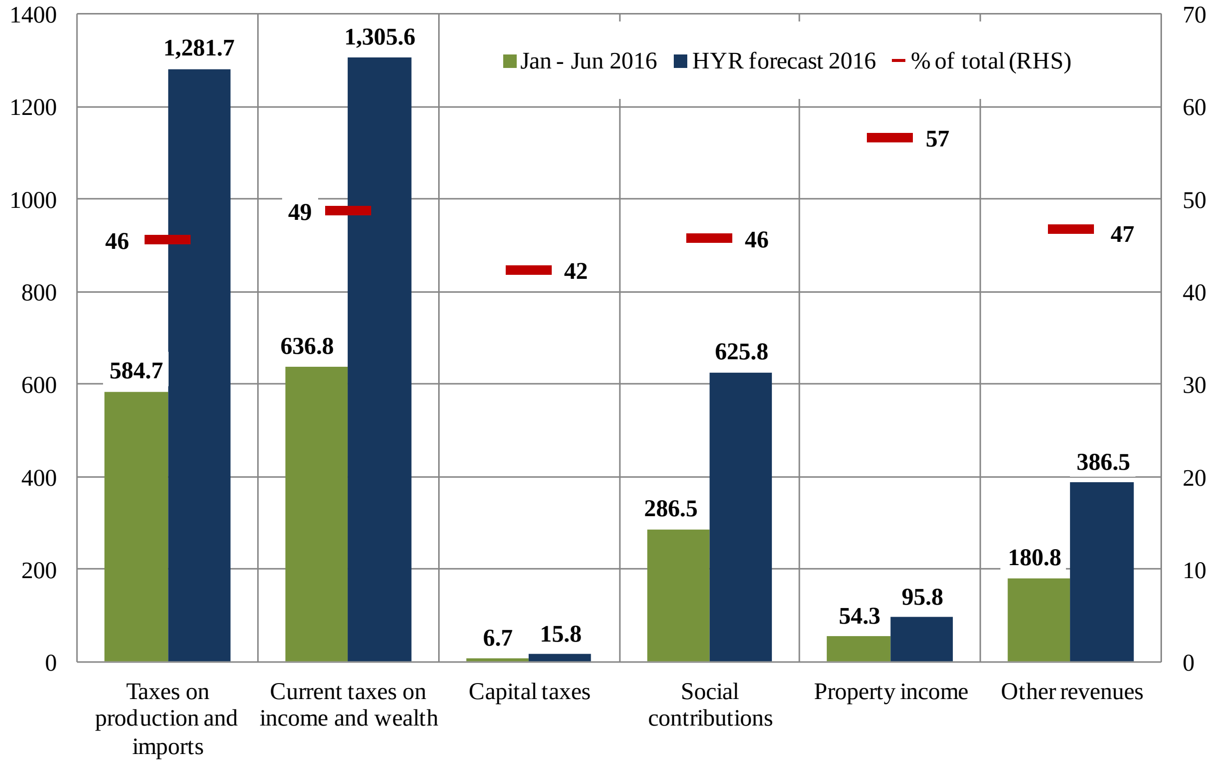
Table 5: Half-yearly overall fiscal performance on an ESA basis (EUR million)

	Jan – Jun 2016	HYR 2016 forecast	% of total
Total revenue	1,749.9	3,711.3	47.2
Total expenditure	1,789.1	3,781.3	47.3
Fiscal balance	-39.2	-70.0	56.1

Source: MFIN

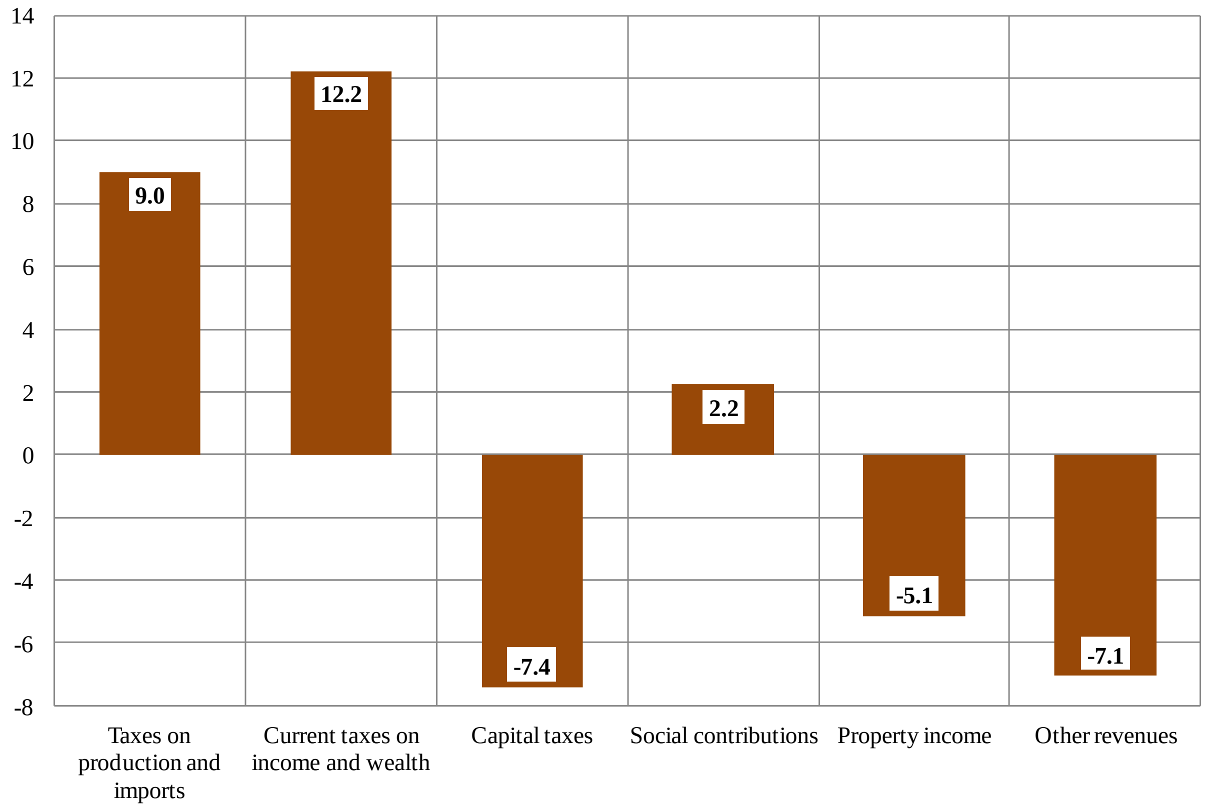
The two largest revenue sources, namely taxes on production and imports and current taxes on income and wealth, respectively yielded 46% and 49% of the projected amounts (see Chart 3). For the first six months of the year, the annual growth rates for these two revenue streams were also strong, respectively up by 9.0% and 12.2% (see Chart 4). Social contributions grew more moderately, up by 2.2%, also owing to the fact that the applicable tax base is capped. On the other hand, some declines were registered across the remaining ESA revenue categories, which however may exhibit more intra-year fluctuations. The HYR does not present specific information to explain the progress in the utilisation of EU funds, to assess whether their use had proceeded in line with what was embodied in the official forecasts or otherwise.

Chart 3: Half-yearly revenue performance on an ESA basis (EUR million)



Source: MFIN

Chart 4: Year-on-year revenue growth (%)



Note: figures show the annual growth rates January - June 2016 compared to January – June 2015

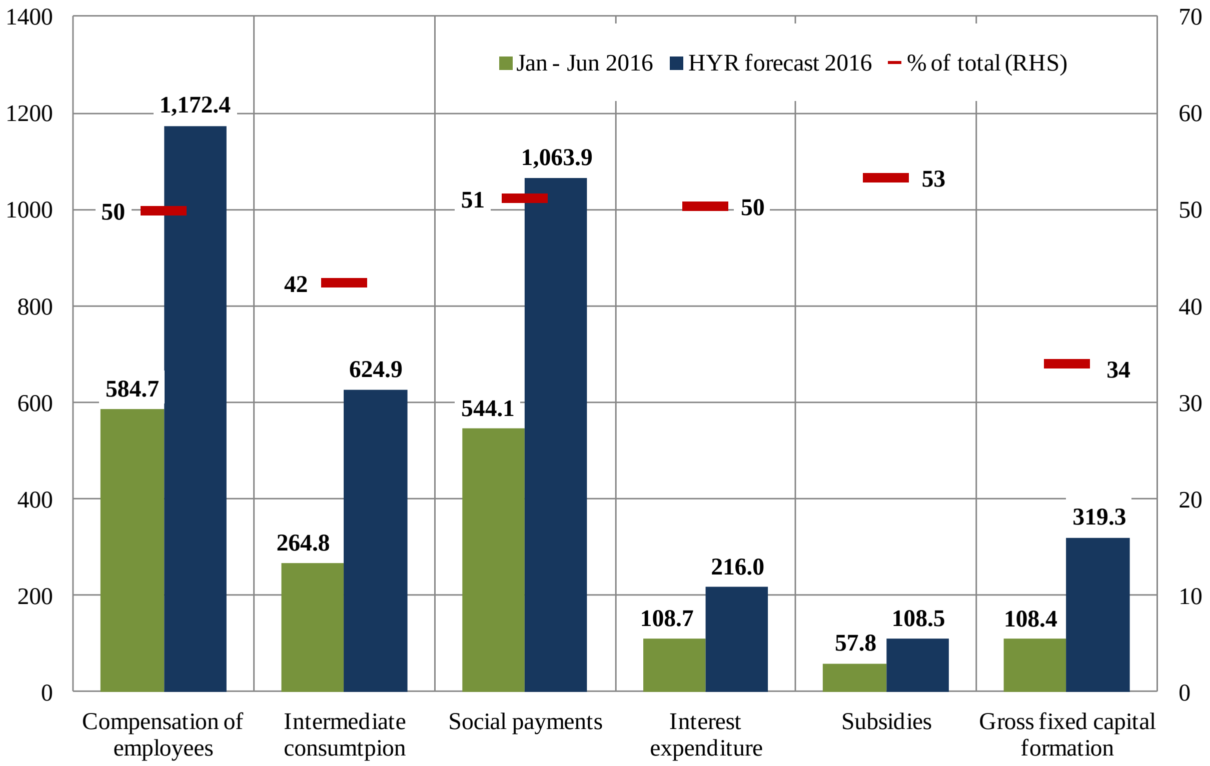
Source: MFIN

Overall, the MFAC considers the HYR revenue forecasts to lie within its endorsable range. The MFAC's plausibility assessment builds on the fact that: (i) it had already judged the USP revenue forecasts to be within its endorsable range; (ii) the revenue revisions indicated in the HYR are minimal; and (iii) the MFAC considers the macroeconomic projections underpinning such fiscal forecasts as still plausible.

In the case of expenditure, the estimated half-yearly outlays amounted to 47.3% of the target. Even in this case, the expenditure forecasts remain within the MFAC endorsable range. Spending on compensation of employees and on social payments, the two largest expenditure categories, respectively absorbed around 50% and 51% of the amount budgeted in the HYR, growing respectively by 5.4% and 0.9% on a year earlier (see Chart 5 and Chart 6).

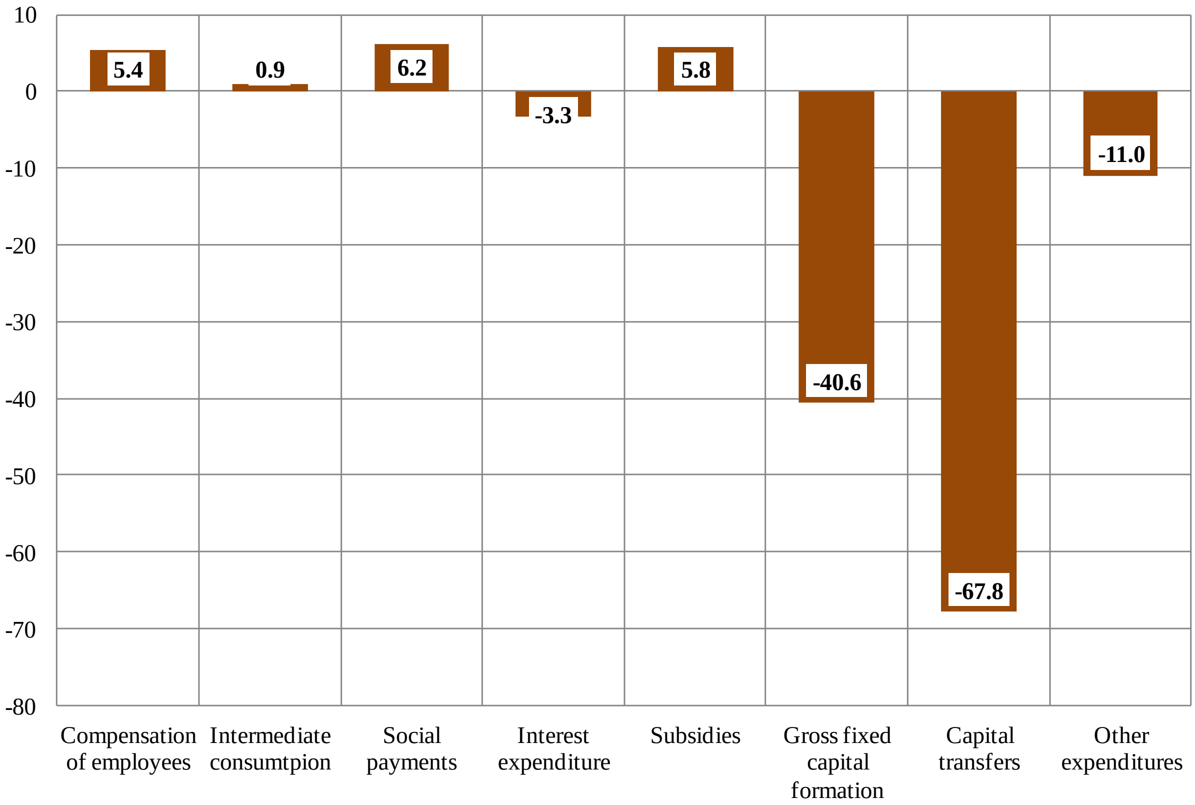
On the other hand, according to the HYR estimates, spending on gross fixed capital formation declined by 40.6% on a year earlier, and thus represented only 34% of the budgeted amount for 2016. However, the quarterly pattern of such expenditure tends to be rather uneven, and thus the half-yearly turnout may not necessarily be representative for the eventual yearly outturn. In addition, owing to the fact that spending on gross fixed capital formation is largely of a discretionary nature, a certain element of expenditure containment may be resorted to if necessary in order to ensure that the target fiscal balance for the year is indeed achieved.

Chart 5: Half-yearly expenditure performance on an ESA basis (EUR million)



Source: MFIN

Chart 6: Year-on-year expenditure growth (%)



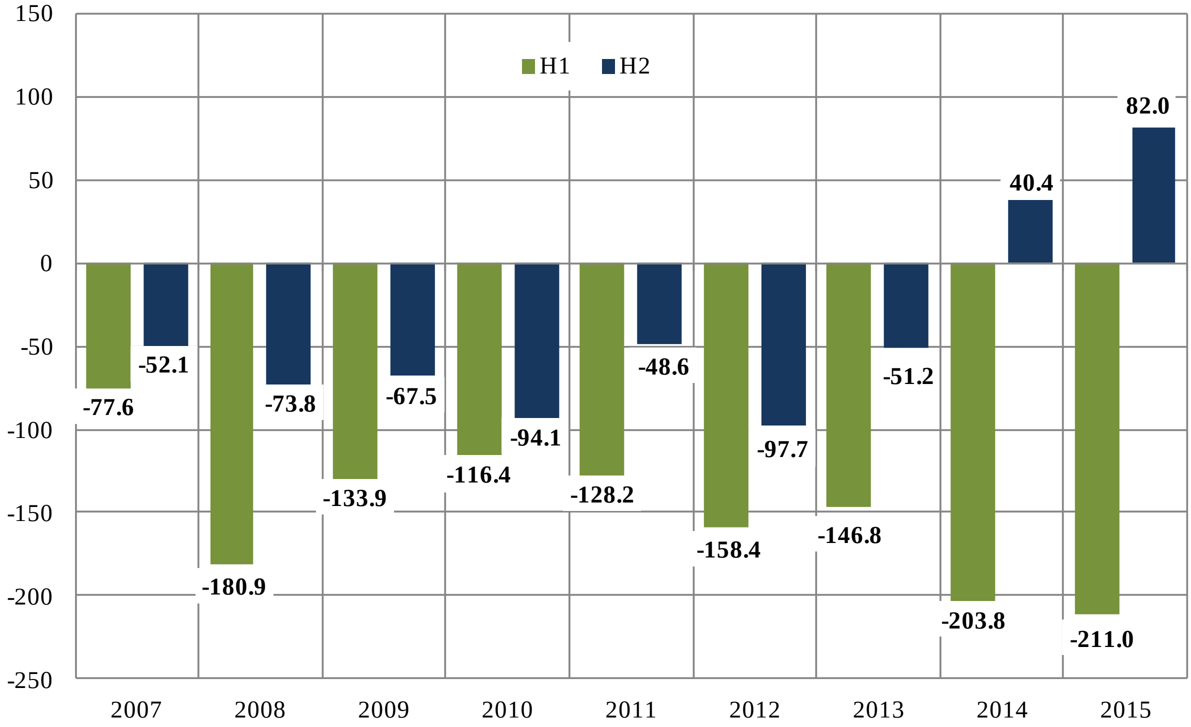
Note: figures show the annual growth rates January - June 2016 compared to January – June 2015

Source: MFIN

With regard to expenditures based on Consolidated Fund transactions, the actual spending as per cent of the approved estimates for the year, varied significantly across votes. Overall, 47.7% of the vote allocations for recurrent expenditure were spent during the first half of 2016. The Council is aware that budget expenditure allocations can be re-allocated across ministries intra-year, in order to ensure that the overall cap is respected.

On the basis of the before-mentioned revenue and expenditure dynamics, the headline fiscal balance for the period January to June 2016 was estimated at €39.2 million in ESA terms, which represents 56.1% of the HYR deficit target for the whole of 2016 (see Table 5). As can be seen in Chart 7, the fiscal deficit in the first half of the year tends to be consistently higher than that recorded in the second half, highlighting the seasonal element of the deficit. The MFAC therefore considers the fiscal target indicated in the HYR to be attainable provided appropriate vigilance is exercised. In particular, savings can be achieved on the basis of the findings emerging from the various Comprehensive Spending Reviews which have been carried out to date.

Chart 7: Half-yearly seasonality of the fiscal balance



Source: Eurostat

The HYR focuses predominantly on the comparison of the HYR revised forecasts to the Budget forecasts. As a result, it does not include information to identify specifically those factors giving rise to the upward revisions in revenues and expenditures compared to the USP.[20] The MFIN attributes the HYR fiscal updates to the figures contained in the USP

[20] The MFAC had analysed the changes between the plausibility of the fiscal forecasts presented in the Budget / DBP and in the USP respectively in the following two reports: "An Assessment of the Fiscal Forecasts prepared

entirely to the fiscal developments to date, since as highlighted in the previous section, the macroeconomic forecasts were not revised post USP.[21]

With regard to developments in the public debt, these had been revised upwards in the USP compared to the Budget, from €5,858.8 million to €5,878.4 million. The HYR indicates that the latter figure was revised slightly down to €5,872.3 million. In terms of composition of public debt, the new targets indicate a higher level of Malta Government Stocks (MGS) and loans by EBU's and Local Councils and a lower level of Treasury bills, when compared to those announced in the Budget (see Table 6). This appears to be in line with the Government's strategy to take benefit of the very low interest rate environment by lengthening the average maturity of the public debt.

Table 6: General government debt and debt servicing (EUR million)

	2016 Budget	HYR June 2016	2016 HYR forecast
Gross debt	**5,858.8**	**5,857.8**	**5,872.3**
of which:			
MGS	5,094.5	5,160.1	5,134.9
Treasury bills	387.4	313.3	348.4
EBUs and local Councils	111.0	121.0	121.0
Foreign loans	19.4	22.1	19.3
Other*	246.5	241.3	248.7
Total debt servicing**	**761.1**	**259.7**	**770.7**
Servicing of local loans	753.3	255.4	762.7
Servicing of foreign loans	7.8	4.3	7.8

* Other debt comprises currency coinage issued by the Central Bank of Malta (CBM) as agent for the Treasury, borrowings from local commercial banks and debt re-routing of the European Financial Stability Facility (EFSF).
** Debt servicing includes the payment of interest due, as well as contributions to Sinking Funds and direct loan repayments.
Source: MFIN

The external debt component remained very subdued, projected at 3.2% of the total in the HYR compared to 3.3% in the Budget. The bulk of external debt reflected debt re-routing in connection with Malta's obligations under the European Financial Stability Facility, with

by the Ministry for Finance and presented in the Draft Budgetary Plan 2016" and "An Assessment of the Fiscal Forecasts for Malta prepared by the Ministry for Finance in April 2016", available on www.mfac.gov.mt.

[21] Although most of Government expenditure forms part of the government consumption aggregate within GDP, and the revised revenue estimates could impact economic behaviour, the extent of the revisions undertaken to the fiscal aggregates between the USP and the HYR is limited, and hence, the possible inconsistency between the macroeconomic and fiscal forecasts in the HYR is judged not to be material.

actual foreign loans accounting for only 0.3% of gross debt. The HYR also indicates a slightly higher figure for the servicing of local loans compared to the Budget. This reflects a slightly higher value for loan repayments, with total interest paid on local loans actually being revised slightly downwards.

The MFAC notes that there are no explanations about the specific changes to the stock-flow adjustments to explain why, despite a somewhat higher projected 2016 deficit in the HYR compared to the USP (up by €4.4 million), the forecast for gross debt has been scaled down in the HYR, by €6.1 million. Whereas the MFAC appreciates that these revisions are relatively marginal in relation to the level of outstanding debt, the MFAC considers that, in order to boost transparency further, it would be useful that any revisions beyond a certain amount, compared to previously announced forecasts (in this case in the USP), are clearly identified and explained.

4. Conclusion and final recommendations

The MFAC takes note that the macroeconomic projections underpinning the fiscal forecasts have remained unchanged in the HYR compared to the USP. The justifications provided for such approach are judged by the MFAC to be sound.

The MFAC concludes that on the basis of the information contained in the HYR, good progress has been made in relation to the fiscal targets for the year. While the MFAC invites the MFIN to remain vigilant, it considers that the fiscal developments recorded during the first six months of the year are generally conducive to the attainment of the 2016 fiscal targets as well as compliance with the SGP fiscal rules. The MFAC also notes positively that there has been increased effort on the part of the MFIN to adhere to the Council's recommendation to explain better the drivers of variations in fiscal data across forecast vintages. The HYR suggests that the MFIN have considered that the available information does not identify the emergence of any new specific upside or downside risks to these forecasts.

The MFAC further welcomes the HYR assertion that "most of the additional revenue will be utilised for fiscal consolidation".[22] This is in line with the recommendation being repeated in many of the MFAC's publications that possible revenue windfalls in excess of forecast errors are not used to finance permanent expenditure initiatives.

The MFAC takes note that the Government's intention is to aim for an improvement in the structural balance of 0.8pp of potential output, slightly more than the 0.6pp which had been initially indicated in the Budget. The MFAC recognises that this is necessary in order to correct for the lack of compliance with the structural balance criterion and the expenditure benchmark, in 2015. It is thus very important that expenditure growth is closely monitored

[22] HYR page 10.

not only to ensure that the targeted improvement in the structural balance is achieved but also to ensure that the expenditure benchmark is also respected in 2016.

With regard to public debt management, the MFAC welcomes the fact that during the first half of 2016, the Government managed to increase the weighted average maturity of MGS from 8.7 years at the end of 2015, to 8.9 years by June 2016. In August 2016 the Treasury also issued longer dated MGS, with a maturity of 25 years, which would help further extend the average debt maturity.[23] Such extension of the average maturity of public debt against a background of very favourable low interest rate conditions should generate significant savings in debt servicing costs.

The MFAC notes positively that according to the data presented in the HYR, the outstanding creditors (amounts owed by the Government to suppliers) declined between the end of 2015 and the first half of 2016, from €137.4 million to €111.2 million. However, the MFAC draws attention to the fact that in the case of the Government Property Division, which accounts for around 40% of outstanding creditors as at June 2016, the outstanding balance actually increased slightly when compared to the end of 2015. It is important that such outstanding credits remain under check.

With regard to the collection of revenue arrears, the MFAC notes positively that €35.7 million were collected by the end of June 2016, exceeding the target of €21.7 million which had been set in the Budget estimates. This notwithstanding the fact that the 2016 target for the collection of arrears was 9% of the total arrears, which was higher than the 8% target set for 2015. The overall result was mainly driven by stepped up efforts by the Inland Revenue Department within the MFIN. The MFAC emphasises on the need that revenue arrears are kept under scrutiny in order not to prejudice their collectability. Given the rather buoyant macroeconomic conditions and the exceptionally low interest rate conditions, there appears to be scope for a more ambitious target for the collection of such arrears in future.

The MFAC considers that the HYR broadly meets the requirements prescribed by Article 39 (8) of the FRA. However, the MFAC would like to draw attention to the fact that Article 39 (8) (h) of the FRA requires "data on the absorption of European funds, indicating the approved program, the results achieved in the first six months and an updated forecast for the entire year". The MFAC acknowledges that the HYR makes occasional reference to EU funds, but falls short of providing sufficient information to fully explain the progress to date. The MFIN is thus invited to provide more information in this regard in the HYR.

Finally, the MFAC refers to Article 39 (9) of the FRA which provides that the HYR "must take into account, to the extent possible, any Government decisions or other developments, which may have an effect on the fiscal and economic prospects for the year." In this context, the MFAC considers useful that the HYR would pro-actively elaborate more fully on

[23] This was the second time that 25 year MGS were issued. These are the longest dated MGS that have been issued to date.

potential risks that the latest developments may pose to the outturn for public finances, at least in a qualitative manner. This would ensure a more transparent assessment of risks to the baseline fiscal projections. Likewise, it would be useful for the MFIN to include in the HYR, an update with regard to the specific progress achieved with respect to the measures announced in the Budget and also about other specific important items within the Budget. By identifying specifically the percentage of the estimated revenue or expenditure impact which has materialised during the first six months in respect of such measures, it would be easier to assess the extent to which the yearly targets are likely to be attained or otherwise.

APPENDIX I: Extract from the Fiscal Responsibility Act

Article 39 (7) of the Fiscal Responsibility Act, 2014 (Cap. 534) stipulates that "in July of each year, the Minister for Finance shall compile and lay on the table of the House of Representatives a half-yearly report on the economic and budgetary situation".

Article 39 (8) of the said Act further specifies that such report "shall, without being limited to, contain the following:

a) a review of the macroeconomic situation that would include the latest significant changes and trends since the finalization of the annual budget;

b) an assessment of the impact on the fiscal targets of any changes in the macroeconomic situation;

c) a presentation of necessary corrective measures to be taken to address such impacts;

d) an explanation of how the implementation of the budget is consistent with the Government's European commitments, in particular the terms of the Stability and Growth Pact;

e) data on the general budget revenues, detailed for each category of revenue, indicating the initial forecast, revenues collected in the first six months and an updated forecast for the entire year;

f) data on the general budget expenditures, detailed by economic and functional classification for each constituent budget of the general government budget, indicating the approved expenditure, the expenditures incurred in the first six months and an updated forecast for the entire year;

g) data on the budgetary balance of the general government budget (total and primary), indicating the approved program, in the first six months and an updated forecast for the entire year;

h) data on the absorption of European funds, indicating the approved program, the results achieved in the first six months and an updated forecast for the entire year;

i) data on all outstanding creditors for the first six months of the year;

j) data on government debt and financing of the budget deficit;

k) explanations for any failure to collect the forecasted revenues and revenue arrears, indicating the measures taken and any planned measures to improve such collection."

Article 39 (9) of the FRA further specifies that the information contained in the HYR "must take into account, to the extent possible, any Government decisions and other developments, which may have an effect on the fiscal and economic prospects for the year."

In turn, Article 39 (10) of the FRA states that "the data and information contained in the half-yearly report on the economic situation and the budget must be presented in a format comparable to those in the annual budget and in the fiscal strategy".

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