Overall Assessment

Draft Budgetary Plan 2018

A REPORT PREPARED

BY THE MALTA FISCAL ADVISORY COUNCIL

MFAC
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DECEMBER 2017

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29 December 2017

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Ph.D (Toronto), D.S.S (Oxon) MP
Minister for Finance
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South Street
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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 transmit a report prepared by the Malta Fiscal Advisory Council (MFAC) on the conduct of fiscal policy and compliance with the fiscal rules, as outlined in the Draft Budgetary Plan 2018. This assessment was carried out by the MFAC in line with the requirements prescribed in the Fiscal Responsibility Act, 2014 (Cap. 534).

The Council views positively that after having achieved a fiscal surplus in 2016, the Government plans to continue running a fiscal surplus also in 2017 and in 2018. This policy is prudent in the light of the benign economic conditions currently being experienced by the country. Should the outstanding level of debt in 2018 decline in absolute terms as anticipated, this would represent another milestone in the fiscal consolidation process, departing from the previous years' pattern of debt increases fuelled by persistent fiscal deficits.

The attainment of the targets for the fiscal balance and the public debt, which had been endorsed by the Council on 29 November 2017, would allow for the build-up of fiscal space. This is necessary and desirable as in the future it would enable the Government to provide resources for public purposes without undermining fiscal sustainability. This is particularly relevant in view of the ambitious plans to improve the physical infrastructure in future years as well as the anticipated higher age-related costs facing Malta in the longer term.

The Council confirms that the fiscal plans announced in the Draft Budgetary Plan published on 16 October 2017 comply with the requirements of the Fiscal Responsibility Act. Specifically, these plans would safeguard the Medium-Term Budgetary Objective of at least structural balance over 2017 and 2018, something which Malta has committed to as a euro area Member State. The implementation of such plans would also lower further the debt-to-GDP ratio, to 50.8% of GDP by 2018, thereby being comfortably below the 60.0% debt-to-GDP threshold.

However, turning to the compliance with the Stability and Growth Pact, the Council shares the assessment by the European Commission that Malta's fiscal policy is 'broadly compliant'. This is attributable to the fact that whereas the budget and debt rules are fully satisfied, there could be the risk of a deviation from the expenditure benchmark in 2018. Indeed, the planned expenditure growth for 2018 exceeds the prescribed limits envisaged by the expenditure benchmark, both according to the Commission's forecasts, as well according to the forecasts prepared by the Ministry for Finance.

The Council is aware that, despite the possibility that the yearly deviation could exceed 0.5% of GDP, Malta's situation would still technically not constitute a significant deviation. This is in view of Article 6(3) of Regulation No 1466/97 of 7 July 1997 which specifies that "the deviation of expenditure developments shall not be considered significant if the Member State concerned has overachieved the medium-term budgetary objective". This clause is applicable in the case of Malta as the country overachieved its Medium-Term Budgetary Objective in 2016, three years ahead of the original plans.

The Council shares the Commission's invitation to the authorities "to stand ready to take further measures within the national budgetary process to ensure that the 2018 budget will be compliant with the SGP". The Council reminds of the importance that the country aims towards full compliance with the Stability and Growth Pact. At the same time, the Council refers to its report dealing with the endorsement of the fiscal forecasts, wherein it had identified a possible mitigating factor, related to the downside risks to total expenditure growth for 2017 and 2018. In this case, the relevant savings are linked to the possibility that as in 2016, there would be no recourse to the Contingency Reserve in 2017 and 2018.

Looking ahead, the Council invites the Ministry to explore the possibility of introducing changes to the Fiscal Responsibility Act, so that direct reference to the requirements of the expenditure benchmark is included in the legislation, irrespective whether the risk of deviation is significant or not. This would ensure that the expenditure benchmark is elevated to the same status as the debt and the budgetary rule, even under Maltese legislation. This would catalyse greater attention on the need to control underlying expenditure growth in line with the economy's growth potential. This would also help mitigate the risks that revenue windfalls are channelled into higher expenditure, rather than used for debt reduction, as suggested by prudent

policy making. It would also be in the same spirit as the opinion expressed by the Economic and Financial Committee of the European Union published on 29 November 2016, wherein there was an increased focus on the expenditure benchmark for assessing compliance with the European fiscal rules.

Finally, the Council expresses satisfaction at the ongoing constructive dialogue with the Ministry for Finance, across all levels. The Council appreciates the frank internal discussions and the adequate information provided to the Council to enable it to carry out its functions.

Yours sincerely

Rene Saliba
Chairman

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Abbreviations

AGS	Annual Growth Survey
AMR	Alert Mechanism Report
COM	European Commission
CSR	Country-Specific Recommendations
DBP	Draft Budgetary Plan
EDP	Excessive Deficit Procedure
EU	European Union
FRA	Fiscal Responsibility Act
GDP	Gross Domestic Product
IIP	Individual Investor Programme
IMF	International Monetary Fund
MFAC	Malta Fiscal Advisory Council
MFIN	Ministry for Finance
MTO	Medium-Term Budgetary Objective
pp	percentage point
SGP	Stability and Growth Pact
TSCG	Treaty on Stability, Coordination and Governance in the Economic and Monetary Union

Executive summary

The Draft Budgetary Plan published on 16 October 2017 updates Malta's official macroeconomic and fiscal projections for 2017 and 2018. These projections indicate that the macroeconomic conditions are expected to remain benign, and in this light, the Government plans to run a fiscal surplus, equivalent to 0.8% of GDP in 2017, and 0.5% of GDP in 2018. The Government also plans to lower the public debt-to-GDP ratio further, to 50.8% of GDP by 2018. Besides continuing to fully comply with the debt rule (which requires debt to be below 60% of GDP), Malta is thus expected to be among the Members States to register the lowest debt ratios across the euro area.

Should the macroeconomic and fiscal developments progress in line with these plans, between 2016 and 2018, the revenue-to-GDP and expenditure-to-GDP ratios would respectively be 1.1 percentage points and 3.7 percentage points lower than observed over the previous three-year period. This is ascribed to the growth in nominal GDP which is expected to outstrip that in total revenue and total expenditure. The Fiscal Council also notes the relative stability in Malta's budget allocations, as the yearly fiscal initiatives implemented by the Government, are not expected to alter the revenue and expenditure breakdown in any significant way.

The fiscal plans and the anticipated macroeconomic conditions over the period 2017 to 2018 are expected to safeguard Malta's Medium-Term Budgetary Objective of a structural balance over the forecast horizon. This would ensure continued compliance with the structural balance rule. However, the structural balance is expected to ease, from a surplus of 0.8% of potential output in 2016, to 0.6% in 2017, and to balance in 2018. The planned easing of the structural balance is tantamount to a negative structural effort at a time when the economy's cyclical conditions are stable and slightly above potential. This implies a slight pro-cyclical fiscal expansion.

Should the expenditure plans materialise, there could be a deviation from the expenditure benchmark in 2018. The forecasts by the European Commission suggest a larger possible gap than that based on the projections by the Ministry for Finance. Nonetheless, this possible deviation is not anticipated to be labelled as 'significant'. Accordingly, the Fiscal Council shares the European Commission's assessment that in relation to 2018, Malta is 'broadly compliant' with the requirements of the Stability and Growth Pact. This risk of deviation is also partially mitigated by the possible expenditure savings, should the Contingency Reserve not be resorted to in 2018. Since no significant deviation is anticipated vis-à-vis the expenditure benchmark, the Fiscal Council thus considers that there is full compliance with the requirements of the Fiscal Responsibility Act.

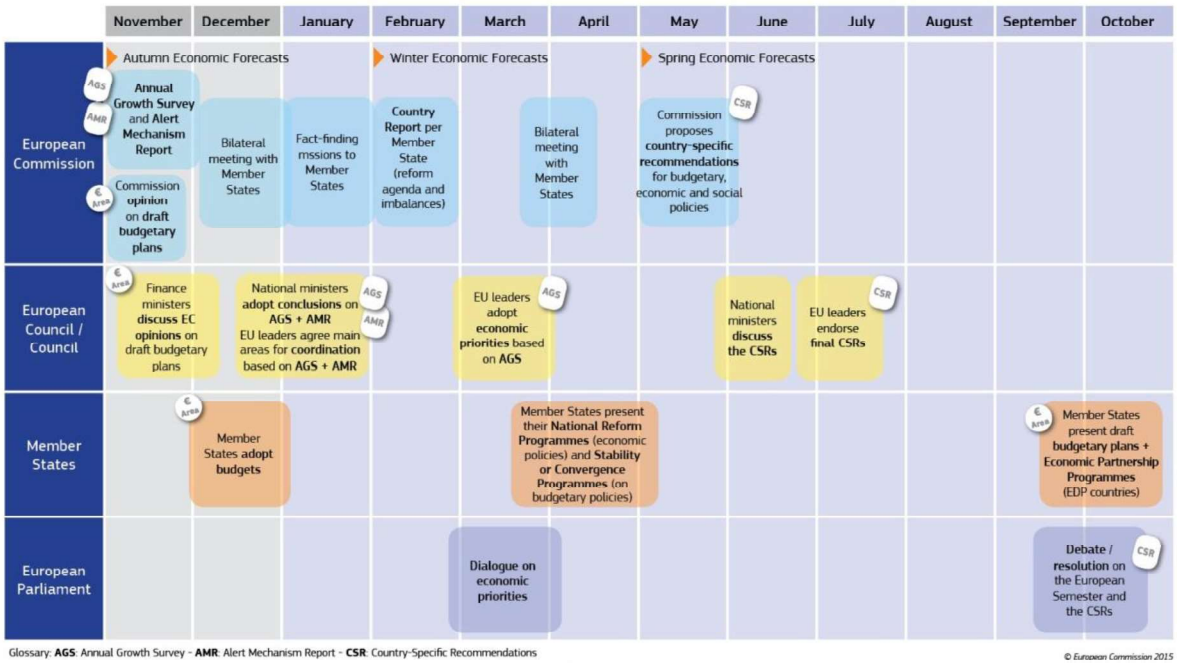
In the Council's view, maintaining a fiscal surplus, is not only desirable, but warranted, given the current macroeconomic conditions. Indeed, prudent fiscal policy requires that fiscal policy builds buffers particularly against possible bad times and future liabilities. The Council also supports the ongoing decline in the debt ratio, as this also allows for the build-up of fiscal space. Fiscal space allows the government to provide resources for public purposes without undermining fiscal sustainability. This is particularly relevant in view of the anticipated higher age-related costs facing Malta in future.

1. Introduction

The Draft Budgetary Plan (DBP) updates Malta's official macroeconomic and fiscal projections for the current year and the next. This document provides the necessary information for the European Commission (COM) and the Malta Fiscal Advisory Council (MFAC) to evaluate the extent to which, the actual and planned conduct of fiscal policy in Malta, conforms to the fiscal rules prescribed by the Stability and Growth Pact (SGP) and the Fiscal Responsibility Act (FRA).

The COM's opinion on the DBP, which is issued in November each year, initiates the European Semester (see Diagram 1). This is a cycle of economic and fiscal policy coordination within the European Union (EU) and forms part of the EU's economic governance framework.

Diagram 1: European Semester timeline



Source: COM

The MFAC has already published two reports in relation to the DBP for 2018. The first report, which was issued on 16 October 2017, assessed the plausibility of the macroeconomic forecasts, while the second report, issued on 30 November 2017, evaluated the plausibility of the fiscal projections.[1] The MFAC endorsed both the macroeconomic and the fiscal forecasts contained in the latest DBP. In relation to the macroeconomic forecasts, the MFAC concluded that "the official real GDP growth forecasts of 5.9% for 2017 and 5.6% for 2018 presented in the Draft Budgetary Plan for 2018 lie within the endorsable range of the Fiscal Council. These growth rates are judged to be compatible with the assumptions employed and the estimated economic relationships." In turn, after scrutinising the various revenue and expenditure components, the MFAC stated that in relation to the fiscal projections "there are upside risks

[1] Both reports are available on https://mfac.org.mt/en/publications/Pages/Publications.aspx.

to total revenue and downside risks to total expenditure, both for 2017 and 2018" adding that "their combined effect translates into an upside risk for the fiscal balance across the forecast horizon".

This third report assesses the conduct of fiscal policy, as presented in the DBP, and evaluates the compliance with the fiscal rules. The Report's cut-off date is 30 November 2017 and proceeds as follows. Section 2 presents an overview of the macroeconomic and fiscal scenario which is expected to materialise in 2017 and 2018. Section 3 assesses the ex-ante compliance with the three fiscal rules, namely the debt criterion, the structural adjustment rule and the expenditure benchmark, covering the years 2017 and 2018. Section 4 concludes with some final considerations.

2. Macroeconomic and fiscal conditions

The actual and anticipated macroeconomic conditions for the period 2016 to 2018 are benign. These are characterised by elevated real GDP growth rates, ranging between 5.5% and 5.9% (see Table 1). Likewise, nominal GDP growth rates are expected to be high, averaging 7.6% during this period. The estimates by the Ministry for Finance (MFIN) also indicate that potential output growth is expected to remain sustained over the forecast horizon, although it is expected to gradually ease slightly, from 6.5% in 2016 to 5.6% in 2018.

Table 1: Key macroeconomic and fiscal developments

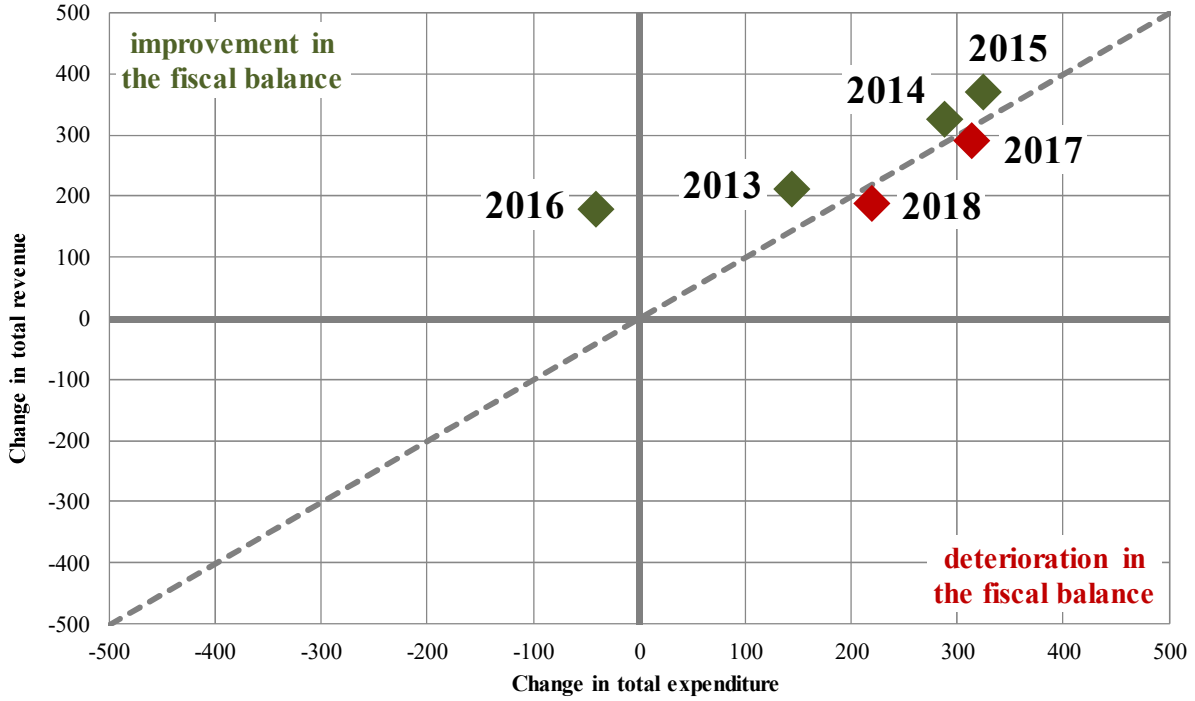
	2016	2017	2018
Real GDP growth (%)	5.5	5.9	5.6
Nominal GDP growth (%)	7.2	8.1	7.6
Potential output growth (%)	6.5	6.0	5.6
Output gap (% of potential output)	0.9	0.8	0.8
Unemployment rate (%)	4.7	4.1	4.2
Inflation rate (%)	0.9	1.3	1.5
Fiscal balance (EUR millions)	112.9	88.0	54.0
Fiscal balance (% of nominal GDP)	1.1	0.8	0.5
Structural balance (% of potential output)	0.8	0.6	0.0
Public debt (EUR millions)	5,727.9	5,905.5	5,874.9
Public debt (% of nominal GDP)	57.6	54.9	50.8

Source: MFIN

Overall, the Maltese economy is expected to continue operating slightly above potential, with a small positive output gap, of below 1.0 percentage point (pp), being anticipated. Meanwhile, the unemployment rate is expected to remain low, slightly above 4.0%. On the other hand, the inflation rate is expected to pick up slightly, but remain comfortably below 2.0%.

In the light of such macroeconomic conditions, in 2016, a fiscal surplus amounting to €112.9 million, or 1.1% of GDP, was recorded. This is expected to be followed by further fiscal surpluses, according to the MFIN's projections for 2017 and 2018, which have been endorsed by the MFAC. However, the projected yearly surplus is expected to be smaller, respectively €88.0 million (0.8% of GDP) in 2017 and €54.0 million (0.5% of GDP) in 2018. Indeed, the planned rise in total expenditure in each of the forecast years is slightly higher than the anticipated increase in total revenue (see Chart 1).

Chart 1: Year-on-year changes in total revenue and total expenditure (EUR millions)

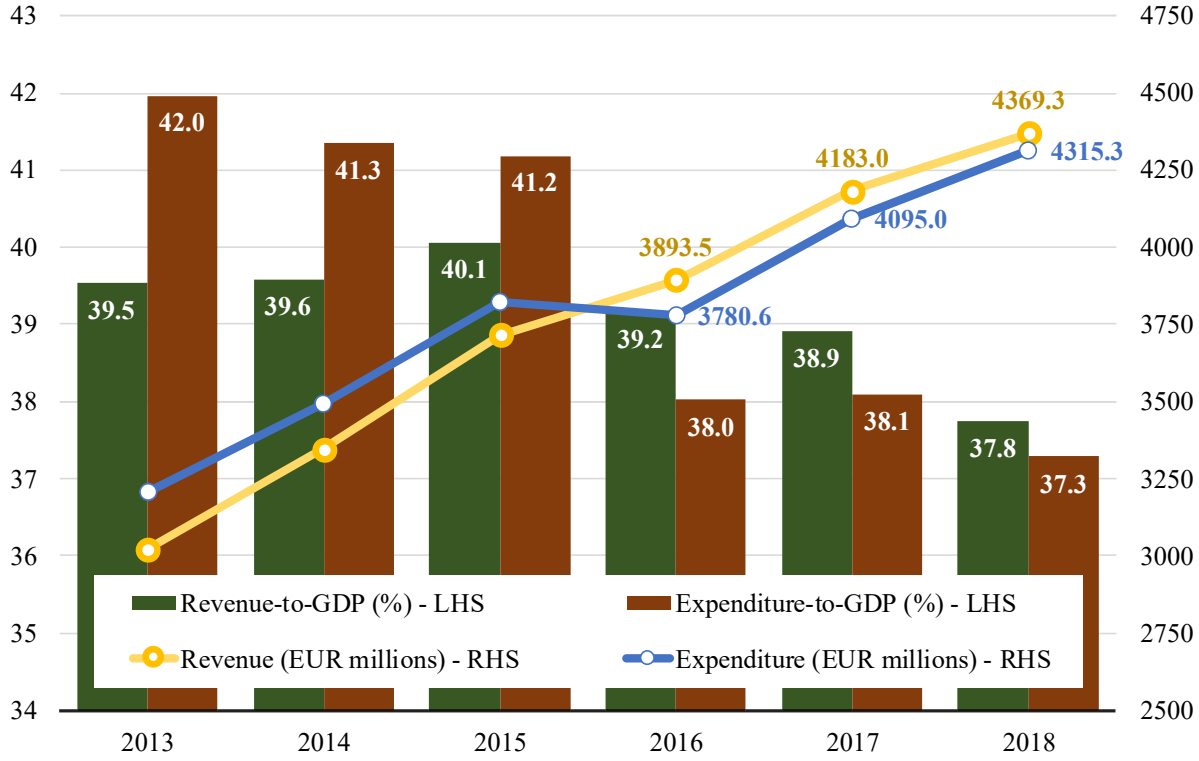


Note: Anywhere above the dashed line (green diamonds) indicates combinations of revenue and expenditure developments leading to an improvement in the fiscal balance, whereas anywhere below the dashed line (red diamonds) indicates combinations which lead to a deterioration in the fiscal balance. Anywhere along the dashed line represents a stable fiscal balance.

Source: MFIN

Should the macroeconomic and fiscal developments progress in line with the plans indicated in the latest DBP, between 2016 and 2018 the revenue-to-GDP and expenditure-to-GDP ratios would be lower than those observed over the previous three-year period (see Chart 2). Growth in nominal GDP is expected to outstrip that in total revenue and total expenditure throughout the period 2016 to 2018.

Chart 2: Revenue and expenditure as percentage of GDP and in absolute terms



Source: MFIN

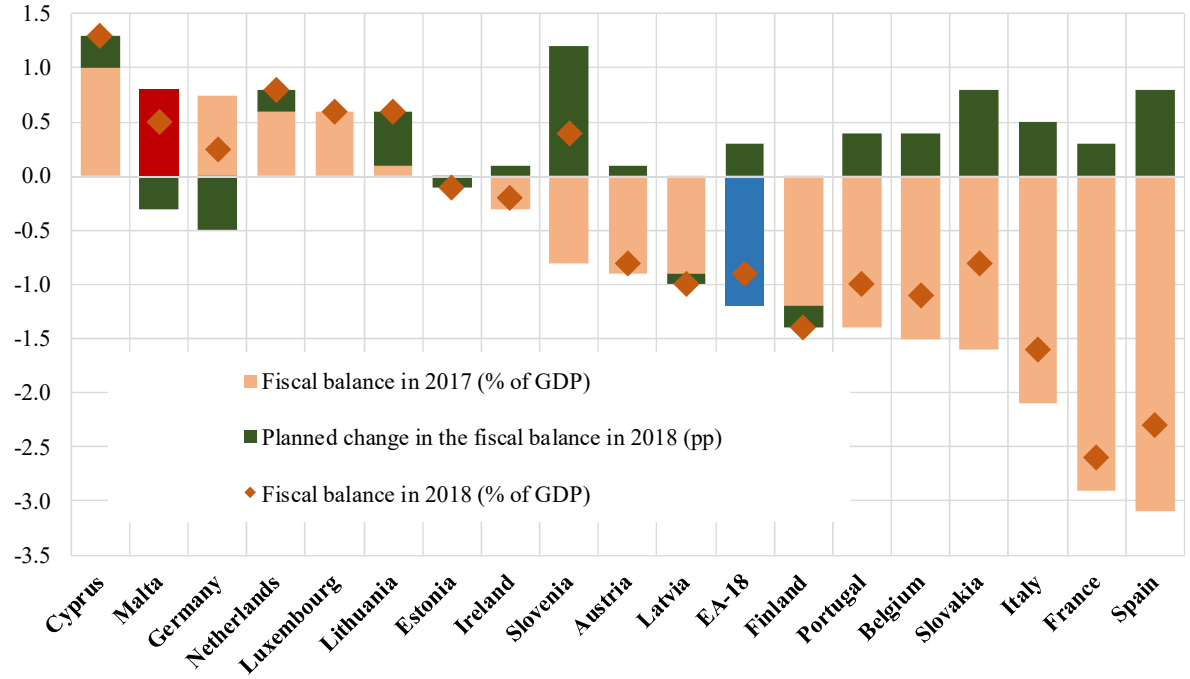
Should the outturn for 2017 materialise as planned, Malta's fiscal balance would be the second highest compared to the other euro area Member States (see Chart 3). However, whereas most euro area countries are planning to improve their fiscal balance in 2018 (as indicated by the green bars which are above the x-axis), Malta is targeting a small reduction in its fiscal surplus. Still, Malta's fiscal balance is expected to remain in surplus in 2018, while most euro area countries are still expected to experience a fiscal deficit (as indicated by most of the diamonds which are below the x-axis).

The fiscal plans and the anticipated macroeconomic conditions safeguard Malta's Medium-Term Budgetary Objective (MTO) of a structural balance over the forecast horizon. The structural balance is expected to ease, from a surplus of 0.8% of potential output, in 2016, to 0.6% in 2017, and to balance in 2018, according to the MFIN's estimates. Between 2016 and 2018, Malta's structural balance is estimated to be lower than the headline balance.[2] This is due to the positive output gap conditions, which have been prevailing since 2014 (see Chart 4).[3]

[2] The structural balance corrects for the economic cycle as well as nets outs the impact of temporary and one-off measures from the overall balance.

[3] A positive output gap indicates that actual GDP exceeds potential GDP whereas a negative output gap denotes that actual GDP falls short of potential. The output gap plays an important role in the assessment of compliance with fiscal rules, since it determines the size of the cyclical element within the budget, which is netted off to estimate the structural balance.

Chart 3: Targets for the fiscal balances across the euro area (% of GDP)



Note: The figures are based on the DBPs submitted by the various Member States. Greece is not included since it is not obliged to submit a DBP.

Source: COM

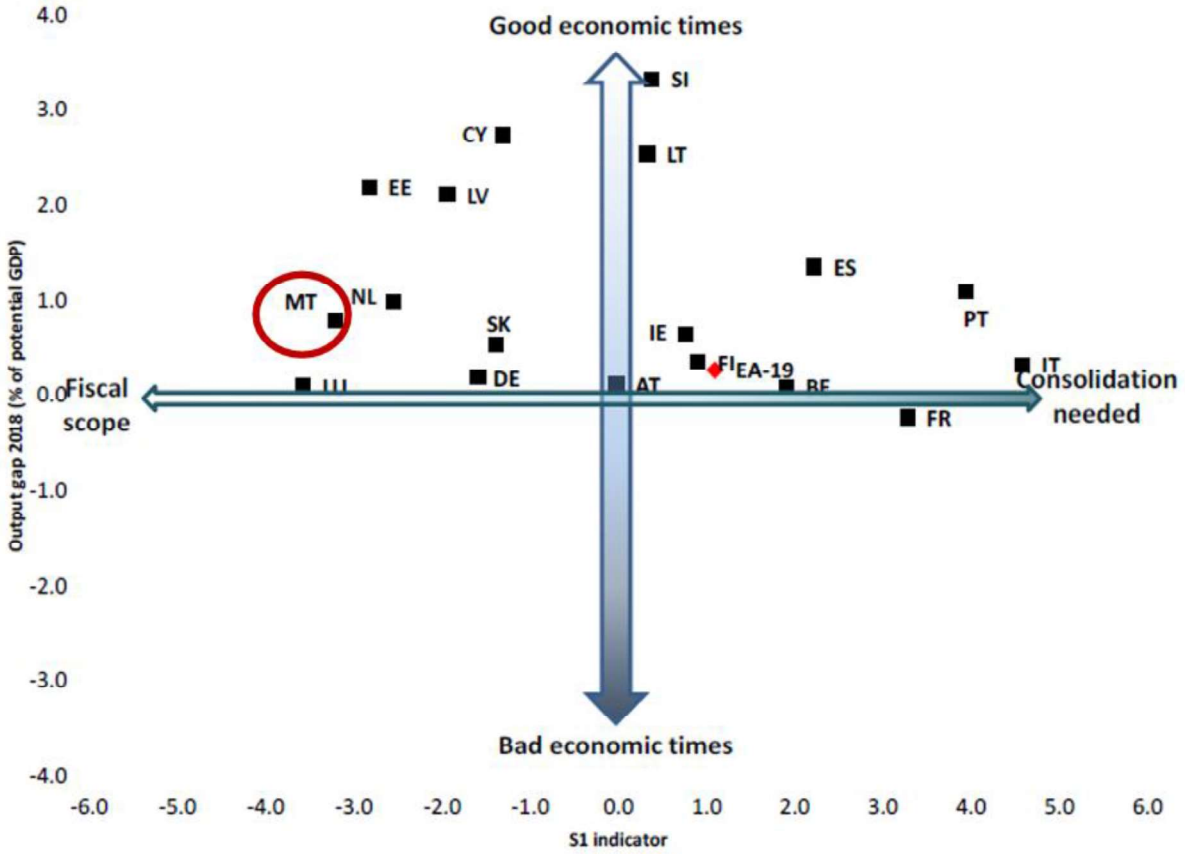
Chart 4: Malta's potential output growth and output gap estimates (%)

Note: The chart is reproduced from the DBP 2018 document.

Source: MFIN

According to the COM's latest forecasts, all euro area countries apart from France, are expected to experience positive output gap conditions in 2018. Hence, Malta is expected to operate under 'good economic times', in line with general economic conditions anticipated across the euro area Member States (see Chart 5).

Chart 5: Fiscal map for the euro area in 2018



Note: The chart is reproduced from the 2018 Draft Budgetary Plans: Overall Assessment by the COM. Good economic times are measured by the output gap. Fiscal scope indicates that a country does not need further adjustment to lower the debt-to-GDP ratio to 60% by 2031, while fiscal consolidation indicates additional effort necessary to lower the debt ratio to 60% by 2031.

Source: COM

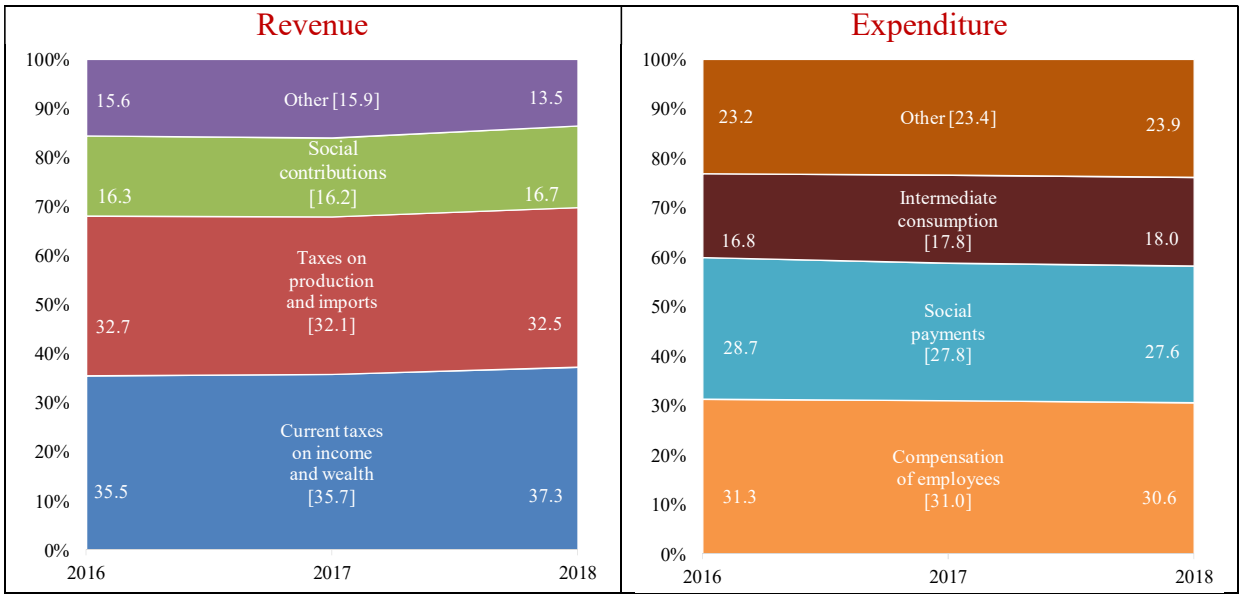
In 2017, the positive stock-flow adjustments are expected to more than offset the planned fiscal surplus.[4] As a result, public debt is expected to grow from €5.7 billion in 2016 to €5.9 billion in 2017. However, in 2018, public debt is expected to decline marginally, down by €30.6 million. This follows from the fact that the size of the anticipated positive stock-flow adjustments is slightly less than the planned fiscal surplus for the year. The expected decline in the outstanding level of debt, in absolute terms, would represent a departure from the trend increases recorded in recent years. Overall, the public-debt to GDP ratio is expected to extend its downward trajectory, to reach 50.8% by 2018, aided mainly by the ongoing robust nominal growth conditions. The MFAC welcomes the sustained decline in Malta's debt ratio achieved in recent years, and which is expected to continue over the forecast years.

The MFAC notes the relative stability in Malta's budget allocations. Indeed, the fiscal initiatives implemented and planned by the Government between 2016 and 2018 are not expected to re-allocate the budget in any significant way. The relative shares for the major revenue and expenditure components within the budget are expected to remain broadly stable.

[4] Positive stock-flow adjustments result from transactions which raise the public debt, but which have no impact on the fiscal balance.

For the period 2016 to 2018, slightly more than one third of revenues (average 36.2%) is set to be derived from current taxes on income and wealth (see Chart 6). Taxes on production and imports are expected to account for almost another one third (average 32.4%). The remaining revenues are practically evenly sourced from social contributions (average 16.4%) and other sources (average 15.0%). The yearly change in the 'other' revenue category is also driven by the absorption of EU funds and the revenues from the Individual Investor Programme (IIP), whose developments have tended to compensate for each other over the recent years.

Chart 6: Budget revenue and expenditure components (%)



Source: MFIN

On the expenditure side, compensation of employees is expected to continue accounting for the largest share of expenditure, around 31.0% of the total. In turn, the share of social payments is anticipated to remain around 28.0% of total expenditure. Likewise, the share of spending on intermediate expenditure is expected to remain stable around 17.0%. The remaining quarter comprises the aggregate of the smaller expenditure items.

3. Compliance with fiscal rules

The EU's fiscal framework envisages that when conducting fiscal policy, Member States respect the debt rule, the budget balance rule, and the expenditure benchmark (see Box 1). These rules are designed to encourage countries to prioritise fiscal sustainability and prevent the build-up of fiscal imbalances (see Box 2). The debt rule and the budget balance rule feature identically in the SGP and the FRA, while the expenditure benchmark features directly in the SGP, but is only indirectly referred to in the FRA, in the case the COM identifies a 'significant deviation' from the MTO.[5]

[5] A deviation is considered 'significant' if it amounts to 0.5% of GDP or more in a year, or an average of 0.25% or more over a two-year period.

Box 1: FISCAL RULES

DEBT RULE

A Member State is non-compliant with the debt requirement if its general government debt is greater than 60% of GDP and is not sufficiently diminishing and approaching 60% of GDP at a satisfactory pace.

BUDGET BALANCE RULE

A country must achieve and maintain its MTO, or otherwise converge to the MTO, through yearly structural effort, the magnitude of which, depends on the state of the economy. Malta's agreed MTO is structural balance, that is the cyclically-adjusted general government budget position, net of one-off and other temporary measures, should be in balance.

Signatories to the Treaty on Stability, Coordination and Governance in the Economic and Monetary Union (TSCG) (which covers, inter alia, all euro area Member States) have committed themselves to MTOs of at least -0.5% of GDP, unless their debt ratio is significantly below 60% of GDP and the risks in terms of the long-term sustainability of their public finances are low. In those cases, the lower limit for the balance is at -1.0% of GDP.

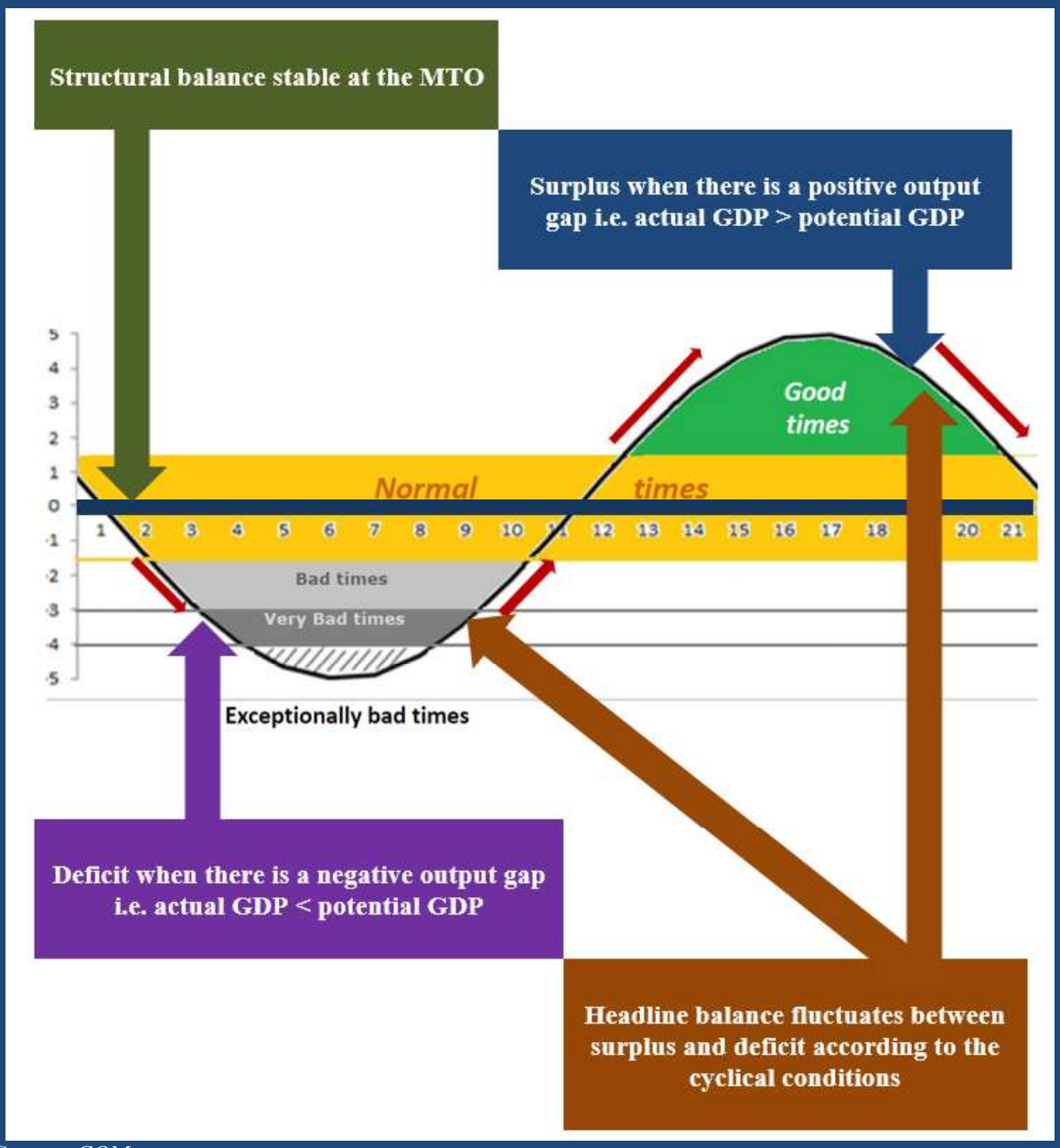
EXPENDITURE BENCHMARK

For Member States which have achieved the MTO, annual nominal expenditure growth (adjusted) should not exceed a reference medium-term rate of potential GDP growth (expressed in nominal terms), unless the excess is matched by discretionary revenue measures. In the case of Members States which have not yet attained their MTO, net expenditure growth must be lower, in line with a rate of growth which is below the reference potential growth rate.

Box 2: STYLISED FISCAL FRAMEWORK

The preventive arm of the SGP works on the premise that the country's underlying fiscal position (as measured through the structural balance) is stable, with the headline fiscal balance shifting between a small surplus and deficit depending on whether the economy is operating slightly above or slightly below potential (see Diagram A). On the other hand, when the economy's output gap is significantly positive (i.e. when actual GDP is significantly above potential GDP), a larger fiscal surplus is prescribed. In the case of a significant negative output gap (i.e. when actual GDP is significantly below potential GDP), this would allow a higher deficit, which would only breech the 3.0% deficit-to-GDP limit when economic conditions are very bad.

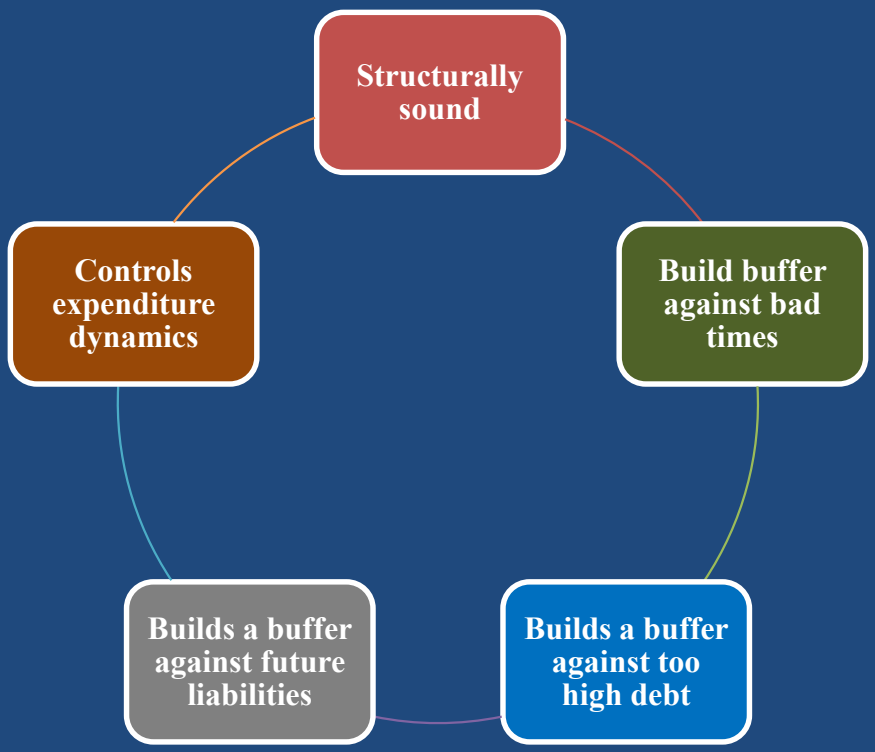
Diagram A: Cyclical conditions and the fiscal balance (% of GDP)



Source: COM

Thus, the MFAC considers that maintaining a fiscal surplus, is not only desirable, but warranted, given the current macroeconomic conditions. Such buffers are necessary to counteract against possible bad times in successive periods and future fiscal liabilities (see Diagram B). Prudent fiscal policy requires that during benign economic times the fiscal strategy should ideally be geared to build buffers.

Diagram B: Elements of a prudent fiscal policy



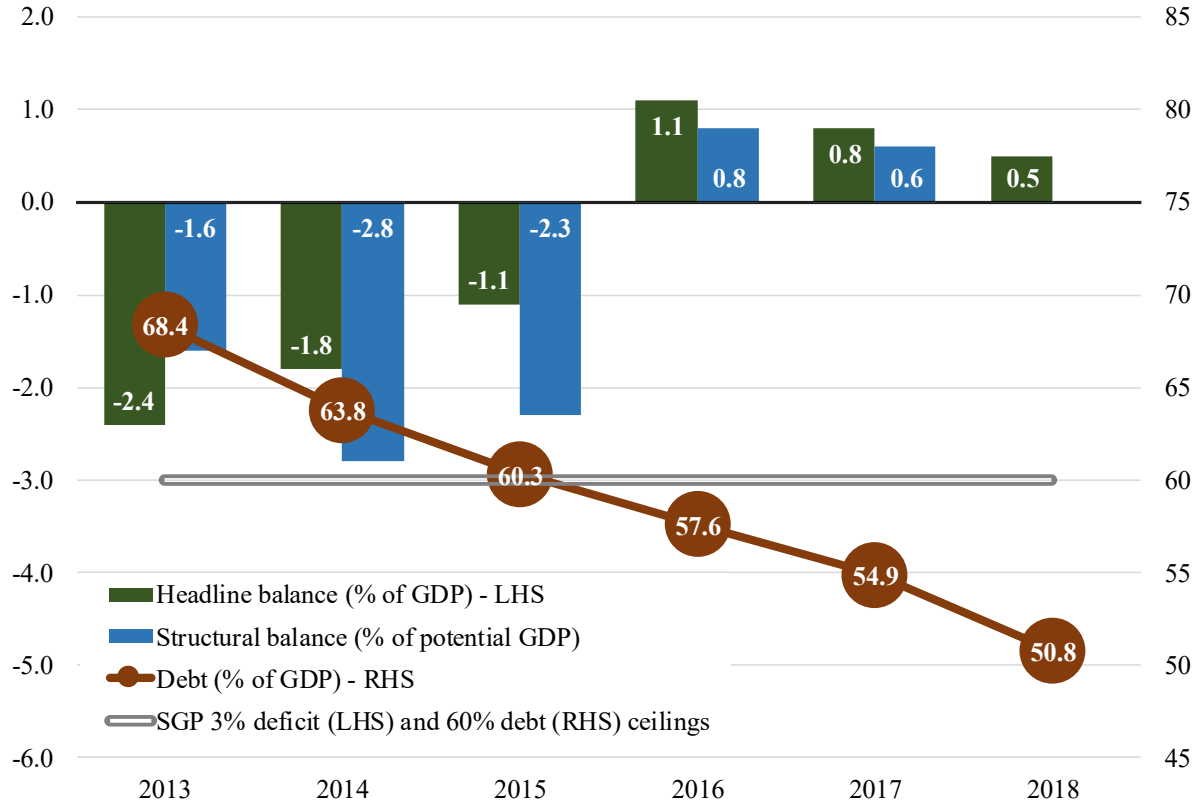
Source: COM

The **debt rule** requires that a country's debt-to-GDP ratio is below 60% or else approaching that ceiling at a satisfactory pace. In 2016, Malta's debt ratio amounted to 57.6%. According to the MFIN, the anticipated debt dynamics over 2017 and 2018 are such that the debt ratio is expected to fall further, to 54.9% in 2017 and 50.8% in 2018, thus continuing to satisfy fully the 60.0% debt-to-GDP ceiling (see Chart 7).[6] Malta is among the Members States expected to register the lowest debt ratios across the euro area in 2017, based on the information presented in the various countries' DBPs (see Chart 8). This also reflects the fact that, in Malta, the Government did not need to intervene to save failing banks due to the global financial crisis, something which inflated significantly some other countries' debt levels.[7] Malta's planned decline in the debt ratio in 2018, is also in line with similar anticipated developments across most euro area countries.

[6] The COM's forecasts indicate a similar trajectory for the debt-to-GDP ratio, 54.9% in 2017 and 51.6% in 2018.

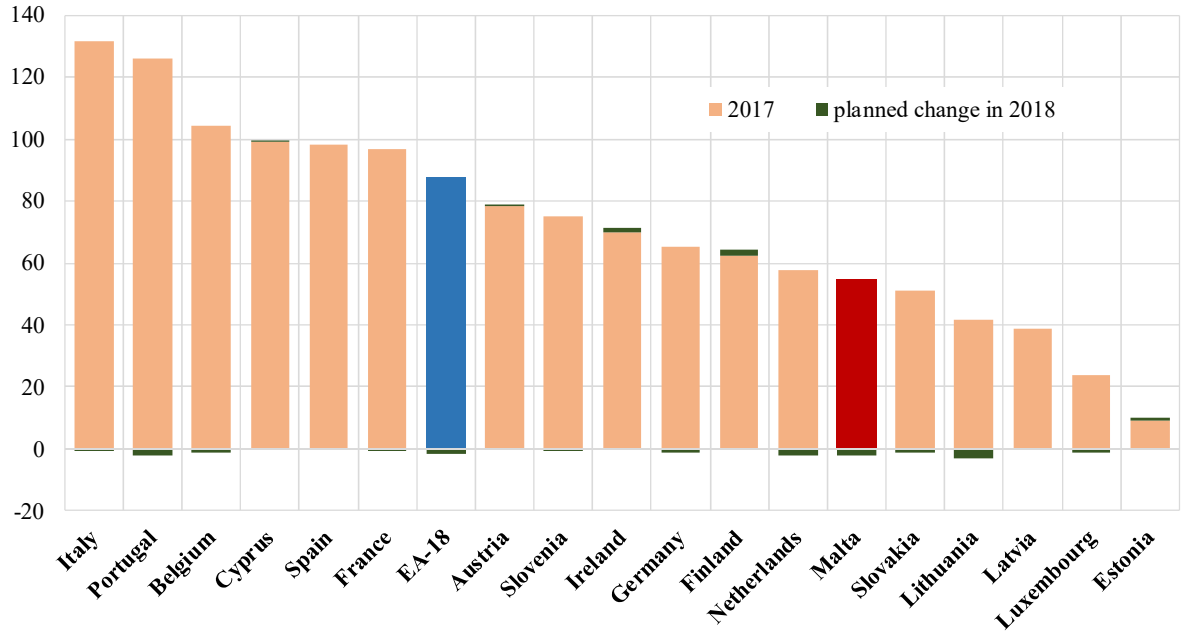
[7] The European countries which experienced the largest change in government debt over the period 2008 to 2014, due to the support to the financial sector were respectively Ireland, Greece, Spain and Portugal. For further details refer to "The fiscal impact of financial sector support crisis" available on https://www.ecb.europa.eu/pub/pdf/other/eb201506_article02.en.pdf?fadae43a45a35a30cd17d3213277042d.

Chart 7: Fiscal balance and public debt



Source: MFIN

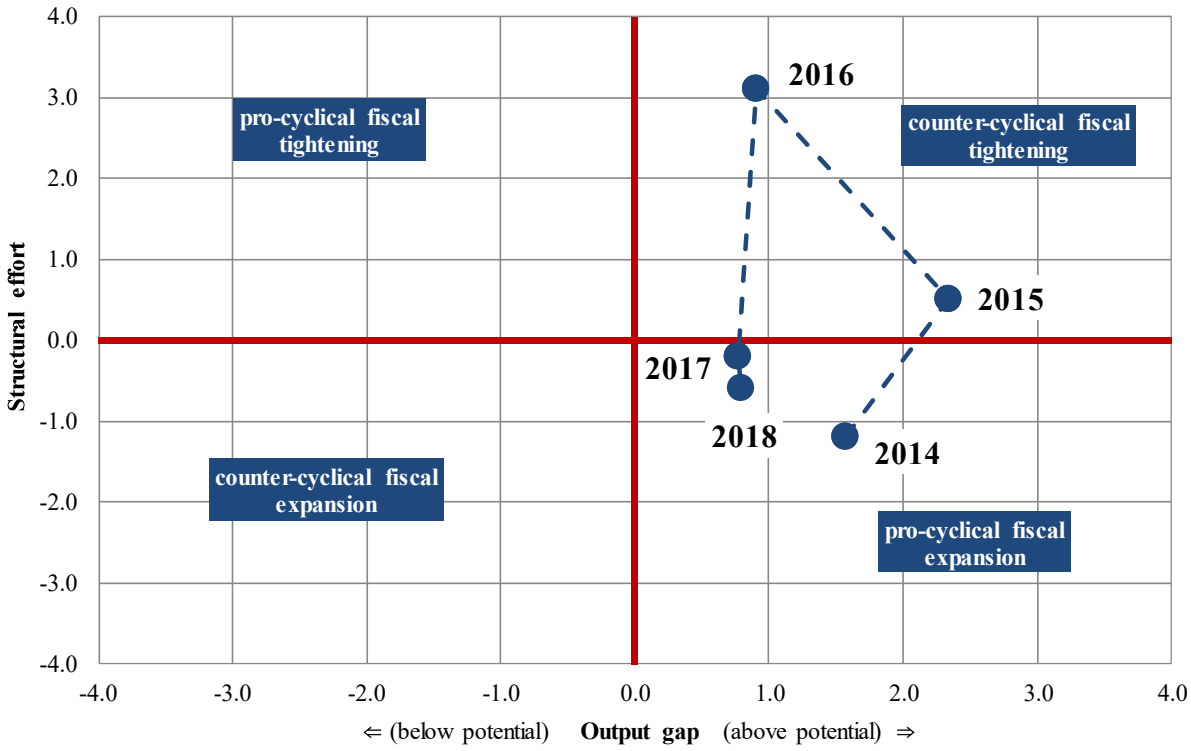
Chart 8: Planned debt ratios across the euro area (% of GDP)



Note: Greece is not included since it is not obliged to submit a DBP.
Source: COM

Turning to the **structural balance**, in 2016, Malta achieved a structural surplus of 0.8% of potential output. The target of a structural surplus amounting to 0.6% of potential output in 2017, followed by a balanced budget in structural terms in 2018, fully complies with the budgetary rule, as it fully respects Malta's MTO of a structural balance.[8] However, it is worth noting that the easing of the structural balance (which reflects a negative structural effort) at a time when the economy's cyclical conditions are stable and marginally above potential, implies a small pro-cyclical fiscal expansion. This could amplify slightly the business cycle (see Chart 9).[9] This contrasts with the counter-cyclical fiscal tightening undertaken in 2015 and 2016.

Chart 9: Cyclical conditions and structural effort (percentage points of GDP)



Source: MFIN

When a country has reached its MTO (as has been the case for Malta), the standard reference rate which forms part of the **expenditure benchmark**, is applicable for the following year.[10] Accordingly, the expenditure benchmark prescribes that, in 2018, nominal (adjusted) expenditure growth in Malta, after carrying out certain adjustments, must not exceed 8.4%, based on the COM's calculations (see Table 2 and Diagram 2).[11]

[8] The COM's forecasts indicate a similar trajectory for the structural balance, a surplus of 0.6% in 2017 and 0.1% in 2018.

[9] Business cycles refer to the economic phenomenon whereby economies pass through a phase where economic activity is buoyant (above potential) and another phase where economic activity is more subdued (below potential). This pattern is highly stylised across countries. However, the length of the business cycle varies across countries, and is difficult to predict.

[10] In the case of countries which have not yet attained their MTO, the permissible expenditure growth is reduced in order to ensure convergence towards the MTO.

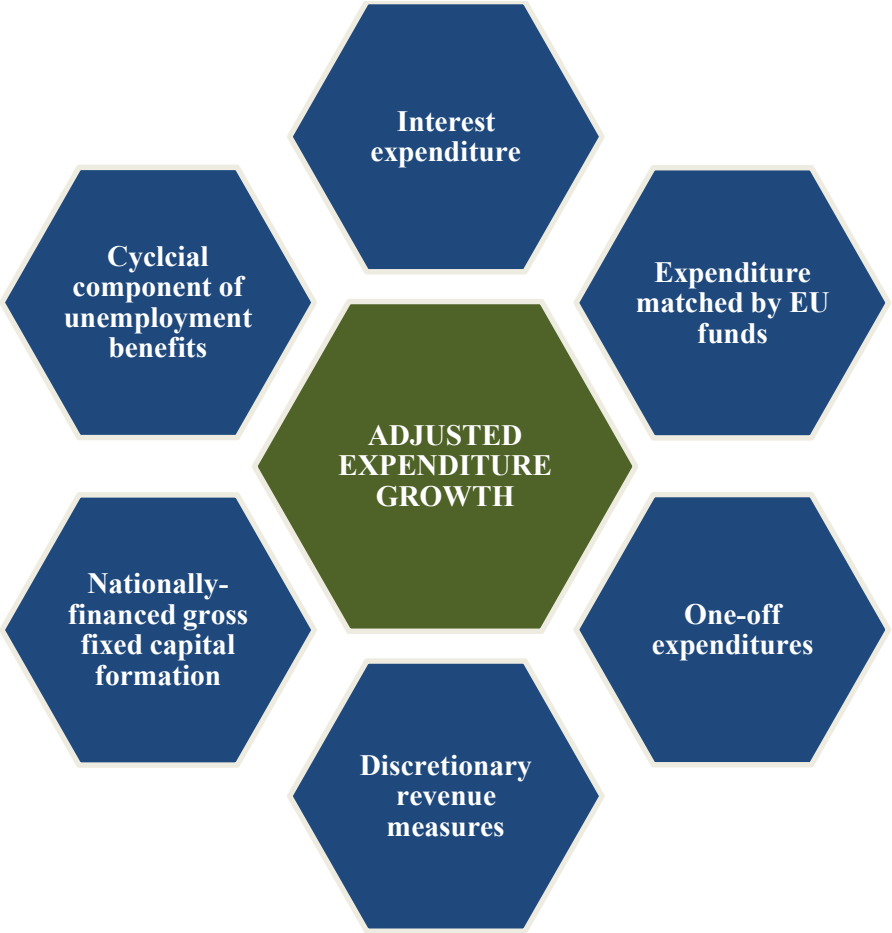
[11] The adjustments net out certain expenditures while discretionary revenue measures are also netted out. For further details refer to Vade Mecum on the Stability and Growth Pact (2017 edition) available on

Table 2: Expenditure benchmark

	2018
Applicable reference rate established by the COM (%)	8.4
Nominal expenditure growth calculated by the COM (%)	10.4
One-year deviation (% of GDP) – COM	-0.6
Two-year deviation (% of GDP) – COM	-0.2
One-year deviation (% of GDP) – MFIN	-0.2
Two-year deviation (% of GDP) – MFIN	0.0

Source: COM

Diagram 2: Adjustments to derive the applicable expenditure growth



Source: COM

https://ec.europa.eu/info/publications/economy-finance/vade-mecum-stability-and-growth-pact-2017-edition_en.

However, the COM estimated that the nominal growth rate of government expenditure net of revenue measures would amount to 10.4% in 2018, thus exceeding the applicable reference rate. This would lead to an excess of expenditure growth, which amounts to 0.6% of GDP. Using the MFIN's projections, the COM has estimated the excess to be lower, but would still amount to 0.2% of GDP.

Thus, should the expenditure plans materialise, there could be a deviation from the expenditure benchmark. Based on the MFIN's projections, the deviation would however be lower than the threshold to be considered as significant. At the same time, despite the yearly deviation being potentially higher than 0.5% of GDP, according to the COM's forecasts, Article 6(3) of Regulation No 1466/97 of 7 July 1997 specifies that "the deviation of expenditure developments shall not be considered significant if the Member State concerned has overachieved the medium-term budgetary objective". Thus, according to this clause, Malta's situation would technically not constitute a significant deviation, even under the COM's projections.

Over a two-year period (2017 – 2018) the average deviation would amount to 0.2% of GDP using the COM's projections. On the other hand, no deviation would be recorded under the MFIN's projections. In either case, the estimates point to an average deviation which is less than 0.25%, which is the threshold for a significant deviation when looking at two-year averages.

Overall, the MFAC welcomes the fiscal outturn in 2016, which resulted in full compliance with the three fiscal rules. Likewise, for 2017 full compliance is again expected. At the same time, the MFAC takes note of the fact that in relation to 2018, the COM has classified Malta (together with four other euro area Members States under the preventive arm of the SGP) as 'broadly compliant' (see Table 3).[12] The MFAC fully shares the COM's view. On the other hand, since no significant deviation is anticipated vis-à-vis the expenditure benchmark, the Fiscal Council thus considers that there is full compliance with the requirements of the FRA.

In Malta's case, the risks of non-compliance are exclusively related to the anticipated dynamics of public expenditure, and the possible deviation with respect to the expenditure benchmark. In this respect, the MFAC shares the COM's invitation to the authorities "to stand ready to take further measures within the national budgetary process to ensure that the 2018 budget will be compliant with the SGP". Should the actual expenditure growth in 2018 be contained to within the limits prescribed by the expenditure benchmark, Malta would be fully compliant, rather than broadly compliant, with the requirements of the SGP.

[12] The preventive arm of the SGP aims to ensure sound budgetary policies over the medium term by setting parameters for Member States' fiscal planning and policies during normal economic times, while taking into account the ups and downs of the economic cycle. The corrective arm of the SGP ensures that Member States adopt appropriate policy responses to correct excessive deficits (and/or debts) by implementing the Excessive Deficit Procedure (EDP). For further details refer to https://ec.europa.eu/info/business-economy-euro/economic-and-fiscal-policy-coordination/eu-economic-governance-monitoring-prevention-correction/stability-and-growth-pact_en.

Table 3: Expected SGP compliance in 2018

Compliant	Broadly Compliant	Risk of Non-Compliance
Finland	Cyprus	Belgium
Germany	Estonia	France*
Latvia	Ireland	Italy
Lithuania	Malta	Austria
Luxembourg	Slovakia	Portugal
Netherlands		Slovenia
Spain*		

Note: Member States marked with (*) are under the Corrective Arm of the SGP, while the other Member States are under the Preventive Arm of the SGP. Greece does not have to submit its DBP as it is subject to a stability support programme and surveillance takes place in the context of that programme.
Source: COM

The MFAC would like to refer to the downside risks to total expenditure, which it has identified through its risk assessment undertaken as part of its endorsement of the DBP fiscal projections, contained in the report published by the MFAC on 30 November 2017 (see Table 4).

Table 4: Summary of risks to the expenditure projections

	2017	2018
Compensation of employees	⇓	⇔
Intermediate consumption	⇑	⇔
Social benefits	⇔	⇑
Interest expenditure	⇔	⇔
Subsidies	⇔	⇔
Gross fixed capital formation	⇓	⇓
Capital transfers payable	⇔	⇔
Other expenditure	⇓	⇓
Total expenditure	⇓	⇓

Note: The Table is reproduced from the MFAC's report assessing the fiscal projections contained in the DBP.
Source: MFAC

These downside risks could help mitigate somewhat the concerns that the expenditure benchmark is not fully respected in 2018. It is pertinent to note, however, that the downside risk associated with spending on gross fixed capital formation financed by EU funds is not applicable since this expenditure is netted out from the expenditure benchmark calculations. Hence, in this case, the main possible expenditure savings could relate to the non-utilisation of the Contingency Reserve (classified under 'other expenditure'), which amounts to €11.6 million.

4. Conclusion

The MFAC welcomes the fact that the attainment of a fiscal surplus in 2016, is set to be followed by other fiscal surpluses in 2017 and 2018. This is conditional on the fiscal plans outlined in the DBP for 2018, and the anticipated macroeconomic developments. Targeting a fiscal surplus is necessary to ensure that Malta maintains, or overachieves its MTO of structural balance, at a time when the economy continues to operate above potential. The further decline in the debt ratio is also viewed positively, as this allows for the build-up of fiscal space. Fiscal space allows a government to provide resources for public purposes without undermining fiscal sustainability. This is particularly relevant in view of the anticipated higher age-related costs facing Malta in future years.

The MFAC also notes that the currently benign conditions are additionally being favoured by the very low interest rate environment, which is resulting in important savings on public debt interest payments. The Council therefore advocates that such conditions would not only be used for creating fiscal leeway but also to implementing the necessary structural reforms. At the same time, it is important that while fiscal surpluses are aimed for, these should not undermine the effective functioning of government, or foregoing the attainment of worthy social objectives. The MFAC fully concurs that promoting inclusion should be another important priority for the conduct of Malta's fiscal policy, in line with one of the basic principles outlined by the Director Fiscal Affairs of the International Monetary Fund (IMF) with regard to the general conduct of a smart fiscal policy (see Appendix 1). This would also help spread better the positive impact of economic growth onto the population.

Finally, the MFAC invites the MFIN to monitor expenditure developments carefully, not only to ensure full compliance with the SGP requirements, but also to maintain prudent fiscal policy. This notwithstanding that in the COM's opinion there appears to be no risk of significant deviation in relation to the expenditure benchmark. Looking ahead, the MFAC also invites the MFIN to explore the possibility of introducing changes to the FRA, so that direct reference to the requirements of the expenditure benchmark is included in the legislation, irrespective whether the risk of deviation is significant or not. This would ensure that the expenditure benchmark is elevated to the same status as the debt and the budgetary rule, even under Maltese legislation. This would catalyse greater attention on the need to control underlying expenditure growth in line with the economy's growth potential. This would also help mitigate the risks

that revenue windfalls are channelled into higher expenditure, rather than used for debt reduction, as suggested by prudent policy making.

APPENDIX 1

SMART FISCAL POLICY

Based on a blog entry by Vito Gaspar, Director Fiscal Affairs Department of the International Monetary Fund (IMF).

1. Fiscal policy should be countercyclical

Fiscal policy can be used to smooth the business cycle. That's known as countercyclical policy. In bad times, taxes are lowered and spending is increased to put more money in the pockets of companies and consumers; in good times, spending is reduced and taxes raised. Fiscal policy has a greater role to play in economic stabilization today than in the past, because central banks in many advanced countries have cut interest rates very close to zero and the limits of monetary policy are being tested. In normal circumstances, a countercyclical fiscal policy should rely on "automatic stabilizers," that is, on spending and revenue that adjust to the ups and downs of the economy.

2. Fiscal policy should be growth friendly

Tax and spending measures can be used to support the three engines of long-term economic growth: capital, labour and productivity.

3. Fiscal policy should promote inclusion

Globalization and technological change have been major drivers of growth and convergence between countries. Taxes and public spending are powerful means to ensure that countries share the growth dividend among the population. Fiscal policy should also help people fully participate in and adapt to a changing economy. Better access to education, training, and health services, as well as social insurance, can make it easier for workers to bounce back from a job loss or illness.

4. Fiscal policy should be supported by a strong tax capacity

Governments need a strong capacity to tax to carry out the before-mentioned policies. Taxation provides a stable and adjustable source of revenue that can be mobilized if needed. It is also a central element in determining the ability of a country to repay its debt.

5. Fiscal policy should be prudent

The global financial crisis showed that public finances are exposed to large risks that are often underestimated. Bailouts of failing banks and a deep economic slump drove public debt in advanced economies to levels unprecedented in peacetime. Governments need to better understand the risks they are exposed to and adopt strategies to manage them. The authorities recognize the need to tame the pace of debt accumulation and reduce financial risks. Addressing these risks early on would improve the prospects for sustainable growth in the medium to long term.

Source: https://blogs.imf.org/2017/04/19/five-keys-to-a-smart-fiscal-policy/

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