Overall Assessment

Update of Stability Programme 2017 – 2020

A REPORT PREPARED

BY THE MALTA FISCAL ADVISORY COUNCIL

June 2017

MFAC
MALTA FISCAL ADVISORY COUNCIL

Overall Assessment
Medium-Term Fiscal Strategy:
Update of Stability Programme
2017 – 2020

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30 June 2017

The Hon Prof Edward Scicluna B.A. (Hons) Econ, M.A. (Toronto),
Ph.D (Toronto), D.S.S (Oxon) MP
Minister for Finance
Maison Demandols
South Street
Valletta VLT 2000

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 by the Malta Fiscal Advisory Council (MFAC) assessing the planned conduct of fiscal policy as outlined in the Update of Stability Programme for the period 2017 to 2020, which represents the Government's Medium-Term Fiscal Strategy. This report also contains the Council's assessment on the extent to which the numerical fiscal rules prescribed in the Stability and Growth Pact and the Fiscal Responsibility Act, are being complied with.

The Council views positively the attainment of a fiscal surplus of 1.0% of GDP in 2016, well in advance of the surplus that was intended to be achieved by 2019 consistent with the attainment of Malta's Medium Term Budgetary Objective. This was a significant favourable turnaround compared to the 1.3% deficit-to-GDP ratio recorded in 2015, and the stream of higher deficits which were recorded in earlier years. The Council fully supports the Government's plans to maintain a fiscal surplus between 2017 and 2020, equivalent to 0.5% of GDP.

The planned conduct of fiscal policy shows that both total revenue and total expenditure will grow by less than nominal GDP throughout the forecast horizon. These plans reflect an element of prudence in the revenue projections, combined with an element of expenditure restraint. In this regard, the Council highlights the importance that any new initiatives which could be considered over and above what was factored into the Medium-Term Fiscal Strategy document, do not derail the commitment to comply with the Medium Term Budgetary Objective of structural balance. It is also important to maintain adequate fiscal buffers for times when economic conditions could be less favourable than at present.

The Council confirms that in 2016 there was full compliance with the three fiscal rules which feature in the Stability and Growth Pact and the Fiscal Responsibility Act. The debt rule, the budget balance rule and the expenditure benchmark were all fully met. This was an improvement compared to the partial compliance reported in 2015. The upward revision in nominal GDP which was undertaken in December 2016 contributed to lower the debt ratio to below the 60% of GDP threshold. Indeed, public debt declined to 58.3% of GDP in 2016 and is projected to fall further, to 47.6% of GDP, by 2020. In turn, the improvement in the fiscal balance resulted in a structural effort which was substantially larger than the 0.6% of GDP structural adjustment requested by the European Council for 2016. Furthermore, expenditure developments were within the growth limits set by the expenditure benchmark. Provided that the medium term strategy is adhered to, these numerical fiscal rules are expected to be complied with over the period 2017 to 2020.

Apart from compliance with fiscal rules, it is essential that fiscal policy is sustainable. On the basis of the Commission's assessment framework, short and medium term risks to fiscal sustainability are judged to be low in the case of Malta, as a result of the benign macroeconomic conditions as well as the improved fiscal conditions, which are expected to persist in the short term. On the other hand, the Commission is projecting that there could be medium risks in the long run. These reflect the higher ageing costs being anticipated for the future, largely in connection with the necessary future outlays for pensions, health care and long term care.

In this respect, the Council draws attention to the key role played by population projections in assessing the long term sustainability risks. The Council notes that in the case of Malta, population projections appear to be rather volatile from one vintage to the other. Thus, it is important to treat long-term estimates with caution because they are contingent on the assumptions used. Moreover, the Council encourages the Government to continue to sustain the pension reform process in order to address long term sustainability challenges.

The Council would also like to recommend that the implications of population growth dynamics should not be restricted to fiscal sustainability issues, but also to ensure that the country's infrastructure and provision of public services adequately match the evolving needs of the growing population. It is important that expenditure restraint is sought in areas where savings are feasible, but at the same time, ensure that budgeted amounts are sufficient to cover the rising demand for public services, commensurate with a larger population.

On the quality of public finances, the Council positively notes that the Government's interventions in this regard have been broad and focused on three different areas: productivity, expenditure and revenue. In this respect, the Council invites the Government to intensify its efforts to channel best practices across the various departments and entities in

order to achieve further productivity gains, without however impairing on the service quality. Likewise, the opportunities for rationalisation of resources identified through the Comprehensive Spending Reviews should be fully tapped. These Reviews serve as useful tools to help alleviate expenditure pressures while at the same time improve the quality of public services. In this respect, the Council fully supports the European Commission's recommendation to expand the scope of the ongoing spending reviews to the broader public sector and introduce performance-based public spending. Turning to the area of taxation, it is important that tax reforms continue aiming towards simplification and greater efforts to curb tax evasion.

The Council would like to reiterate the importance of conducting fiscal policy which is geared more towards the medium and longer term. This would require a more effective transposition of a three-year policy framework, away from the tendency of yearly moving targets for the various revenue and expenditure components. Such a strategy would enhance the transparency, continuity and consistency of budgetary objectives.

Finally, the Council would like to express its satisfaction at the ongoing constructive dialogue with the Ministry and its officials and the sustained support received to facilitate the Council's operations.

Yours sincerely

Rene Saliba
Chairman

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Abbreviations

COM	European Commission
CSR	Comprehensive Spending Review
DBP	Draft Budgetary Plan
DSA	Debt Sustainability Analysis
EU	European Union
EUROPOP	Eurostat Population Projections
FRA	Fiscal Responsibility Act
FWT	Final Withholding Tax
GDP	Gross Domestic Product
IIP	Individual Investor Programme
MFAC	Malta Fiscal Advisory Council
MFIN	Ministry for Finance
MTFS	Medium Term Fiscal Strategy
MTO	Medium Term Objective
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 planned conduct of fiscal policy which is outlined in the Update of Stability Programme – Medium Term Fiscal Strategy, for the period 2017 to 2020.

Strong economic growth conditions have facilitated the attainment of a fiscal surplus, which amounted to 1.0% of GDP in 2016. This was a significant turnaround compared to the 1.3% deficit-to-GDP ratio recorded in 2015, and the stream of higher deficits which were recorded in earlier years. The Government plans to maintain a fiscal surplus between 2017 and 2020, equivalent to 0.5% of GDP.

It is anticipated that macroeconomic conditions will remain benign over the period 2017 to 2020. However, the output gap is expected to narrow and gradually swing from positive to negative over the forecast horizon.

The planned conduct of fiscal policy shows that both total revenue and total expenditure will grow by less than nominal GDP throughout the forecast horizon. As a result, both the revenue-to-GDP ratio and the expenditure-to-GDP ratio are expected to decline. These plans reflect an element of prudence in the revenue projections, combined with an element of expenditure restraint.

The Malta Fiscal Advisory Council confirms that in 2016 there was full compliance with the three fiscal rules which feature in the Stability and Growth Pact and the Fiscal Responsibility Act. The debt rule, the budget balance rule and the expenditure benchmark were all fully met. This was an improvement compared to the partial compliance reported in 2015.

In 2016, the debt-to-GDP ratio fell below the 60% of GDP threshold. Indeed, a significant upward revision in nominal GDP statistics, which was undertaken in December 2016, accelerated the decline in the debt ratio and enabled it to fall to 58.3% of GDP. Looking ahead, the downward trend in the debt ratio is set to continue, as debt accumulation is expected to be slower than nominal GDP growth.

Furthermore, in 2016, Malta over-achieved its Medium Term Budgetary Objective of structural balance, ahead of the 2019 deadline. Indeed, in 2016, it was estimated that the structural surplus amounted to 0.2% of GDP. The structural adjustment undertaken by Malta in 2016 exceeded the 0.6% of GDP which had been recommended by the European Commission. The Government plans to achieve structural surpluses throughout 2017 to 2020, and in this manner continue complying with Malta's Medium Term Budgetary Objective.

Turning to the expenditure benchmark, this was likewise fully respected in 2016. Expenditure (as defined under the expenditure rule) was stable on a year earlier, and thus within the applicable reference rate. Looking ahead, as long as Malta maintains a structural surplus, the practice of the Commission is that compliance with the expenditure benchmark will not be

assessed as part of the numerical fiscal rules. Nevertheless, the Malta Fiscal Advisory Council would like to encourage the Government to continue to monitor closely expenditure trends in order to avoid any unfavourable developments that might jeopardise compliance with the Medium Term Objective.

The analysis carried out by the European Commission points toward low risks to sustainability for Malta, in the short term and in the medium term. This assessment is influenced by the positive fiscal outturn in 2016 and the planned trajectories for the main fiscal and macroeconomic variables. However the European Commission judges that there are medium risks in the long term, mainly on account of the estimated future increases in ageing related costs. Under a scenario of less favourable ageing cost projections, or a scenario in which the structural primary balance returns to its historical value, the Commission identifies that there could even be risks of a high rather than medium nature for Malta's public finances over the long term. Therefore, the Malta Fiscal Advisory Council encourages the Government to continue to sustain the pension reform process in order to address long term sustainability challenges.

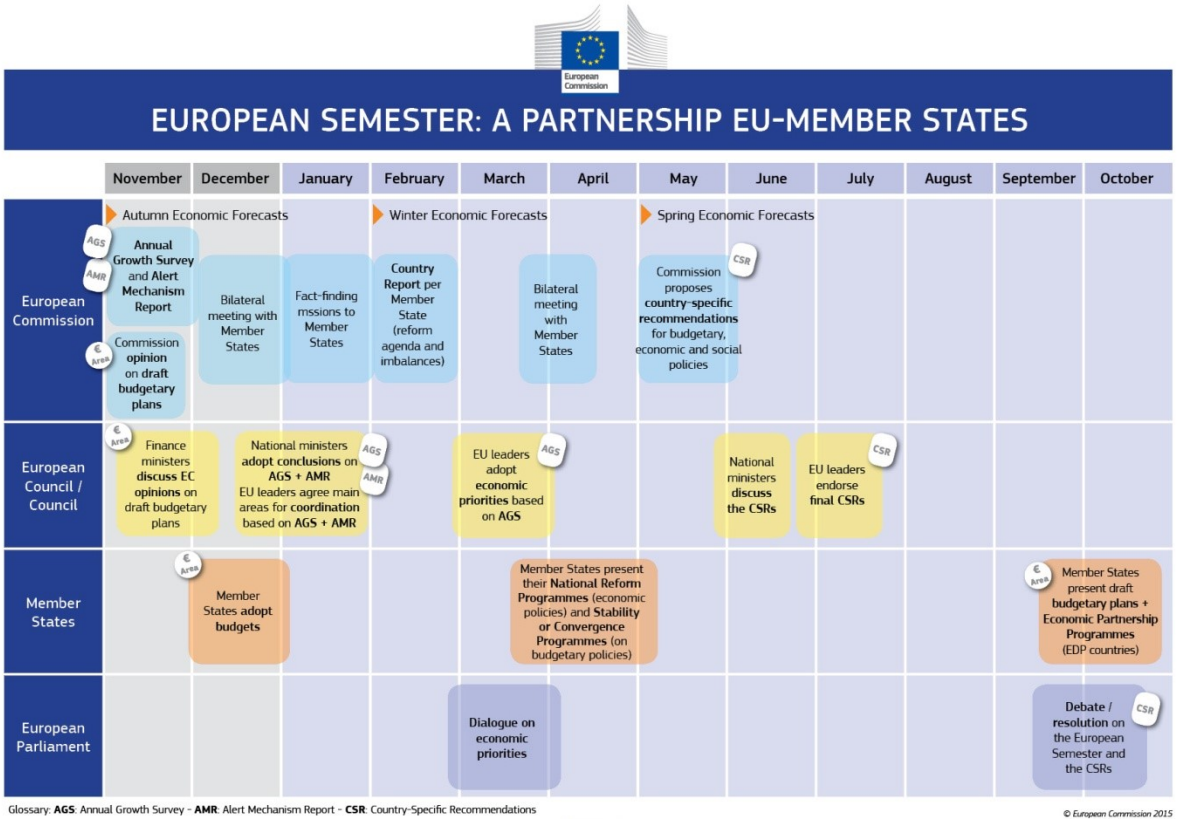
On the quality of public finances, the Malta Fiscal Advisory Council positively notes that the Government's interventions in this regard have been broad and focused on three different areas: productivity, expenditure and revenue. On the basis of studies carried out by the Ministry for Finance, it appears that between 2005 and 2015, the Government was able to raise its output at a faster pace than the labour input, thereby giving rise to productivity gains in the public sector. The Council welcomes drives to quantify public sector productivity and particularly initiatives to boost productivity within the public sector. It invites the Government to intensify its efforts to channel best practices across the various departments and entities. In this respect, the Malta Fiscal Advisory Council fully supports the Commission's recommendation to the European Council to address the Country Specific Recommendation to Malta to "expand the scope of the ongoing spending reviews to the broader public sector and introduce performance-based public spending".

Finally, the MFAC would like to reiterate the importance of conducting fiscal policy which is geared more towards the medium and longer term. This would require a more effective transposition of a three-year policy framework, away from the tendency of yearly moving targets for the various revenue and expenditure components. Such a strategy would enhance the transparency, continuity and consistency of budgetary objectives.

1. Introduction

The Update of Stability Programme (USP), which covers the period 2017 to 2020, also serves as Malta's Medium Term Fiscal Strategy (MTFS). The Government is required to submit a USP to the European Commission (COM) by the end of April annually as part of the European Semester, which provides a framework for the coordination of economic policies across the European Union (EU) (see Diagram 1). The European Semester allows EU countries to discuss their economic and budget plans and monitor progress, at specific times throughout the year. The USP must be prepared in accordance with various European Council Regulations, as well as the requirements of the Stability and Growth Pact (SGP).[1] On the other hand, the MTFS is prescribed by Article 15 (1) of the Fiscal Responsibility Act (FRA) which specifies that "In every financial year, the Government shall lay on the table of the House, the Medium Term Fiscal Policy Statement and the Fiscal Policy Strategy", and by Article 15 (2) which states that "The Medium Term Fiscal Policy Statement and the Fiscal Policy Strategy Statement shall set forth the Government's fiscal objectives, strategic priorities and a three-year rolling target for fiscal management together with a description of any underlying assumptions".[2]

Diagram 1: European Semester timeline



Source: COM

[1] For further details about the SGP refer to the 2017 edition of the Vade Mecum on the Stability and Growth Pact available on https://ec.europa.eu/info/publications/economy-finance/vade-mecum-stability-and-growth-pact-2017-edition_en.

[2] The FRA is available on http://www.justiceservices.gov.mt/DownloadDocument.aspx?app=lp&itemid=26047&l=1.

Malta's USP-MTFS was published on 2 May 2017.[3] Since its publication, the Malta Fiscal Advisory Council (MFAC) has issued two reports to analyse its contents. The first report assessed the macroeconomic forecasts, while the second report assessed the fiscal projections, which underpin the USP-MTFS.[4] After having assessed the plausibility of the macroeconomic forecasts for the period 2017 - 2020, the MFAC concluded that "the projected increase in the headline GDP figure for 2017 and the outer years is within the MFAC's endorsable range". With regard to the fiscal projections, after scrutinising the various revenue and expenditure components, the MFAC stated that "the risks to the fiscal balance appear to be neutral for the period 2017 to 2020, as the upside risks to revenue and expenditure compensate for each other". The MFAC further added that "even the planned downward trajectory for the public debt ratio appears achievable". The MFAC thus endorsed both the macroeconomic as well as the fiscal forecasts contained in the USP-MTFS.

The aim of the third report in the series is to evaluate the conduct of fiscal policy as outlined in the USP-MTFS. In particular, this Report evaluates the extent to which the planned fiscal policy complies with the fiscal rules which are prescribed by the SGP and the FRA. This Report, whose cut-off date is 15 June 2017, proceeds as follows. Section 2 presents an overview of the macroeconomic and fiscal scenario which materialised in 2016, as well as that being projected over the period 2017 to 2020, by the Ministry for Finance (MFIN). Section 3 assesses the compliance with the three main pillars of the numerical fiscal rules, namely the debt criterion, the structural adjustment rule and the expenditure benchmark. Section 4 focuses on the sustainability of public finances, based on the assessment framework employed by the European Commission (COM). Section 5 focuses on the quality of public finances. Section 6 concludes with some final considerations.

2. Overview of the actual and forecast macroeconomic conditions and the planned conduct of fiscal policy

In 2016, Malta's real GDP expanded by 5.0% while nominal GDP growth amounted to 6.7% (see Table 1 and Chart 1).[5] It is anticipated that macroeconomic conditions will remain benign over the period 2017 to 2020. Real and nominal GDP growth rates are expected to remain elevated, albeit easing slightly. Real GDP growth is expected to decelerate to 4.3% in 2017, and gradually to 3.4% by 2020. Meanwhile, nominal GDP is anticipated to expand by 6.3% in 2017, and subsequently grow by around 6.0% in each of the outer years.

[3] The document is available on https://ec.europa.eu/info/sites/info/files/2017-european-semester-stability-programme-malta-en.pdf.

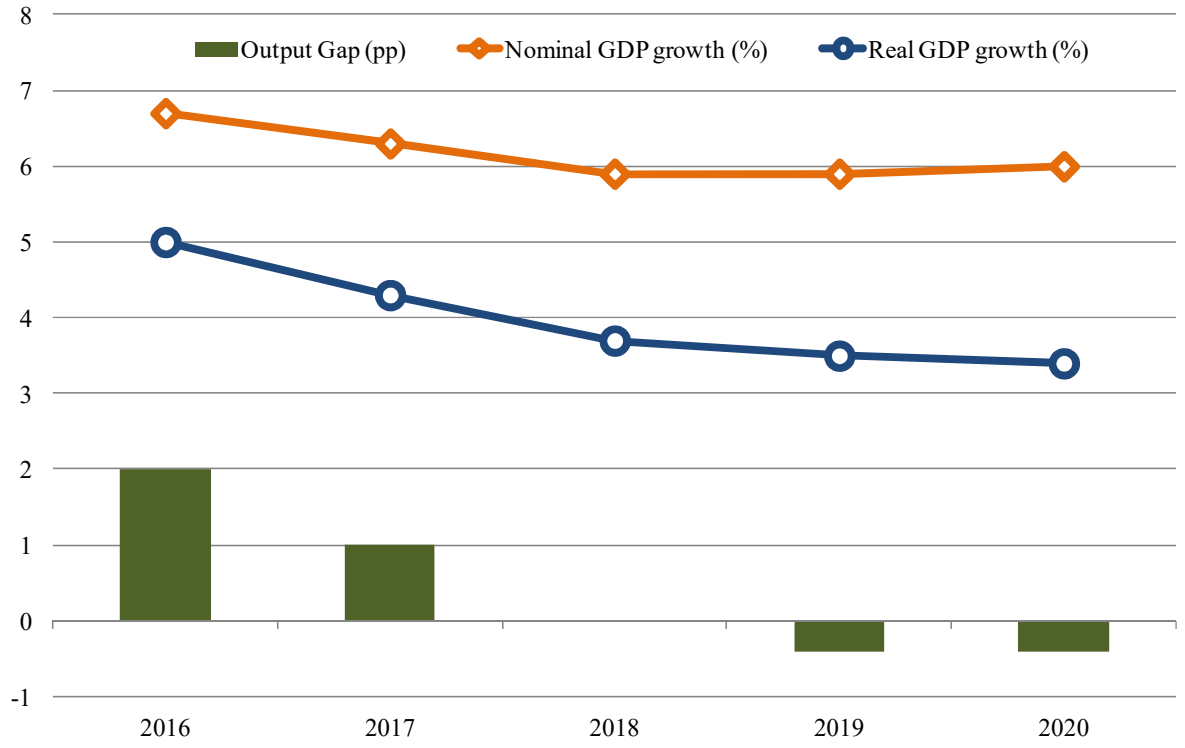
[4] The two reports entitled, Assessment of the Macroeconomic Forecasts and Assessment of the Fiscal Forecasts – Update of Stability programme 2017 – 2020, were published on 2 May 2017 and 31 May 2017 respectively, and are available on http://mfac.org.mt/en/publications/Pages/Publications.aspx.

[5] All the analysis and figures quoted in this Report are based on the News Release 041/2017, which was published by the National Statistics Office (NSO) on 8 March 2017. These are the same figures used by the MFIN to prepare the contents of the USP-MTFS, as well as by the COM in its assessment report. On 8 June 2017, the NSO issued the second vintage national accounts estimates for 2016 as a whole, by means of News Release 093/2017. The updated figures reconfirmed Malta's real and nominal GDP growth for 2016 respectively at 5.0% and 6.7%, with a marginal decline (in absolute terms) in the level of real and nominal GDP for the year.

Table 1: Key macroeconomic and fiscal developments (% of GDP)

	2016	2017	2018	2019	2020
Real GDP growth	5.0	4.3	3.7	3.5	3.4
Nominal GDP growth	6.7	6.3	5.9	5.9	6.0
Unemployment rate	4.7	4.6	4.7	4.8	4.8
Inflation rate	0.9	1.5	1.8	1.8	1.9
Potential output growth	5.8	5.3	4.7	3.9	3.4
Output gap (% of potential output)	2.0	1.0	0.0	-0.4	-0.4
Fiscal balance-to-GDP (headline)	1.0	0.5	0.5	0.5	0.5
Structural balance (% of potential output)	0.2	0.2	0.5	0.6	0.6
Public debt-to-GDP	58.3	55.9	52.5	50.0	47.6

Chart 1: Actual and projected macroeconomic conditions (2016 – 2020)



Source: MFIN

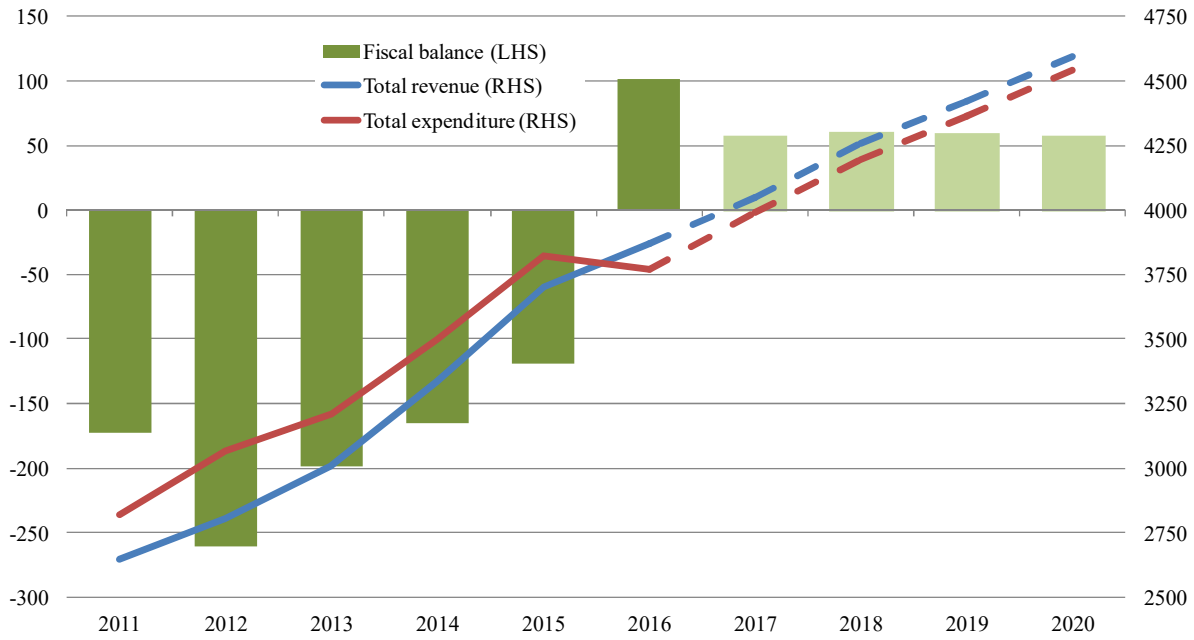
According to the MFIN's calculations (using the commonly agreed methodology across the EU) the output gap, which compares the level of real GDP to potential output, is expected to narrow and gradually swing from positive to negative over the forecast horizon.[6] Specifically,

[6] A positive output gap means that real GDP is higher than potential output while a negative output gap implies that real GDP is below potential output. Economic theory suggests that economies grow in cycles, with some years of buoyant economic activity, followed by years wherein economic activity is more subdued. For a detailed description of the current version of the production function methodology which is used by the COM

Malta's output gap was estimated at 2.0% in 2016 (i.e. above potential) but it is expected to become slightly negative as from 2019. For 2020, the output gap is estimated at -0.4% (i.e. below potential).

Strong economic growth conditions have facilitated the attainment of a fiscal surplus equivalent to 1.0% of GDP in 2016. This was a significant turnaround compared to the 1.3% deficit-to-GDP ratio recorded in 2015 and the stream of higher deficits recorded in earlier years. The improvement in the 2016 fiscal balance resulted from a 4.5% increase in total revenue, which extended the recent years' trend increases, and a concurrent exceptional 1.4% decline in total expenditure (see Chart 2 and Chart 3). The outturn in 2016 was thus significantly better than what was indicated in the Draft Budgetary Plan (DBP) which was published in October 2016.[7] Indeed, the latest DBP (for 2017) had targeted a less ambitious fiscal outcome for 2016, specifically a fiscal deficit amounting to 0.7% of GDP.

Chart 2: Main fiscal developments (2011 – 2020) (EUR millions)

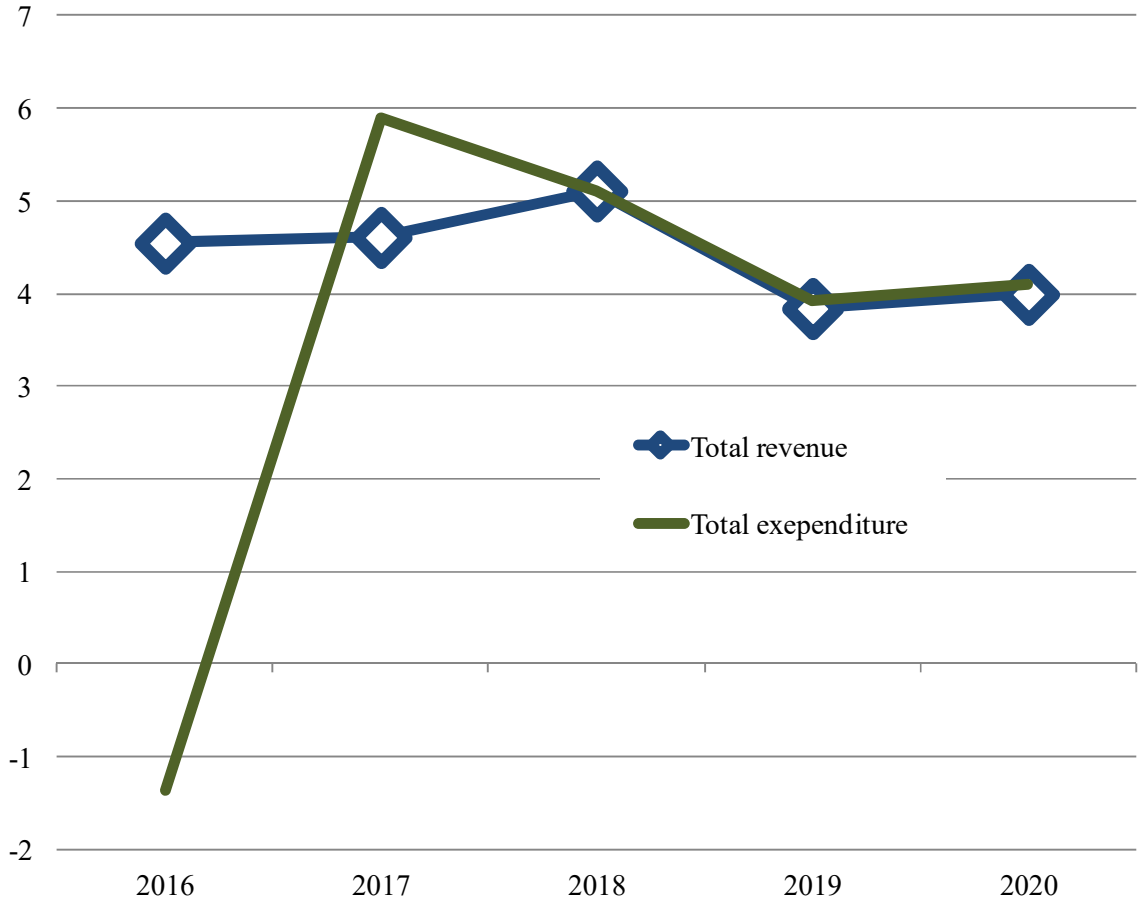


Source: MFIN

for assessing both the productive capacity (i.e. potential output) and cyclical position (i.e. output gaps) of EU economies, refer to http://ec.europa.eu/economy_finance/publications/economic_paper/2014/pdf/ecp535_en.pdf.

[7] The 2017 DBP can be downloaded from https://ec.europa.eu/info/files/draft-budgetary-plan-malta-2017_en.

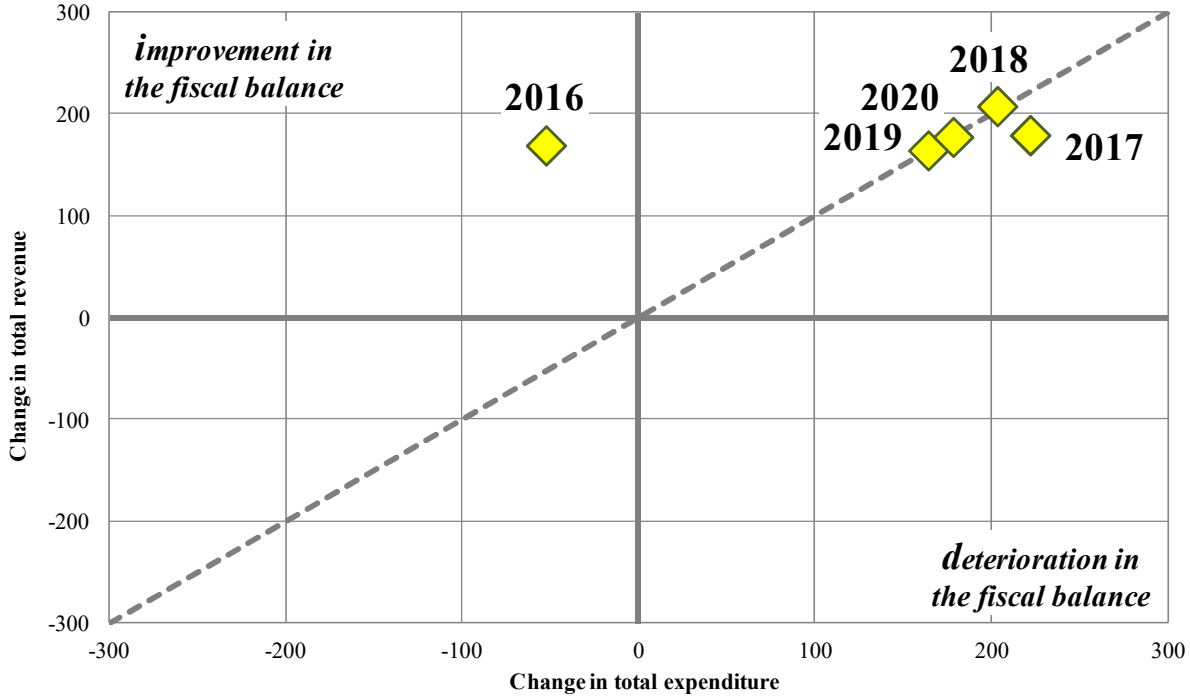
Chart 3: Total revenue and total expenditure growth (%)



Source: MFIN

Between 2017 and 2020, the Government plans to maintain a fiscal surplus, albeit slightly lower than that recorded in 2016. The aim is for an annual surplus equivalent to 0.5% of GDP, which is equivalent to an average of around €58.4 million yearly. Expenditure is expected to rise slightly more than revenue in 2017, thus leading to the small deterioration in the fiscal balance compared to 2016 (see Chart 4). Thereafter, for the period 2018 to 2020, broadly similar revenue and expenditure growth patterns are projected, consistent with the target of a stable annual fiscal surplus.

Chart 4: Yearly revenue and expenditure patterns (EUR millions)



Note: Anywhere above the dashed line indicates combinations of revenue and expenditure developments leading to an improvement in the fiscal balance, whereas anywhere below the dashed line indicates combinations which lead to a deterioration in the fiscal balance. Anywhere along the dashed line indicates combinations which lead to a stabilisation in the fiscal balance.

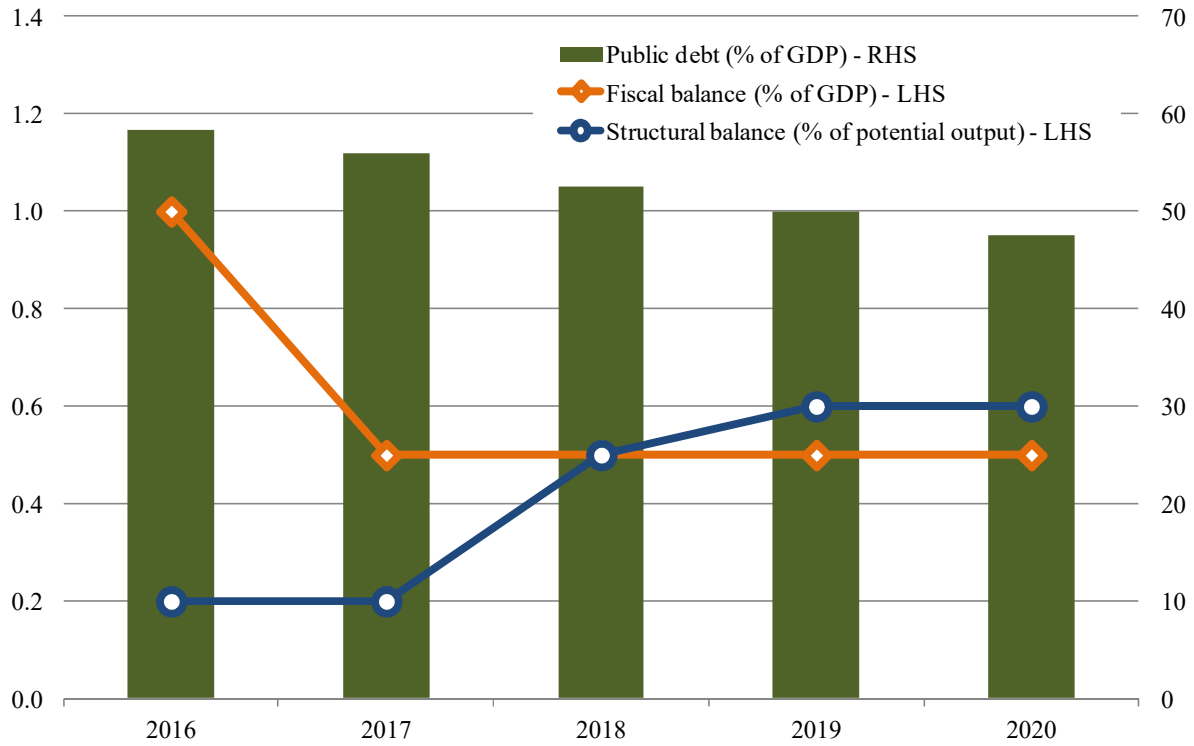
Source: MFIN

The annual fiscal surplus being projected, together with the expansion in nominal GDP is expected to extend the downward trend in Malta's debt-to-GDP ratio. Thus, while in 2016 public debt amounted to 58.3% of GDP, this is expected to decline to 47.6% of GDP by 2020 (see Chart 5).

Since in 2016, the economy operated above potential (as indicated by the positive output gap), the structural surplus was lower than the overall surplus.[8] The structural surplus was estimated by the MFIN at 0.2% of potential output. The projected fiscal developments correspond to an unchanged structural balance in 2017, equivalent to 0.2% of potential output. Although the projected fiscal surplus of 0.5% in 2017 is half that recorded in 2016, the effect of the smaller surplus is expected to be neutralised by the change in the economic cycle conditions and the magnitude of the one-off and cyclical effects. The structural surplus is then expected to improve to 0.5% of potential output in 2018, and to stabilise at 0.6% in 2019 and 2020. On the other hand, the COM is expecting a more favourable outturn. As can be seen from Chart 6, the structural surplus in 2016 is estimated by the COM at 0.4% of potential output and is expected to remain the same in 2017. It is then projected by the COM to increase to 0.7% in 2018.

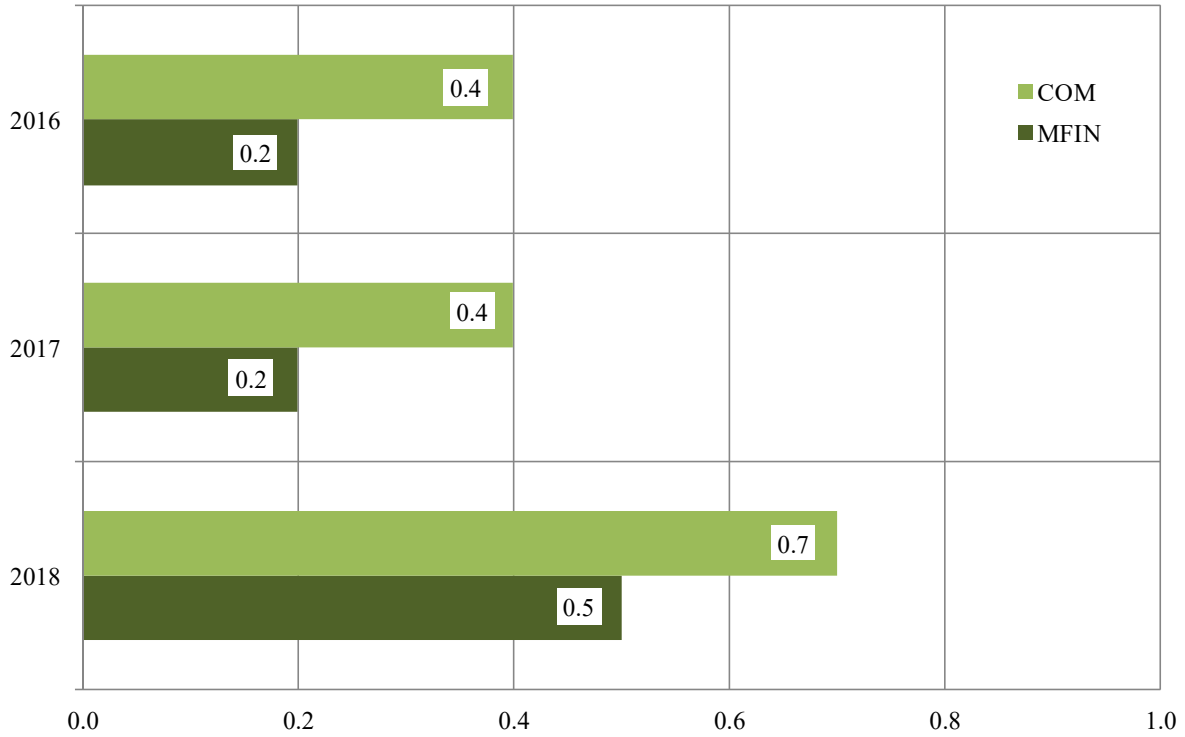
[8] The structural balance corrects for the economic cycle as well as nets outs the impact of temporary and one-off measures from the overall balance.

Chart 5: Actual and projected fiscal conditions (2016 – 2020)



Source: MFIN

Chart 6: Structural Balance (% of potential output)

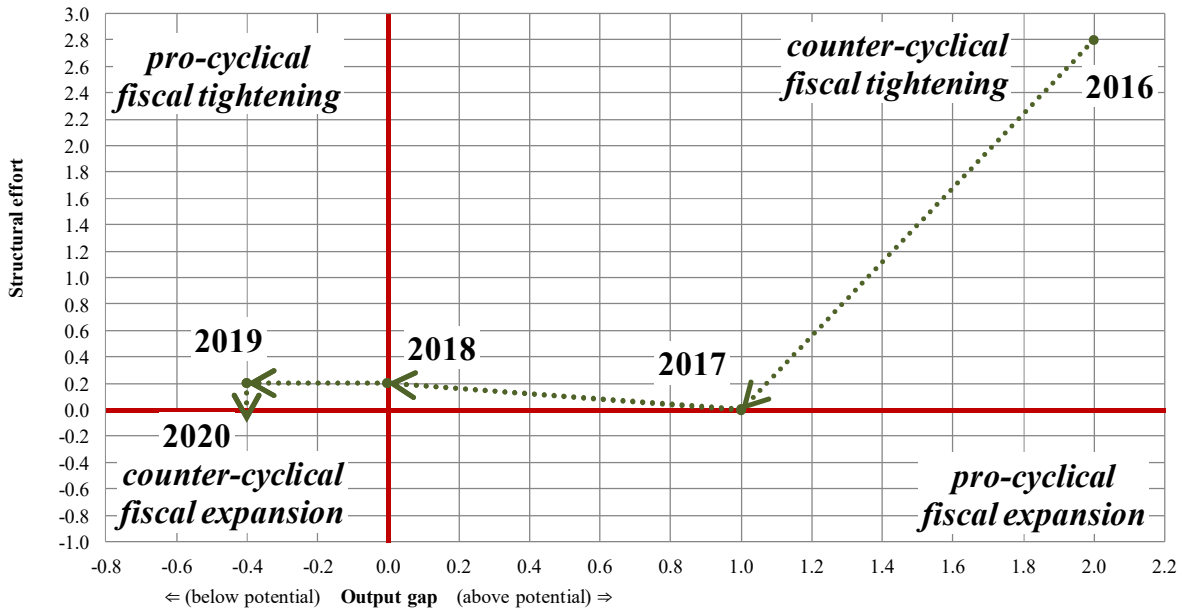


Source: MFIN and COM

The planned structural effort is uneven across the years. Following the exceptionally high structural effort of 2.8% of potential output recorded in 2016, no structural improvement is expected for 2017, at a time when the economy is projected to operate 1.0% above potential (see Chart 6). On the other hand, a 0.2 percentage points (pp) structural adjustment is planned for 2018, at a time when the output gap is expected to have closed off completely. A similar adjustment is planned for 2019, in terms of magnitude of the structural effort, even though in that year the economy is expected to operate marginally below potential. For 2020, the structural effort is anticipated to ease somewhat to -0.1 pp of potential GDP, again coinciding with below potential growth conditions.

The uneven structural effort over the forecast horizon is the direct result of the stable fiscal surplus being targeted for this period, coinciding with a phase when the economic cycle is projected to swing from above potential to below potential. In this respect the MFAC considers opportune for the MFIN to focus greater attention onto the trajectory of the structural balance. This will be useful to avoid possible amplification of the business cycle which may occur when fiscal policy is conducted pro-cyclically.[9] At the same time, the MFAC acknowledges the challenges involved to pin down precisely the phase of the economic cycle and to calibrate accurately the structural effort. As can be seen from Chart 7, the fiscal stance was strongly counter-cyclical in 2016 while it is projected to be slightly pro-cyclical in 2019 and broadly neutral in the remaining years covered by the USP.

Chart 7 Cyclical conditions and structural effort (percentage points of GDP)



Source: MFIN

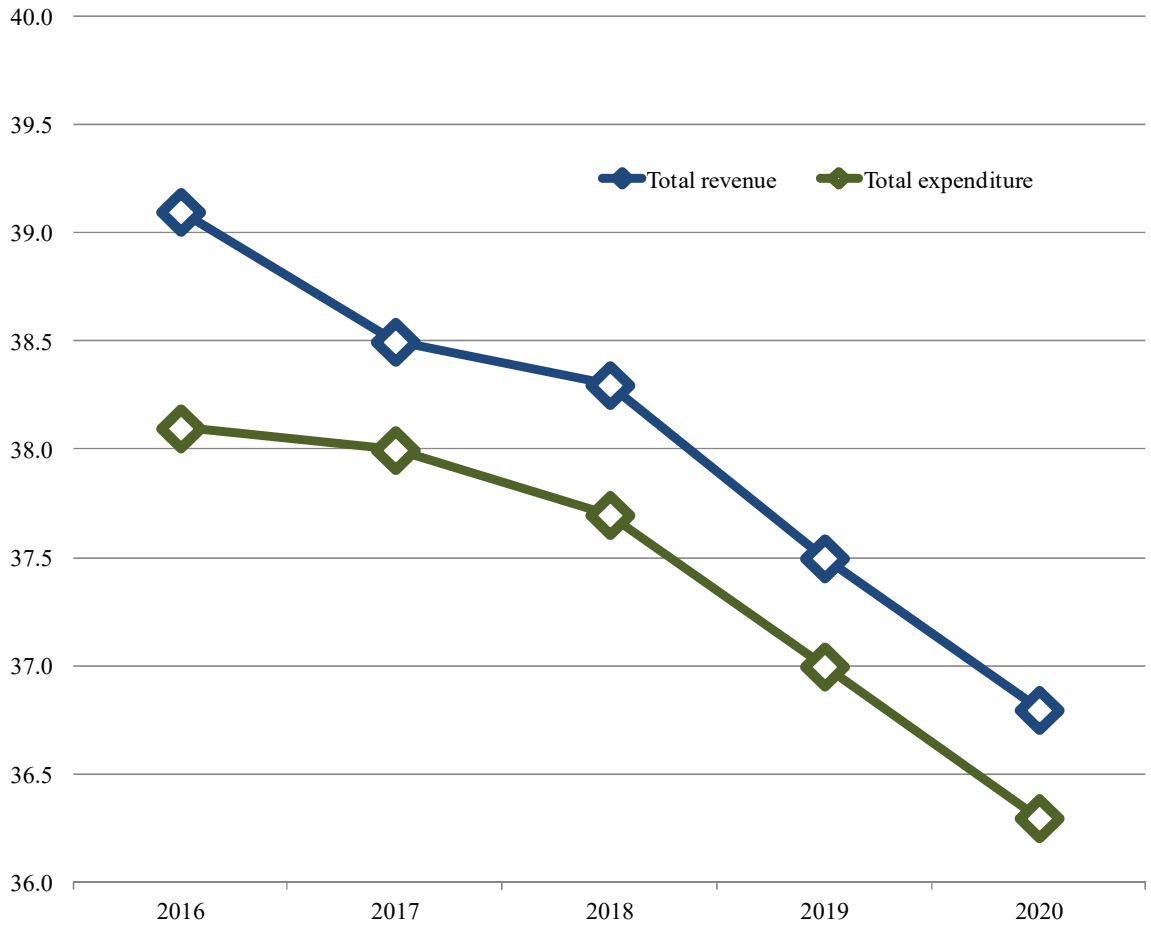
The conduct of fiscal policy outlined in the USP-MTFS suggests that both total revenue and total expenditure will grow by less than nominal GDP throughout the forecast horizon. As a

[9] Pro-cyclical behaviour happens when fiscal policy is expansionary (negative structural effort) at a time when the economy is operating above potential or contractionary (positive structural effort) when the economy is operating below potential.

result, the revenue-to-GDP ratio is expected to decline by 2.3pp between 2016 and 2020, from 39.1% to 36.8%. During the same period, the expenditure-to-GDP ratio is projected to decline by 1.8pp, from 38.1% to 36.3% (see Chart 8). These plans indicate a certain degree of prudence with respect to revenue projections. Indeed, it is the MFIN's stated intention to present rather conservative revenue forecasts on the basis of prudent elasticity assumptions. This MFIN practice reflects its stance to give priority to the importance of safeguarding against the risk of lower than expected revenue streams. At the same time, the expenditure projections point towards a certain element of restraint. This is in line with the MFIN's strategy of maintaining expenditure growth within pre-set parameters. The effects of these two factors compensate for each other, with the MFAC's assessment concluding that the risks to the fiscal balance appear to be neutral over the forecast horizon. This assessment is conditional on the presumption that the plans indicated in the USP-MTFS are closely adhered to. At the same time, the MFAC emphasises the need that the baseline revenue and expenditure projections should be unbiased, and the focus should not be limited to the fiscal balance, but rather to ensure that the forecasts for the main revenue and expenditure components are as close as possible to the actual turnout.

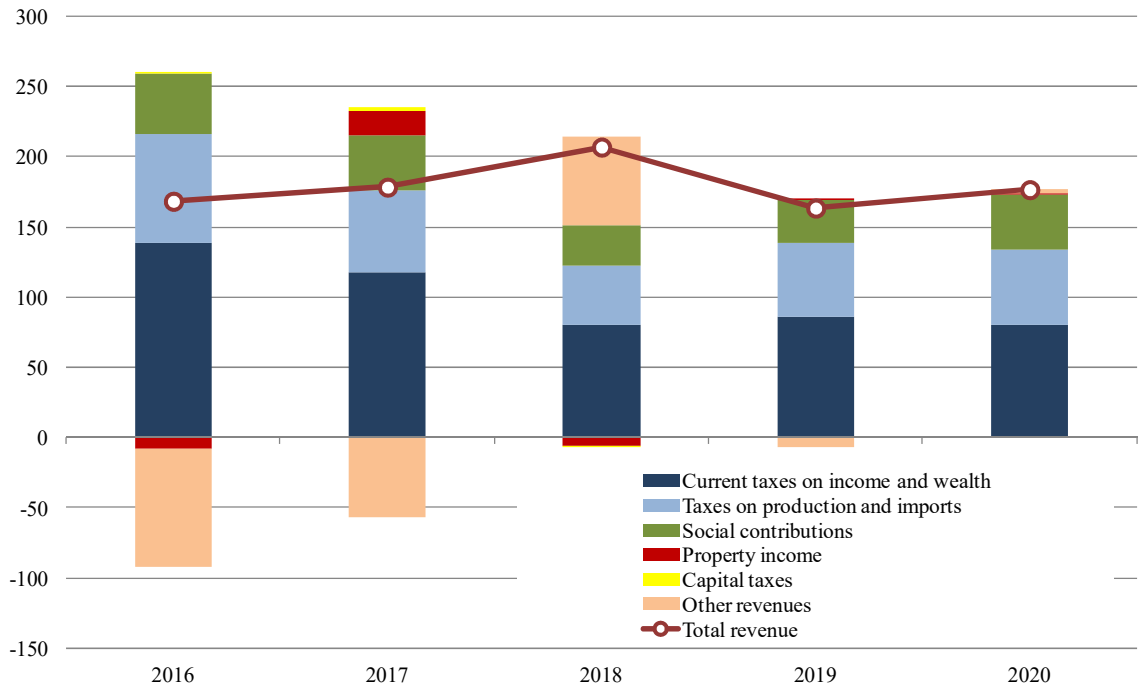
In absolute terms, the yearly additions to total revenue are broadly stable over the forecast horizon and comparable to the increase which was recorded in 2016 (see Chart 9). Current taxes on income and wealth, combined with taxes on production and imports account for the bulk of the projected revenue increases. Social contributions are also expected to generate steady yearly increases. On the other hand, the projections for the 'other revenue' category are expected to fluctuate, contingent on the assumed patterns for the utilisation of EU funds and the yields from the Individual Investor Programme (IIP), which feature among this category.

Chart 8: Revenue and expenditure ratios (% of GDP)



Source: MFIN

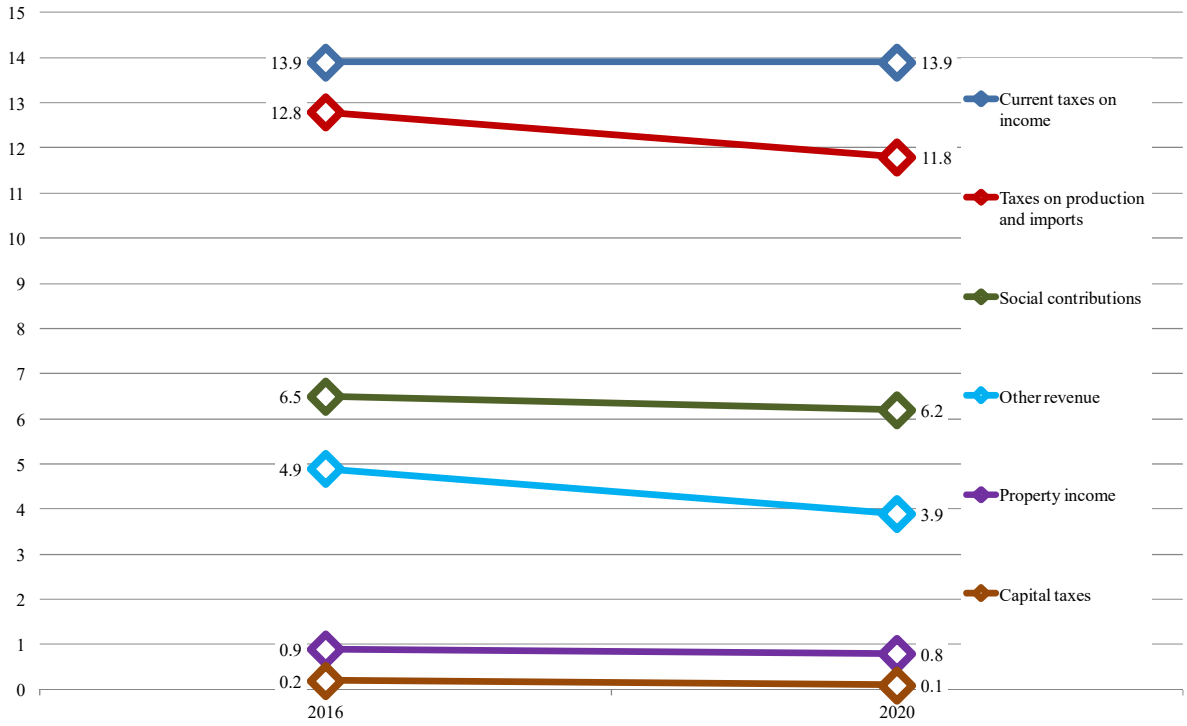
Chart 9: Revenue changes (2016 – 2020) (EUR millions)



Source: MFIN

In relation to GDP, the most notable developments on the revenue side relate to taxes on production and imports, and the 'other revenue' category, whose shares in GDP are both expected to be scaled back by one percentage point (see Chart 10). In the first case, this largely mirrors the rather conservative assumptions employed to forecast this variable. In the second case it reflects the assumption of possibly lower revenues from the IIP. On the other hand, the remaining revenue components are expected to maintain a rather stable ratio to GDP.

Chart 10: Revenue components (% of GDP)



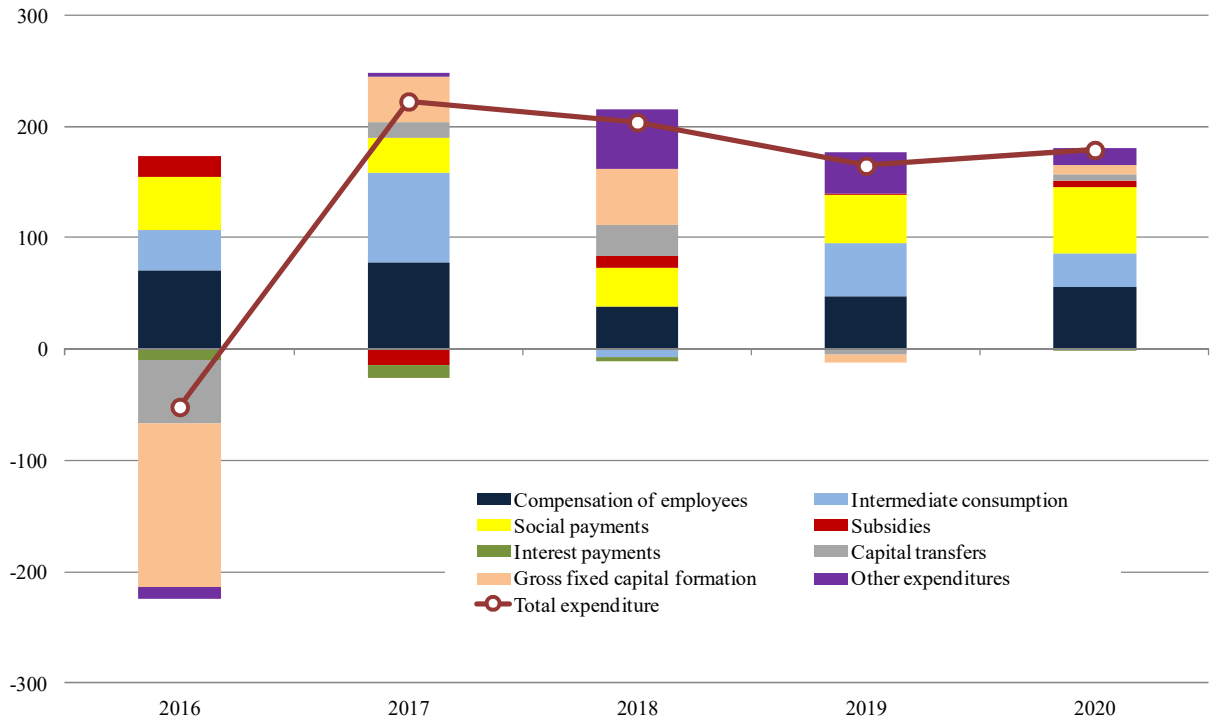
Source: MFIN

Following the exceptional decline in 2016, total expenditure as a percentage of GDP is again expected to increase on a yearly basis over the forecast horizon. The absolute yearly changes are roughly stable over these years, with slightly higher increases in 2017 and 2018 and slightly lower increases in 2019 and 2020 (see Chart 11). The dynamics of the various expenditure components, in terms of their yearly changes, are rather volatile across the years.

There is a generalised decline between 2016 and 2020 across many expenditure components, when compared to nominal GDP. The largest projected decline is in social payments, which is expected to drop by 0.9pp, followed by compensation of employees which is projected to decline by 0.8pp (see Chart 12). Interest payments are also expected to decline, by 0.6pp, while subsidies are expected to drop by 0.3pp. On the other hand, growth in gross fixed capital formation, capital transfers payable and 'other expenditure' is expected to outpace that in nominal GDP thereby contributing to a slight increase in the ratio in these cases. The MFAC considers important that changes in the relative shares of the various expenditure components, when compared to GDP, are built on efficiency gains, and that they do not

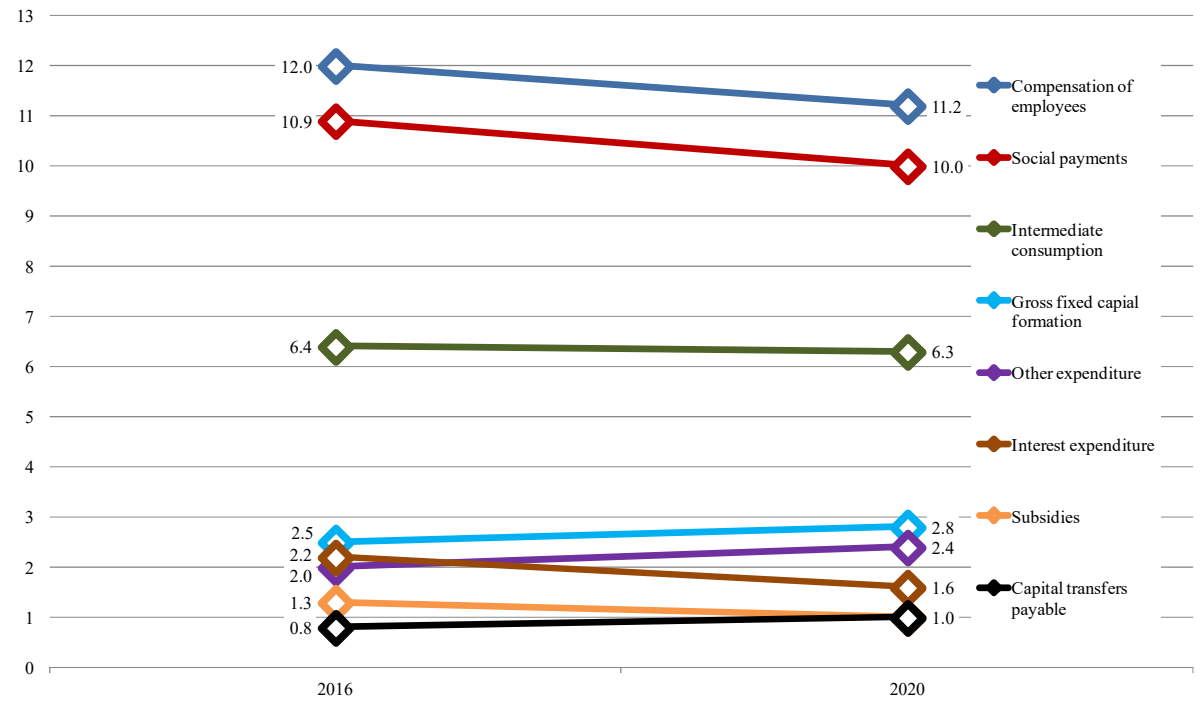
jeopardise the smooth functioning of the economy or the delivery of essential high quality public services, while maintaining an acceptable income distribution within the country.

Chart 11: Expenditure changes (2016 – 2020) (EUR millions)



Source: MFIN

Chart 12: Expenditure components (% of GDP)

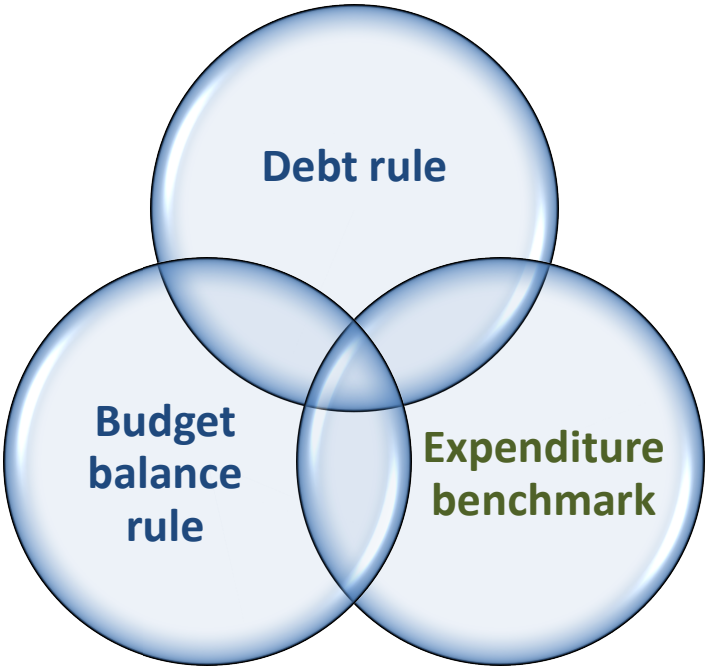


Source: MFIN

3. Compliance with fiscal rules

The EU's fiscal framework envisages that Member States respect the debt rule, the budget balance rule, and the expenditure benchmark (see Diagram 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 indirectly referred to in the FRA, in the case the COM identifies a 'significant deviation' from the Medium Term Budgetary Objective (MTO). These rules are designed to encourage countries to prioritise fiscal sustainability and prevent against the build up of imbalances.

Diagram 2: Fiscal rules



Source: MFAC

i) Debt rule

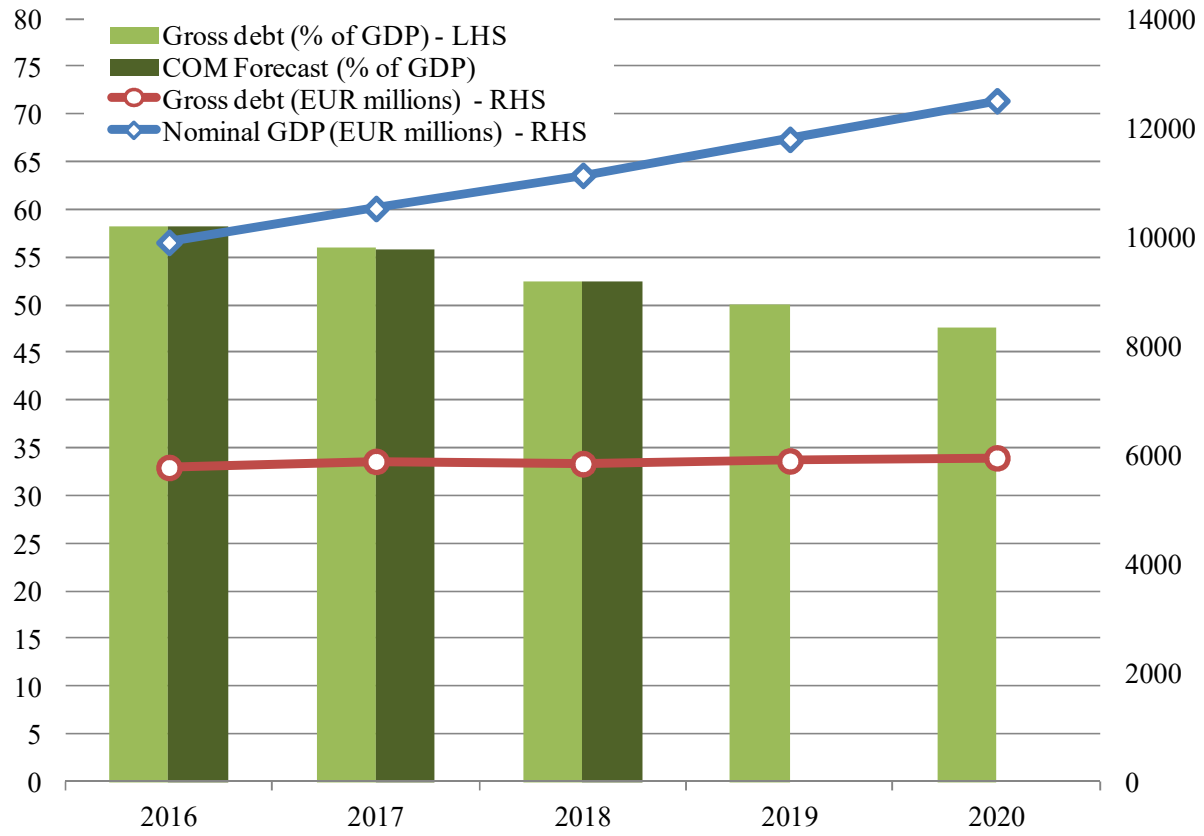
Compliance with the debt rule requires that a Member State's outstanding level of public debt is not greater than 60% of GDP, or else, it is declining steadily towards this ceiling (see Rule 1). In 2016, Malta's public debt stood at 58.3% of GDP, which is below the 60.0% ceiling (see Chart 13).

Rule 1: 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.

Source: Vade Mecum on the Stability and Growth Pact 2017 edition

Chart 13: Government debt (2016 – 2020)[10]



Source: MFIN

The MFAC positively notes that the debt-to-GDP turnout in 2016 was lower when compared to the latest DBP targets. Indeed, the DBP had anticipated a debt ratio equivalent to 63.3% of GDP for 2016. However, a significant upward revision in nominal GDP statistics, which was undertaken by the NSO in December 2016, contributed to accelerate the decline in the debt ratio well ahead of the planned trajectory. The upward revision in nominal GDP amounted to 5.3%, when compared to the previous vintage published in September 2016.[11] This base effect facilitated the substantial scaling back of Malta's public debt ratio. As can be seen from Chart 13, the forecasts for the public-debt-to-GDP ratio by the COM for the period 2016-2018 are virtually the same as those of the MFIN.

Notwithstanding the planned annual fiscal surpluses, gross debt is expected to increase gradually in absolute terms over the forecast horizon, to reach around €6.0 billion by 2020. This is due to positive stock-flow adjustments which are expected to maintain the upward trend in the outstanding level of public debt. However, since nominal GDP is expected to expand at a faster pace than the pace of debt accumulation, the debt ratio is projected to fall steadily, to reach 47.6% by 2020. The attainment of this target would place Malta's debt-to-GDP ratio within a comfortable buffer below the 60% of GDP threshold indicated in the SGP.

[10] COM forecast available till 2018.
[11] Sources: NSO News Release 142/2016 and News Release 199/2016.

ii) Budget balance rule

The structural deficit for 2015 was estimated by the MFIN at 2.6% of GDP. In order to ensure sufficient progress towards a balanced budget in structural terms by 2019, which is Malta's current MTO, the EU Council in July 2016 had recommended that the structural adjustment should be at least 0.6% of GDP in 2016 and 2017 (see Rule 2). The actual structural adjustment undertaken during 2016 was estimated by the MFIN at 2.8% of potential output (see Chart 14).[12] On the other hand, the COM estimated the 2016 structural effort at 3.0% of potential output. The EU Council's recommendation was thus fully met, and exceeded in 2016. Indeed, according to the MFIN, a structural surplus equivalent to 0.2% of GDP was achieved in 2016, compared to the structural deficit of 1.1% that had been estimated in the DBP. As a result, the MTO which had been projected for 2019 was actually reached in 2016. Even when combining 2015 and 2016 together, the average structural adjustment during this period was estimated by the MFIN at 1.6% of GDP, which was well above what was required in terms of the SGP.

Rule 2: BUDGET BALANCE RULE

Achieve an annual fiscal adjustment of 0.6% of GDP towards the Medium-Term budgetary Objective (MTO) in 2016 and in 2017.

The MTO:

(i) provides a safety margin with respect to the 3% of GDP deficit limit. For each Member State, that safety margin is estimated in the form of a minimum benchmark which takes past output volatility and the budgetary sensitivity to output fluctuations into account;

(ii) ensures sustainability or rapid progress towards sustainability. That criterion is assessed against the need to ensure the convergence of debt ratios towards prudent levels with due consideration to the economic and budgetary impact of ageing populations.

(iii) in compliance with (i) and (ii), allow room for budgetary manoeuvre, in particular taking into account the needs for public investment.

The Members States' MTOs are updated every three years, taking into account the latest economic and budgetary costs of ageing as published in the triennial Ageing Report.

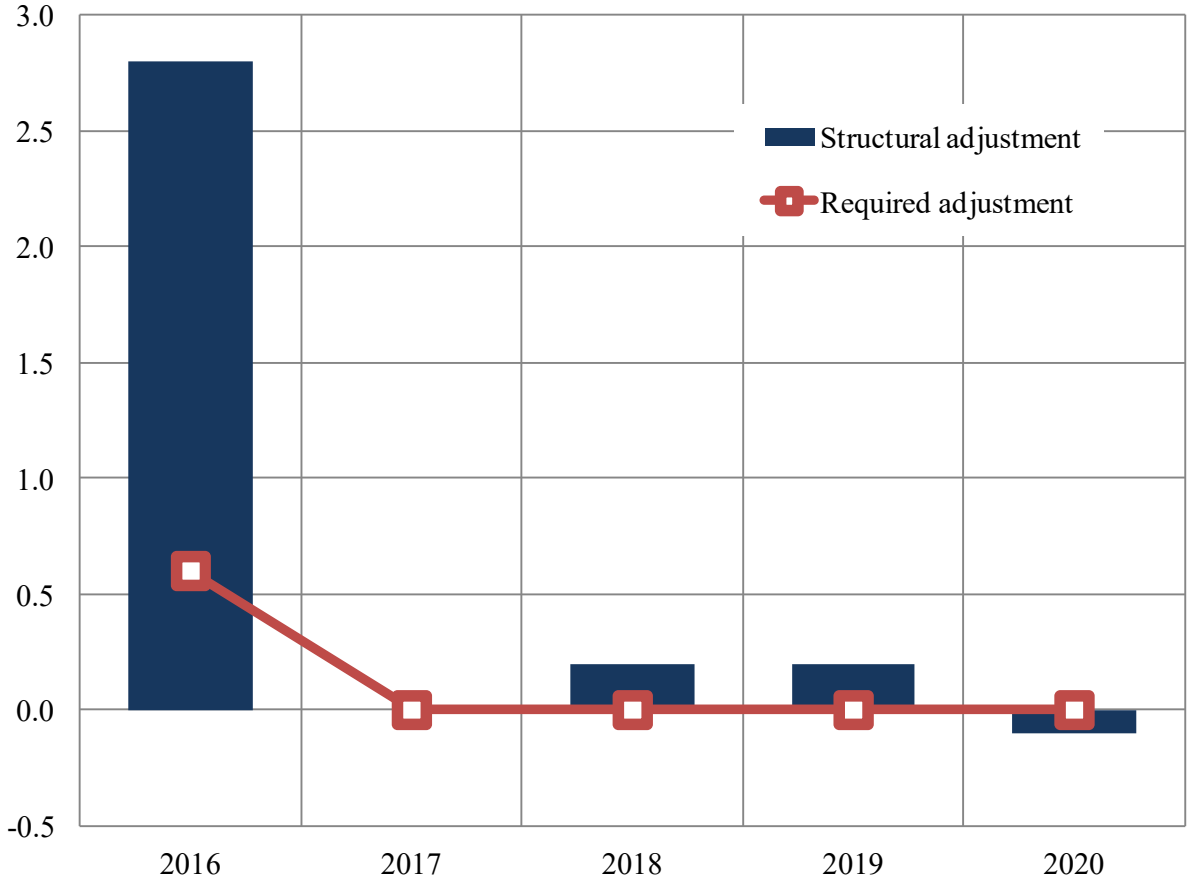
The current MTO for Malta has been set at balanced budget in structural terms and the country was required to achieve it by 2019.

Sources: EU Council Country Specific Recommendation of 12 July 2016; Vade Mecum on the Stability and Growth Pact 2017 edition

[12] The COM estimated the structural adjustment slightly higher, equivalent to 3.0% of GDP.

Going forward, it would be desirable for the country to maintain a fiscal balance at least equal to the MTO of a balanced budget.[13] It appears that the fiscal balance will remain above this MTO requirement over the programme horizon, as the Government plans to maintain a structural surplus of around 0.5% of GDP in each of the forecast years. The MFAC positively notes that the Government's plans offer a reasonable buffer over the minimum requirement in terms of the budget balance rule. On the basis of the MFIN's targets, which had been judged by the MFAC to be within its endorsable range, the likelihood of any significant deviation with respect to the budget balance rule appears to be well contained.

Chart 14: Structural adjustment (% of potential output)



Source: MFIN

[13] As per Article 10(1) of the FRA, the lower limit of the medium-term budgetary objective shall be an annual structural balance of the general government of minus 0.5 per cent of gross domestic product at market prices. Moreover, as outlined in Article 10(2), if the ratio of general government debt to gross domestic product at market prices is significantly below 60 per cent, and the risks in terms of long-term sustainability of public finances are low, the lower limit of the medium-term budgetary objective shall be an annual structural balance of the general government of minus 1 per cent of gross domestic product at market prices.

iii) Expenditure benchmark

In order to sustain convergence towards the MTO, the yearly expenditure growth, netted of certain adjustments, must respect an applicable reference rate, which is established by the COM on the basis of a specific methodology (see Rule 3).[14]

In the case of Malta, the reference rate for 2016 was set at 1.3%. On the other hand, the actual expenditure (as defined under the expenditure rule)[15] during 2016 was estimated by the COM to have remained stable over 2015 (i.e. zero growth). As a result, the expenditure benchmark was fully adhered to, with a 1.3pp negative deviation from the benchmark, meaning that actual expenditure growth was well below the reference rate. When considering 2015 and 2016 together, the expenditure benchmark was likewise respected, with a negative deviation of 0.2 pp. As long as Malta continues to satisfy its MTO, which appears to be plausible both on the basis of the MFIN's projections as well as the COM's forecasts, the practice of the COM is that compliance with the expenditure benchmark is not assessed as part of the numerical fiscal rules. Nevertheless, the MFAC would like to encourage the Government to continue to monitor closely expenditure trends in order to avoid any unfavourable developments that might jeopardise compliance with the MTO.

Rule 3: EXPENDITURE BENCHMARK

Annual expenditure growth should not exceed a reference medium-term rate of potential GDP growth, unless the excess is matched by discretionary revenue measures, thus, allowing the Member State to remain at its MTO. Countries that have exceeded their MTO do not need to be assessed for compliance with the expenditure benchmark.

Source: Vade Mecum on the Stability and Growth Pact 2017 edition

iv) Overall compliance

Overall, the MFAC confirms that ex-post, the debt criterion has been met in 2016 and ex-ante it is expected to continue being met throughout the period 2017 to 2020 (see Table 2). Likewise, the MFAC confirms that ex-post the structural adjustment criterion has been met in 2016 and ex-ante it is expected to continue being met throughout the period 2017 to 2020. The MFAC also confirms that the expenditure benchmark was met in 2016 and for the period 2017 to 2020 it will not be applicable in case the Government achieves its plans to maintain a better fiscal position than its current MTO. The MFAC welcomes the fact that in 2016 there

[14] For an explanation of the various features of the expenditure benchmark, refer to the MFAC's 2016 Annual Report, Chapter 7, available on http://mfac.org.mt/en/publications/Pages/Publications.aspx.
[15] The expenditure rule does not apply to total expenditure but rather excludes cyclical unemployment spending, interest expenditure and expenditure on EU programmes that are fully matched by EU fund revenue.

was full compliance with the three fiscal rules, which is an improvement compared to the partial compliance reported in 2015.[16]

Table 2: Compliance with fiscal rules

	2016	2017	2018	2019	2020
Debt rule					
Budget rule					
Expenditure benchmark		Not applicable			

Note: Green shading indicates full compliance. The Expenditure Benchmark is not applicable when the MTO is achieved or exceeded.
Source: MFAC

4. Sustainability of public finances

Apart from compliance with fiscal rules, it is essential that fiscal policy is sustainable. In order to gauge the extent of sustainability, the COM estimates a series of indicators for each Member State. These indicators focus respectively on the short term (S0), medium term (S1) and long term (S2) risks. On the basis of the COM's assessment, short and medium term risks to sustainability are judged to be low in the case of Malta, but there are medium risks in the long run (see Table 3).

Table 3: Sustainability indicators

Short term	Medium term	Long term
S0	S1	S2
	DSA	

Note: Green shading indicates low risk and orange shading indicates medium risk.
Source: COM

The S0 indicator points to low risks within a one-year horizon. This result is primarily driven by the good fiscal outturn and the strong economic growth recorded during 2016.[17] For the

[16] The COM, in its assessment of the USP 2016-2019, had concluded that in 2015 Malta failed to meet the required adjustment towards the MTO of 0.6% of GDP. In addition, the applicable expenditure benchmark rate was exceeded by 1.1% of GDP.
[17] The S0 indicator incorporates 14 variables under the sub-component 'fiscal index' and another 14 variables under the sub-component 'financial competitiveness index'. These two sub-indices mainly capture fiscal and macroeconomic conditions which empirical evidence has shown to be good predictors of fiscal stress. The S1 indicator is a medium-term sustainability gap; it measures the upfront fiscal adjustment effort required to bring the debt-to GDP ratio to 60 % by 2031. The S2 indicator is a long-term sustainability gap; it shows the upfront and permanent fiscal adjustment required to stabilise the debt to-GDP ratio over the infinite horizon, including

medium term, the S1 indicator also confirms low fiscal risks, reflecting the initial budgetary position of the structural primary balance in 2016. Likewise, the Debt Sustainability Analysis (DSA) conducted by the COM, which focuses on the future trajectory of the public debt ratio, also points towards low risks in the medium term. This follows from the fact that Malta's debt-to-GDP ratio has already fallen below the 60% threshold, and is expected to maintain its downward trend over the next ten years to reach around 30% by 2027.

On the other hand, the S2 indicator, which focuses on the long term, points towards medium risks, mainly on account of the higher ageing costs which are being anticipated for the future, largely in connection with pensions, health care and long term care. In fact, the S2 indicator for Malta has been estimated by the COM (under a no-policy change scenario) to amount to some 2.8 pp of GDP, with the cost of ageing accounting for 4.8 pp of GDP.[18] These figures, which lie within the 2 pp – 6 pp range for the COM's medium risk measure, are based on the EUROPOP2013 population projections.[19] Under a scenario of less favourable ageing cost projections, or a scenario in which the structural primary balance returns to its historical value, the COM identifies that there could be risks of a high (that is, the S2 indicator exceeding the 6pp critical threshold) rather than medium nature for Malta's public finances over the long term.[20]

Long term indicators are useful because they help focus attention on issues beyond the electoral cycle, where risks may be latent but could have significant effects. On the basis of EUROPOP2013, the COM is projecting a steadily growing population, which is estimated to rise by 12.7% during the period 2013 – 2060 to reach 476,383 by 2060 (see Chart 15). However, it is important to treat long-term estimates with caution because they are contingent on the assumptions used. Moreover, the MFAC notes that in the case of Malta, population projections, which are a key component of any sustainability analysis, appear to be subject to frequent change. In fact, the projections based on EUROPOP2013 are significantly different from the scenario of a shrinking population that had been generated under the previous forecast vintage (EUROPOP2010). The latter had in fact projected a decline in the population of 6.2% during the period 2013 – 2060 to 386,935.

More updated projections, (EUROPOP2015) point to an even larger Maltese population in 2060, at 519,214. The projected size of the population in 2060 was thus revised upwards by 23.1% in the 2013 vintage compared to the 2010 vintage, and by a further 9.0%, in the 2015 vintage in relation to the 2013 vintage. As a result, the old-age dependency ratio, which was

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the costs of ageing. For further details about the various indicators used by the COM in its sustainability analysis refer to Box 2 in the MFAC's report entitled "An Overall Assessment of the Medium-Term Fiscal Strategy for Malta 2016 – 2019" available on http://mfac.org.mt/en/publications/Pages/Publications.aspx.

[18] The figure for the S2 indicator is based upon the COM's assessment of the USP for Malta 2017-2019. This reflects an update with respect to that recorded in the Debt Sustainability Monitor 2016, with the difference attributed to an updated 'initial budgetary position' component.

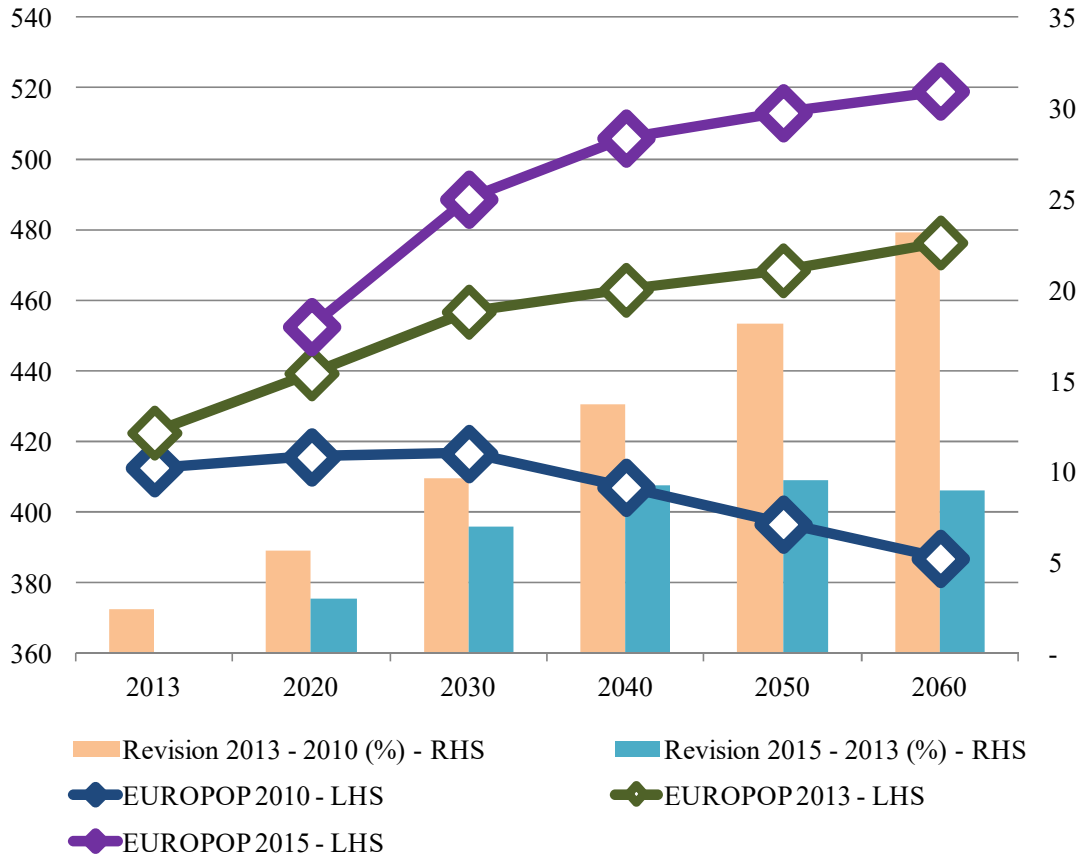
[19] EUROPOP represent long term population projections for all EU Members, computed by the COM based on a common EU-wide framework led by Eurostat. Such projections are updated on a regular basis by the COM.

[20] Source: COM (2017) Debt Sustainability Monitor 2016, Institutional Paper 047.

projected at 55.9% in 2060 on the basis of the EUROPOP2010, was revised down to 50.9% in the EUROPOP 2013, and further down to 47.2% in the EUROPOP2015.

On the basis of EUROPOP2013, the outlook appears to be more favourable from a long term sustainability perspective in relation to earlier population projections. For instance, whereas in the 2012 Ageing Report, the ratio of pension expenditure-to-GDP was projected to rise by 5.7pp between 2013 and 2060, it is now projected to increase by 3.2pp. Similarly, the projected increase in the health expenditure-to-GDP ratio for the same long term forecast horizon has been scaled down from 2.6pp in the 2012 Ageing Report (based on EUROPOP2010) to 2.1pp in the 2015 Ageing Report, based on EUROPOP2013.

Chart 15: Population projections (thousands)



Source: EUROSTAT

The MFAC, however, would like to underline the importance not to be complacent in this respect, especially in view of the projected steady contraction in the share of the working age population and the concurrent rise in the old-age dependency ratio. The MFAC favourably notes the series of measures taken by the Government through the Budgets for 2016 and 2017 with a view to striking a balance between the sustainability and the adequacy of the pension system. It encourages the Government to continue to sustain the pension reform process in order to address long term sustainability challenges. The MFAC further emphasises the importance of monitoring closely population trends so as to be in a better position to take pre-

emptive measures to address future challenges to fiscal sustainability in the event of unfavourable demographic developments.

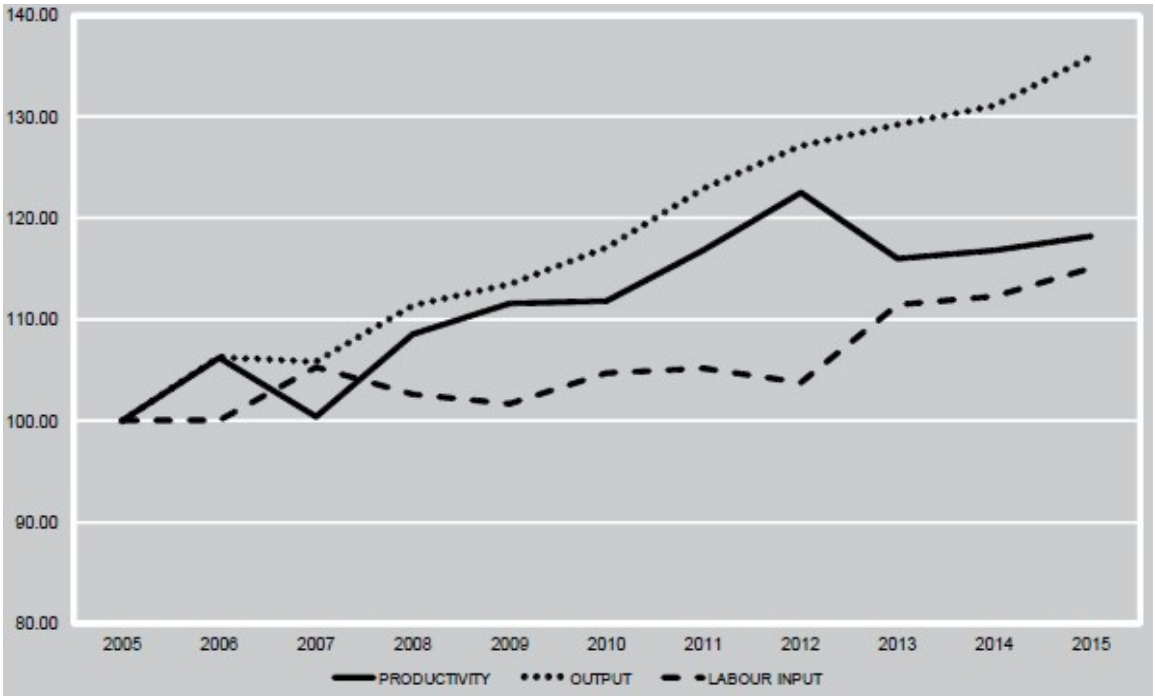
The implications of population growth dynamics should likewise not be restricted to fiscal sustainability issues, but also to ensure that the country's infrastructure and provision of public services adequately match the evolving needs of the growing population. It is important that expenditure restraint is sought in areas where savings are feasible, but at the same time, budgeted amounts are sufficient to cover the rising demand for public services, commensurate with a larger population.

5. Quality of public finances

Turning to the quality of public finances, the MFAC positively notes that the Government's interventions in this regard have been broad and focused on three different areas: productivity, expenditure and revenue.

Studies carried out by the MFIN show that between 2005 and 2015, the Government was able to raise its output at a faster pace than the labour input, thereby giving rise to productivity gains in the public sector (see Chart 16). The MFAC welcomes such improvements. At the same time, these results should be treated with caution, because the research relied on some simplifying assumptions, and in particular the quality of the services delivered was not directly measured, albeit one appreciates the technical difficulties involved in estimating productivity gains regarding public services.

Chart 16: Public sector productivity



Note: This chart is reproduced from the USP 2017 – 2020 document.

Source: MFIN

Nevertheless, the MFAC welcomes drives to quantify public sector productivity and particularly initiatives to boost productivity within the public sector. In this respect, the MFAC takes note of recent measures to broaden the use of technology and introduce greater flexibility in work practices. It invites the Government to intensify its efforts to channel best practices across the various departments and entities. It is important that productivity gains be given priority, without however impairing on the service quality.

The drive to enhance the quality of public finances has led to a series of expenditure reforms which have been mainly driven by the Comprehensive Spending Reviews (CSRs) conducted by the MFIN. To date, CSRs have been carried out in the areas of social security benefits, health and education, which are by far the largest cost components of the public service. The MFAC acknowledges the strong contribution of CSRs to identify areas of possible further improvement in policies and procedures and to present recommendations for remedial action. It encourages further momentum to the CSR process and considers that discussions by MFIN with stakeholders help increase ownership and better identify areas for possible improvement.

The MFAC supports the Government's strategy built on achieving savings on social security benefits through incentives to work. Indeed, the tapering of benefits, the in-work benefit, and free child care services to working parents, appear to have contributed very positively in this respect. The MFAC also supports the initiatives by the Government to achieve savings in health expenditure through better controls, to avoid waste and increase cost awareness. The MFAC also takes note of the Government's aim to improve student performance by reforming teaching and learning to be more student-focused.

It is important that opportunities for rationalisation of resources identified through the CSRs are fully tapped. CSRs serve as useful tools to help alleviate expenditure pressures while at the same time improve the quality of public services. The MFAC fully supports the COM's recommendation to the European Council to address the Country Specific Recommendation to Malta to "expand the scope of the ongoing spending reviews to the broader public sector and introduce performance-based public spending."[21]

In the area of taxation, the MFAC notes that over the years Malta's fiscal policy has gradually shifted the tax burden away from labour income, by lowering income tax rates and increasing some indirect taxes. The expansion of tax bases, primarily by encouraging higher employment, is a positive development. Simplification of the taxation system, such as the shifts towards Final Withholding Tax (FWT) in the case of some property transactions and rental income, is also beneficial. Efforts to combat tax evasion and avoidance through the integration of the various tax departments and making it mandatory to register rent agreements beyond three months are also a step in the right direction. It is important that tax reforms continue aiming towards simplification and greater efforts to curb tax evasion in particular.

[21] Source: https://ec.europa.eu/info/sites/info/files/2017-european-semester-country-specific-recommendations-commission-recommendations_-_malta.pdf.

6. Conclusion

The MFAC welcomes the fact that in 2016 there was full compliance with the three fiscal rules. The attainment of Malta's MTO, ahead of the original plans is also considered very positively by the MFAC. The fact that the Government aims to maintain a fiscal surplus throughout the forecast horizon is equally positive. On the basis of the USP macroeconomic and fiscal projections, which the MFAC has already endorsed in its earlier publications, the Government should meet the numerical rules requirements in terms of the SGP and the FRA. In this regard, the MFAC highlights the importance that any new initiatives which could be considered over and above what is factored in the USP, do not derail the commitment to remain above the MTO. At the same time, it is important to maintain adequate fiscal buffers for times when economic conditions could be less favourable than at present.

Finally, the MFAC would like to reiterate the importance of conducting fiscal policy which is geared more towards the medium and longer term. This would require a more effective transposition of a three-year policy framework, away from the tendency of yearly moving targets for the various revenue and expenditure components. Such a strategy would enhance the transparency, continuity and consistency of budgetary objectives.

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