Overall Assessment

Update of Stability Programme 2018 - 2021

June 2018

MFAC
MALTA FISCAL ADVISORY COUNCIL

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Medium-Term Fiscal Strategy:

Update of Stability Programme

2018 – 2021

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28 June 2018

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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 2018 to 2021, and which represents the Government's Medium-Term Fiscal Strategy. In addition, this report 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 welcomes the fact that, in 2017, for the second-year running, a fiscal surplus was achieved. It is positive to note that the fiscal surplus, amounting to 3.9% of GDP, or 3.6% of potential output when measured in structural terms, was substantially higher than originally anticipated. This has also contributed to accelerate the reduction in the debt ratio further, declining to 50.8% of GDP as at end 2017.

On this basis, the Council confirms that in 2017 there was full compliance with the fiscal rules prescribed by the Stability and Growth Pact and the Fiscal Responsibility Act. The debt rule was respected as the debt-to-GDP ratio stood well below the 60% of nominal GDP threshold. In structural terms, the recorded positive fiscal turnout comfortably met, and indeed exceeded, the requirement to maintain Malta at its Medium-Term Objective (MTO) of a balanced budgetary position. Such over-achievement in relation to the MTO means that the expenditure benchmark is technically not binding in the current circumstances. This notwithstanding, the Council would like to encourage the Government to remain vigilant and to continue to monitor carefully expenditure developments to avoid any significant departure from the fiscal targets.

Sustained commitment to the materialisation of the Government's latest fiscal plans, which the Council has already considered as plausible and within its endorsable range, will ensure that between 2018 and 2021 the fiscal rules would continue to be complied with.

At the same time, the Council considers equally important that, apart from compliance with fiscal rules, the conduct of fiscal policy is one which is conducive to the sustainability of public finances. In this respect, the Council draws attention to the European Commission assessment that in the case of Malta, whereas it is positive to note that there is low risk to the sustainability of public finances in the short term and medium term, there is a medium risk in the long term.

More specifically, the benign macroeconomic and positive fiscal developments which Malta has experienced in recent years, and which the Ministry expects to continue prevailing throughout the forecast horizon, are conducive to fiscal sustainability in the short and medium term. On the other hand, the long-term outlook may be less benign in view of the projected sharp rise in the old-age dependency ratio which is estimated to almost double by 2070 and which is forecast to lead to substantially higher outlays for pensions, health care and long-term care. Indeed, the Council observes that the Commission's assessment indicates that when compared to the other Member States, Malta stands out as the country with the second-highest projected increase in age-related expenditure in relation to GDP between 2016 and 2070, based on the latest available demographic projections. Against such a scenario, the Council's view is that the build-up of further fiscal buffers should remain a priority.

In this respect, the Fiscal Council also suggests that long term fiscal issues are given even more priority in the economic discussions between the constituted bodies and the Government. The prevailing benign macroeconomic and fiscal conditions offer a window of opportunity for carrying out the necessary reforms to address such long-term challenges.

Turning to the quality of public finances, the Council considers that the Comprehensive Spending Reviews are an excellent instrument to identify deficiencies and to propose improvements. In this respect, the Council views favourably the launch of further reviews, as well as the institutionalisation of the process. At the same time, it is important that such reviews translate into concrete action.

The Council is also fully supportive of the Government's invitation to the IMF to carry out a Fiscal Transparency Evaluation exercise. The Council is grateful that it has been given the opportunity to participate in the discussions with the IMF and offer its views on the matter. The Council is confident that this exercise could lead to enhance the comprehensiveness, clarity, reliability, timeliness, and relevance of public reporting on the state of public finances.

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
DSA	Debt Sustainability Analysis
EU	European Union
EUROPOP	Eurostat Population Projections
ESSPOP	European Statistical System Population Projections
FRA	Fiscal Responsibility Act
FSAP	Financial Sector Assessment Programme
FTE	Fiscal Transparency Evaluation
GDP	Gross Domestic Product
IIP	Individual Investor Programme
IMF	International Monetary Fund
JETF	Joint Enforcement Task Force
MCAST	Malta College for the Arts, Sciences and Technology
MEU	Management Efficiency Unit
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
PMSC	Public Service Management Code
S0	Short-term indicator
S1	Medium-term indicator
S2	Long-term indicator
SGP	Stability and Growth Pact
SMEs	Small and Medium-sized Enterprises
USP	Update of Stability Programme
VAT	Value Added Tax

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 Medium Term Fiscal Strategy: Update of Stability Programme, for the period 2018 to 2021.

According to the projections by the Ministry for Finance, which have been previously endorsed by the Fiscal Council, macroeconomic conditions will remain benign over the period 2018 to 2021, albeit real and nominal GDP growth are expected to ease gradually, when compared to the high growth rates recorded in recent years. By 2021, GDP growth is expected to moderate to 4.6%, in real terms, and to 6.6%, in nominal terms.

The strong economic growth conditions, which contributed positively to tax revenues, combined with the significant proceeds collected through the Individual Investor Programme, have facilitated the attainment of a substantially higher fiscal surplus in 2017, equivalent to 3.9% of GDP, compared to 1.0% in 2016.

The Malta Fiscal Advisory Council confirms that in 2017 there was full compliance with the fiscal rules which feature in both the Stability and Growth Pact as well in the Fiscal Responsibility Act. The debt rule was respected as the debt-to-GDP ratio stood at 50.8%, which is well below the 60% of nominal GDP threshold. The structural balance rule was also respected as a structural surplus, estimated at 3.6% of potential output, was attained. The latter was comfortably above the requirement to maintain Malta's Medium-Term Objective of structural balance. When the MTO is overachieved, and this is not due windfalls, the expenditure benchmark is not binding.

The Government is targeting a structural surplus in each of the forecast years, ranging from 0.6% of potential output in 2018 to 1.8% in 2021. The Government also plans to reduce the debt ratio further, to 35.6% of GDP by 2021. The materialisation of these fiscal plans, which the Council has already considered as plausible and within its endorsable range, will ensure that over the period 2018 to 2021 the fiscal rules continue to be complied with.

According to the latest assessment by the European Commission, in the case of Malta there is low risk to the sustainability of public finances in the short term and medium term, but there is medium risk in the long term. This assessment is unchanged when compared to the exercise carried out by the Commission a year earlier.

The low risk in the short to medium term reflects the positive fiscal outturn in 2017 and the anticipated favourable trajectories for the main fiscal and macroeconomic variables. On the other hand, the medium risk to fiscal sustainability in the long run is entirely due to the projected rise in age-related expenditure. This reflects the higher anticipated outlays for pensions, health care and long-term care. Indeed, when compared to the other Member States, Malta stands out as the country with the second-highest projected change in age-related expenditure between 2016 and 2070.

The Government's recent actions aimed at improving the quality of public finances have focused on raising productivity; carrying out Comprehensive Spending Reviews; implementing a number of tax reforms; and other initiatives relating to the financial services sector and fiscal transparency. Such initiatives are positively viewed by the Malta Fiscal Advisory Council as they are expected to yield benefits.

Finally, the Council draws attention to the importance of fiscal buffers, apart from ensuring full compliance with fiscal rules. Such buffers are necessary for times when economic conditions could be less favourable than at present. They are also important since the long-term fiscal outlook is less benign, due to the anticipated high costs of ageing facing the country. In this respect, the Fiscal Council views very positively the Government's plans to achieve a permanent structural surplus, net of the proceeds collected through the Individual Investor Programme.

The Council also considers important that long term fiscal issues are given even more priority in the economic discussions between the constituted bodies and the Government. The benign macroeconomic and fiscal conditions offer a window of opportunity for carrying out the necessary reforms to address such long-term challenges.

1. Introduction

The latest Update of Stability Programme (USP), which also serves as Malta's Medium Term Fiscal Strategy (MTFS), was published on 30 April 2018.[1] This document contains the macroeconomic and fiscal forecasts which cover the period 2018 to 2021, and forms part of the suite of documents required by the European Semester (see Box 1). Both the macroeconomic and fiscal forecasts were assessed by the Malta Fiscal Advisory Council (MFAC), and considered plausible and within its endorsable range. The assessments were respectively published in two separate reports.[2]

With regards to the macroeconomic forecasts, the MFAC viewed the balance of risks to GDP growth for the period 2018 to 2021 as broadly neutral, with possible downside risks associated to the external sector, likely to be compensated for by possible upside risks related to domestic demand.

In relation to the fiscal forecasts, the MFAC considered the revenue forecasts as generally prudent, with the possibility of upside risks in relation to taxes on production and imports over the period 2018 to 2021. On the other hand, the item-by-item examination of risks to the expenditure forecasts indicated that on aggregate there could be possible downside risks in 2018, but upside risks for the period 2019 to 2021. For 2018, the upside risks to total revenue and the concurrent downside risks to total expenditure suggested the possibility of a larger than anticipated fiscal surplus. For the period 2019 to 2021, the magnitude of the upside risks to total expenditure appeared to be larger than the magnitude of the upside risks to total revenues. As a result, the MFAC concluded that the yearly fiscal surplus could be less than expected during these years.

This Report, which is the MFAC's third report based on the USP puts forward an evaluation of the overall conduct of fiscal policy over the period 2018 to 2021. It also evaluates the extent to which the projected outcomes, based on the fiscal plans outlined in the USP, comply with the fiscal rules which are prescribed by the Stability and Growth Pact (SGP) and the Fiscal Responsibility Act (FRA). This Report proceeds as follows.[3] Section 2 presents an overview of the macroeconomic and fiscal scenario which materialised in 2017, as well as that being projected over the period 2018 to 2021, by the Ministry for Finance (MFIN). Section 3 focuses on the compliance with the three numerical fiscal rules, namely the debt criterion, the structural adjustment rule and the expenditure benchmark. Section 4 deals with the sustainability of public finances, based on the assessment framework employed by the European Commission (COM). Section 5 evaluates the quality of public finances. Section 6 concludes with some final considerations.

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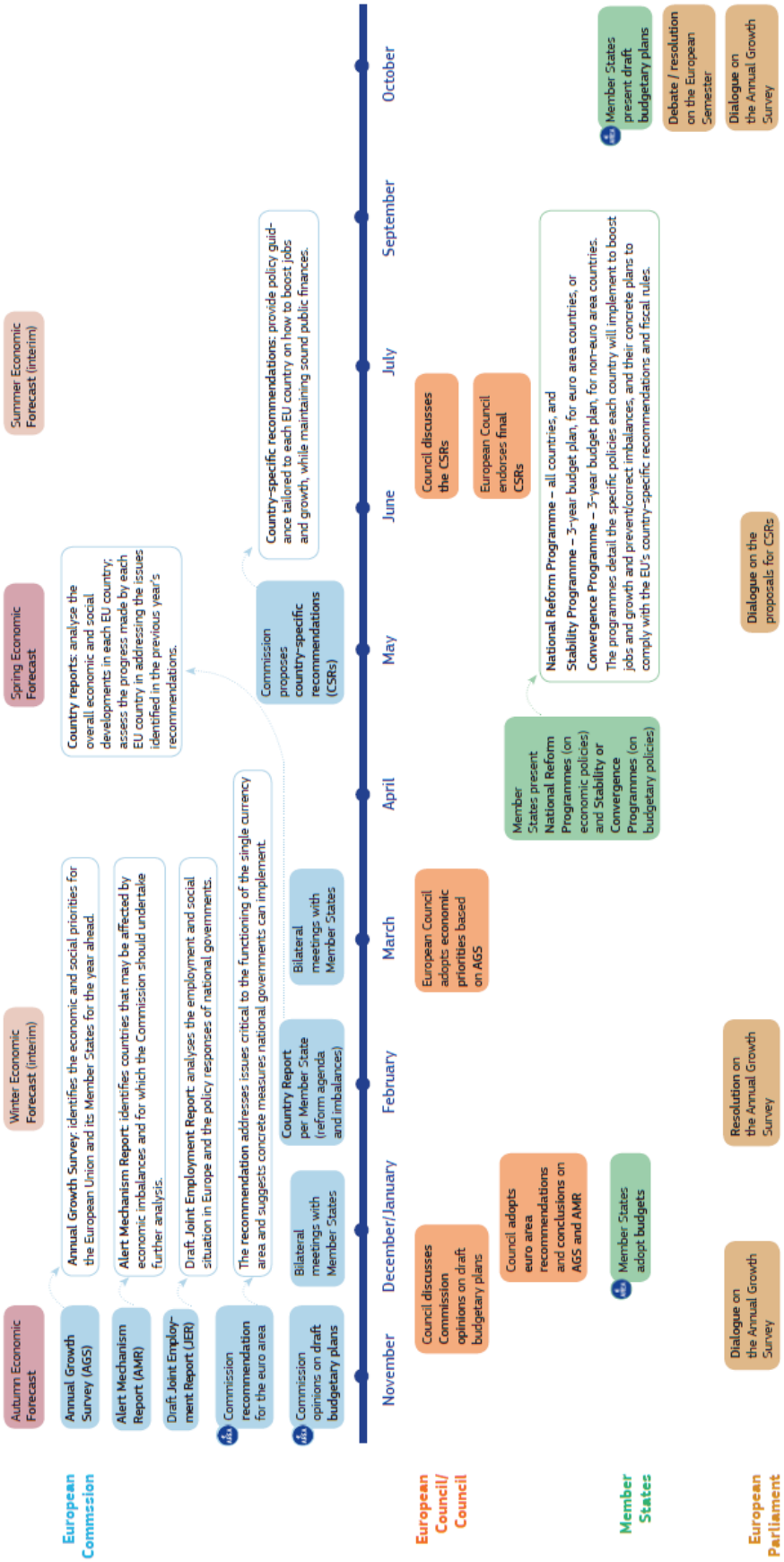
[1] The USP 2018 – 2021 is available on https://ec.europa.eu/info/sites/info/files/2018-european-semester-stability-programme-malta-en.pdf.

[2] The two reports entitled, Assessment of the Macroeconomic Forecasts and Assessment of the Fiscal Forecasts – Update of Stability programme 2018 – 2021, were published on 30 April 2018 and 31 May 2018 respectively. Both reports are available on http://mfac.org.mt/en/publications/Pages/Publications.aspx.

[3] The cut-off date is 15 June 2018.

Box 1: European Semester timeline



Source: COM - https://ec.europa.eu/info/sites/info/files/2018-european-semester-timeline_en.pdf

2. Macroeconomic and fiscal developments

In 2017, Malta's real GDP expanded by 6.6%, while nominal GDP growth amounted to 9.0% (see Table 1).[4] It is anticipated that macroeconomic conditions will remain benign over the period 2018 to 2021, with real and nominal GDP growth easing gradually, when compared to the generally exceptionally high growth rates recorded in recent years.[5] By 2021, GDP growth is expected to moderate to 4.6%, in real terms, and to 6.6%, in nominal terms. Such economic conditions are expected to maintain the unemployment rate low, in the region of 4.0%, throughout the forecast horizon. Likewise, the inflation rate is expected to remain subdued, but to increase slightly, to 2.0%, by 2021.

Table 1: Key macroeconomic and fiscal developments

	2017	2018	2019	2020	2021
Real GDP growth (%)	6.6	6.1	5.3	4.8	4.6
Nominal GDP growth (%)	9.0	8.3	7.5	6.7	6.6
Unemployment rate (%)	4.0	3.8	3.9	4.0	4.0
Inflation rate (%)	1.3	1.6	1.8	1.9	2.0
Potential output growth (%)	6.3	6.0	5.9	5.2	5.0
Output gap (% of potential output)	1.0	1.0	0.4	0.0	-0.6
Fiscal balance (% of GDP)	3.9	1.1	0.9	0.9	1.6
Structural balance (% of potential output)	3.6	0.6	0.7	0.9	1.8
Public debt (% of GDP)	50.8	45.8	42.5	39.3	35.6

Source: MFIN

According to the MFIN's calculations, Malta's potential output growth is expected to remain high throughout the forecast horizon, but will moderate slightly, from 6.3% in 2017, to 5.0% in 2021. Using the commonly agreed methodology across the European Union (EU), the MFIN have estimated the output gap – which compares the level of real GDP to potential output – to

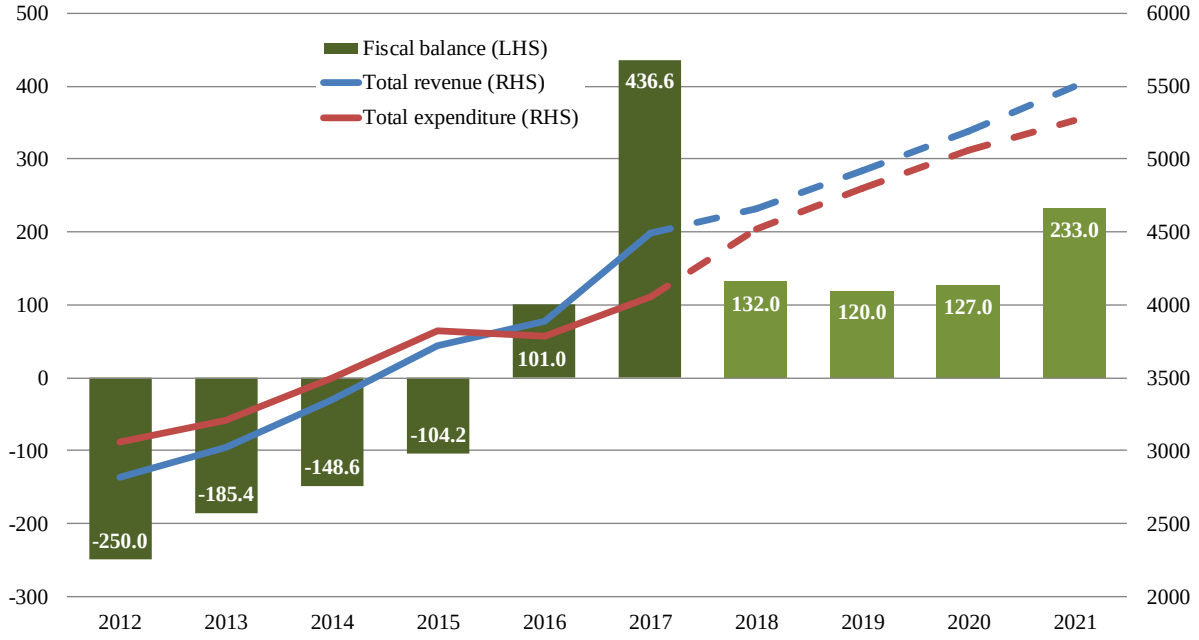
[4] All the analysis and figures quoted in this Report are based on News Release 038/2018, which was published by the National Statistics Office (NSO) on 8 March 2018. These are the same figures used by the MFIN to produce the USP-MTFS, as well as by the COM in its assessment report. On 5 June 2018, the NSO published the second vintage of yearly national accounts estimates for 2017, in News Release 089/2018. The updated figures for Malta's real and nominal GDP growth for 2017 showed only minor changes. The updated GDP growth rates for 2017 were estimated at 9.1% in nominal terms (marginally up from the previous estimate of 9.0%), and 6.4%, in real terms (marginally down from the previous estimate of 6.6%).

[5] Real GDP growth was estimated at 8.1% in 2014, 9.9% in 2015 and 5.5% in 2016, based on the official statistics available at the time the USP was produced.

narrow, and gradually swing from positive to negative, over the forecast horizon.[6] Malta's output gap was estimated at 1.0% in 2017 (i.e. above potential), but it is expected to become slightly negative, -0.6%, in 2021 (i.e. below potential).

In 2017, strong economic growth conditions, which contributed positively to tax revenues, combined with the significant proceeds collected through the Individual Investor Programme (IIP), have facilitated the attainment of a substantially higher fiscal surplus amounting to €436.6 million, equivalent to 3.9% of GDP (see Chart 1). This followed the €101.0 million fiscal surplus which was recorded in 2016. The Government plans to maintain a positive fiscal balance in each of the forecast years, which would represent six consecutive years of fiscal surpluses.

Chart 1: Main fiscal developments (2012 – 2021) (EUR millions)



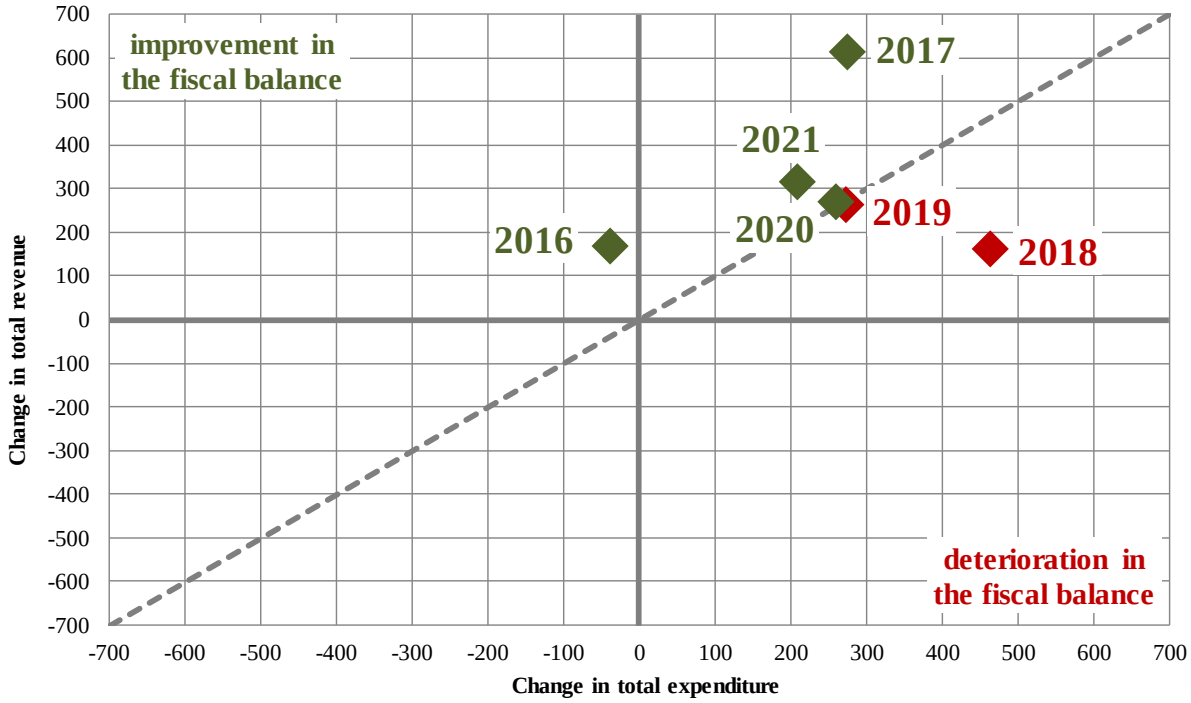
Source: MFIN

In 2018 and 2019, the increase in total expenditure is expected to outpace that in total revenue, thus resulting in smaller fiscal surpluses (see Chart 2). On the other hand, in 2020 and 2021, the fiscal balance is expected to improve compared to the previous year, as total revenue is projected to rise by more than total expenditure.

Since the size of the output gap and the impact of temporary factors are rather small throughout the forecast horizon, developments in the structural balance follow rather closely those in the headline fiscal balance. The structural balance is projected to remain in surplus throughout the forecast horizon, amounting to 0.6% of potential output in 2018, and rising to 1.8% of potential output in 2021.

[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 above-trend economic activity, followed by years of below-trend economic activity.

Chart 2: 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 (years shown in green). Anywhere below the dashed line indicates combinations which lead to a deterioration in the fiscal balance (years shown in red). Anywhere along the dashed line indicates combinations which lead to a stable fiscal balance.

Source: MFIN

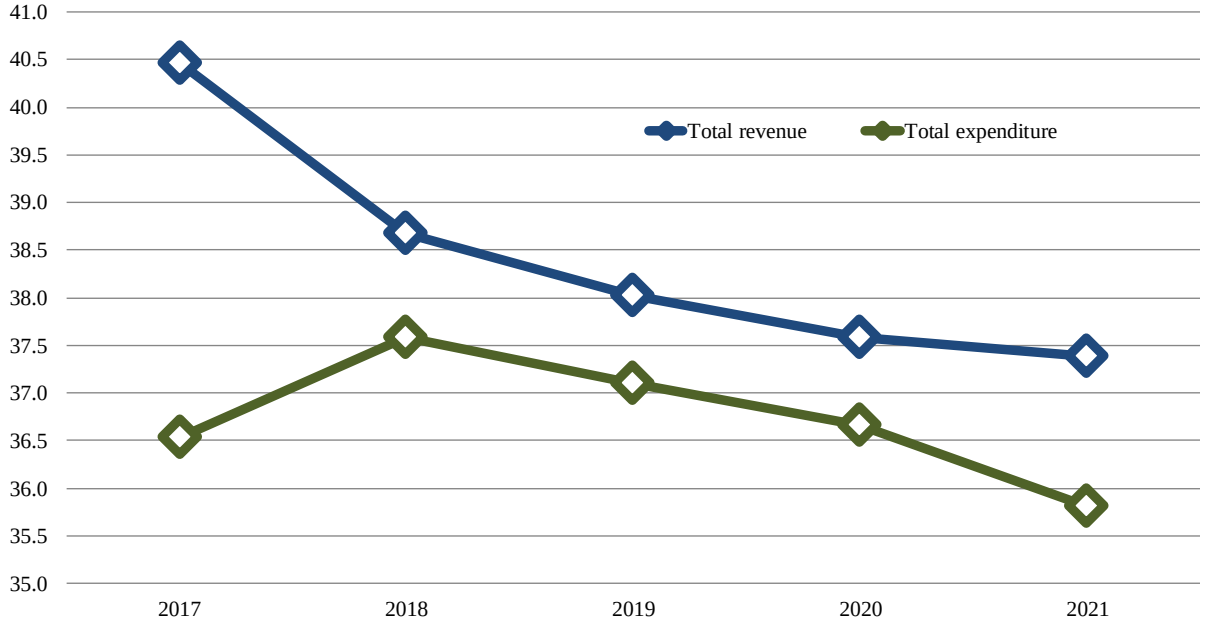
The stream of fiscal surpluses, combined with the expansion in nominal GDP are expected to maintain the downward trend in the debt-to-GDP ratio, over the forecast years. The debt ratio is thus expected to fall from 50.8% in 2017 to 35.6% by 2021.

The trajectory for total revenue as a percentage of nominal GDP shows a downward trend throughout the forecast horizon (see Chart 3). This is partly explained by the general level of prudence embedded in the revenue forecasts. Except for 2018, the same downward pattern is observable in the case of the total expenditure-to-GDP ratio. This partly reflects the MFIN's aim to curb expenditure growth below that of nominal GDP.

On the revenue side, at a component level, notable developments relate to the decline in the ratios for taxes on production and imports and 'other revenue', as a percentage of nominal GDP (see Chart 4). Such declines are partly offset by the rising ratio for current taxes on income and wealth, which is the largest revenue component in the budget. Meanwhile, the remaining revenue components are expected to maintain a rather stable ratio to GDP.

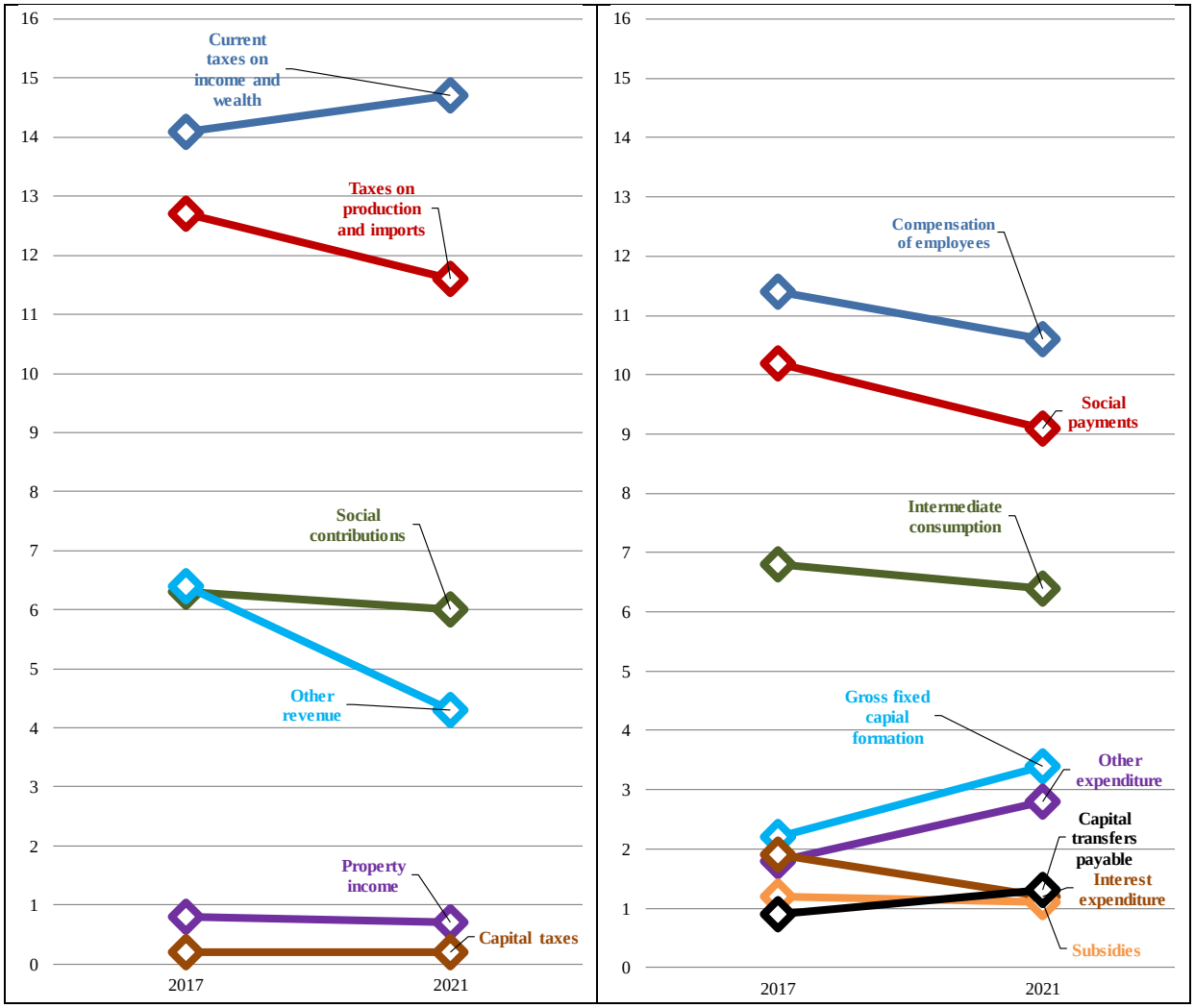
Turning to expenditure, upward pressures (leading to an increase in the ratio with respect to GDP) reflect the government's plans for higher expenditure on gross fixed capital formation, capital transfers and 'other expenditure'. However, these increases are more than offset through declines in the ratio to GDP in certain components, namely compensation of employees, social payments, intermediate consumption and interest expenditure.

Chart 3: Total revenue and total expenditure (% of GDP)



Source: MFIN

Chart 4: Revenue and expenditure components in 2017 and 2021 (% 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**. These rules are designed to encourage countries to prioritise fiscal sustainability and prevent the build-up of fiscal imbalances. The debt rule and the budget balance rule feature identically in the SGP and the FRA. On the other hand, the expenditure benchmark which features in the SGP is only indirectly referred to in the FRA, in the case the COM identifies a 'significant deviation' from the Medium Term Budgetary Objective (MTO).

3.1 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.

The concepts of "sufficiently diminishing" and "satisfactory pace" are defined in Regulation (EC) 1467/97 as being fulfilled if "the differential [of the debt ratio] with respect to the reference value has decreased over the previous three years at an average rate of 1/20th per year as a benchmark".

The Regulation then lays down that "the requirement under the debt criterion shall also be considered to be fulfilled if the budgetary forecasts of the Commission indicate that the required reduction in the differential will occur over the three-year period encompassing the two years following the final year for which data is available".

It further provides that "the influence of the cycle on the pace of debt reduction" should be taken into account.

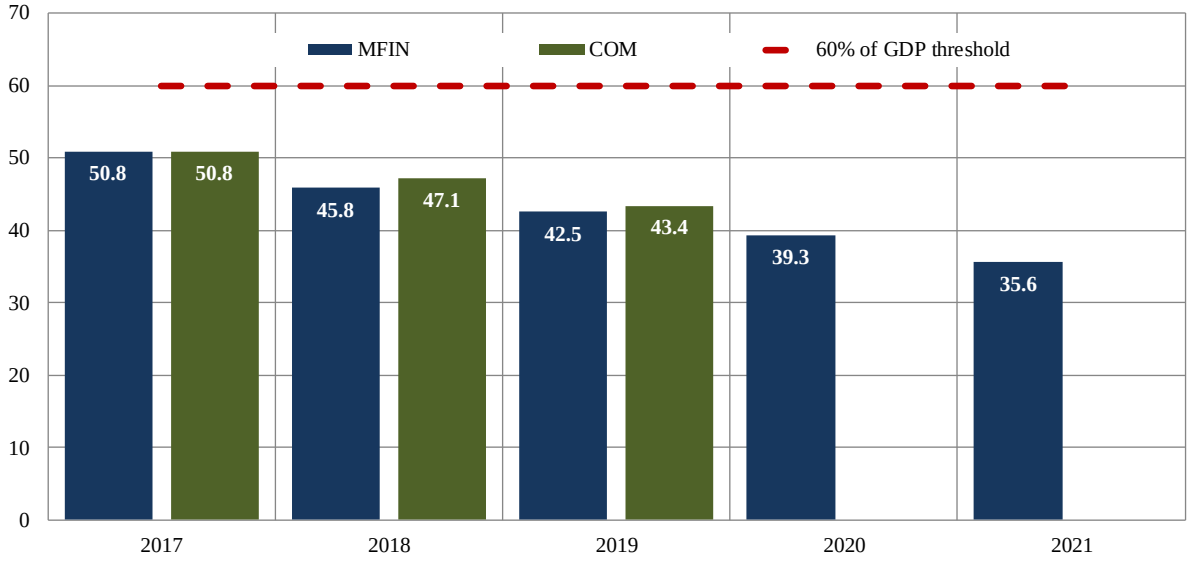
Those elements are translated into a debt reduction benchmark which has been agreed with the Member States in the Economic and Financial Committee of the Council and is set out in the Code of Conduct on the SGP.

Reproduced from the Vade Mecum on the Stability and Growth Pact, 2018 edition.

In 2017, Malta's debt-to-GDP stood at 50.8% of GDP, well below the 60% threshold (see Chart 5). This confirms full compliance with the debt rule ex-post. The forecasts by the MFIN and those by the COM both indicate a downward trajectory for Malta's public debt ratio in 2018 and 2019. The MFIN's projections place the debt ratio at 45.8% in 2018 and 42.5% in 2019, while those by the COM are slightly higher at 47.1% and 43.4% respectively. In either case, the projections indicate full compliance with the 60% requirement, ex-ante. This is also expected to remain the case in the outer forecast years, as the debt ratio is planned to decline further in 2020 and 2021 according to the MFIN's projections.[7]

[7] The forecasts by the COM are available up to 2019.

Chart 5: Government debt (% of GDP)



Source: MFIN

3.2 Budget balance rule

According to the preventive arm of the SGP, Member States must attain the MTO or be on an appropriate adjustment path towards it.

The structural balance is compared with the MTO to see whether the MTO has been attained, and if it is not the case the change in the structural balance is considered to see whether the Member State is on an appropriate adjustment path.

Reproduced from the Vade Mecum on the Stability and Growth Pact, 2018 edition.

The current MTO for Malta has been set at balanced budget in structural terms. Malta was required to achieve its MTO by 2019, but it managed to attain it in 2016, due to better-than-expected fiscal developments. Over the forecast horizon, Malta's MTO remains that of a structural balance of 0.0% of potential GDP.

In 2017, Malta attained a structural surplus of 3.6%, based on the MFIN's calculations, and 3.5%, based on the COM's calculations (see Table 2). This confirms full compliance with the budget balance rule for 2017, ex-post. The projections by both the MFIN and the COM indicate that the structural balance is expected to remain in surplus throughout the forecast horizon. In 2018, both institutions are projecting a structural surplus of 0.6%. For 2019, the MFIN is estimating a structural surplus of 0.7%, while the COM's estimate is slightly higher, at 1.1%. For the period 2020 to 2021, the MFIN is anticipating a structural surplus of 0.9% and 1.8% respectively. These projections confirm full compliance with the budget balance rule ex-ante. Indeed, it is expected that the MTO will continue to be over-achieved over the forecast years.

Table 2: Structural balance (% of potential output)

	2017	2018	2019	2020	2021
MTO (required balance)	0.0	0.0	0.0	0.0	0.0
MFIN's projections	3.6	0.6	0.7	0.9	1.8
COM's projections	3.5	0.6	1.1	-	-

Source: MFIN, COM

3.3 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.

Member States that have exceeded their MTO do not need to be assessed for compliance with the expenditure benchmark.

Reproduced from the Vade Mecum on the Stability and Growth Pact, 2018 edition.

The expenditure benchmark is used as a tool to ensure that the Member State controls expenditure growth, and more specifically that expenditure growth is below GDP potential growth.[8] When the MTO has not yet been attained, the observance of the expenditure benchmark helps the country to converge towards its MTO.

In 2017 Malta has over-achieved its MTO (as was also the case in 2016), and the projections by both the MFIN and the COM indicate that the MTO is going to continue being overachieved and this is not due windfalls. Accordingly, the expenditure benchmark is thus not generally applicable to evaluate compliance with the SGP requirements.[9] In this respect, the expenditure benchmark can be interpreted as non-binding in terms of compliance with the SGP. Furthermore, since the COM has not identified any 'significant deviation' by the country, the FRA's clause relating to the expenditure benchmark is not applicable in current circumstances. This notwithstanding, the MFAC considers important that expenditure developments continue to be carefully monitored.

3.4 Overall compliance

Overall, the MFAC confirms that in relation to 2017, the debt rule and the budget balance rule were fully complied with and the excess over the MTO was not deemed to be the result of

[8] The expenditure aggregate is comprised of overall government expenditure net of interest payments, spending on EU programmes paid for by EU funds and cyclical elements of unemployment benefits, while nationally financed government investment is smoothed over four years.
[9] Technically the expenditure benchmark could still be binding, if the excess over the MTO is due to windfalls.

revenue windfalls such that the expenditure benchmark was not applicable (see Table 3). The MFAC also confirms full compliance ex-ante with the fiscal rules for the period 2018 to 2021.[10]

Table 3: Compliance with fiscal rules

	2017	2018	2019	2020	2021
Debt rule					
Budget balance rule					
Expenditure benchmark	**Not applicable**				

Note: Green shading indicates full compliance.
Source: MFAC

4. Sustainability of public finances

Apart from complying with fiscal rules, it is important that the conduct of fiscal policy is one which is conducive to the sustainability of public finances. The COM assesses the sustainability of each Member State's fiscal policy along three separate timeframes. The COM computes a **short-term indicator (S0)**, a **medium-term indicator (S1)** and a **long run indicator (S2)**.[11] It also carries out a **Debt Sustainability Analysis (DSA)** for the medium-term, by means of simulations.

According to the COM's assessment, in the case of Malta there is low risk to the sustainability of public finances in the short term and medium term, but there is medium risk in the long term (see Table 4). This assessment is unchanged when compared to the assessment carried out by the COM in 2017.

The benign macroeconomic and positive fiscal developments, which the country has experienced in recent years, and which are expected to continue prevailing throughout the forecast horizon, are conducive to fiscal sustainability in the short term. Indeed, both the fiscal sub-index and the financial and competitiveness sub-index (which compose the S0 indicator) point to low risk.

[10] In other words, if the fiscal turnout turns out in line with the current projections, the fiscal rules would be respected.
[11] 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 capture fiscal and macroeconomic conditions which have been 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 the costs of ageing. For further details refer to Box 2 in the MFAC's report "An Overall Assessment of the Medium-Term Fiscal Strategy for Malta 2016 – 2019" available on http://mfac.org.mt/en/publications/Pages/Publications.aspx.

Table 4: Sustainability indicators

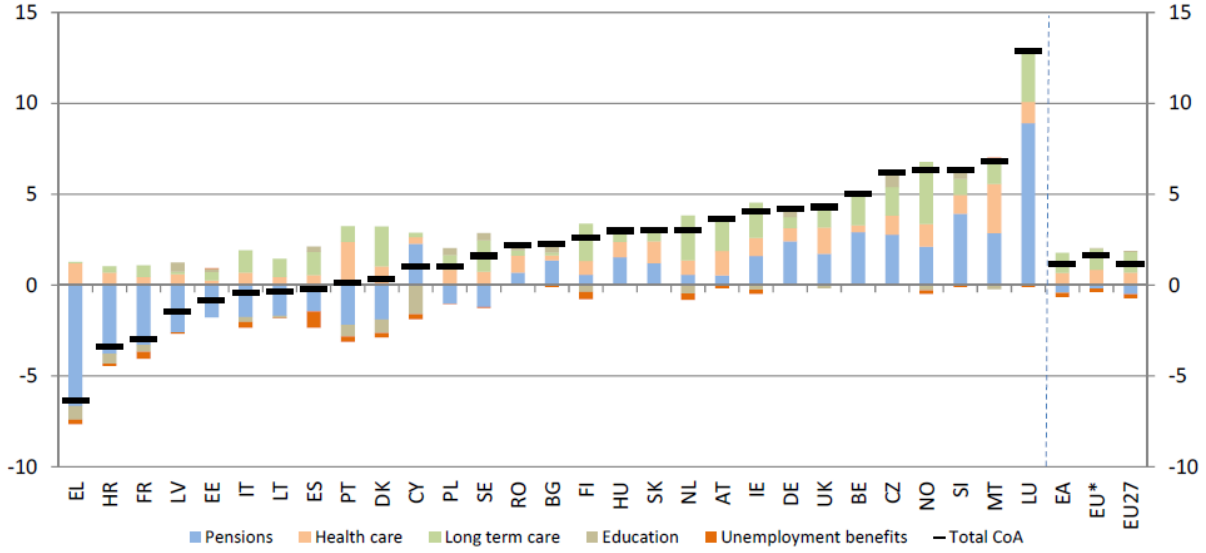
Short Term	Medium Term	Long Term
S0	S1	S2
	DSA	

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

Likewise, over the medium-term Malta's fiscal policy is viewed as sustainable, as pointed out by the S1 indicator. This follows from the fact that Malta's debt-to-GDP ratio has already fallen below 60%, and is expected to continue trending downwards over the forecast horizon. The DSA corroborates the assessment of low risk over the medium-term. Indeed, the COM's simulations show that the full implementation of the Stability Programme would extend the downward trend in the debt ratio, to reach 13.4% of GDP by 2028.

On the other hand, the S2 indicator indicates medium risk to fiscal sustainability in the long run. This is entirely due to the projected increase in age-related expenditure which is estimated at 6.9 pp of GDP. This reflects the higher anticipated outlays for pensions, health care and long-term care. When compared to the other Member States, Malta stands out as the country with the second-highest projected change in age-related expenditure between 2016 and 2070 (see Chart 6). The favourable initial budgetary position, due to the fiscal surpluses attained in 2016 and 2017, mitigates, in part, this long-term risk, thus placing the country at medium risk, according to the S2 indicator.

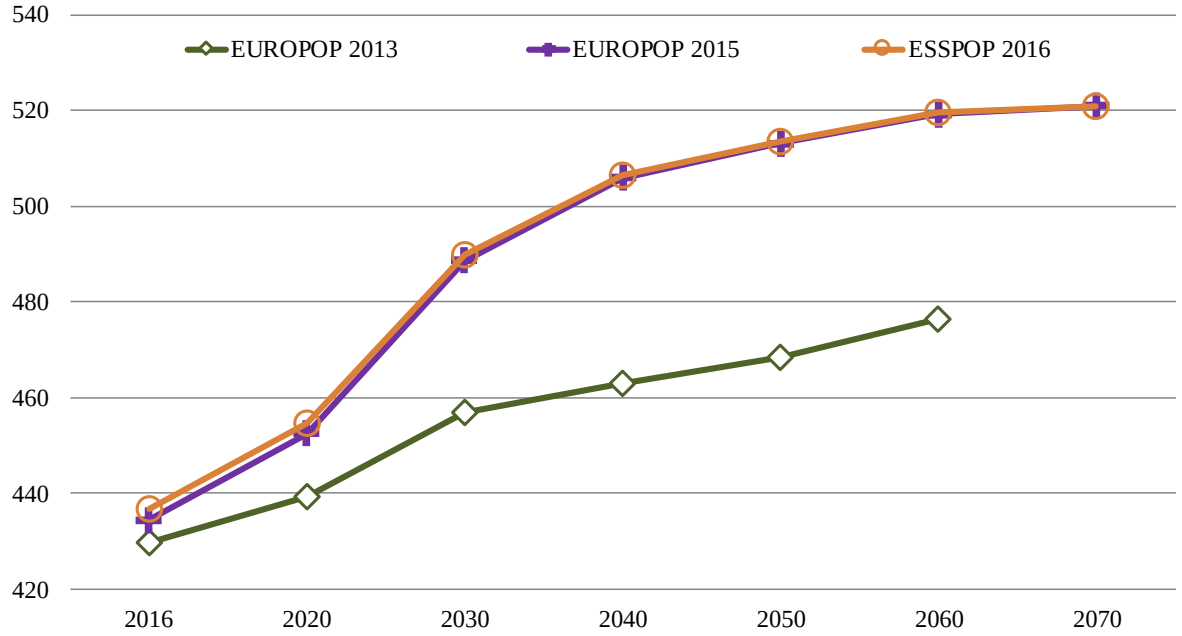
Chart 6: Projected change in age-related expenditure between 2016 and 2070 (pp of GDP)



Source: COM (reproduced from the 2018 Ageing Report)

The projected costs of ageing are based on updated population estimates, as part of the ESSPOP 2016 projections which were published in the COM's 2018 Ageing Report.[12] The latest projections show a steadily growing population in the case of Malta. The population in Malta is expected to grow by 19.3% between 2016 and 2070, from 436,658 to 520,761 (see Chart 7).

Chart 7: Population projections (thousands)



Source: Eurostat

The updated projections (ESSPOP 2016) are perfectly in line with the previous vintage (EUROPOP 2015), and thus higher than those indicated in EUROPOP 2013. Changes are noticeable in the projected age structure of Malta's population between the 2015 Ageing Report and the 2018 Ageing Report (see Table 5). According to the 2018 Ageing Report, the old-age dependency ratio is set to increase from 29.1% in 2016 to 53.9% in 2060.[13] This is 3.0 pp higher than what had been projected in the 2015 Ageing Report. By 2070, the old-age-dependency ratio is set to increase further, to 55.8%, almost double the ratio in 2016.[14]

Table 5: Old-age dependency ratio

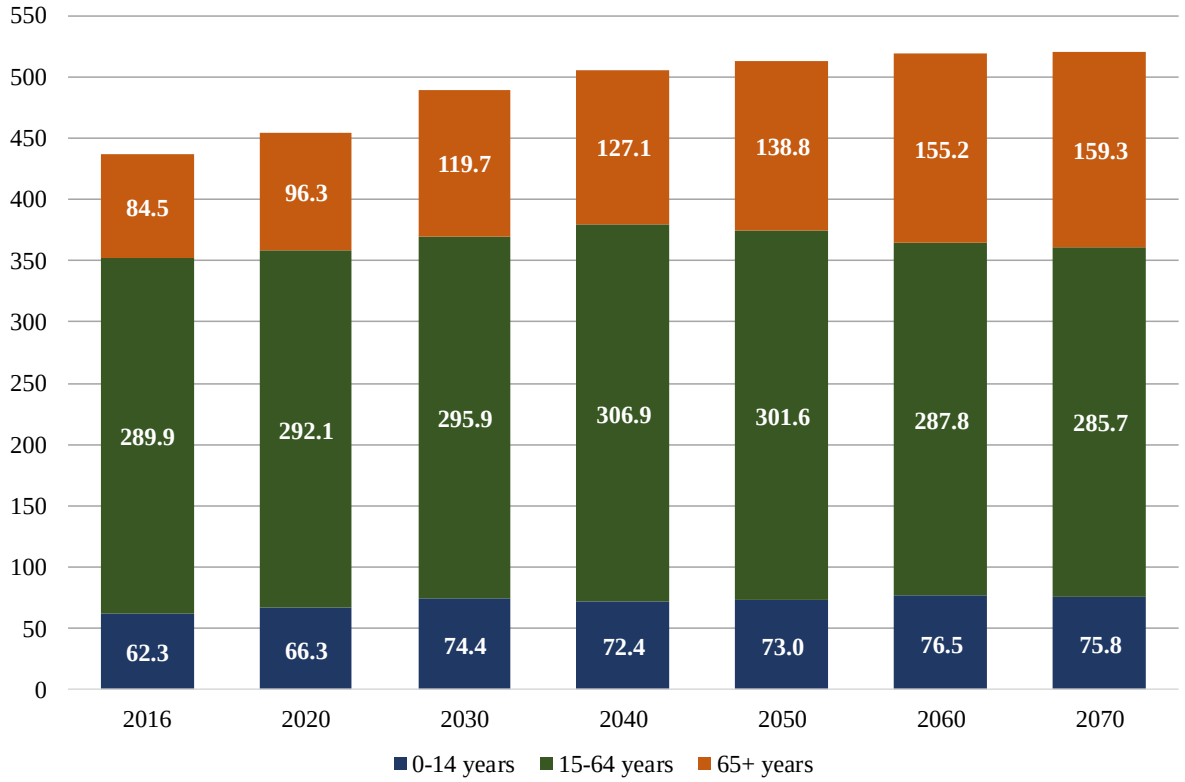
	2016	2020	2030	2040	2050	2060	2070
2015 Ageing Report	29.4	33.2	40.5	40.8	45.0	50.9	-
2018 Ageing Report	29.1	33.0	40.4	41.4	46.0	53.9	55.8

Source: MFIN

[12] The approach has shifted from EUROPOP (EUROstat POPulation projections) population projections to ESSPOP (European Statistical System Population Projections).
[13] The old-age dependency ratio refers to the population aged 65 years and older as a proportion of those aged between 15 and 64.
[14] The 2015 Ageing Report did not produce projections up to 2070.

The number of people aged 65 and over is set to nearly double between 2016 and 2070 (see Chart 8). Indeed, this category is projected to experience the strongest changes. Meanwhile, the working age population (aged between 15 and 64) is set to increase by 5.9% until 2040, but thereafter to start declining. In turn, the younger cohort (aged between 0 and 14) is expected to rise by 19.4% up to 2030, and thereafter to remain relatively stable around that level.

Chart 8: ESSPOP 2016 projections by age group (thousands)



Source: Eurostat

The anticipated changes in the population age structure would lower the support ratio. At present, there are more than three persons working for every person aged over 65. By 2070, there would be fewer than two persons, according to the latest demographic projections. Apart from leading to the before-mentioned additional spending of some 6.9 pp of GDP, the shift in demographics would also lead to an estimated 1.8 pp of GDP decline in social contributions on the revenue side.

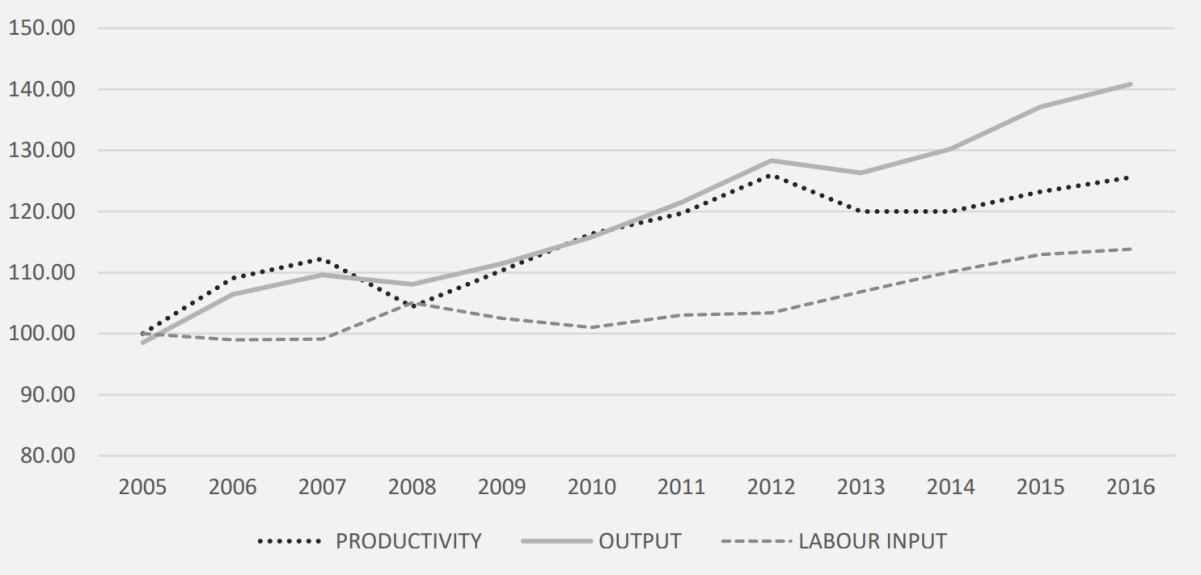
5. Quality of public finances

As explained in the latest USP, the Government's recent actions aimed at improving the quality of public finances have focused on raising productivity; carrying out Comprehensive Spending Reviews (CSRs); implementing a number of tax reforms; and other initiatives relating to the financial services sector and fiscal transparency.

5.1 Productivity

Studies carried out by the MFIN show that between 2005 and 2016, the Government's output grew by 3.3% per annum on average, while labour input grew by 1.2% per annum (see Chart 9). This contributed to productivity gains of 2.1% in the public sector, with increases most noticeable between 2008 and 2012 and since 2014. These results should be treated with caution, since the research relies on a number of simplifying assumptions, and the quality of the services delivered was not directly measured.

Chart 9: Public sector productivity



Source: MFIN (reproduced from the USP 2018 – 2021)

The recent initiatives to broaden the use of technology and introduce greater flexibility in work practices should enable further productivity gains.[15] The MFAC views productivity gains as the best way to help contain expenditure growth, without impairing on the quality of the service being delivered.

5.2 Comprehensive Spending Reviews

Some reforms have also been driven by the Comprehensive Spending Reviews (CSRs) which have been carried out by the MFIN over the recent years. Between 2014 and 2017, different CSRs were carried out in the largest cost areas, namely healthcare, education and social security benefits.

[15] Measures include the 'servizz.gov' community hubs to enable easier access to services for citizens, a more concise Public Service Management Code (PSMC), efforts to reduce bureaucracy within the Public Service while safeguarding accountability, as well as reforms in the fields of public procurement and simplification of financial regulations.

The MFAC supports the Government's strategy aimed at achieving savings on social security benefits through incentives to work. Indeed, the tapering of benefits and the in-work benefit system appear to have contributed very positively in this respect, by raising the labour force participation rate. The MFAC also supports the initiatives by the Government to achieve savings in health expenditure through better controls. This is important to avoid waste and to increase cost awareness. This is also in line with the observation by the International Monetary Fund (IMF) in its 2017 Article IV Report on Malta that "improving the efficiency of healthcare spending by building on the recommendations of the recent spending review would also help contain age-related spending growth". As further remarked by the IMF, "potential savings from the implementation of the recent spending reviews and execution of additional reviews could be redirected towards investment".

The MFAC also welcomes the setting up of a team tasked with the evaluation and monitoring of progress on the recommendations made in the CSRs, particularly on health and education. This team is chaired by the Permanent Secretary within the MFIN and includes directors from various ministries. It is important that opportunities for rationalisation of resources identified through the CSRs are fully tapped.

The CSRs can be very helpful to identify deficiencies and to propose improvements. In this respect, the MFAC views favourably the launch of new CSRs dealing with the Management Efficiency Unit (MEU) and the Malta College for the Arts, Sciences and Technology (MCAST), which are expected to be finalised by end 2018. The setting up of a new directorate within the MFIN, which is geared towards trying to increase the effectiveness of public spending, is a way how the CSR process can become more institutionalised, and in this manner, reap greater benefits. As stated by the COM, in its assessment of the 2018 Stability Programme for Malta "these initiatives seem promising and should contribute towards increased effectiveness in public spending, provided those are properly implemented".

5.3 Tax reforms

In recent years, the tax reforms carried out by the Government have focused mainly towards shifting the tax burden away from labour, widening the tax bases, making the tax system more transparent, and combatting tax evasion and tax avoidance.

The MFAC notes that the latest budget has continued to build on previous efforts to shift the tax burden away from labour income, by granting a tax rebate to persons in employment earning less than €60,000 a year. In terms of simplification of the taxation system, the latest budget included an increase in the threshold below which the Small and Medium-sized Enterprises (SMEs) will have the option not to charge Value Added Tax (VAT).

Other initiatives were launched with the aim to combat money laundering, tax evasion and fraud. A Joint Enforcement Task Force (JETF) has also been set up with the aim of reducing unjust competition in commerce and tax evasion.

5.4 Other initiatives

In 2018, the International Monetary Fund (IMF) and the World Bank were invited to conduct a Financial Sector Assessment Programme (FSAP) by the end of the year. The goal of FSAP assessments is twofold: to gauge the stability and soundness of the financial sector and to assess its potential contribution to growth and development.[16] The IMF were also asked to carry out a Fiscal Transparency Evaluation (FTE) exercise.[17] Fiscal transparency deals with the comprehensiveness, clarity, reliability, timeliness, and relevance of public reporting on the past, present, and future state of public finances. The MFAC considers both evaluations as very useful to ensure that the financial services sector in Malta operates to the highest levels, and that the level of transparency of Malta's fiscal policy is boosted further, in line with best practices.

6. Conclusion

The MFAC acknowledges the clear commitment by the Government to maintain the country's MTO. Indeed, 2017 was the second-year running of over-achievement of Malta's MTO, and the Government's aim is to continue to over-achieve the MTO in each of the forecast years.

While commending such policy, the MFAC underlines the importance that the plans outlined in the latest USP are closely adhered to. This is necessary to ensure that the fiscal rules are fully respected between 2018 and 2021, as was the case in 2017. More significantly, placing public finances on stronger foundations should remain a priority. The MFAC reiterates its suggestion that any revenues higher than projected are mainly channelled into fiscal buffers, and that expenditure pressures are adequately contained.

Fiscal buffers are necessary for times when economic conditions could be less benign than at present. They are also important since the long-term fiscal outlook is less favourable, due to the anticipated high costs of ageing facing the country. In this respect, the Fiscal Council views very positively the Government's plans to achieve a permanent structural surplus, net of the proceeds collected through the IIP.

The MFAC also considers important that long term fiscal issues are given even more priority in the economic discussions between the constituted bodies and the Government. The benign macroeconomic and fiscal conditions offer a window of opportunity for carrying out the necessary reforms to address such long-term challenges.

[16] For further details refer to https://www.imf.org/en/About/Factsheets/Sheets/2016/08/01/16/14/Financial-Sector-Assessment-Program.
[17] For further details refer to http://www.imf.org/external/np/fad/trans/.

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